Subscription Finance Loan Agreement Series — Part 1

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This is Part 1 of a series of articles in which we take a close look at some of the provisions and issues in loan agreements that are specific to subscription finance transactions. The commentary is based on LMA (*i.e.*, UK/European) forms of Capital Call/Subscription Finance Loan Agreements, rather than the LSTA (*i.e.*, U.S.) forms. Much of the commentary will be relevant to both but, where principles or considerations differ, this will be flagged in the relevant article. We hope you will follow the series and, to help you do so, the articles will as far as practical follow the same order as the loan agreement.

So we start with the parties.

The focus here is on the "borrower"/"fund" side parties. There are very few real issues or differences between the finance parties (*i.e.*, the "lender" side) and the issues around those parties in a subscription or capital-call financing or any other more standard "corporate" financing, so the commentary on that side is much more limited.

On the fund side:

This will start with the borrower (or borrowers). It will usually be the fund (or funds) which are making the investments being financed by the facility or an SPV or SPVs of those funds and will include any parallel funds or their SPVs. Just to note that depending on the jurisdiction of any fund borrower, that fund may or may not have a distinct legal "personality" and, in any event, in general it will act either through its general partner or manager and/or will be represented by them.

Then there are the guarantors. Three main issues to consider here. First, if the borrower is an SPV, then the fund owner of that SPV should be a guarantor. Second, if there is more than one borrower (in particular, parallel funds which are all borrowers) then all the funds should be guarantors of each other. If they are not, then their investors cannot all be counted in the same borrowing base or leverage-investor base and would have to be counted separately. This can and does happen, but it is a more difficult credit decision (and requires some further tinkering with the documentation). Third, if there is a feeder fund involved (and the investors in that feeder fund are to be counted in the relevant borrowing or leverage-investor base), ideally that feeder fund should also be a guarantor. One issue to be aware of – and that should always be very carefully checked with both "other" funds and/or feeder funds becoming guarantors – is that these funds have the necessary powers to become guarantors in their LPAs (or equivalent).

Next is the manager and/or the general partner (in their own capacities rather than as representatives of the fund). Occasionally, the necessity to include either of these separately as a party is queried. However, it is standard practice to include whichever of the general partner or the manager is primarily responsible for the operation of the fund or funds which are parties as borrowers or guarantors. Whether this is the general partner or the manager will depend on the particular jurisdiction and constitution of the relevant fund, and sometimes it is both. Their inclusion allows the finance parties to take comfort from the fact (among other things) that representations and covenants are made by the primary legal entity or entities responsible for "running" the underlying funds and, where this is an issue, for these to be coming from an entity which is a legal "personality." Sometimes, the manager or general partner may itself be a fund in which case consideration should be given to whether their own manager or general partner should be added as a party.

As with any other financing, there will usually be further provisions allowing additional parties to accede to the facility in any of the categories above. One point of difference between this type of facility and a standard "corporate" facility is that, in general, while parties can accede, there are usually only very limited circumstances in which parties can "retire" or cease to be parties. Where this is allowed, it is usually only in relation to the manager or general partner and then (if allowed at all) only if a suitable replacement becomes a party in their place. And a word here about "qualified borrowers": More common in U.S.-style documentation, these are entities which are permitted to borrow under a facility which contemplates more than one borrower but which, while they themselves are guaranteed by the other borrowers as guarantors, are not themselves required to become guarantors of the other borrowers. Such entities will accede as borrowers in the normal way (but not become guarantors).

So, that's pretty much it . . . except for two things and a final point below. First, the due diligence on the structure of the fund or funds which are to be parties has to be carefully done so as to ensure that every entity which needs to be a party to the facility is (and can be) a party. Second, the finance parties will need to have carried out and be satisfied with their own KYC, sanctions, credit and other checks on all the "fund side" parties.

And on the finance party side: As stated at the beginning of this article, there is little difference here between a subscription finance/capital-call facility and any other “corporate”-type facility. The only issue we would highlight here is the potential inclusion (or not) of hedge counterparties. Traditionally, funds had organised their hedging requirements outside the direct ambit of subscription finance facilities. But, over the last few years, it has become much more common for finance parties to include hedging in their offering for that to impact the borrowing base/leverage calculations and for such hedging to benefit in terms of pricing from being part of the secured debt. If this is part of the transaction, then the parties would usually want to ensure that the hedge counterparty is either included as a finance party in the facility agreement from the outset (along with the other finance parties) or there are suitable provisions for it to accede as such when the hedging is concluded.

Coming to Fund Finance: Current Expected Credit Losses

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By **Chris van Heerden**
Director | Fund Finance

SEC registrants, including banks, will be required to record allowances for credit losses at loan origination based on a life-of-the-loan loss forecast effective January 1, 2020, under an accounting standard that has been years in the making. FASB, **earlier this month**, revised the implementation schedule of its current expected credit losses ("CECL") methodology to allow "smaller reporting companies," as defined by the SEC, more time to implement the change in GAAP. The delayed implementation, however, applies to institutions sized below any participants in fund finance lending.

Having been in the works since 2016, the implementation of CECL may not be news. The new accounting standard nonetheless represents a sea change in GAAP because it replaces the existing incurred loss framework, which captures probable and estimable losses, with one based on forward-looking loss estimates. The thinking behind CECL came about after the financial crisis in response to what was perceived as a tendency towards "too little, too late" in banks' loss provisioning. The aim of the new standard is to improve transparency and extend the forecast horizon by requiring a model-based life-of-the-loan loss forecast at the time a loan is originated. (While we've focused on loans here, the application reaches to a wide range of credit assets.)

Concerns that are germane to the fund finance market have already been aired elsewhere in feedback to FASB and the SEC. There are operational considerations related to implementation, with the availability of through-the-cycle representative performance data being one. Beyond fund finance, concern has been raised over a potential increase in loss reserves at implementation and the follow-through effect on capital — banks that provided CECL impact estimates in Q1 and Q2 have generally shown increases in loss reserves. Regulators have been responsive by allowing banks to phase in implementation over three years.

Even so, the untested nature of the standard and the potential for pro-cyclical swings in reserves as the economic outlook shifts continue to be points of unease. The CECL framework breaks the lifetime loss estimate into a "reasonable and supportable" period component and a long-term mean loss estimate, leaving banks with discretion to define the appropriate period for each. This element of discretion risks introducing volatility in loss reserves and could cloud the comparability of financial results between banks.

Net, net, we think CECL may aid the relative attractiveness of subscription lending over other bank assets. Here, we particularly have longer-lived real estate, consumer and commercial assets and longer average-life securities in mind. Short loan terms and the revolving nature of subscription loans limit the effective life of the loan over which losses are required to be forecasted. The clean performance history of the product should be an additional benefit. We can envision a scenario where CECL, while challenging to banks overall, drive greater allocations of balance sheets to fund finance and bring more lenders into the space.

Abraaj Fined, Detailed Reconstructed Timeline Released

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The Dubai Financial Services Authority (DFSA) this week **announced** fines totaling $314.6 million against two Abraaj group companies for unauthorized activities and misusing investors' money. DFSA committed to consider the implications for fund investors prior to taking any actions to enforce the fines. Media reports have zeroed in on revelations that the fund manager prioritized making distributions to more vocal investors over "legacy investors" and "passive voices."

Of more significance to *FFF* readers will be the details on the use of recallable distributions under one fund's LPA to disguise flows out the fund to service the liabilities of other funds and to pay parent-company expenses. Further details show how the investment manager changed the fund's fiscal reporting period to prop up reported cash balances and sought to isolate LPs that asked difficult questions. The timeline reconstructed by DFSA can be found **here**.

What We are Reading on Private Markets

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Carlyle announced it would be abandoning its partnership structure and becoming a corporation with a single class of shares, expected to complete on 1 January 2020. Carlyle follows in the wake of other PE powerhouses who have made the switch to a C-corporation, including **Ares Management**, **KKR** and **Blackstone Group** following the passing of the 2017 U.S. tax law that lowered the highest corporate tax from 35% to 21%. Carlyle's single-share structure will however lend itself to inclusion in broad market indices which opens up a wider variety of potential investors.

Dyal Capital, best known for buying stakes in private equity funds, has now raised approximately $1bn to provide long-term loans to these funds, which want to raise liquidity but without selling a stake in their firms. The loans will be backed by management fee income streams. Watch this space to see how these loans sit with traditional fund finance products.

Glendower Capital has raised the largest first-time secondaries fund. The Deustche Asset Management spin-out has raised $2.7bn for Secondary Opportunities Fund IV, exceeding its $2.5bn hard-cap.

Oklahoma Teachers' Retirement Fund has appointed Meketa Investment Group to identify and correct errors in GP fee calculations, having noted at least four errors in GP reporting last year, ranging from carried interest to misreported capital contributions. This looks to be a continuing trend with LPs seeking external audit-type exercises on GPs to ensure that they are accurately reporting on the fee positions of the GPs they invest in.

Subscription Facilities Addressed on KKR Earnings Call

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Subscription facility borrowing is used for administrative ease, and performance is reported to LPs on a gross and an ex-facility basis, according to comments from KKR's CFO, William J. Janetschek, on the company's Q2 earnings call Q&A earlier this week. The comments perhaps illustrate growing attention being paid to the use of credit facilities and the interest in the potential effects on reported fund performance. A full transcript of the call is available **here**.

Player Profile - James Rock-Perring

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Player Profile

FFF: How did you end up in fund finance?

I started my career at Deloitte in South Africa before moving to the UK in 2000. Since then I have worked in the Sponsor Coverage/Leveraged Finance Teams at both Credit Suisse and Lloyds, and a move into the Lloyds Fund Finance team seemed like a natural progression given my PE relationships and Leveraged Finance background and experience.

FFF: How has the first half of 2019 shaped up compared to 2018?

Well, for me, it has been very different! I left Lloyds at the end of last year and in March joined Intertrust to set up their Fund Finance Advisory Team with Cliff Pearce (ex-BAML) and Andrea Williams (ex-Blackstone). It has been a challenging but rather rewarding few months, having met with a large number of sponsors whilst at the same time meeting with the many lenders in the Funds space. It has been a real eye-opener and very interesting to understand the differing appetites and niches across products and sectors in the lending space. From the sponsor perspective, it has been very pleasing to see their response and secure engagement on a number of deals in the first few months. Whilst I initially expected the focus to be Mid-Market managers, I am pleased to say that there is strong interest and traction not only in the Mid-Market to smaller/first-time managers space but at the larger end as well.

FFF: Are there any emerging issues that might prove relevant for the fund finance markets?

We all know there continues to be strong demand for all forms of fund financing facilities against the backdrop of record levels of private markets fund raising and the number of new lender entrants. This has in turn fuelled the need and emergence of a few debt advisors in the space. I am confident that the right advisor can work collegially with both lenders and sponsors to drive an efficient market. From the sponsor perspective, an advisor can help them navigate the lending market/product space and, from the lender perspective, I would expect an advisor to work in partnership to introduce new deals and help best service client needs.

FFF: Who has had the most influence on your career?

There have been many over the years. In my early career I was lucky enough to work for an extremely bright and dynamic individual who ended up as CEO of a large banking institution. More recently, I would say Stephen Quinn – bright, commercial, creative and someone who empowers people to make things happen. Although he did have 14 years of learning from me as well!!!

FFF: What do you think it takes to be successful in the fund finance industry?

It’s like anything – you need to work hard and be true to yourself about what is achievable. Above all, perseverance to be a market leader and work collegially.

FFF: If you could give the Fund Finance Association one piece of advice, what would it be?

I think they are doing a great job. Maybe more education pieces for distribution to Sponsors/Investors.

FFF: What do you like to do outside of the office?

Golf. These days that’s less and less! I have two young kids, a boy and a girl, so I really do enjoy spending time with them. But I do still try to find time to play some other sports and over-exert myself!

FFF: Tell us two truths and one lie about yourself?

I (i) used to be an actor; (ii) I fought in a war; and (iii) I started a surfing brand.

FFF: Any fund finance predictions for the rest of the year?

I am seeing more and more appetite for leverage, especially on the PE side in later life type facilities. More lenders/institutions are looking at this space as well.

Fund Finance Hiring

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Fund Finance Hiring

East West Bank is currently seeking a senior Relationship Manager for its Private Equity business in the Eastern U.S. The Relationship Manager will work with other relationship team members in sourcing new business, structuring and underwriting loans, and managing relationships with a variety of private capital firms. For more information or to apply, click **here**.

If you have an opportunity you would like posted on *Fund Finance Friday*, email us at **fund-finance-friday@cwt.com**.