Professional Perspective

Structuring and Diligence Considerations for Separately Managed Account Subscription Credit Facilities

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Institutional investors and sponsors continue to find value in private investment vehicles organized by a sponsor for a single investor or group of affiliated investors, known as separately managed accounts (SMAs or funds of one). According to industry data, there were 175 such private equity SMAs that had raised roughly $19 billion over the course of 2020 and 2021.

From a sponsor's perspective, SMAs provide an opportunity to attract or strengthen their relationship with desirable investors, such as large pension funds, sovereign wealth funds, insurance companies, and endowments that are willing to make sizeable investments to the sponsor's funds. From an investor's perspective, SMAs are attractive because unlike commingled funds with large pools of investors, SMAs can offer the investor a tailored investment strategy based on the investor's objectives, portfolio management needs, and risk appetite.

Additionally, when compared to commingled funds, SMAs can provide investors with greater control and an increased ability to influence the fund's investment strategy and portfolio. While large institutional investors may have one representative on the fund's limited partner advisory committee, investors participating in SMAs may have complete veto rights over a potential investment. Also, there are other benefits to investors participating in SMAs, including better economics, such as favorable fee arrangements, increased efficiency with respect to certain administrative processes, and increased reporting.

Subscription Credit Facilities

Subscription credit facilities are revolving credit facilities that are secured by the right to call, receive, and enforce capital commitments of a private investment vehicle's investors and the deposit account used for receipt of capital contributions. Sponsors of commingled funds use fund-level subscription credit facilities to bridge capital calls, provide working capital, access letter of credit capabilities, or take advantage of the ability to draw on short notice to make quick acquisitions.

Recognizing the utility that such financings have provided to sponsors of commingled funds, it is unsurprising that sponsors are likewise in search of financing sources for SMAs. However, while the inner workings of subscription credit facilities provided to commingled funds and SMAs are similar, subscription credit facilities for SMAs are often quite bespoke as a result of the concentrated nature of the collateral, customized fund documentation, and legal considerations that may apply to the SMA investor.

Due Diligence

Lenders rely on the strength of underlying fund documentation and investor quality when extending subscription credit facilities to both commingled funds and SMAs. However, there are different and additional due diligence considerations that lenders should take note of when structuring and underwriting a subscription line to an SMA.

When underwriting a commingled fund with dozens or hundreds of investors, lenders take comfort that loans provided under subscription credit facilities are overcollateralized by a diversified pool of investor capital commitments and that availability under the credit line will be set by reference to a borrowing base comprised of only unfunded capital from investors that are sufficiently creditworthy—discussed in more detail below. Consequently, in such facilities, if there is an adverse circumstance involving only one or a couple of investors—such as a failure to honor a capital call, a ratings downgrade, or an insolvency proceeding—the lender has a number of other investors it can rely upon to satisfy obligations under the subscription line. Thus, pursuant to most loan documentation governing a subscription facility to a commingled fund, the lender will remain obligated to continue funding loans so long as sufficient capacity remains once the affected investor or investors are removed from the borrowing base and such exclusion event did not trigger an event of default.

Lenders to SMAs, on the other hand, can only rely upon the single investor or group of affiliated investors as its primary source of repayment for subscription line obligations. Therefore, from an underwriting perspective, the lender and its credit committee need to be comfortable regarding the creditworthiness and financial wherewithal of the single investor. Given that many SMAs are formed for large institutional investors, lenders typically rely on an investment grade rating or another specific metric, such as a sovereign wealth rating or a bespoke financial covenant and will impose more significant consequences—such as an event of default or termination of the facility—in the loan documentation if such rating is downgraded or other credit condition fails to be satisfied.

In addition to underwriting the investor's financial strength, the lender should work closely with external counsel, including local counsel if necessary, to determine whether any additional legal and regulatory due diligence on the investor should be completed, such as research into the nature, jurisdiction, or regulatory status of the investor. For example, lenders should understand whether the investor could successfully challenge its funding obligations on grounds of sovereign immunity or otherwise as a result of any applicable laws or regulatory regime.

Additionally, diligence should be completed to determine whether any outside approvals are necessary for the investing entities to enter into the investor documentation, including any credit support or credit linkage documentation requested by the lender. Frequently certain risks associated with an investor's jurisdiction or regulatory status are addressed and/or mitigated by provisions in the applicable governing documentation or consent letters signed by the investor in favor of the subscription lender (each, an investor letter), but understanding the relevant issues helps the lender to price in the risk and structure any necessary or desirable additional mitigants.

As with subscription lines to commingled funds, all of the legal documentation governing the investor's relationship with the SMA and the general partner or other managing entity should be requested and reviewed. The universe of fund documentation for commingled funds is often limited to the vehicle's governing agreement, the private placement memorandum, the investment management agreement, subscription agreements signed by the investors, and any side letters or other amendments to the governing documents. However, this is not always the case for SMAs, where there can be global or other agreements existing between the investor or group of affiliated investors and the sponsor. Such agreements may detail the terms of the investor's or group of affiliated investors' global commitment to the sponsor for purposes of deploying capital to a number of different SMA vehicles established by the sponsor.

These types of global or other relevant agreements can contain termination, excuse, withdrawal and other provisions that may need to be mitigated in the credit documentation. Additionally, if the SMA is set up for a group of affiliated investors, such agreements may include re-allocation rights that permit one of the investors to re-allocate all or a portion of its commitment to the SMA vehicle to one of its affiliates. Such a provision may create natural tension between the sponsor and the lender, as the sponsor will seek to ensure continued access to the subscription line while the lender may not want to pre-approve such affiliates.

As is the case with commingled funds, to facilitate a financing to an SMA with desirable terms and pricing, review by the lender of any program documentation, including the limited partnership or other governing agreement of the vehicle prior to execution by the investor is helpful, so that necessary subscription lending provisions can be confirmed, or added, if necessary, and any problematic provisions can be altered.

Insufficient governing documentation may not be a complete showstopper for a subscription lender to move forward with the contemplated financing, as, in the event of a deficiency in documentation, the lender will likely require the investor to sign an investor letter containing language the lender would otherwise have required in the governing documentation. Investor letters are consent letters that are executed by the investor directly for the benefit of a lender where the investor, among other things, acknowledges the credit facility and pledge of its unfunded capital commitments, agrees to fund any capital calls to repay the facility without defense, setoff or counterclaim, and agrees to fund any such capital into an account pledged to the lender. This language is often found directly in the governing agreement for most commingled funds to avoid the hassle and expense of seeking investor letters from each investor in the fund (as was the practice before this language became commonplace in governing agreements). Additionally, as discussed below, given the significant exposure to a single investor in an SMA, lenders will often require the investor to execute an investor letter, whether or not the governing agreement is sufficient in this respect.

Finally, investors committing capital to an SMA often do not have side letters in place with respect to its investment in the SMA notwithstanding that these vehicles are typically set up for large institutional investors with substantial bargaining

power. Given that the investor or group of affiliated investors are the sole investor in the vehicle, the investor has the ability to negotiate for inclusion, alteration or removal of certain provisions directly in the vehicle's governing agreement, negating the need for a side letter. In any event, the lender should review all applicable provisions carefully and receive a representation from the fund vehicle and its general partner or other managing entity that all side letters entered into in connection with the SMA have been provided to the lender.

Investor Documentation

As noted above, many of the governing agreements for SMAs contain market subscription-line lender friendly provisions, such as authority to enter into financing documents, ability to pledge the relevant rights and certain agreements from the investors, including an agreement to fund contributions without defense, counterclaim or offset with respect to capital calls issued for the purpose of repaying obligations under a subscription facility.

Notwithstanding whether the governing agreement has robust subscription line provisions, lenders to an SMA will typically require an investor letter in order to have such acknowledgments be made directly in its favor. While the investor may agree, in the governing document that the SMA can have a subscription line, the investor letter goes a couple of steps further by identifying the exact provider of such financing and requiring that certain acknowledgments and agreements be made directly in favor of the specific lender.

When lenders and funds are in initial discussions regarding a potential financing to an SMA, lenders often provide funds with a sample "form" investor letter to share with the applicable investor. However, investor letters for SMAs often become bespoke in order to address specific risks detected in the governing or overarching agreements or the regulatory regime or laws applicable to an investor.

Therefore, to the extent lenders share generic forms of their investor letters with funds prior to engaging counsel, it is recommended that lenders include caveats that the investor letter is likely to evolve as diligence is performed and completed. This can help to avoid a situation where an investor approves the form and submits its signature pages to such form before the lender and its counsel have finalized the letter.

Some lenders to commingled funds elect to require investor letters in instances where the investor pool is overly concentrated or if the governing agreement is deficient. There, the lenders may or may not opt for legal opinions or authority certificates provided with respect to the investor letter, the investor's subscription agreement and the governing document. This is typically a point of negotiation, as these documents can cause delay with respect to getting the financing in place and drive up legal costs.

For SMA financings, however, lenders should obtain additional comfort that the investor does in fact have the authority to enter into such documents and has obtained any necessary approvals, which could take a number of forms. Whether the lender will receive a legal opinion can still be a point of negotiation, and the lender should discuss with counsel, which may include involving non-US local counsel or local counsel in a state other than New York and Delaware, depending on the investor's jurisdiction. Many institutional investors will also insist on utilizing their own form of legal opinion, certificate, or other authority document, rather than generating new documentation for each credit facility, and any such document should be reviewed by the lender and its counsel as early in the diligence process as possible.

Finally, if the investing entity is a subsidiary or special purpose vehicle of a creditworthy parent, which vehicle may simply be a holding company through which the parent entity invests and with no assets of its own, the lender will likely require a guaranty or comfort letter from the parent as a condition to the financing—other bespoke forms of credit enhancement may also be considered based on the lender's relationship with the investor. Given that the holding company may not have sufficient assets of its own, a rating or other evidence of creditworthiness absent support from its parent entity, the parent entity will guaranty the investor's obligations under the governing agreement and investor letter or provide the lender with comfort that it has an ownership interest in the subsidiary and will keep such subsidiary sufficiently capitalized in order to meet its funding obligations.

Credit Documentation

While many of the provisions in subscription line loan documentation for an SMA look substantially similar to loan documentation for commingled funds, the SMA structure drives a number of changes to the terms and conditions related to the borrowing base, collateral and timing for enforcement of remedies and termination of the facility. Additional or tighter exclusion events, representations, warranties, covenants, and events of default are advisable.

One example is the conversion of certain exclusion events to automatic events of default, entitling the lenders to enforce remedies immediately. Subscription facilities for both commingled funds and SMAs often utilize a borrowing base as in asset-based lending to calculate how much the lender is obligated to advance against the fund's unfunded commitments.

An advance rate, reflected as a percentage, which could be 0% for certain investors in commingled transactions, is applied to each investor's unfunded commitment, reducing the amount of the unfunded capital commitment included in the borrowing base. In commingled funds, the investors' unfunded commitments may be further reduced as a result of application of concentration limits, a protection to make sure exposure to any one investor or class of investors is not too large. The aggregate amount of such adjusted unfunded commitments forms the borrowing base.

The loan documentation then includes "exclusion events" which serve to remove an investor's unfunded capital commitment from the borrowing base upon the occurrence of certain agreed-upon adverse or potentially adverse circumstances. The list of exclusion events in subscription facilities is lengthy and includes investor insolvency events, failure to fund capital, material judgements, loss of credit rating and being subject to sanctions (something the fund finance market has had to grapple with in 2022 as a result of Russia's invasion of Ukraine) to name a few.

In a commingled fund, if an investor is subject to an exclusion event and such exclusion causes the aggregate amount of the principal obligations outstanding under the subscription line to exceed the borrowing base, the fund will be obligated to pay down such excess within two to three days if the fund has cash on hand or within twelve or so days if it needs to call capital to make such repayment. To the extent the fund does not pay down the requisite amount by the required time, an event of default will occur which, subject to any negotiated standstill period, allows the lender to begin enforcing remedies immediately.

In SMAs, lenders often mandate that certain exclusion events will trigger automatic events of default or permit the lender to terminate the facility immediately, typically including exclusion events triggered by a clear credit issue affecting the investor and failures to fund in capital. Additionally, in an SMA, lenders may push for stricter exclusion events, thresholds or cure periods, such as, for example, a broad exclusion event driven by the lender's determination that any circumstance has arisen that could have a material adverse effect on the investor's ability to fulfill its obligations to fund capital.

The rationale for this is that the investor is the sole source of repayment, and if the investor itself has caused the borrowing base deficiency, or recovery from the investor is potentially seriously impaired, there is likely little value in providing the fund with time to call capital to obtain funds for a mandatory prepayment or permitting the fund to draw down further funds on the line. Instead, the lender should have the right to quickly assess the circumstances and if necessary or advisable, exercise remedies immediately rather than waiting twelve days before doing so.

Lenders should analyze the common suite of exclusion events to determine which events should trigger events of default. This will of course depend on the underwriting, such as reliance on a credit rating, and diligence discussed above. There will likely remain curable exclusion events which do not trigger an automatic event of default, and credit documentation should permit the lender to terminate the facility at some point in time after an exclusion event remains uncured. Otherwise, the lender may find itself in a situation where the borrower cannot use the facility, but the lender is obligated to keep the credit agreement and its commitment in place, which could present the lender with operational and capital inefficiencies.

Other instances of where terms in the credit documentation when compared to the credit documentation in a commingled transaction may be tighter include the investor's ability to transfer without lender consent and timing for notification of certain investor events. While lenders to a commingled fund might permit the fund to approve the transfer of an investor's capital commitment so long as any resulting mandatory prepayments is made prior to the transfer, similar to the rationale identified above with respect to exclusion events, a lender to an SMA will be wary of permitting any transfer of capital commitments without its consent.

Lenders should contemplate and document how increases to an investor's capital commitment will be treated for borrowing base purposes and ensure that when an investor does increase its commitment, it provides documentation regarding its increased capital commitment amount and re-affirms that its investor letter remains in place with respect to the new higher capital commitment.

Finally, in an SMA, the investor may negotiate in the governing documentation of the fund for specific consent or veto rights to any investment. In such a situation, the borrowing conditions in the credit agreement should account for any necessary consent right or veto period prior to the lender issuing a loan, the proceeds of which would be used to acquire such investment. The lender and fund will also need to come to mutual agreement as to how the investor's consent should be evidenced, which may be by certification from the fund, or receipt of such approval directly from the investor.

Conclusion

Overall, lenders have been more willing to extend credit to SMA private investment vehicles in the last few years given their popularity and based upon longstanding relationships with sponsors. That said, SMA subscription facilities inherently present a lender with greater risk, given that the lender is relying on the credit of a single investor instead of a diversified pool.

For that reason, it is vital for lenders to fully understand the nuances of the SMA structure as compared to a commingled fund, including risks associated with the investor, the terms and conditions of the underlying fund documentation and certain market-standard credit enhancements. With proper underwriting, diligence, and structuring, much of the single-investor risk can be mitigated in order to avoid lending to a fund of none instead of the intended fund of one.