KEYNOTE INTERVIEW

Subscription lines' ESG evolution

While covid-19 has shone a spotlight on liquidity, ESG-linked innovation is continuing to emerge in the fund finance market, say Debevoise & Plimpton partners Thomas Smith and Pierre Maugüé

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Q What trends are you seeing in the subscription line facilities market for funds?

Thomas Smith: Some trends are driven by the circumstances around covid-19 and funds looking for sources of liquidity. Pre-covid, the market for subscription lines was buoyant, with an increasing number of sponsors putting in place sub lines, and more and more lenders entering the market.

When covid-19 hit, sponsors' immediate reaction was to look for pockets of liquidity, both through sub lines and other types of fund-level financing, such as net asset value facilities. The question for sponsors around sub lines was, would the banks still be there to lend and would the market hold up? The question for banks was whether LPs would continue to fund capital calls.

Thankfully, we saw no defaults by LPs into funds, lenders remained open to the fund finance market and raising of sub lines remained robust through the pandemic. Although some lenders retrenched a little, others stepped up to take market share, so growth in the fund finance market has continued.

Pierre Maugüé: We spent part of the spring reviewing subscription line facilities to analyse the risks that would result from defaults by LPs in the event of capital calls, summarising the default triggers and looking at what would happen if more than a certain percentage of LPs failed to fund a capital call.

However, those concerns did not materialise. As a result, there has just been a minor change in the perception of the risk, which has meant pricing has increased slightly but remains low. Pricing adjusts to market conditions quickly, so if there is a large second wave there is going to be pressure on pricing again but that will pass as things stabilise.

For a while we were also concerned that it would become difficult to extend facilities at the end of their term, but sponsors have been able to do that, sometimes with a small price increase but not always.

Q How has the pandemic impacted that market?

TS: The only real change of substance of capital call facilities was an impact on the pricing; pricing jumped a little because of lenders' additional costs of capital. We are already seeing pricing coming down and, subject to ongoing covid-19 impacts, we expect that to continue, so we do not see that jump in pricing as permanent.

Another significant change is the growth in NAV facilities, where sponsors have been looking for additional liquidity and lenders have stepped up. This is a trend that we expect to continue as the private equity NAV lending market and structures have evolved through the last six months.

Q What environmental, social and governance-related developments are occurring in fund finance?

TS: Around a year ago, ESG had not yet reached capital call facilities. The big bang in ESG financing was a deal we advised on in June. We acted for a private equity fund in a new €2 billion-plus subscription line facility that incorporated ESG mechanics, and which was signed up to by a large club of lenders. If the sponsor successfully improves certain ESG metrics of its portfolio companies, the margin on the facility will go down, and if certain metrics are not met, the margin will go up.

The deal was among the first of its type and remains the largest of its kind. There have been a couple of other similar deals done since, and we see that market growing because LPs are very focused on encouraging GPs to do more and sponsors are themselves looking to improve their ESG approaches.

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> **THOMAS SMITH**

The real advantage of putting in place a capital call facility with ESG mechanics is that it institutionalises the focus on ESG for a sponsor. The benefit from the margin adjustment encourages the deal teams to improve ESG metrics in the portfolio companies so everyone in the firm becomes focused around that objective.

It is also interesting to see banks' views on ESG-focused facilities changing. You could argue this could be of less interest to banks than it is to sponsors and LPs, but a lot of lenders are seeing the benefits as well. Everyone is aligned and we are being inundated with enquiries about these kinds of deals.

Q What are the attractions of ESG mechanics, and how do you expect them to evolve?

PM: For sponsors that are serious about ESG, adding ESG mechanics to a subscription line facility is a tool that allows them to demonstrate that commitment.

The purpose is not to limit the type of investment the fund can make. The fund is meant to invest in private equity assets and make money. ESG provisions in a subscription line facility are not intended to require a fund to pass up investment opportunities. Rather, they are designed with a focus on ensuring the sponsor improves ESG metrics post-investment, which means these deals are very bespoke.

TS: This is clearly a mechanism that is conducive to private equity, but it could potentially even work for a credit fund that does not have control over the underlying asset. We are exploring ways to do that, and we see this expanding through the whole sponsor market.

The subject of ESG is broad and the sponsors can choose what makes sense in terms of ESG metrics. On some deals we have seen the sponsor focusing on one issue to do with the environment, one social, and one governance. The metrics have the potential to be very complex, so it is better to look to narrow the focus of the ESG tests.

PM: While the tests can be complicated, if the sponsor is already advanced in its thinking about ESG and has developed guidelines and metrics, creating the facility is simply a matter of adapting what already exists.

Q How has the pandemic affected GP and LP perspectives on fund finance?

TS: Pre-covid, many LPs were very positive about sub lines and some not so much. The trend seems to be towards LPs becoming more positive about their use. We have not come across any recent material misalignment between GPs and LPs when looking to provide for flexibility in fund documents for a sponsor to raise a capital call facility. One thing the covid-19 crisis has shown LPs is that there are benefits of having some form of capacity for liquidity at the fund level.

PM: The focus has shifted to whether limited recourse fund-level financing should be allowed. That will be the next discussion, alongside whether sponsors will start asking for longer maturities on subscription facilities and will be prepared to pay a bit more in exchange for a longer maturity. ■