

CADWALDER

Analysis of the Technical University of Munich's Study on Subscription Facilities

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By Michael Mascia
FFA Board Member

Earlier this month, an extremely detailed academic analysis on the impact of subscription facilities on fund IRRs was published in Europe, titled “Distortion or Cash Flow Management? Understanding Credit Facilities in Private Equity Funds.” The authors, Pierre Schillinger, PhD Candidate and Research Assistant at Technical University of Munich, Reiner Braun, Professor at Technical University of Munich, and Jeroen Cornel, Director at BlackRock Private Equity Partners in Switzerland, are clearly highly competent in data analytics and have produced the most thorough analysis on the subject to date. They have also endeavored in good faith to analyze the data objectively, without the inflammatory bias that has been prevalent in a lot of media pieces. And, for once, it is nice to read something written by authors that understand the difference between subscription facilities and true leverage.

To conduct their simulation, the study takes 6,353 historical buyout deals and distributes them into hypothetical buyout funds. It then takes the cash flows from the deals and calculates the IRRs for the hypothetical funds. The influence on the IRRs is then tested by deferring the cash inflows as if the capital calls were fronted by borrowings under hypothetical subscription facilities, modeling the various impacts of six month, one year and two year tenors for each individual loan (among a variety of other assumptions they simulate). The results are not surprising. They found that “unless used extensively,” subscription facilities only have a modest effect on final fund performance and fund ranking. Under the six month deferral scenario, they found that median and mean net IRR is improved by 0.20 and 0.47 percentage points, respectively. The improvement was of course slightly higher in the one year and two year deferral simulations. Additionally, despite relatively high pricing assumptions for the costs of the hypothetical subscription facilities, the impact of a subscription facility on net multiples “is marginal, on average merely 0.02.”

There is not a lot in the study’s data analysis to take issue with. The data and math all seem professionally managed and directionally correct. Some of the assumptions about the terms of subscription facilities are a little off market from a practical perspective, but not in a way that strikes me as material to the calculations or conclusions. The numbers all make good sense.

There are however a few qualitative assumptions and conclusions worth comment and some areas where additional research might be clarifying. The first involves their conclusion that if individual loan maturities are set at two years, “*if not properly understood by Investors,*” subscription facilities could mislead investors as to the investing skill of the manager. Two years is, of course, an off market long assumption. But leaving that to the side, what I think this conclusion misses is that, frankly, all of this is easy. It is just not very hard to understand that a fixed dollar return generates a higher IRR if your capital is deployed for less time. If an investor does not understand this basic concept, they are simply not ready to be investing in private equity. Subscription facilities are disclosed at length in PPMs and fund partnership agreements. A high school investment club could figure this out – private equity investors are not proverbial widow and orphan retail investors; they understand it. Note, of course, transparency of calculations to enable an investor to easily make what they deem an apples for apples comparison between funds is a different issue. And although the article does not say it, if what they mean is that transparency around financing in fund reporting is helpful for comparisons, I would certainly understand and agree. But that is not what it says. Rather, it suggests investors could be “misled,” and we think the ‘intent to deceive’ connoted by the term ‘misled’ in this context is both inaccurate and inappropriate.

There is also a second premise in their conclusions that I believe rests on some suspect assumptions. The authors are of the view that, if investors do not understand how to account for a subscription line properly (again, they should), investors will improperly interpret the increase in IRR as “attributable to manager skill,” making them more likely to invest with that manager over other, better alternatives. What this misses is that great managers are more than the equity cash multiples of their specific investments. They are great at regulatory compliance, they are great at investor relations, they are great at risk mitigation. And they are great at optimizing the capital stack of their funds. IRR is a function of investment and divestiture decisions, operational improvement and, yes, financial competence – the CFO’s contribution is clearly a component of manager skill. No one would ever look at the return on a leveraged buyout investment and suggest that it should be deconstructed because the portion attributable to the financing is not a component of the manager’s skill; quite the contrary, actually. And the same is true with subscription finance. While it needs to be transparent, understood and on terms consented to upfront by the investor, a higher IRR because the manager tied up an investor’s capital for less time is clearly positive, not negative. That is, comparing fund IRRs based

purely on each investment's equity cash flows without consideration of a subscription facility is not exactly an apples to apples comparison either. It neglects the extra time monies sit in the investor's pocket. Money in an investor's pocket earning a return from other sources is relevant – perhaps that reality should be included in future research.

We would also like to see further research on how subscription facilities allow fund managers to better forecast the time of upcoming capital calls and how that timing information allows investors to better optimize their liquidity. That optimization can help investors improve their aggregate returns. Also of interest would be how much money in interest expense a fund can save for a period of time by using a subscription facility instead of more expensive investment-level leverage. And how a subscription facility's letter of credit feature can save a fund the expense of needing cash to secure an investment bid or an FX hedge. What about the quantifiable benefit of avoiding the need for subsequent close investors to true up original close investors during the fundraising period? These subscription facility uses (among others) all have IRR and return multiple benefits to a fund but get completely neglected in the IRR research. Future research should also probe the link between manager-reported IRRs and capital allocations. To sustain a conclusion that the subscription facility impact on IRRs "could effectively distort future fundraising concerns," the authors should establish that a meaningful segment of investors rely mostly or exclusively on trailing IRRs to make investment decisions. We think, in reality, the investor universe on the whole is more sophisticated than that assumption and makes decisions on a range of quantitative and qualitative considerations.

The article does positively advance the cause of a more informed discussion by: (1) making it clear that subscription facilities are not net leverage to funds; (2) pointing out that there are advantages to investors from facilities; (3) demonstrating that the cost component of a facility has little influence on IRRs; (4) quantifying the modest impact of a facility on median and mean IRR under "standard conditions"; and (5) acknowledging that facilities do not skew net multiples, PME and direct alpha, and that investors that use broader performance measures will have a more complete performance picture.

The article is available [here](#). Fair warning: It is longggg... I felt like I deserved a medal for finishing it.

The press has picked up on the research. Despite a plethora of results in the data that shows that a subscription facility's impact on IRR is modest and the costs are not impactful to return multiples, *Institutional Investor's* headline and tagline for its article on August 20 was: "The Private Equity Tool Distorting Returns: Long-term use of subscription lines of credit can "mislead investors with regard to the buyout industry's true skill and return opportunities," new research shows." The substance of the article is more balanced than the headline and is available [here](#).

Barron's also picked it up in an article on August 22 titled "How Private Equity Funds Can Artificially Boost Their Returns," available [here](#). We expect the press to continue to draw from this research in the future.

Regulators OK Fund-Linked Products Under the Volcker Rule

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By **Brian Foster**
Partner | Fund Finance

The recently adopted changes to the Volcker Rule regulations add an exemption for risk-mitigating hedging in the context of covered fund activities. The exemption allows a banking entity to hold ownership interests in covered funds, including hedge funds and private equity funds, to facilitate the exposure by its customers to the profits and losses of such covered funds. The ownership of the covered fund interests must be designed to reduce or mitigate specific identifiable risks arising out of customer requests.

Many practitioners will remember that such an exemption was included in the 2011 proposed Volcker Rule regulations, but was unexpectedly left out of the final regulations adopted in 2013. The final regulations retained only a narrowed hedging exemption with respect to covered funds, limiting banking entities to risk-mitigating hedges related to employee compensation arrangements. As a result, following the 2013 rulemaking, many existing fund-linked products that involved the banking entity offering a customer an instrument referencing the performance of a covered fund (including total return swaps, structured notes, warrants and call options) had to be restructured or terminated because the banking entity was no longer permitted to retain the necessary hedge to its exposure. Such products were used to provide customers exposure to covered funds in a manner that was tailored to specific tax, accounting and/or leverage objectives. U.S. banks ceased to offer such products after the final Volcker Rule regulations became effective in 2017, and non-U.S. banks were forced to move their fund-linked derivatives businesses outside the United States.

The restoration of the risk-mitigating hedging exemption has been anticipated for some time, and has raised expectations for a revival of fund-linked products in the U.S. market.

Subscription Finance Loan Agreement Series Part 5 — Investor Commitments and Available Commitments

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A topic that should be fairly straightforward this week, but as always, with a couple of twists. Given that the ultimate recourse under a capital call / subscription facility is to the Investors, it is very important to be clear about the nature and extent of the commitments which Investors have undertaken to the Fund which are available to repay the Lenders – and it is the Investors' commitments which are the primary building blocks of the borrowing base or leverage against which the Lenders will provide to the Facilities.

How these commitments are constituted will vary considerably depending on the nature and jurisdiction of the Fund. In a Fund which is a traditional English law limited partnership, historically the commitments will be provided by a mix of "capital" and "loan" commitment (with the majority of the commitment (99.99%) being in the form of loan commitments). In other jurisdictions this may or may not be the case. For example, commitments under a Delaware law limited partnership will generally be by way of capital commitment only (there will be no "loan" element). In Luxembourg, Investor Commitments may be constituted similarly to those in English limited partnerships but they may also, depending on the specific nature / type of Fund, be more akin to capital or equity commitments.

In assessing the quantum of any Facility, the Lenders will want to retain sufficient headroom between the Investor Commitments which are available for repayment and the amount of the Facility that can be drawn. In deciding what Investor Commitments are in this sense "available" to them, Lenders will be keen to ensure that there are no obstacles to those available commitments being called to repay the Facility. In doing this, Lenders should carefully consider the following:

- The way in which "available" commitments are defined (most commonly in terms of those commitments being "uncalled") in the underlying Limited Partnership Agreement or other relevant constitutional documents of the Fund.
- Whether there are any specific conditions to those payments being made, and if there are, whether it will always be within the Lenders' power to satisfy those conditions. For example, where the commitment is in the nature of a subscription for shares, then Lenders must be satisfied that either (i) the obligation to pay in the commitment is not conditional on the issue of share certificates or registration of the new shareholder in the books of the Fund; and / or ii) that such issue or registration will occur without any preconditions (even on a Fund's insolvency). In most jurisdictions a Fund's insolvency (and perhaps other events) can restrict or prevent shares being issued or registered, so the better course in most circumstances is to look to ensure that the commitments are unconditional.
- Whether the availability of commitments (either generally or for specific purposes including perhaps repayment of debt) is time limited (for example, by reference to the Fund's investment period).
- What other factors might affect the level of that available commitment. For example, unless specifically excluded in the Fund's constitutional documents, it may be that there are rights of set off or counterclaim as between the Investors and the Fund which could reduce the amount of the available commitment, or an Investor could be excused from honouring its commitment in respect of a particular type of Investment. In both those cases, the Lenders will consider whether those Commitments should be removed from what are counted as "available" commitments.
- And finally, how to deal with "recallable" commitments in this context. These are commitments which arise (or are preserved) as a result of Investors being refunded or repaid usually as a result either of (i) Investors being asked to pay in commitments which for whatever reason are not actually utilised and therefore are returned to them unused once a defined period has elapsed (often around 60 or 90 days) or (ii) Investors receiving repayments out of Investment proceeds where the Limited Partnership Agreement (or equivalent) specifically provides that either an amount equal to these repayments (or some proportion of that amount) will be added back to that Investor's "available" commitments, often for a defined period after receipt. In legal terms, (provided the applicable provisions of the Limited Partnership Agreement are properly reflected) these commitments are as "available" as any others but Lenders may consider whether, particularly where Investment proceeds have already been returned to Investors, Investors may find it more difficult in practice to return these to repay debt.

All of the above should always be matched with the results of what should always be a very full due diligence process to ensure that what is written into the Facility Agreement properly reflects the way in which the commitments and their availability work through the Fund's constitutional documents and any investor subscription agreements / side letters.

Player Profile — Alistair Russell

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Player Profile



FFF: Tell us about how you ended up in fund finance and in the Cayman Islands. . .

I started my career in London in 2006. After seven years, initially with Cleary Gottlieb and then Skadden Arps, we decided to move to the Cayman Islands in 2013. As someone originally from the Caribbean, a move back to the region was always a possibility we had considered and, although I do try to dampen my praise when speaking to friends and former colleagues in the UK (particularly during the winter months), it is a wonderful place to be both personally and professionally.

My onshore practice always had a strong finance focus; primarily LBO work and corporate lending, although unsurprisingly that dropped off somewhat in 2008. My fund finance related work in London was, for the most part, sponsor side.

My fund finance work over the last six years in the Cayman Islands has instead been almost exclusively lender side, which I particularly enjoy. It has been truly impressive to see the product grow and innovate in the way it has over that period. The increase from fewer than 100 people at the FFA conference in New York a few years back to almost 700 people in Miami today (not to mention the events in London, Asia and beyond) is a testament to the success of the industry and in particular those at the FFA who have championed it.

FFF: What's new and different in fund finance in 2019?

From my perspective, the last few years in the industry have largely continued an evolutionary rather than a revolutionary trend.

From the lender's side of the table, we continue to see growing sophistication in fund documentation and a greater appreciation of some of the risks that lenders face. Thankfully, I think participants tend to understand that, for the most part, mitigating such risks is likely to improve efficiency, ability to lend, and overall terms, to the benefit of sponsors and credit providers alike; the continued refining of the product is rarely a zero-sum process.

We did initially see some anxiety arising out of Abraaj, but in my experience that has largely faded as participants have gained a better understanding of the specifics. Indeed, in my opinion there is genuine comfort that the industry can take from the way that the product worked "in the wild" and there are ways in which remaining concerns can be addressed.

With that said, these events have certainly focused minds; a welcome development from my perspective, particularly given the number of new entrants to the market. As a product that is predicated, in part, on being low risk for lenders, it is incumbent on advisors to ensure that pitfalls can be identified and, where possible, dealt with (particularly where, as above, there is no material cost to the parties to do so).

I admit of course that my lender-side bias may be showing here.

FFF: Carey Olsen has been doing interesting work on Blockchain technology. Do you see a future application for Blockchain in fund finance?

While I work with and have a working grasp of Blockchain, as a mere lawyer I am of course wary of making any detailed predictions about the future of the technology. I am reminded of the Richard Feynman quote: "if you think you understand quantum physics, you don't understand quantum physics." With that said, given its application to the recording, storage and transfer of data, I suspect it will invariably find its way into areas that touch upon the industry in some form in the medium to long term. In particular, Blockchain can improve access to – and verification of – information, increase confidence in the accuracy of such information, and reduce time frames and costs for dealing with and reviewing the same.

As such, from a fund finance perspective, some of the practical applications for the technology may include (i) tracking capital calls and contributions, (ii) verification of investor identity and commitments, (iii) improved certainty around the delivery of notices and information between relevant parties (including investors), (iv) onboarding and KYC for lenders, and (v) facilitating ongoing monitoring of covenants from credit parties.

I suspect however that there are many more ways in which Blockchain will have a role to play.

FFF: Maybe the better question is where you see the technology making the greatest advances in finance?

Beyond the uses mentioned above (which are likely to apply in one form or another to a wide variety of financing transactions), I think one of the first widespread uses we will see of the technology will be its application to help increase the ease and speed of the transfer of funds (whether on a bilateral or multilateral basis). Similarly, it may also be something that can be deployed to aid in bank syndication processes.

As a lawyer, I am also interested to see whether Blockchain is adopted to assist with enforcement mechanics around financing transactions, particular in the case of security interests. The use of smart contracts with a self-executing element could in theory be used to help lenders effect a transfer of assets or funds in a more automated manner and could aid the "self-help" remedies that credit providers favour.

Lastly, almost every element of the financial sector has faced some increase in regulation over the past few years. Where these aspects involve the vetting of information, regulatory reporting, data sharing, or indeed data security, the hope would be that Blockchain will have a role to play in easing the already sizeable burden.

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

I am incredibly grateful for the training and mentorship I received in the early years of my career, particular from some of the partners at Cleary Gottlieb. While it was a particularly demanding environment with the expected long hours and exacting demands, I would certainly be the poorer for not having had the experience. No doubt it is now somehow less painful than it should be for me to spend a Saturday evening reading through a credit agreement as a result. The fact that they also made a point of giving junior lawyers high levels of responsibility at an early stage has also, I think, benefited those that have gone through it. Perhaps more important however has been the lesson that the stresses and demands of the job can sit comfortably alongside humour and thoughtfulness.

FFF: What advice do you have for the young fund finance attorney just getting underway in the sector?

While anyone's career is subject to the usual doses of luck and the influence of various circumstances beyond one's control, on the whole, I think hard work and integrity will generally get you where you want to go. The fund finance industry is also a tremendously supportive one for those coming through the ranks, and one that genuinely values those who are collaborative and give consideration to what is beneficial for the sector as a whole. I would certainly advise those new to the industry to attempt to carry that tradition forward.

FFF: Any suggestions for the Fund Finance Association?

The work of the FFA to promote the industry has been incredibly successful, and the events have (barring the occasional snowstorm) always been fantastic. Moving the global conference to Miami has also of course proven to be a good decision. I think my only suggestion would be to continue the drift southward by a few hundred miles. A 2021 conference in Cayman has a certain appeal. Happy to pitch in for the rum.

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

I know a lot of people answer questions like this by highlighting their passion for travel. Personally I tend to get enough of that with work! When family responsibilities allow, I really enjoy taking advantage of the water here in Cayman. We have some of the best diving in the world, and getting out on the boat to fish or simply cruise around is one of the highlights of living here.

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

Not particularly bold. Putting aside any predictions about the macroeconomic climate (and the political landscape's impact on it), I expect the market to continue in a relatively similar vein as to the year to-date. Perhaps a growth in velvet Gucci slippers at the next FFA event?

Private Funds CFO Article on LP Defaults

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Private Funds CFO earlier this week published an article titled “Defaulting on Commitments: What Happens,” written by Ed Hall, a partner in Goodwin Procter LLP’s private investment funds team. The article covers default remedies when an investor fails to fund a capital call and references overcall limitations and subscription lender preferences. The article is available [here](#).

PEI Article on ATP Private Equity Partners

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Private Equity International earlier this week published an article titled “Danish Pension’s Investment Arm to Quiz GPs on Credit Lines – Exclusive.” The article reports that ATP Private Equity Partners is going to be asking the funds it invests in to provide IRR calculations with and without subscription line impact. There is also a stray reference to Abraaj and the delivery of investor notices. The subscription required article is available [here](#).

Carnegie Mellon Research on Subscription Facilities

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In late June, Carnegie Mellon University Professors James Albertus and Matthew Denes published a white paper on the impact of subscription facilities on fund IRR. The academic and data-centered piece is available [here](#).

On the Move — Fund Finance Tidbits

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On the Move

Sammy Asoli and Jill Wilson of Lloyds Banking Group were recently named as Global Co-Heads of Financial Sponsors Coverage. In their roles, Sammy and Jill will manage a New York and London-based team that supports the financing needs of alternative asset managers. The team also supports clients in areas such as debt and capital markets, foreign exchange and treasury risk management. Sammy and Jill are based in New York and London, respectively.

FFA Next Generation in Fund Finance New York Event — September 16

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Join us the night before FFA University for light hors d'oeuvres and beverages at Haynes and Boone's New York Office in Rockefeller Center. Connect with colleagues after an eventful summer and prepare for FFA University's two-day intensive program led by senior fund finance practitioners. Whether you'll be flying in from out of town or walking across from Park Avenue, we're excited to see you.

Date of event:

Monday, September 16

Venue:

Haynes and Boone, LLP

30 Rockefeller Plaza, 26th Floor

New York

Time:

7-9 pm

Register [here](#).

Recommended Reading

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Certain investors are borrowing against their portfolios to use leverage to enhance their aggregate returns. [[PERE](#)]

The Business Roundtable, an association of chief executive officers of nearly 200 American companies and chaired by JPMorgan Chase CEO Jamie Dimon, has revised its Statement of Purpose away from shareholder primacy to a broader view emphasizing supporting their communities, investing in employees, delivering value to customers, dealing fairly with suppliers and creating long-term value for shareholders. [[Fortune](#)]

The United States Democratic presidential candidates are floating a number of tax increase proposals targeting the assets held by affluent Americans, from making death a realization event for triggering capital gains taxes on appreciated assets to an outright direct tax on wealth based on market value, regardless of a liquidity event. [[Wall Street Journal](#)]

Is German political reluctance to employ fiscal stimulus a negative for the entire EU? [[Markets Policy Partners](#)]

Simon Havers of executive search firm Odgers Berndtson details why carried interest allocation is not smooth sailing. [[Private Equity International](#)]

Preqin survey reveals 93% of investors plan to increase or maintain PE commitments. [[Real Deals](#)]

City of London reacts to Boris Johnson's intention to suspend Parliament. [[PE News](#)]

