

Fund Finance Friday



The Intersection of Overall Limitations and the Investor Default EOD Trigger

April 26, 2019 | Issue No. 26



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The subscription facility (each, a “facility”) market has for ages included an event of default trigger tied to a certain percentage threshold of investors failing to timely fund their capital calls (going forward, the “Cumulative Default EOD”). A typical Cumulative Default EOD would be triggered if 10-15 percent or more of the investors are delinquent on capital calls for longer than, say, five business days from the date due. Lenders, of course, underwrite facilities with the expectation that the credit wherewithal of unaffiliated investors is minimally correlated. Thus, the purpose of the Cumulative Default EOD is to function as an early warning signal and protect the lenders if something is going systemically wrong with the fund and/or the investor pool. The 10-15 percent threshold is seen so frequently that it is hard to argue it is not a market standard. But should it be?

A lot has changed since that standard was developed. The Facility product grew up in the real estate space where there were historically hardly ever overcall limitations in fund partnership agreements. Over time, and as the product has permeated buyout and other asset classes, overcall limitations have become far more prevalent. And overcall limitations have a direct linkage with a transaction’s Cumulative Default EOD. That linkage often appears to be overlooked.

For example, consider a hypothetical transaction with an exceedingly tight overcall limitation: 20% of the original capital call. That is, if an investor or investors defaulted on a capital call, the fund is authorized to call upon the non-defaulting investors to make up the shortfall, but only up to 20% of the amount of their original capital call. Assume the Cumulative Default EOD percentage in the credit agreement is set at 20% of aggregate Capital Commitments (admittedly, off market on the high side, but helpful for an illustrative example). Below is a calculation of how this could play out. Assume the following:

\$100,000,000	Aggregate Capital Commitments
\$100,000,000	Aggregate Unfunded Capital Commitments
\$65,000,000	Facility Borrowing Base
\$20,000,000	Loan to Acquire the Initial Investment
\$20,000,000	Capital Call Made to Repay Loan
18%	Investors Default on Capital Call

\$16,400,000	Capital Call Proceeds Received from Original Capital (\$20,000,000 x 82% = \$16,400,000)
\$3,280,000	Overcall to Non-Defaulters, capped at 20% (\$16,400,000 x 20% = \$3,280,000)
\$19,680,000	Total Capital Contributions Received to Repay Loan (\$16,400,000 + \$3,280,000 = \$19,680,000)
-\$320,000	Deficit Owed to Lenders (\$20,000,000 - \$19,680,000 = \$320,000)

This example illustrates that, with an overcall limitation threshold set at 20% of the prior call, the fund and lenders are out of the money if as few as 18% of the investors default. But what if the Cumulative Default EOD threshold was set at 20%? The Cumulative Default EOD would provide the lenders no utility in our example.

Thus, Cumulative Default EOD percentages, to truly function as an early-warning signal, should always be set with an understanding of the inflection point at which an overcall limitation could keep the lenders out of the money (for a 30% of prior call overcall limitation, the investor default inflection point is just over 23% and for a 50% of prior call overcall limitation, the inflection point is around 33.3%). If the Cumulative Default EOD percentage is not set well inside the overcall limitation inflection point, it offers the lenders little benefit.

Interestingly, a minority of banks in the United States that have historically banked the venture capital and buyout community have set their Cumulative Default EOD percentage at 5% of total commitments. Perhaps they have this credit analysis more rightly sized than the market as a whole.