

PRIVATE DEBT INVESTOR

FOR THE WORLD'S PRIVATE DEBT MARKETS

What you need to know about sub lines for SMAs

Subscription lines are used by many multi-investor funds, but what do you need to consider when applying a sub line to a single-investor account? **Leon Stephenson** of Reed Smith explores the key issues, together with **Tom Smith** and **Felix Paterson** of Debevoise & Plimpton

Single investor vehicles, commonly referred to as separately managed accounts or "SMAs", rose in popularity in the aftermath of the financial crisis. They enable institutional investors, which are willing to write substantial cheques, to create a customised investment programme that is managed by a single sponsor, typically on a discretionary basis. This is often on bespoke terms, including more favourable economic terms to the investor than those of a typical pooled investment fund.

Some SMAs principally invest directly in one or more funds sponsored by the manager of the SMA, while others provide greater flexibility to co-invest alongside funds sponsored by the SMA manager, or directly in deals outside that manager's fund investment strategy. SMAs have the flexibility to craft an investment strategy tailored to individual investor needs.

Commercial rationale for subscription line facilities ("sub-lines")

There are multiple commercial reasons for an SMA to use a sub-line, i.e. a revolving credit facility at fund level from a third-party lender, with security given by the fund to the lender over the right to call investor commitments from its limited partner investor(s), similar to the rationale for their use by a multi-investor fund.

Historically, sub-lines have been used for two main reasons: cash management and efficiency. An SMA may require liquidity on a frequent basis for fees, expenses, servicing hedging needs and other non-investment liabilities.

SMAs may also have other specific needs for which a sub-line can provide flexibility. For example, access to funding on one business day's notice may provide a competitive edge in an auction process. Speed of funding, in our experience, is particularly important for direct lending funds or other credit funds that need to deploy capital frequently and quickly. SMAs may wish to draw a sub-line in different currencies to align the source of funding to the investment currency.

Single investor sub-line considerations

One of the key credit considerations for lenders when considering providing a sub-line is the contractual relationship between a fund and its investors, in particular the investors' obligation to contribute capital when called. In the case of SMAs, where there is only a single investor, these considerations are amplified. Lenders will more closely scrutinise

the partnership agreement and side letter between an SMA and its investor. These fund documents need to expressly authorise the SMA to incur debt, and its general partner or manager to give security over undrawn capital commitments and the SMA's drawdown accounts.

To address the greater exposure lenders have to a single investor in an SMA, it is common for lenders to require that the investor enter into an "investor" or "comfort" letter. In this letter, the investor may acknowledge and agree to the sub-line. The investor may also give representations and covenants to the lenders - that it has authority to enter into the investor letter, confirming that it is aware that security will be granted over undrawn capital commitments (and associated remedies) in favour of the lenders, and that it will honour drawdowns made by the general partner or manager. This letter creates a direct contractual relationship between the investor and the lenders. As such, it reinforces the lenders' collateral.

Sponsors should consider negotiating any side letter with an SMA investor with lenders in mind. Lenders to an SMA will focus on provisions that could adversely affect the creditworthiness of the SMA. Side letter provisions subject to extra scrutiny include:

1. Transfers

Some investors seek enhanced flexibility in connection with the transfer of their interests to third parties and/or affiliates. They may require that the sponsor consents to any transfer. In a multi-investor fund, this is less of an issue - if the transferee is not sufficiently creditworthy for the lenders, the lenders may simply reduce the amount they are willing to lend under the facility proportionately. In an SMA context, there is significantly increased concentration risk. Lenders may require that the SMA investor does not transfer its capital commitments unless either the investor first pays capital to the fund to repay outstanding borrowings, or the lender approves the identity of the transferee. These provisions should be built into the SMA investor side letter as necessary to avoid issues with the financing.

2. Withdrawal rights

Side letter provisions, permitting the investor to unilaterally withdraw from the SMA, are also problematic. Again, the investor may need to agree to contribute sufficient capital to repay sub-line debt prior to a withdrawal.

3. Information requests

Investors in co-mingled funds sometimes seek to limit their obligations to respond to lenders' information requests or other documentary requirements. In SMA financings, lenders may only get comfortable providing the financing if they have sufficient information from the SMA investor, so there is a balance to be struck on a case by case basis.

Lenders approach to SMAs

Not all lenders are comfortable providing a sub-line to an SMA. Some lenders require diversity of investors, so that if one investor fails to pay capital calls, there is recourse against other non-defaulting investors, through overall rights. However, it becomes much easier for a lender to get comfortable with the credit analysis of an SMA financing if the SMA investor is a well-known, highly rated entity that may also be a client of the lender. Large investors, such as state pension plans and sovereign wealth funds, with enormous amounts of capital deployed around the world, are more likely to honour capital calls to avoid impact to their reputation.

A key initial lender (and lender counsel) diligence question is whether the ultimate investor is investing directly into the SMA or through SPV entities. If the latter, the lender will need to diligence the creditworthiness of the SPV. If the SPV is not creditworthy on a standalone basis, it will be important for the ultimate investor, or another sufficiently rated affiliate, to provide "investor letter" comfort that the SPV investor will satisfy its capital commitment obligations. In addition, lenders may periodically need updated information on the financial status of the investor if that investor does not have a public credit rating.

Provisions of SMA sub-lines

SMA sub-lines (and related investor letter) will contain certain provisions different from a typical sub-line to a multiple investor fund. For example:

There will not be a borrowing base, or concept of included or excluded investors. Rather the lenders will take the commitments of the SMA investor and apply a single advance rate or financial covenant, with respect to the amount of debt the lenders will provide against that SMA investor. If the investor defaults on capital calls, or becomes subject to other "exclusion events", this will trigger an event of default and/or mandatory prepayment of the full amount of the facility.

1. Some lenders may request additional "exclusion events" such that a certain downgrade of credit rating of the investor will also trigger mandatory prepayment or event of default.
2. Inclusion of a covenant prohibiting the general partner or manager of the SMA to consent to the investor transferring its commitment, unless the lender consents or there is no debt outstanding under the sub-line.
3. The investor letter may require a waiver of the investor's ability to claim sovereign immunity to circumvent its obligations to pay capital commitments.

4. There may be a requirement, or an obligation on the general partner or manager, to use best efforts to ensure that the investor acknowledges any notification sent to the investor confirming security has been given over the right to call its capital commitments.

Lender concentration risk "hair-cut" protections are not relevant to a sub-line on the creditworthiness of one single investor.

SMA umbrella facilities

An SMA "umbrella" agreement is a facility that allows separate, multiple, SMA sub-lines to be documented quickly and efficiently based on common terms and conditions agreed between the SMA sponsor and a group of lenders. At the outset, the sponsor and a group of its key lenders likely to finance the sponsor's SMAs will agree "umbrella" terms which would govern individual SMA facilities as and when they are put in place, with key commercial terms for those individual facilities supplementing the umbrella terms.

The key commercial terms for individual SMA facilities are included in a "facility request", which adopts the overarching legal terms contained in the umbrella agreement and amends or supplements those terms, agreed on an SMA-by-SMA basis.

One key question is whether the same group of lenders will finance all SMA facilities under the umbrella. If not, the terms of each facility request should remain confidential between those lenders actually financing a particular SMA. Legal counsel acting for the fund and lender group should adopt practices to ensure this information is tightly monitored.

The future

More recently, there has been a significant increase in SMA structures set up by private funds to accommodate larger investors' needs. This has led to a marked growth in SMA financings, as funds obtain financing against such commitments. As SMA financings become more popular, it is important that sponsors negotiate fund documents that give sufficient comfort to lenders to ensure financing can be put in place, and that lenders develop practices that appropriately deal with the nuances of single investor financings. Development of a market practice in this manner will both assist sponsors and their lenders in explaining to SMA investors why additional requirements, such as an investor letter and/or periodic financial information, are necessary, and consequently to quickly and efficiently negotiate an SMA fund level financing.

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