Governance/Underwriting/Due Diligence[1]

By Monika Sanford, Isabella Shaw and Phong Tran

The "Governance/Underwriting/Due Diligence" panel covered questions relating to the subscription credit facility underwriting and due diligence process from the perspective of lenders and sponsors.

The panel discussed the following questions:

- **When should a sponsor start communicating with lenders?** Sponsors should consider credit facility needs well before the fund creation and fundraising process. Even as early as a year out, sponsors should start communicating with lenders to get a sense of fit. Starting this process early is especially important if the sponsor wants to have the line in place concurrently with the initial investor closing.

- **What are a lender's initial considerations?** Some key considerations for lenders include the fund's investment strategy, utilization needs, and the anticipated investor pool. While lenders will look favorably upon a fund with a large number of highly rated institutional investors, funds comprised of a single investor or significant commitments from high net worth individuals may have a more difficult time identifying interested lenders. Further, lenders will also consider whether the sponsor is looking only for a subscription line or could also be served with other bank products.

- **What initial diligence items do lenders focus on?** Lenders and their counsel will want to receive the limited partnership agreement (the "***LPA***") as soon as possible, along with draft side letters, structure charts and an anticipated initial investor list. Prospective lenders should engage their counsel early and have them review the LPA to ensure it contains the necessary bankable provisions as well as any side letters to identify problematic provisions and mitigating factors. If drafts are provided, lenders and their counsel may be able to propose revisions to smooth out the credit approval process, thereby enabling an otherwise ineligible investor or capital commitment to be included in the borrowing base. Further, reviewing the structure chart is necessary to structure the facility by revealing the applicable jurisdictions, the collateral structure (including whether a cascading pledge structure is needed), and applicable fund vehicles (*e.g.*, parallel funds, blockers, feeders, AIVs, etc.).

  Funds should note that material deviations in the LPA or initial investor pool from what is initially provided to lenders may cause significant delays. If the LPA is amended in a manner that is adverse to lenders or a key investor drops out, the prospective lender's credit approval process could be impacted. Further, if a creditworthy prospective investor subscribes to the fund via a bankruptcy remote vehicle with no obvious credit tie to its parent entity, this will complicate the underwriting process and may require credit linkage documentation. To avoid delays, the fund should promptly notify the lender of any changes to the investor pool or governing documents so issues can be addressed early.

- **What are sponsors' most important considerations when selecting a lender?** Many sponsors have multiple different funds with varying structures, investor pools, and investment strategies. In selecting a

[1] The panelists were Gino De Bernardo, Senior Vice President at Comerica Bank, Mike Henry, Managing Director at U.S. Bank, Joe O'Donnell, Partner at Morrison Foerster, Mary Jo Sanderson, Managing Director at Värde Partners, and Guy Simpson, Head of Equity Fund Resources at Bridge Bank. The panel was moderated by Anthony Pirraglia, Deputy Chair of the Finance Department at Loeb & Loeb LLP.

lender, the fund must ensure that the lender is comfortable with the structure of the applicable fund. While pricing is important, sponsors will also consider other terms, including anticipated utilization, commitment amount, clean down requirements, tenor, and whether the fund is seeking a flat advance rate or an investor-by-investor analysis. Relationships are key to lender selection, including a lenders' existing comfort with the sponsor and the ability of the sponsor to make use of other financial products offered by the bank.

- **What do lenders consider when looking at the investor pool?** Lenders consider a number of factors when reviewing an initial investor list from a sponsor. These factors include the investor pool composition, credit quality of the individual investors, whether there are any potential "problem investors" in the list, and anticipated fund size and percentage of first close in overall fund size. It is easier to underwrite a deal when the initial close makes up 30-40% of the anticipated fund size than if it only makes up 10%. One consideration for lenders when reviewing the investor list is the fund's desired availability at closing. For example, if not enough capital was raised in the first close to meet the fund's needs, a lender may agree not to include concentration limits in the calculation of the borrowing base until the fundraising period is over.

  The panelists also discussed the value to a lender of maintaining internal databases of investors. A database compiling information such as investor names, known side letter issues, jurisdiction of formation, and deals in which they appear can be invaluable to a lender – it permits the lender to spot issues in indicative borrowing bases as well as ensure consistency of investor treatment across deals. It also provides an efficient way to monitor concentration so the lender can ensure that any single investor is not overly concentrated across the bank's portfolio. If a historically creditworthy investor experiences distress in the future (for example, if an investor enters into bankruptcy proceedings or becomes a sanctioned entity), the lender can move quickly to identity impacted facilities and work with funds to solve the issue rather than being caught off guard.

  When maintaining these databases, it is essential to remember that the output is only as good as the input – if information is entered incorrectly or incompletely, the results will be unreliable. If a bank hires a service to aggregate the investor data rather than prepare the database internally, the bank needs to do its due diligence on the service provider as some are significantly more reliable than others.

- **Is there any appetite for facilities to a Separately Managed Account ("SMA")?** An SMA will typically be a fund with only one investor. Despite the inherent risk involved when there is a single investor versus a commingled fund of diverse investors, many banks are open to lending to SMAs. Sponsors have found that interest is generally high if the single investor is a well-known, highly-rated investor. Even for less prominent investors, banks may be interested if they believe the relationship with the sponsor or investor could lead to a broader banking relationship. In particular, SMAs offer an opportunity for a lender to get its foot in the door with a sponsor – the lender may not be able or ready to agent a multi-billion dollar facility to a large commingled fund, but they may be able to agent a smaller facility for an SMA.

  When considering whether to lend to an SMA, banks will first look at the creditworthiness of the investor. Banks typically want to see a highly-rated investor that would qualify as a "rated included investor" in a commingled facility. Additionally, banks will almost always require an investor letter addressed to the agent and in which the investor acknowledges the facility and its obligations to fund capital contributions to repay the facility. The investor letter is a key element of an SMA because it creates direct privity between the investor and the agent and puts the lenders in a stronger position in an enforcement scenario.

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- **How do lenders address sanctions issues that arise with respect to investors?** Sanctions has been an emerging issue in the subscription line market due to the sanctions that were levied against certain private equity investors in connection with the war in Ukraine. While a sanctioned investor can typically be replaced in the secondaries market, the sale process is time consuming and may interfere with the fund's intended plans for using the credit facility or trigger a mandatory prepayment event that requires an untimely capital call on fund investors. Addressing these issues has been a learning process for sponsors and lenders as best practices have started to develop in the market. In response to sanctions issues, loan documents often include provisions that allow the general partner to remove any investor that becomes subject to sanctions. Additionally, one key takeaway from the emergence of the sanctions issues has been the importance of having a great relationship between the sponsor and lenders. It is important for the parties to proactively spot issues as they arise and work efficiently to minimize the impact on the fund's ability to use the subscription facility.

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