

The Subscription Line is Fine

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A May 1 article in the *Financial Times* caused some raised eyebrows in the fund finance market by implying that subscription line facilities create substantial risks to banks and investors. The article references a [memo](#) on Oaktree Capital's website by Howard Marks, Oaktree's co-chairman and founder, in which he discusses some of the perceived costs and risks associated with such facilities.

If readers dig into the memo, they will find that Mr. Marks contributes a balanced and thoughtful analysis, including discussing "the positives" of subscriptions lines. Some perspective on the longevity of subscription financing in the market and the close vetting these facilities have historically received is instructive.

Subscription line financings have been utilized by private equity funds since the late 1980's. That's a three-decade period of history from which we can draw some conclusions about the value of the financing to PE funds, the satisfaction of investors with the product as a tool for the fund managers, and the risk of the product to the funds and lenders.

While the market understands that past performance is not a predictor of future results, the use of subscription lines has grown exponentially since the product was created, weathering three recessions¹ and adapting to the needs of funds over time. In what is now a very competitive market, funds have the negotiating power to craft facilities that provide what they need at a price that makes sense.

From time to time, investors (or, more frequently, their advisors) have questioned the benefit of these financings. Over time, though, it has become pretty clear that the value of access to short-term financing can not only result in a marginal increase in return on investment but provide needed liquidity that allows the funds to call capital only when it will be permanently invested. Why? Because the financing provides working capital that allows the funds to smooth out capital calls, manage quick execution on investment closings (and provide a bridge to capital), and provide interim financing while arranging long-term debt on assets and portfolios. In the early-2000's, some funds were getting resistance from, in particular, pension plan investors about using subscription lines. Early concerns about unrelated business income tax and fund managers keeping advances outstanding for too long had been largely overcome, but investors were still not entirely convinced that the benefit of the facilities were worth the somewhat decreased return from delaying capital calls. Two things occurred to change their view.

First, fund documents adapted to require shorter-term advances and to adjust return mechanics. Second, and unforeseen, was the recession of 2007-2009, during which liquidity was at a premium. Investors did not necessarily have the cash to fund capital calls without liquidating investments at an unacceptable price point. Funds with subscription lines in place were able to use the lines to manage capital needs during that period of uncertainty and volatility.

In assessing the usefulness and risk of the subscription line product, participants should keep in mind that the major, experienced lenders have developed a core set of structural elements that are

fairly consistent across transactions. Given the lack of defaults in 30 years, lenders continue to be comfortable with the risk profile of these facilities. Investors seem to appreciate the role the facilities play in the funds' management of capital and investments, and the competitive market gives the funds serious negotiating power to obtain a subscription facility that fits their business model.

¹ Official dates of recessions in the U.S. during this time were July 1990 – March 1991, March 2001 – November 2001, and December 2007 – June 2009.