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Financing Facilities

Subscription Facilities Provide Funds With Needed Liquidity But Require Advance Planning by Managers (Part One of Three)

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In order to quickly act on investments, instead of waiting for investors to fund capital calls, private equity and other private funds are turning to subscription credit facilities for necessary liquidity. Along with other types of fund financing facilities, subscription credit facilities are becoming more prevalent in the asset management industry. However, to facilitate the execution of a subscription facility, a manager must make certain preparations, particularly at the outset of the fund.

In a recent interview with the Hedge Fund Law Report, Zac Barnett and Liz Soutter, partners at Mayer Brown, discussed subscription and other financing facilities used by funds. In this first article of a three-part series, Barnett and Soutter examine the prevalence of subscription facilities in the asset management industry, investor response to these structures and primary considerations for managers anticipating entering into such a facility. The second article will review the evolution of other types of financing facilities in the current market, including fund-of-fund facilities, portfolio acquisition facilities and general partner support facilities. The third article will focus on market, structuring and operational considerations for managers when establishing financing facilities.

For more on subscription financing, see "How Can Private Fund Managers Use Subscription Credit Facilities to Enhance Fund Liquidity?" (Apr. 4, 2013).

Subscription Facilities

HFLR: What distinguishes subscription facilities from other types of debt facilities?

Soutter: The main difference with subscription financing is that the lender has recourse to the fund vehicle itself. This is different from other types of financing that most people would be more familiar with, which generally have recourse to siloed assets or portfolios of assets. The primary recourse for subscription financing facilities is to the uncalled capital of investors.

However, even in a subscription facility where primary recourse is to the uncalled capital, because the lender is lending to a fund vehicle, it will have secondary recourse to the other assets of the funds as well. And of course a lender shall have unlimited recourse to the general partner's (GP's) assets (to the extent there are any) as well.

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HFLR: Are subscription facilities primarily used by private equity funds, or are they also used in the hedge fund context? Are they comparable to liquidity facilities employed by fund-of-funds?

Barnett: In terms of subscription facilities where the collateral is the right to call and receive unfunded capital contributions, as well as a pledge of the account to which those contributions are funded into, they are not as applicable in the hedge fund context. With most hedge funds, the investors fund their money right away.

There aren't a lot of subscription financings for hedge funds of which I am aware. If you had a hedge fund where there was some delayed funding mechanism, then because of that unfunded component subscription financing would certainly be feasible. But, with most hedge funds, investors sign and fund their money right away.

[See "Can a Capital on Call Funding Structure Fit the Hedge Fund Business Model?" (Nov. 5, 2009).]

HFLR: What about hybrid hedge/private equity-style structures? In other words, the industry has seen an increase in hedge fund vehicles that include certain private equity features. For example, a fund may make only certain limited investments and may have a capital call feature built into it. Would subscription facilities be useful for that sort of hybrid structure?

Soutter: It depends on what the lock-in periods are and how you structure around them, but you could use a subscription facility for one of those more open fund structures.

Barnett: I agree we'll be seeing more and more hybrid structures. We had our Sixth Annual Fund Finance and Subscription Credit Facility Symposium in New York back in March. Attending it were several big institutional investors looking to hedge fund managers to set up specific investment programs that looked and sounded to me a lot like private equity fund structures – although on either a club-style basis for investors or similar to a separate account plan with an unfunded component. Of course, that led to a natural discussion of having some kind of subscription credit facility in place. So for your traditional hedge fund, subscription facilities would not necessarily be a fit, but as the market evolves – and I think we'll see further blending of private equity and hedge funds – I think there will certainly be some spillover.

[For more on hybrid funds, see "Hedge Fund Managers Turn to Hybrid Fund Structures to Reconcile Fund Liquidity Terms and the Duration of Assets" (Feb. 4, 2009).]

HFLR: What are the differences between and viability of subscription financing for open-end versus closed-end vehicles?

Barnett: In the U.S., they have been very viable. We did the first subscription facility for an open-end fund that I'm aware of five years ago here at Mayer Brown. The key is the redemption notices; the fund's limited partnership agreement (LPA) has to allow enough time between the submission of the redemption notices by the private equity fund investor so that, before they actually exit, there's enough time there for the subscription line lender to come in and make a capital call if necessary, should the facility be in default.

There have been numerous subscription facilities put in place for open-end funds, but initially lenders thought of it as kind of a square peg in a round hole. Because of the fluid nature of the open-end commitments, they were worried about lending against them. Lenders need to conduct appropriate due diligence on the fund's LPA and make sure there is enough time to make a capital call between redemption notice submission and investor exit. And, there is a little bit more work on the lender's side – they have to recalculate the borrowing on a quarterly basis

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because of investors entering and exiting the fund. However, it is certainly possible, and we've done several.

Soutter: I would agree with Zac. Actually the majority of what we do is funding for closed-end structures, because they are more readily suited to subscription facilities. But, with the right tweaks and a bank that is willing to take on additional monitoring requirements, it is possible to offer subscription financing to an open-end structure.

HFLR: What overall trends have you seen in the industry with respect to subscription facilities? Are they increasing in use and popularity?

Barnett: Certainly they are. Conservatively, we estimate that there are $300 billion in lender commitments out there, and that number is up significantly from 10 years ago, where we'd estimate there would have been less than $100 billion in lender commitments. I think we'll continue to see more and more subscription facilities.

Looking at the Preqin private equity fund data, it appears that there is probably anywhere from $1.2 to $1.4 trillion in dry powder out there. Doing the math: it looks like only 25% of the aggregate unfunded capital commitment is currently being lent against. That number probably can go up safely without any kind of tragic credit consequence, given the creditworthiness of the investors.

The subscription facility market is maturing, but not quite mature. In terms of potential for rapid growth, I think there are a lot of hedge and private equity fund managers that are looking for more liquidity above the fund level – from GP lines, to management company lines, to partner loan programs to help the principals fund their commitments to private equity and hedge funds. There are liquidity needs there, and banks are working on filling those voids or needs.

Soutter: One of the biggest trends in subscription facilities is that their sizes are simply getting bigger in line with the growth of fund sizes and requirements. Whereas previously, certainly in the European market, deals had largely been done on a bilateral basis – even at some quite chunky numbers (say, up to about £400 million) – it is not unheard of anymore to see facility sizes of around £1-3 billion. Because of these facility sizes and a lender's need to diversify its fund relationships, club deals are becoming increasingly common and a growing trend in the European market. Consequently, funds are making the most of the increase in competition amongst banks and the opening up of the lender market in Europe.

Barnett: To give rough (erring on the side of conservative) numbers, there are at least 50 or so active lenders in the subscription facility market and probably 12 to 15 that regularly lead subscription facilities.

HFLR: As mentioned previously, the underlying collateral of a subscription facility consists of the unfunded capital commitments, leaving the recourse in the event of default against remaining limited partners (LPs). How have investors responded to these facilities (as, in essence, they are forced to bear the burden of the behavior of bad actors)?

Soutter: Investors share the brunt of the action of their co-investors in any event. Whenever there's a defaulting investor, it's generally up to the other investors to stump up the remaining cash in order for the fund to be able to make its investments, even absent a subscription facility, and the LPA will set out the provisions dealing with defaulting investors and actions and remedies a manager can take in such scenarios.

Although the investors subscribe to a fund on the basis that they share in the fund's profits and loss pro rata, investors as a general rule have started to take a bit of umbrage to being on the hook for the default of other investors without limit (up to the amount of that investor's total

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uncalled capital). What we're now seeing more in LPAs are caps on LP liability, where investors allow the fund to recover against their uncalled capital when another investor defaults, but only up to a certain amount, such as 125-150% of the original amount of the call.

So, I don't think the subscription financing changes the position that your investors will share pro rata in the losses as well as the profit. However, this is an issue that investors, amongst themselves, are sensitive to in any event.

Barnett: I would agree 100%. Investors are on the hook for investor default in any case. Whether a subscription facility is used as a leverage tool for convenience doesn't make it any more likely that investors will push for overcall limitations.

The fund still has to go out and conduct its business to call capital and make investments. If it uses the subscription facility as a tool for efficiency purposes, in terms of being able to access liquidity quicker and smoothing capital calls, then so be it.

If investors are pushing for capital calls, it's not because they have to pay back debt on the credit facility; it's because they would have to true-up on capital calls to fund investments anyway.

To be clear, with a subscription facility, at no time are investors liable for anything in excess of their unfunded capital commitments, just like they would be in connection with ordinary funding of investments.

HFLR: What are the primary considerations a manager looking to enter into a subscription facility should keep in mind?

Soutter: In order to ensure the financing is as smooth and efficient a process as possible, the key primary consideration for any manager is to have done its homework at the outset and have already negotiated with its investors a well-drafted LPA containing the main provisions a lender will require as part of any financing package. Specifically, the LPA should contemplate that subscription facilities can be put in place; that security can be taken in respect of the uncalled capital of the investors; and ideally that the investors are not going to exercise any kind of counterclaim or defense or rights of setoff in respect of a lender's ability to step in and call capital when capital is required to be called from the investor.

The last thing a manager and the investors want is to get into discussions with the lender about the LPA provisions when the LPA has already been signed. At that point it would involve potentially amending the LPA or obtaining specific investor consent, which can often be very challenging.

So, the biggest consideration for a manager that thinks it might be possible that the fund will enter into a subscription facility, is to make sure that the LPA contains all of the key ingredients so that is acceptable to a potential creditor, bearing in mind that not all lenders share the same credit requirements. The safest position to take is one that caters to the most conservative lenders in order to give the fund the greatest flexibility of choice when it comes to the financing.

Barnett: Another consideration is how the subscription facility should be used – if the manager is looking to use it for leverage or merely as a bridge to capital calls. Some funds use subscription facilities but don't like holding long-term debt, or their investors don't like having long-term debt. So, investors will specify that they want the facility debt or fund-level debt to only be out there for a couple of months. That would be a consideration if the manager is looking for a leverage facility that would actually leave the debt out for the longer term.

So, in terms of GP/LP negotiations, as investors are coming in and the fund is being formed, the manager must think how it wants to use the debt at the fund level – whether it will be long-term

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or short-term. As pointed out above, those types of LPA and side letter negotiations will be critical to the size and type of facility that winds up being established.

The investor base – specifically, the creditworthiness of the investors – also matters. While the fund wants to get whatever subscriptions it can, for a fund looking to have subscription facility debt, it is better to have AAA-rated investors, rather than random individuals signing subscription agreements.

Thus, managers should first think about whether they want fund level debt, how they're going to use it and how much availability they want, because the borrowing base will be determined upon the creditworthiness of the investors. If you're signing up a bunch of random individuals, you're probably not going to have much of a borrowing base or much of a facility at all.

Soutter: The key is that the manager does not want to have to go back to the investors, particularly on the basis of the financing. That's secondary to what the manager does, and it doesn't want to have to keep going back to its investors with LPA amendments that need to be made or in respect of lender consents. Advance planning is the absolute key; get it right from the outset.

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