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FUNDS

Mega-funds and their mega-financings

Co-ordinating large subscription lines for mega-funds presents a unique set of challenges, write Debevoise & Plimpton's Thomas Smith and Felix Paterson

The private equity fundraising market is booming – with sponsors raising over $450 billion from investors in 2017. Both the number, and size, of funds being raised is increasing. In this context, so-called 'mega' buyout fundraisings (considered to be funds with assets of at least $4.5 billion) are more and more prevalent. These mega-funds alone raised more than $170 billion last year.

At the same time, use of fund level subscription lines by private equity funds is increasingly popular. While, historically, many of these facilities were relatively small in absolute money terms, the flexibility and liquidity they provide sponsors (and their investors) has led to an increase in their prevalence and size. For mega-funds, their subscription line needs may be much too great for a single bank to underwrite – rather the fund may need to find a club of up to as many as 20 lenders. This dynamic presents different challenges in a market where bilateral relationship loans dominated. Here are some practical solutions to ensure smooth execution:

1 APPOINT A LEAD BANK AS A DOCUMENTATION CO-ORDINATOR

In an ideal world, a mega-fund sponsor would negotiate a subscription line with only one lender. This is not possible if the subscription line is so large that one lender cannot underwrite the total commitments. Rather, the sponsor must negotiate individually with each member of the lending 'club'. To streamline the process, it is helpful to have an experienced lender as a documentation co-ordinator. The documentation can first be agreed with them, and then presented to the wider banking syndicate. This should minimise comments from the rest of the club. With fund finance seen by lenders as an appealing area in which to deploy capital, 'new' lenders (i.e., those with little prior fund finance experience) are increasingly entering the market. In that context, it is helpful to agree a 'first round' subscription line with an experienced lender, before extending the negotiation to multiple lenders with varying levels of experience.

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2 THE IMPORTANCE OF PRECEDENT

Private equity firms raising mega-funds are likely to have a long fundraising history, and have put in place subscription lines for prior funds. When negotiating with a very large number of lenders, a precedent assumes greater significance. It is commercially imperative for a sponsor that the subscription line terms to be no less favourable than its preferred precedent. This benchmarks the precedent as a base position for negotiations – and avoids protracted negotiation with multiple lenders at full form documentation stage.

3 FOCUS ON FUND DOCUMENTS

Finance counsel review should be an integral part of the drafting and negotiation of the governing documents (especially the limited partnership agreement and investor side letters). One of the key credit considerations for lenders when considering providing a subscription line is the contractual relationship between a fund and its investors (and, in particular, the investors' obligation to contribute capital when called to do so). The fund »

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» documents should anticipate and provide for putting a subscription line in place. With more lenders, there is more scrutiny on the fund documents, as they must be acceptable to even the most conservative lender in the club.

4 NEGOTIATE AT THE TERM-SHEET STAGE

Subscription lines, historically, were often characterised as 'relationship loans' between a sponsor and single lender. Once the subscription line was put in place, it was relatively easy to obtain the lender's consent to amend. Large club transactions are a material shift away from this model. Amendments require at least consent of a majority of the club (this generally means two-thirds in the European market and more than 50 percent in the US) and changes to key economic and certain other fundamental terms will require consent of all lenders. For a sponsor, the initial commercial terms must therefore meet its needs because it may be difficult, slow and expensive to obtain post-closing facility amendments from a large banking group. A sponsor's negotiation position is strongest at term sheet stage, before the sponsor has designated the lenders. Sponsors should therefore spend time negotiating fulsome terms at term sheet stage with lenders individually – although this sounds cumbersome, it makes the full form documentation stage more efficient.

5 UNDERSTAND RECENT MARKET TRENDS

Fund finance is an evolving product. It is important to accommodate the latest market trends in mega-fund financings as the sponsor may not be able to change financing terms after closing. A few hot topics include:

Investor transfers

Lenders' credit support is largely focused on fund investors' uncalled capital commitments. The investors' identity goes to the value of the lenders' security. Lenders therefore often seek control over the transfer of investors' interests, and historically subscription lines often contained covenants limiting LP transfers without lender consent. However, this must be weighed against investor views – which have recently been voiced loudly (among others, by the Institutional Limited Partners Association in its 2017 guidelines on subscription lines). A blanket restriction on LP transfers without lender consent is likely to be unacceptable to investors. It should be possible to negotiate a middle ground that works for both parties – i.e., that LP transfers are not permitted if the transfer would cause the amount drawn under the subscription line to be greater than the LP commitments borrowing base. This approach allows the sponsor to retain control over transfers (as it can pay back the subscription line as necessary to avoid a lender veto right).

Side letters

It is common to address specific investor issues in a side letter. Their provisions are increasingly complex and may adversely affect the lenders' recourse to the uncalled capital commitments of the fund. The fine detail, and impact on subscription line lenders, must be considered as part of the negotiation process with funds' investors. This avoids the risk that side-letter terms inadvertently cause an investor to be excluded from the borrowing base, or worse still, prevent a subscription line being put in place at all.

Lender transferability

Lenders gain privileged access to private equity funds' governing documents, information in relation to performance and other information provided to funds' investors. It is imperative for sponsors to protect their discretion over the identity of their subscription line lenders. The intent is to avoid the risk that a competitor gains access to this confidential information. The concern is exacerbated for mega-fund financings with multiple 'day one' lenders. Sponsors, particularly in mega-fund financings, are increasingly focused on restricting lender transfers.

Increase mechanisms

Flexible 'facility size increase' mechanisms in subscription lines are particularly important for mega-fund financings with a large banking club. Sponsors often put a smaller facility in place around the fund's first close, but wish to increase subscription line size as new investors commit. It may be possible to negotiate flexibility, allowing the sponsor to increase its facility on multiple occasions without any further existing lender consent, with the increase amounts provided by either existing or new lenders (at the sponsor's discretion).

The need for mega-fund financings is growing, as fundraisings get bigger. Involving multiple lenders in a subscription line presents its own set of commercial, regulatory and administrative challenges. Forewarned is forearmed.

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