Management Fee Lines: Just Like Subscription Lines, Except Different

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By **Kurt Oosterhouse**
Partner | Fund Finance

In-person client presentations have taken a hiatus in the last year plus, but when they were occurring, the question, "Are you seeing a lot of management fee lines these days?", would always come up. The answer to that question has been: "They are still not that common, but we are starting to see more." Gaining momentum is still the correct answer. That trend has continued through the hiatus, and while we are not yet willing to say that they are common, we certainly continue to see a higher percentage of them.

With that being the case, it would be valuable to once again take a look at management fee lines − what they are, what they are not, and what are (or should be) the underwriting pillars of a loan to a management company.

Fund Finance Friday has already covered the "micro" nuts and bolts issues surrounding management fee lines of credit ("Management Fee Lines"), so the goal here is to provide more of a "macro" view of how we, on the legal side, think about Management Fee Lines from a legal/credit/conceptual perspective – more of a 101-level approach than a graduate-level approach.

From a credit/conceptual perspective, subscription lines of credit ("Subscription Lines") and Management Fee Lines are typically covered by the same bankers and they are both loans "to private equity funds," but, from our perspective, that is mostly where the similarities end.

What is a Management Fee Line and how is it different than a Subscription Line? How are Management Fee Lines and Subscription Lines different (and similar) to the other types of loans made by lenders to not only private equity funds but also to goods and services companies?

Management Fee Lines v. Subscription Lines

There are clear structural differences with respect to who is the borrower/provides the credit and what the collateral is, as well as obvious (or not so obvious) credit/conceptual differences with respect to how a lender is repaid with respect to Management Fee Lines and Subscription Lines. In a typical Subscription Line, the borrower is a fund, whereas in a Management Fee Line, the borrower is the general partner or management company of a fund (or, typically, a series of funds) (collectively, the "Management Company"). The collateral in a Subscription Line is the uncalled capital of the investors in the fund and the collateral in a Management Fee Line is the *operating income/cash flow* of the Management Company – the income it generates from managing the fund.

Management Fee Lines and Subscription Lines v. General Corporate Lines of Credit

Different institutions and law firms alike categorize the loan business differently (business sectors versus loan size, etc.), but at the most basic level, there are three types of loans: (i) investment grade/unsecured facilities ("IG Facilities"), (ii) asset-based loan facilities ("ABL Facilities") and (iii) non-investment grade/secured facilities ("Cash Flow Facilities").

Here is a 30,000-foot level summary: (i) IG Facilities are to very good companies with large balance sheets with very little repayment risk to the lender and thus a low interest rate; (ii) ABL Facilities are to companies, but they are secured only by the assets being financed (typically, not "all assets"), with some type of borrowing base and advance rates set to assume an adequate collateral cushion such that the lender will have very little repayment risk and thus an interest rate reflective of the quality of the collateral (not necessarily the quality of the borrower); and (iii) Cash Flow Facilities are to companies that typically have a higher level of debt when compared to earnings and/or a new or uncertain credit history. While a lender is typically secured by all material assets of the company in a Cash Flow Facility, the liquidation value of the assets of the company would not necessarily cover the amount of the facility, and the lender is primarily looking to the cash flow from the operation of the business as the primary source of repayment. As a result, a Cash Flow Facility will have a higher interest rate since the ultimate repayment risk to the lender is much greater than an IG Facility or an ABL Facility.

In the early years of Subscription Lines, the parties involved would have likely viewed them as IG Facilities, since, although they were secured by the uncalled capital of the fund, they were primarily relationship loans reserved for only the premier private equity clients of a lender. In that way, and in that day, Subscription Lines would arguably have been seen as an extension of a lender's cash management services as well as an accommodation to facilitate a lender's ability to secure future loan activity, especially the more lucrative acquisition finance business from those private equity clients. Any risk of non-payment was further reduced when viewed against the reputational damage such an event would have on a premier private equity client, not to mention its ability to continue to access financing.

Today, Subscription Lines are more akin to ABL Facilities. They have a borrowing base reflective of an advance rate on the collateral (uncalled capital), and the credit risk is somewhat (but not completely) divorced from the business of the fund. It was often said that lenders of traditional ABL Facilities don't care about the business of the borrower; they only care about the collateral being financed and whether, upon liquidation, they would be paid in full. Similarly, a fund is not an operating business in the traditional sense, and while the success of the fund certainly serves as an incentive for investors to fund capital commitments and a potential secondary source of repayment, a Subscription Line lender is not primarily looking to the cash flow of the fund as a significant source of repayment.

Historically, Management Fee Lines would have also been similar to IG Facilities – premier sponsors had the balance sheets and creditworthiness to repay their loans, and reputational damage would have been a critical motivation to avoid any loan shortfall. Today, Management Fee Lines would be characterized as Cash Flow Facilities. Relationships are still important, but few would view Subscription Lines as lender "accommodations" to premier private equity clients or simply a means to drive financing of the acquisition business of those clients.

The comparison isn't perfect, but conceptually, it's better to view Management Fee Lines as fitting the profile of a Cash Flow Loan than an "ABL Facility like" Subscription Line – offices and printers are leased and the lender is dependent on the Management Company receiving payment for its services to repay the loans. Subscription Lines and Management Fee Lines are both to a private equity enterprise (one to the actual fund, the other to the Management Company of the fund), both are secured, and the Management Fee Line may even have covenants that monitor the value of the collateral (*i.e.*, the operating income/payment streams from the funds), making it seem similar to a Subscription Line. However, at its core, a Management Fee Line is very different. Unlike a Subscription Line that relies on a pool of collateral somewhat distinct from the operations/performance of the fund, a Management Fee Line's primary source of repayment is the cash flow of the operating business of the Management Company, similar to a Cash Flow Facility.

As a result, access to the "cash flow collateral" is directly dependent on the performance history, management experience, and continued operational viability of the Management Company. Even more so than a Cash Flow Facility to traditional operating company where there is likely some liquidation value (assets or "enterprise value" even for service business), in the context of a Management Company, even if the Management Fee Line is secured by "all assets," the reality is that its customer base (and accounts receivable) is only as varied as the (most likely affiliated) funds it manages. In addition, with respect to enterprise value, it's unlikely that a Management Company could be sold as a going concern or maintain its only assets of value – the management contracts and the professionals who perform the services with the funds.

While the foregoing may come across as a negative assessment of Management Fee Lines, that isn't the intent. For many reasons, including strong performance history, significant management experience, and sustained operational success, Management Fee Lines can provide a lender with a very high probability of repayment, no different than the thousands of Cash Flow Facilities that are made to operating companies every day. The point is that they are strikingly different from Subscription Lines and should be viewed and reviewed accordingly.

FFA NextGen – 'Spreading the mESsaGe: ESG's Rise in Fund Finance'

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By **Katie McShane**
Special Counsel | Fund Finance

FFA NextGen hosted a live webinar about ESG's rise in Fund Finance earlier this week. The event was moderated by Annabella Kwei (Citi), and the panelists included Christopher Spitzhoff (Carlyle), Jose Liz-Moncion (Bank of America), Harlin Singh Urofsky (Global Head of Sustainable Investing at Citi Private Bank) and our very own Wes Misson (Cadwalader).

The panel discussed a broad range of topics about ESG in Fund Finance, including an overview of the types of facilities used and the factors that parties look at when determining pricing. Chris also provided a recap of the recent $4.1BN ESG-focused facility with Bank of America as the sole lead arranger, which was the largest-ever ESG-linked facility in the U.S. to date. Harlin provided her insightful view about greenwashing and also about some of the major factors that propelled the incorporation of ESG in the private and public markets in recent years. Jose provided an interesting rundown of how lenders are implementing KPI monitoring for ESG-linked facilities. Wes also discussed the regulations that are in the works to address ESG compliance and also some of the main trends in the market today. The panelists closed by sharing some advice to the young professionals who are interested in pursuing a career in law or finance with an ESG focus.

With ESG being at the forefront of investors' minds nowadays, the discussion was particularly interesting in that it covered how fund managers, bankers and attorneys are each adapting to the shift in the marketplace.

Notable in NAV: PitchBook Examines Accounting Fair Value

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Fair value accounting, commonly used to value fund assets, tends to understate the true volatility in asset values, according to a research note published by *PitchBook*. While the findings are not new, NAV lenders may find the summary to be thought-provoking given their reliance on asset values.

Fair value accounting tends to smooth asset value changes due to the infrequency of such assessments (typically quarterly) and because GPs tend to act conservatively in reflecting changes in asset values to either the upside or downside. This tendency is understandable given the absence of frequent observable transactions in any particular asset, and, from a fund perspective, it aligns with the long-term investment horizon that funds typically operate in.

NAV lenders, however, don't exactly share the fund perspective. Loan tenors are often shorter than the remaining fund life, and the lender is concerned with being adequately secured at all times. It's a matter of first principles: lenders don't share in the upside in an investment and, therefore, have no interest in riding out the dips in value along the way. Instead, the NAV lender's priority is in accurately gauging the economic value of the assets in its borrowing base throughout the loan term.

The approach to de-smoothing returns highlighted in the *PitchBook* write-up may be more relevant to an LP's conducting historical analyses than to NAV lenders, but here's what we think lenders can take away. First, where possible, it may be helpful to supplement accounting fair value estimates with additional asset value inputs. Second, incorporating a lender appraisal challenge mechanic into the facility may be helpful to reconcile potential gaps between fair value and true economic value. Our Samantha Hutchinson examined lender revaluation negotiation points in more detail in a prior *FFF* **article**. Finally, at the portfolio level, lenders should pay attention to whether correlation and diversification assumptions rely on fair value inputs.

The *PitchBook* research note, which includes de-smoothed volatility estimates for some asset classes, is available **here** (subject to registration).

New Fund Fanatics Episode

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Scott Aleali and Jeff Maier hosted a new **episode** of Fund Fanatics this week featuring guest Max Cantor of Fox Rothschild LLP.

WFF Europe Event Announced

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WFF Europe announced a breakfast discussion event, titled “Raising Your Professional Profile,” which will be held on June 24 at 9 a.m. BST. For more information, click **here**.

Walkers Highlights Key Issues When Lending to Irish Funds

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In “Subscription Line Finance – Irish Funds,” Walkers provides an overview and comparison of the most common regulated and unregulated Irish fund types that they observe in the subscription line finance space. The article also covers some key lender considerations, including due diligence issues and structural features for lenders, and includes a one-page comparison of key features among the different Irish funds. The article is available **here**.

Carey Olsen Reviews Hybrid Deal Considerations in APAC

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Carey Olsen attorneys look at hybrid facilities through an Asia Pacific market lens in a **recent article**. Portfolio company change of control provisions and the lender’s ability to exercise security over shares are among the considerations highlighted in what are typically multi-jurisdictional financings.