Subscription Facilities as a Useful Tool for Energy-Focused Funds in a Capital Constrained Environment

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Subscription-secured credit facilities, or subscription facilities, are typically formed as revolving credit facilities that are secured by the right to call on the unfunded capital commitments of investors in real estate opportunity funds. However, as the private equity industry matured and investors and sponsors became more comfortable with subscription financing, its usage has become increasingly popular with other types of private equity funds, for example, buy-out, infrastructure, debt, and natural resources private equity funds. According to Fund Finance Association's estimate, the overall global market on subscription financing is approximately $400 billion.

In recent years, an increasing number of energy-focused private equity funds have successfully utilized subscription financing for their investment and operational purposes. Although the use of subscription facilities has become more prevalent among general private equity investment funds, energy-focused private equity funds have, from an observer's perspective, under-utilized this useful tool, considering the many advantages of subscription financing compared with other types of financing, as summarized below.

Overview of Subscription Facilities

Under typical subscription facilities, the borrower or guarantor is structured as a limited partnership or limited liability company, with the limited partners or members consisting of institutional investors. Those investors that meet certain credit criteria (usually based on S&P or Moody's ratings) are designated as "Included Investors," and availability under the credit facility is generally calculated as 90% of the aggregate unfunded capital commitments of such Included Investors.

Included Investors are normally highly creditworthy institutional investors (e.g., public or corporate pension funds, endowments and foundations, financial institutions, life insurance companies, and sovereign wealth funds) that have, among other things, an S&P rating of at least BBB- or a Moody's rating of at least Baa3 or are sponsored by such a creditworthy entity. Often, a separate subset of the investors that do not meet such credit criteria but nevertheless deemed by the lenders as having relatively strong credit are designated as "Designated Investors." Designated Investors are generally subject to concentration requirements as to size and type of investor (rated/unrated/sovereign wealth/high net worth, etc.) and availability with respect to Designated Investors is generally calculated as 65% of the aggregate unfunded capital commitments of the Designated Investors, and in such an instance availability under the facility is generally calculated as the sum of: (a) 90% of the unfunded capital commitments of the Included Investors; and (b) 65% of the unfunded capital commitments of the Designated Investors.

In this ever-evolving market, some lenders are even offering subscription facilities with flat advance rates of 50% applicable to all investors. Recently, private equity fund sponsors are also utilizing this financing for single investor, separately managed accounts, particularly for the strongest pension

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funds and sovereign wealth funds. In light of: (i) the numbers of commitments of investors, (ii) the size of commitments of investors, and (iii) the industry sector of investors included in the borrowing base of subscription facilities provide a more diverse base supporting repayment of the credit facility than many corporate credits.

Loan proceeds are available for myriad purposes, including bridge financing, asset acquisition, asset development, equity investment, working capital purposes and other fund expenses. These facilities, which typically have maturities of one to three years, provide flexibility and pricing advantages over other more traditional forms of acquisition/mini-perm facilities in quick-close acquisitions, or in pre-stabilization repositioning situations where the asset is ultimately designated for traditional asset level financing.

A subscription facility may be syndicated (i.e., with a group of lenders providing the facility to the borrower) or bilateral (i.e., between a single lender and the borrower). By sharing the lending risk, a syndicated facility can address a borrower's need for access to larger amount of capitals, with some facilities reaching the size of a few billion U.S. dollars. Moreover, a syndicated facility provides a borrower with access to broader network of financial partners, which affords significant risk mitigation for a borrower. A bilateral subscription facility, on the other hand, often provides more flexible and custom terms and conditions to meet the unique business demands of a borrower.

Advantages of Subscription Facilities

From the perspectives of the private equity funds, subscription facilities have many advantages over other types of secured or non-secured financing, including the following advantages:

- **Collateral for Early-Stage Private Equity Fund**
  If the borrower is a newly formed private equity fund, it generally does not yet have significant investment assets that it can use as primary collateral for a secured financing. In such a circumstance, the borrower can use the unfunded capital commitments from its investors as a primary source of collateral for a secured financing.

- **Increased Borrowing Capacity**
  Borrowers with significant investment assets can also use unfunded investor capital commitments as additional collateral to maximize borrowing capacity.

- **Attractively Priced**
  Because the borrowing base typically consists of highly creditworthy institutional investors, subscription facilities often have quite attractive pricing (in terms of interest rate margin for borrowers), historically with applicable margin over LIBOR ranging between 1.00-2.00% depending on the credit worthiness of the fund's borrowing base and the reputation of the fund's sponsor. The unfunded capital commitments of creditworthy institutional investors are, often more attractive to lenders as collateral than other investment assets of a fund.

- **Broader Access to Corporate Lenders**
  Because credit decisions are based on the creditworthiness of a fund's investors, subscription facilities are more likely to appeal to the broader set of corporate lenders, who are more familiar with such investors, rather than only lenders specializing in a particular asset class.

- **Quick Access to Capital**
  Draw-downs on loans can typically be made between one to three business days for LIBOR

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or prime rate loans, as compared with the typical 10 to 15 business days draw-down period for capital contributions.

- **Bridge to Other Sources of Capital**
  Since most subscription facilities are structured as revolving credit facilities, the borrower has greater flexibility in deciding when and how much it wants to use such a facility and can use such a facility to smooth out capital calls, pay fund expenses, or provide bridging financing to other sources of capital, e.g., capital contributions. This can avoid the problem of calling capital too often, too early, or too much, in which large amounts of capital sit idle.

- **Facilitates "True Up" of Capital**
  Similarly, the borrower can use a subscription facility to facilitate "True Up" of capital when a fund has multiple closings of investors

- **Enhances Fund Yields**
  Leverage is the strategy of using borrowed money to increase return on investments. To enhance the fund's yields, the borrower may elect to use subscription facilities to get access to borrowed money (in addition to the capital contributions) for investments. For transparency to its investors, funds are increasingly reporting investment returns on both a leveraged and unleveraged basis.

- **High Level of Financial Flexibility**
  Subscription facilities can be structured to provide additional options (e.g., letters of credit, alternative currencies, bridge finance, qualified borrowers) depending on a borrower's specific investment or operational needs.

- **Minimum Additional Reporting**
  Most subscription facilities are structured to have minimum additional reporting other than the annual and quarterly financial statements and other reports that the fund typically prepares for its investors.

- **Relaxed Financial Covenants**
  Subscription facilities generally have more relaxed financial covenants, usually only requiring the fund to comply with the leverage limitations set forth in its own governing documents (e.g., the limited partnership agreement or limited liability company agreement of the fund). This is a welcomed feature to many funds, as it may be difficult to stay compliant with more robust financial covenants (e.g., net assets value covenants and loan-to-value covenants) under turbulent market conditions that many funds experienced in the global financial crisis of 2008.

Conclusion

Given the many advantages of subscription facilities as compared with other types of financing, it is not surprising that subscription financing has become increasingly popular and mainstream to private equity funds. Energy-focused private equity funds should, if not already, explore whether they would benefit from subscription financing and whether they can utilize this financing option as a useful tool, particularly as access to debt capital in the energy finance markets is becoming increasingly constrained.

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Note: This article was also featured in the State Bar of Texas International Law Section [International Newsletter](#) (see P. 21).