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Financing Facilities

Trends in the Use of Subscription Credit Facilities: Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions (Part Two of Two)

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The increasing popularity of subscription credit facilities with fund managers has prompted questions about how to structure the facilities to both account for varied investor bases and accommodate other fund types – such as hedge funds – so that they can take advantage of them. These were some of items addressed in a recent webinar, entitled "Pros, Cons and Trends in the Use of Subscription Credit Facilities," which was moderated by Rorie A. Norton, Editor of the Hedge Fund Law Report, and featured Thomas Draper, partner at Foley Hoag, and Michael C. Mascia, partner at Cadwalader.

This second article in a two-part series details key considerations when banks calculate the size of a subscription credit facility based on a fund's investor base and ways to account for certain structural components, as well as provisions to be addressed when preparing fund limited partnership agreements and side letters that facilitate a smooth adoption of the facility. The first article described ways the market has adjusted its use of these facilities to account for certain concerns raised by investors; the economic and logistical benefits they offer; and steps that certain hedge funds and credit funds are taking to adopt them.

See "Types, Terms and Negotiation Points of Short- and Long-Term Financing Available to Hedge Fund Managers" (Mar. 16, 2017); and "Financing Facilities Offer Hedge Funds and Managers Greater Flexibility (Part Two of Three)" (Jun. 9, 2016).

Structuring Issues and Considerations

Calculating the Advance Rate

Lenders use two primary underwriting approaches – referred to as flat coverage and securitization – for determining the amount that can be borrowed under a subscription credit facility (SCF) based on the qualifying subset of a fund's investor base (borrowing base), Mascia explained. These approaches tend to converge and result in similar credit availability, he noted.

Under the flat coverage approach, a lender will lend up to a specified percentage (advance rate) of the amount of the uncalled capital of all investors. This approach has been prevalent in venture capital and has moved into private equity, but it can result in a lower advance rate than

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other approaches. Lenders using the securitization approach, on the other hand, will classify each fund investor based on the investor's creditworthiness, Mascia noted. It considers the investor's credit rating, the size of its endowment, its assets under management and other factors. Using those factors, a lender typically puts each investor into a grid or matrix that determines its individual advance rate, Draper added.

An investor classified as an "included investor" has well-established creditworthiness and could obtain an advance rate as high as 90%, Mascia explained. A "designated" investor, on the other hand, is one that might not have a public rating or may not have significant assets but that is nevertheless creditworthy, based on the lender's prior experience, Draper said. A designated investor is put into the grid under an agreed category, rather than automatically fitting into one of the categories on the grid. Designated investors might get a lower advance rate – perhaps 65%, Mascia said.

Lenders also typically impose a concentration limit, which limits the proportion of the aggregate SCF borrowing base that can come from a single investor, under both approaches to calculating the advance rate, Mascia said. For example, if there are three highly rated investors at the first fund closing, each with a 90% advance rate and a 20% concentration limit, and those three investors comprise one-third of the fund's uncalled capital, the concentration limit will bring the effective advance rate down to about 65% or 70%. Included investors with well-established creditworthiness can have a concentration limit as high as 20%, Mascia explained, while included investors with a lower credit rating or designated investors may have a concentration limit as low as 5%.

See "Understanding Subscription Credit Facilities: Principal Advantages and Key Points to Negotiate in the Credit Agreement (Part Two of Three)" (Mar. 8, 2018).

Issues Posed by High Net Worth and Sovereign Wealth Fund Investors

Some funds have high proportions of high net worth (HNW) investors, which can be problematic because, in Draper's experience, it is much harder for SCF lenders to lend against individuals. Flat coverage lenders will tend to offer a much lower advance rate, he explained, while securitization lenders often provide little or no credit for HNW individuals.

Part of the problem is that SCF lenders do not want sponsors to have to go back to HNW investors to collect underwriting information, Mascia noted. They consider asking for individuals' credit scores and tax returns to be too invasive. Nevertheless, lenders understand that individual investors are worth more than a "true zero," and even if they assign a 0% advance rate to HNW investors, they may give a higher advance rate to rated investors than they otherwise would have. One way to circumvent this issue in a manner that is more attractive to SCF lenders, however, is for HNW individuals to invest via a fund of funds.

Sovereign wealth funds (SWFs) present similar issues because there is often little or no publicly available information about them, Draper said. There simply may not be enough information for banks to obtain a sufficient level of confidence in a credit analysis, Mascia added. However, some SWFs invest repeatedly in U.S. private funds, creating track records that banks may take into account, Draper continued. A bank may include an SWF as a designated investor.

Alternatively, a bank may begin lending against an SWF after that investor has met a significant portion of its capital commitment to the fund, which shows that the SWF is committed to the sponsor. This may work well for a fund sponsor because, at the beginning of the fund's life, its borrowing base is very broad and it may not need an SWF's capacity at that time.

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Duration of SCF Commitment

Some funds are comfortable with a 364-day facility that is renewable, which lenders prefer, and, accordingly, comes with advantageous capital treatment. If a bank's commitment is less than one year, its capital charges are about half of what they would be for a longer commitment, Draper added. Some sponsors even accept a demand facility when they are confident in the creditworthiness of their investors and the likelihood of a demand is extremely low. The demand feature offers even lower pricing than 364-day financing.

A growing number of funds prefer more certainty and opt for a three-year commitment, however, which will have an upfront cost that is triple that of a 364-day facility. However, once the facility extends beyond three years, the lender "takes a harder look at it from a credit perspective" and may impose higher internal capital charges, Mascia said. It is extremely rare for banks to go beyond three or four years except for certain preeminent sponsors.

Pricing and Implementation Costs

There is an upfront fee tied to the risk profile of the deal, commonly 15-25 basis points per year, although some banks take less up front and take more of a spread. Spreads are relatively tight – typically 150-250 basis points over LIBOR, depending on the sponsor and investors. There is also a fee on the undrawn portion of the credit line. Despite some defaults and workouts, recovery rates on SCFs are "extremely high," according to Draper, who was not aware of any bank that has taken a loss on an SCF.

See "Operational Challenges for Private Fund Managers Considering Subscription Credit and Other Financing Facilities (Part Three of Three)" (Jun. 16, 2016).

The cost of SCFs has been relatively low because they are well-established, have well-developed forms and include creditworthy investors, Draper said. Their popularity may diminish if interest rates continue to rise, Mascia cautioned, potentially reverting them solely to their original purpose as logistical bridges. SCFs typically have floating rates, so if interest rates begin to exceed a fund's preferred return, the fund may choose not to use the facility, he added.

Feeder Funds and Parallel Funds

The significance of joint and several liability provisions will depend on the tax sensitivity of the fund investors, Draper explained. Some sponsors use feeder funds to segregate U.S. tax-exempt and foreign investors from their main funds. Those investors may be particularly sensitive to the risk of a fund participating in a U.S. trade or business or having liability for a U.S. domestic fund.

In those cases, the sponsor may have to employ a "cascading" security structure under which the main fund has an SCF secured by its uncalled capital commitments, one of which will be the feeder fund's commitment. The main fund will ask the feeder to secure the feeder's capital commitment by pledging the commitments made by the feeder's investors. Under this structure, the lender will have recourse to the feeder's investors, even if the feeder is not a direct guarantor of the master fund's SCF. This structure is being used less as people become more comfortable with feeder funds as guarantors.

In some cases, parallel funds invest on a side-by-side basis with a main fund. In those structures, sponsors sometimes use a jointly owned subsidiary as a "collector vehicle" to collect capital and make investments, Draper added. Those sponsors are usually comfortable with the parallel funds being jointly and severally liable. When parallel funds are used to keep foreign and tax-exempt

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investors separate from U.S. taxable investors, however, the parallel funds will hold their pro rata shares of investments separately and will not take on joint and several liability. Each will have its own borrowing base to support a separate SCF. Some SWFs or other major investors that invest into a fund of one might even provide their own capital call lenders.

See also "How Can Private Fund Managers Use Subscription Credit Facilities to Enhance Fund Liquidity?" (Apr. 4, 2013).

Partnership Agreement and Side Letter Provisions

There has been a great deal of consolidation among law firms that represent fund sponsors, Mascia said. The remaining firms are very familiar with SCFs and have incorporated appropriate provisions into their fund limited partnership agreements (LPAs). As a result, "unbankable" LPAs are much less common than they were several years ago.

According to Mascia, SCF lenders commonly look for and evaluate the following provisions:

- express authority to borrow and pledge capital commitments;
- authority to incur joint and several liability with affiliated funds;
- investor duty to pay capital calls regardless of setoffs, counterclaims or defenses;
- "overcall" limitations;
- debt limitations;
- investor rights to cease funding; and
- most favored nation provisions in side letters.

An overcall right is a manager's right, when one investor defaults on a capital call, to call additional capital from other investors, Mascia explained. Investors seek limitations on overcalls to ensure diversification of their investments. Banks want managers to have sufficient ability to make overcalls so that they do not end up "effectively alone with a bunch of siloed single investors," he said. Managers also need the ability to make overcalls so that they can continue to function. Banks spend a significant amount of time looking at those limitations and how they would play out in the event of an investor default. These provisions involve significant negotiations between banks and sponsors, Draper added.

Sponsors want clear LPA provisions authorizing them to incur SCFs, Draper continued, while also giving lenders the ability to exercise their remedies under the SCF. They do not want to have to go back to investors to get commitment letters from investors to the bank, which was more common under older LPAs. When a fund has just one or two very large investors, a lender might still seek a letter from those investors, he noted. Banks will definitely ask for a letter from a fund of one, but it is much less common now to ask a traditional commingled fund, Mascia added.

See "Subscription Facilities Provide Funds With Needed Liquidity but Require Advance Planning by Managers (Part One of Three)" (Jun. 2, 2016).

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