The Fundraising Slowdown and Subscription Credit Facilities

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For several years leading up to 2022, favorable economic conditions enabled private equity sponsors to enjoy a golden age of significant investment interest from large institutional investors with respect to such sponsors' private investment vehicles. During this period many sponsors were able to raise larger-than-anticipated funds and rapidly return to market with oversubscribed successor funds. However, the recent decline in values of investments, as well as a tightening of capital have resulted in a significant fundraising slowdown. In North America, the average fundraising time increased from 11.8 months at the end of 2020, to 13.8 months at the end of 2021, to 15.4 months at the end of 2022.[1] Many market observers and participants are expecting this trend to continue into 2023, and "large and established managers have noted that the macro environment coupled with the denominator effect – especially among US institutional investors – has meant their current vehicles are remaining open longer than prior vintages."[2]

The challenges attendant to securing capital commitments for a new fund and an extended fundraising period can add complexity to the credit analysis for subscription line lenders. Sponsors and lenders structuring and negotiating subscription credit facilities during this fundraising slowdown should keep the following considerations in mind:

- **Underwriting the Present** – Sponsors will frequently begin the process of shopping for, structuring and negotiating a subscription credit facility well before the fund's initial investor closing. As part of the underwriting process, lenders analyze and evaluate the fund's expected fundraising timeframe and targets to assess both total investor commitments and the composition of the investor pool, based on the identity of expected investors. However, the current fundraising landscape has served as a reminder that these projections are not guaranteed, and many lenders have had to address the unexpected consequence of a reduced, limited or more concentrated investor pool for a period longer than expected. Lenders should underwrite a subscription credit facility as the fund's investor pool exists at the time of closing of the facility, as opposed to how the fund projects it will look in 6, 12 or 18 months' time. If the current investor pool lacks size and diversity, lenders may request additional information or credit support documents from key investors, or adjust the pricing, advance rates or concentration limits to better reflect the risk.

- **Planning for Future Growth** – If the credit facility is put in place early in the fund's fundraising period, the projected final investor roster and applicable commitments will be largely speculative, and many decisions derived from the composition of the final borrowing base will still need to be made. While many facilities already include uncommitted accordion provisions permitting a fund to request that its maximum commitment be increased as the fund closes in more capital, lenders and funds should consider whether additional provisions are needed to account for ongoing fundraising and a potential downsizing of investor projections. Such provisions may include (1) the ability to join additional fund vehicles (possibly even in new jurisdictions) and additional lenders, without the need for amendments,

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(2) tiered pricing and advance rates that take effect if certain fundraising and diversification targets are met, and (3) concentration limit "holidays" to provide more availability earlier in a fund's life. These provisions allow lenders to provide a facility for the fund as it exists today, while also providing a facility that accommodates the fund's future growth.

- **Maturities and Extensions** – Lenders may want to consider structuring the facility for a fund that is in the early stages of its fundraising to have a stated maturity within the expected fundraising period, with an uncommitted extension option following the final investor closing. This structure provides lenders with an opportunity to diligence and underwrite the final investor pool prior to extending the life of the facility. Such facilities can also include extension options that functionally convert a bilateral bridge facility during a fund's fundraising period to a more traditional syndicated facility once fundraising is complete and certain projections are met. These bridge and syndicated facilities may each have their own unique pricing, advance rates and concentration limit requirements.

- **Staying on Top of Documentation** – For funds looking to maximize borrowing base capacity, it is important to ensure that they are in close contact with lenders regarding their investor pipeline. Consistent with recommended best practices, funds should notify lenders in advance of each additional investor closing. Providing lender's counsel with an opportunity to review and comment on side letters before they are executed will help to mitigate potential issues to inclusion of otherwise qualified new investors in the facility's borrowing base. Legal counsel will also need to review investor documents quickly after each investor closing to help the lenders underwrite and complete their diligence on the new investors before determining such investors inclusion and applicable designation in the borrowing base. As the facility grows and additional lenders and loan parties are added, and as the parties exercise any accordion and extension options, legal counsel will need to help prepare and negotiate the corresponding facility documents.

- **Credit Approvals and Market Conditions** – Lenders and funds should be prepared for potential choppy waters when syndicating facilities in the current economic environment. Every lender has a different risk appetite when it comes to advancing against specific investors, investors domesticated in certain jurisdictions and overall concentration of the borrowing base. Funds and lead lenders should consider expanding their lender networks during this period of extended fundraising and bank capital constraints, so they have a list of lenders to reach out to when the need to syndicate arises. Additionally, funds should keep in mind that lender credit approvals may expire, and the process for refreshing these approvals can be time consuming and lead to new negotiations, particularly if the market has materially shifted in the interim. If a fund starts the process of putting a subscription facility in place, or syndicating such facility, and then has to delay the closing due to an extended fundraising period, the terms originally agreed with the lenders may no longer be available. This is best avoided by funds being transparent and realistic about the timing of anticipated investor closings and lenders communicating upfront the impact any fundraising delays will have on their approvals.

Although these considerations are important, they are by no means an exhaustive list. Lenders should remain mindful of market conditions affecting fundraising and be prepared to work with funds to accommodate borrowing needs. If you have any questions about structuring subscription credit facilities given current market conditions, or any other questions or concerns relating to the fund finance industry, please contact the Haynes Boone Fund Finance team.

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[1] Figures are from PitchBook's 2022 Annual US PE Breakdown.

[2] See "Extended fundraises: Will we see more of them in 2023?", by Carmela Mendoza, published on January 11, 2023 in Private Equity International.

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