

Client Update

Funds Finance Focus: Impact of the ILPA Guidance

The use of fund-level subscription line facilities by private equity funds is currently in the public spotlight. Generally speaking, a subscription line facility is a loan, arranged by the general partner (GP) or manager of a fund, provided by one or more lenders to the fund, with security for the loan given over the right of the fund to call capital from LP investors. The size of any such loan is a proportion of uncalled capital commitments from time to time.

On June 27, the Institutional Limited Partners Association (ILPA), an influential trade association for institutional LP fund investors, entered the fray. ILPA published its “considerations and best practices for limited and general partners”. This update considers ILPA’s recommendations and their impact for LPs and GPs.

WHAT DOES ILPA RECOMMEND?

ILPA recognizes the benefits of lines of credit to cash flows of GPs and LPs, but seeks to address concerns of some LPs (not all LPs have concerns) about the use of subscription lines. It makes a number of recommendations to LPs investing in a fund which may use a subscription line. The recommendations focus on transparency and disclosure:

- **Disclosure** – GPs should give more information to LPs as part of quarterly reports, such as:
 - Disclosing the size of such facilities (dollar amount and percentage of fund uncalled capital), use of proceeds, costs of interest and fees, amount drawn and number of days outstanding of each drawdown; and
 - Reporting net IRR with and without the use of the facility, to address differences in reporting standards across funds.

In addition, disclosure of investment details should not lag execution of a deal if capital calls are delayed by use of a facility for the acquisition.

- **Parameters on Use of Facilities** – LPs could request or discuss reasonable limits and parameters in a fund’s limited partnership agreement (LPA) on use of such facilities, such as:
 - Limiting the facility size to 15-25% of uncalled capital;
 - Limiting drawdowns to up to 180 days;
 - Limiting final maturity date for a facility (although ILPA prefers that facilities are not “on demand”);
 - Requesting disclosure of the terms of the facility if and when entered into;
 - Considering whether it is appropriate to secure facilities over invested assets of the fund in addition to LP commitments; and
 - Considering whether it is appropriate to limit total interest expense.
- **Waterfall** – The distribution waterfall provisions in LPAs should align with the date that the subscription line is drawn rather than when capital is called from the LPs. We consider this in more detail below.

WHAT IS THE LEGAL AND PRACTICAL EFFECT OF THE GUIDELINES?

ILPA is a trade association and its recommendations have no legal effect.

However, ILPA has a far-reaching LP membership base and its recommendations are essentially a negotiation resource for LPs. It will be interesting to see whether ILPA’s recommendations are raised in LPA negotiations as GPs look to raise new funds. Their practical effect will depend on the relationship (and strength of bargaining position) between individual LPs and GPs case by case.

ANALYSIS OF THE GUIDELINES

- **Context** – ILPA, as a trade association for LPs, has of course focused on the LP perspective. The guidelines should be read in that light. The ILPA guidelines are unlikely to create a new market norm for LPs and GPs alike. Rather, they will inform some LPs in negotiating investments in funds and assist some LPs on one aspect of their decision-making regarding whether to invest in a fund.
- **Disclosure** – Given recent discussion among LPs on the need for greater transparency (such as visibility over the effect of subscription lines on IRR), it is understandable that increased disclosure is ILPA’s key focus. Some additional disclosure may be acceptable to some GPs, provided it is reasonable in scope and administratively workable in practice.
- **Parameters on Use of Facilities** – Imposing limits on scope and use of subscription lines goes one step further than increased disclosure requirements. The recommendations

regulate a GP's discretion to manage the fund in the ordinary course. Subscription lines are already subject to parameters imposed by market conditions – for example, facility size is limited by lenders' credit requirements. Equally, GP and LP interests are already aligned with respect to managing interest expense (i.e., that interest expense should be no greater than necessary in current market conditions). Imposing certain limits may not be in the interests of the fund or its LPs – for example:

- If a fund wishes to move quickly to make a large acquisition, the fund may not have sufficient credit, if its facility size has been capped, to bridge capital calls for this purpose; and
- Limiting final maturity date of a facility may cause the fund (and its LPs) cash flow issues down the road. Logically, it is preferable to have a committed multi-year revolving line in place, rather than a facility expiring every year and rolled only if a bank is willing to extend the loan at the end of its term.

We expect consideration of parameters on use of facilities will ultimately be a matter for negotiation between GPs and LPs.

- **Waterfall** – In a typical LPA waterfall, the order of preference of payments of distributions from investments is as follows – first, an LP's capital is returned to the LP; second, an LP receives “preferred return” on its invested capital; third, there is a distribution to the GP to catch up to the agreed profit share; fourth, further profit is shared between GP and LPs in the agreed profit share. ILPA suggests that LPs are deemed to have contributed capital for the purpose of calculating “preferred return” from the date that the subscription line is drawn rather than the date an LP contributes capital (because use of a subscription line may delay an LP contributing capital). Conceptually, this would mean an LP is paid “preferred return” on cash that it has not contributed (and which it could use elsewhere to make a return). GPs are less likely to consider this change to be reasonable than LP requests for increased disclosure.

LOOKING FORWARD

Certain LPs may raise the ILPA guidelines in negotiating investments in new funds. Looking forward, other trade associations in the market may follow suit and issue guidance.

At present, GP practice with respect to use of subscription lines is in part guided by regulatory considerations and in part a matter of negotiation between LPs and GPs. Following issuance of the ILPA guidelines, possible changes in practice remain firmly an LP/GP negotiation point.

HOW CAN WE HELP?

Debevoise & Plimpton LLP has an international funds, funds finance and regulatory practice and so is ideally placed to answer queries and assist with developing market practice on this topic.

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