haynesboone | haynesboone CDG

9 October 2017

ILPA Calls on GPs for Subscription Line Transparency

By Zoë Connor, Ellen Gibson McGinnis, Emma Russell and Albert C. Tan

ILPA's Paper

In June 2017 the International Limited Partner's Association (ILPA) published its paper "**Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners**." Since then there's been a lack of on the record industry commentary from general partners (GPs) on this paper, but it has not gone unnoticed and has triggered much discussion behind closed doors. The below summarises the position and potential considerations for the market.

Subscription Lines

Subscription lines (sub lines) are increasingly utilised internationally across alternative funds of all asset classes. Traditionally sub lines were short-term loans used to facilitate a fund's investments and other permissible uses until such time as capital was called from the investors. Today they are increasingly being put in place for a number of other general purposes (including for paying the fund's fees and expenses as well as transaction expenses) and to provide longer term debt, thereby enabling GPs to manage cashflows and avoid nuisance level calls. These lines are often secured against limited partner (LP) commitments in the fund.

ILPA and its Goals

ILPA, founded in 1990 and once an informal networking club, has transformed itself into a global organisation with over 400 LP members whose goal is to advance the interests of LPs. It's updated Principles, released in 2011, have received support from a long list of GPs, LPs and other industry participants and largely model today's limited partnership agreement (LPA) market positions. ILPA has since developed standardised best practices and reporting templates to increase transparency, efficiency and further partnership between GPs and LPs.

Timing of ILPA's Sub Line Recommendations

Why, after a three-decade period of the established sub line product, has ILPA now sought to lay down best practices for sub line financings? Over the last six months sub lines have become one of the most talked about features in private equity, mainly following one of Howard Marks' (Oaktree's co-chairman and founder) renowned cautionary industry memos discussing the pros and cons of sub lines, their impact on fund performance metrics and their potential systemic risks, before concluding that Oaktree is in the process of developing guidelines intended to mitigate the potential risk of sub line financing while preserving the benefits. This memo has stirred up a healthy dialog within the alternative fund and sub line communities on how to balance the merits of sub lines while mitigating any implied risks to banks and investors arising from the increase usage and global adoption of sub lines by alternative funds. Despite numerous recent GP responses in support of the product, it is hardly surprising that after such public scrutiny ILPA should deem it necessary to help address and resolve the conceptual concerns.

ILPA's Recommendations Versus Reality

ILPA recognises the benefits of sub lines but recommends that greater transparency and disclosure around their use be detailed in the quarterly reports, such as GPs making disclosures as to the total debt in use and debt purpose, providing a breakdown of cost to the fund and informing on the number of days each borrowing under a sub line has been outstanding. In addition, ILPA believes that it is necessary to report net IRR with and without the use of the sub lines. Whilst there is much more transparency on sub lines in today's LPAs and a number of funds may already include some of these disclosures in their quarterly reports, some GPs may find additional disclosures time consuming and administratively burdensome. It is also worth noting that the majority of investors are sophisticated institutional investors who fully understand the use of sub lines and appreciate the benefits they bring.

Similarly, while some funds may have already adopted some of the recommended thresholds for use of sub lines within their respective LPAs, other GPs may find ILPA's suggested thresholds for sub lines and parameters for their use more prohibitive and lacking commercial consideration to adjust to evolving market conditions, such as limiting debt to 15-25 percent of all uncalled capital, limiting outstandings of a borrowing under sub lines to 180 days, limiting the period of time for which such lines can be in place, lines being secured by LP commitments only and not by assets of LPs or the fund (which may curtail the ability for lenders to make available NAV and hybrid type fund finance facilities), prohibiting on demand facilities and limiting total interest expense.

ILPA also recommends that GPs should have a responsibility to disclose the terms of the sub line to all LPs, including disclosure of the loan covenants and those terms which introduce additional risk e.g. payable on demand, lender discretion over management decisions, exposure beyond unfunded commitments, syndication among lenders, cross default provisions, negative provisions and any impact on secondary transfers by investors. Such facility term disclosures may prove to be a step too far for some GPs. There are also concerns that this could be construed as seeking to provide LPs with additional fund management controls which may not be within their interests and where, in certain cases, GPs and LPs interests are actually already aligned.

It would appear that there needs to be greater clarification on ILPA's recommendation that, within LPAs, waterfall provisions should specify that the date used to calculate the GP's preferred return hurdle aligns to when the credit facility is drawn, rather than when capital is ultimately called from the LPs. If the preferred return hurdle is calculated on the date the line is drawn then this suggests that LPs will be paid preferred return on cash that they haven't yet contributed, by virtue of having not yet been called upon by the GP to make a drawdown.

ILPA Impact - Business as Usual?

ILPA's recommendations are guidelines only however, given ILPA's respected standing in the private equity community, its proposals will not go unnoticed and it is expected that certain LPs will raise these recommendations when negotiating their investments into private equity funds. No doubt top performing GPs will continue to be able to dictate their own terms. However smaller GPs or those caught in the middle may be forced to adjust terms to accommodate LP demands. It remains to be seen how the market will react to the recommendations and whether financing queries raised by LPs will affect what bank a GP chooses for its financing, whether LPs themselves may become significantly more involved in establishing the leverage requirements of the fund and whether funds will be expected to comply with any of the recommendations in order to meet lenders' underwriting criteria.

haynesboone | haynesboone CDG

Next Steps for ILPA

At the point of writing this article, it is not known how much (if any) consultation ILPA has had with GPs and sub line lenders on these particular sub line recommendations, albeit it is noted that ILPA's press release flags that they were "developed in concert with LPs, GPs and industry advisers." The guidelines do make clear that ILPA will reflect member feedback into the document. What remains to be seen is whether international GP feedback will also be incorporated into these guidelines, as was the case for the 2009 ILPA Principles which received much industry feedback and were therefore updated and re-released in 2011. The need for GP feedback is equally relevant here given that ILPA informs us that this guidance is to be incorporated into the forthcoming revised ILPA Principles to be released in 2018, which will no doubt cause LPs to add further weight to these recommendations during their negotiations.

If you have any questions about this topic, please contact a member of our Fund Finance Practice Group.