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BY: T. SMITH & A. DAUD
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Fund finance focus: don't neglect the positives

*The use of subscription facilities by funds has seen its criticism, but the practice is not without its positives write **Thomas Smith** and **Almas Daud***

The use of fund-level subscription line facilities by private equity and private debt funds is in the public spotlight. While the focus is increasingly on concerns of some LPs, it is helpful to balance those concerns against the positives. Subscription lines bring material commercial benefit to LPs and GPs alike. Many funds could not do without them.

Commentators are right to consider the impact of the use of credit lines by funds. Most recently, the Institutional Limited Partners Association, an influential trade association for institutional LPs, published its "Considerations and Best Practices". ILPA highlights, for example, GPs using subscription lines can improve a fund's IRR, with potential benefits to GPs but not LPs. ILPA understandably recommends more visibility is given to LPs on changes to IRR.

But what about the positives? Are there benefits for LPs as well as GPs? The short answer is yes, increasingly so. The flexibility afforded to a fund and its LPs by a subscription line is more and more important as funds get larger and more sophisticated.

Historically, subscription lines were used by funds for two principal reasons - cash management and efficiency. Those uses still hold true today.

Subscription lines allow funds to access more quickly than the time it takes to call LP capital. This has many commercial benefits. For example, a fund with hedging requirements can use its facility to post margin calls in circumstances where it does not have time to call capital to meet the deadlines for those payments. The alternative, which is detrimental to LPs, is to hold a reserve of LP cash at fund level.

It is also greatly beneficial to LPs and GPs if the fund does not need to call LP capital whenever it needs cash. A fund needs cash on a frequent basis for fees, expenses, hedging and other non-investment liabilities. Some funds (e.g. credit funds) may make multiple small investments weekly, for which it is not practical for LPs to make capital payments. Smaller LPs may not have (or want) the administrative capability to keep up with regular small payment obligations. For LPs whose business is to invest in other funds, the number of capital calls multiplies.

As the private equity and debt markets get increasingly competitive, funds' use of subscription lines has also evolved. Competition among funds for assets is increasing and many asset sales are run as auctions with multiple bidders. It is in LPs interests for the fund to have the tools to be competitive.

Being able to draw funds for an acquisition on short notice provides a real competitive advantage. The alternative is to draw LP capital well in advance of a possible investment, but the cash may have to be returned if the transaction aborts at the last moment. This is detrimental to LPs.

Having a committed subscription line facility also allows a fund to demonstrate it has "certain funds" for the purpose of an acquisition (both with respect to the equity and debt portions of a typical leveraged acquisition). A seller may require evidence of certainty of funding as part of the sale process.

Availability of a subscription line allows a fund to broaden its acquisition strategies. For example, many funds (and their LPs) may wish to acquire large assets and subsequently sell down part of the investment to co-investors. The subscription line is an efficient source of bridging capital for this purpose. It avoids calling capital from LPs only to return it once the co-invest occurs.

Subscription lines also provide other increasing flexibility to the benefit of fund and LP alike. They may allow a fund to draw letters of credit. They may offer multiple currencies, allowing a fund to use the facility to naturally FX hedge its investments. For funds holding multiple LP closes, a fund can draw the subscription line to prevent LPs having capital called and repaid numerous times to equalize the rights of new investors.

Could a fund obtain these advantages solely through short term borrowing? It is right to ask in the context of the IRR debate. The reality, though, is restricting longer borrowing flexibility will limit a fund's ability to be competitive and efficient. Funds are looking to develop competitive co-invest strategies and credit fund investment strategies, run efficient staggered fund closings, use letters of credit and mitigate fluctuating hedging needs. These require flexibility to borrow longer than a short term capital call bridge.

Use of subscription lines of course has pros and cons. But the benefits are worth remembering.

Thomas Smith is a partner and Almas Daud is an associate at Debevoise & Plimpton LLP