Subscription lines: opportunities multiply as they are seized
Subscription lines: opportunities multiply as they are seized

Subscription lines to funds have been hitting the headlines recently. In this article, Fi Dinh, Relationship Director within the Private Equity team at Barclays, alongside Jeremy Cross, Partner, Co-leader of Global Fund Finance at Cadwalader, Wickersham & Taft LLP, take a closer look at the benefits of the subscription line and the concerns expressed in recent publications, and give their views on the future usage.

Initially used purely for short-term bridging of capital calls, over recent years, subscription lines have become longer term; their range of applications has expanded, ticket sizes have increased, and their use has become more or less ubiquitous, encouraged by both increasing demand by funds wishing to make use of them as well as lenders looking to provide them.

Current estimates of market size are that subscription facilities account for around $200bn in the US alone, with significant volume also in the UK and Europe, and increasingly in Asia (Preqin). It’s clear that subscription lines are popular, but the growth in the market has caused an increasing level of concern from the investors who both commit to the funds and will ultimately be asked to pay for those lines.

**Why use subscription lines?**

One of the primary benefits of subscription lines is their ability to smooth out investor calls and provide predictability of cash flow for both funds and their investors. Historically used mainly to finance investment activity between the first and final close, thereby avoiding the administrative burden associated with reconciliation, subline facilities have evolved to be used by funds of different strategies for widely different purposes.

Whilst buyout funds continue to use these facilities primarily as an easy and quick means of funding an investment prior to calling capital a few months later, real estate and infrastructure funds often appreciate the ability to use these facilities for issuance of guarantees or letters of credit to back asset-level arrangements.

In the meantime, credit and secondary funds value the ability to ramp up their investments and consolidate capital calls, given the sheer volume of deals at any one time. The facilities are also used as a key component in a fund’s investment and portfolio management toolbox; the fact that they’re multi-currency provides a natural hedge against foreign exchange movement, and the transparent pricing structure enables some certainty over the cost of funding for both individual deal and fund-level IRR calculation.

**Beneficial outcomes all round**

A secondary benefit of subscription lines is they enhance IRR (internal rate of return) and have a positive effect on the ‘J curve’. If these enhancements are properly understood and accounted for by investors and funds, these outcomes are of benefit to both.

Finally, subscription facilities are not ‘leverage’, and credit decisions made on these facilities generally look to a pool of fairly significant and well-funded investors. The lack of leverage makes the product somewhat less ‘complex’ from the regulators’ perspective and, done right, the credit is relatively ‘good’ credit. These two factors therefore make the costs of utilising these types of facilities considerably lower for lenders, and consequently funds/investors, than many other ‘leverage’ type credit lines.

In the meantime, credit and secondary funds value the ability to ramp up their investments and consolidate capital calls, given the sheer volume of deals at any one time. The facilities are also used as a key component in a fund’s investment and portfolio management toolbox; the fact that they’re multi-currency provides a natural hedge against foreign exchange movement, and the transparent pricing structure enables some certainty over the cost of funding for both individual deal and fund-level IRR calculation.

**Beneficial outcomes all round**

A secondary benefit of subscription lines is they enhance IRR (internal rate of return) and have a positive effect on the ‘J curve’. If these enhancements are properly understood and accounted for by investors and funds, these outcomes are of benefit to both.

Finally, subscription facilities are not ‘leverage’, and credit decisions made on these facilities generally look to a pool of fairly significant and well-funded investors. The lack of leverage makes the product somewhat less ‘complex’ from the regulators’ perspective and, done right, the credit is relatively ‘good’ credit. These two factors therefore make the costs of utilising these types of facilities considerably lower for lenders, and consequently funds/investors, than many other ‘leverage’ type credit lines.
A look at some of the concerns

Cost
The fund pays fees and interest to a bank, reducing the bottom line profitability of that fund and its investors, although, as stated above, the costs of subscription lines in comparison to many other facilities are relatively low. However, the question for the fund and the investors is whether the benefits of the financing outweigh the cost.

Reduction in the hurdle for payment of incentive fees
This is a commonly expressed area of concern for investors when considering using subscription lines – particularly in relation to IRR enhancement. This is a legitimate concern when reviewing the level the hurdle is set at so that the subscription line makes that hurdle easier to achieve without any particular improvement in underlying performance. However, it must not be forgotten that the hurdle rate in and of itself is an arbitrary number, and the market has developed over recent years so that investors have become increasingly attentive to all aspects of a fund’s and its manager’s or general partner’s performance. Investors are also increasingly well aware of the impact of financing. Since the financial crisis, Limited Partnership Agreements (LPAs) and equivalent fund documentation are increasingly drafted, to cater specifically to subscription financing, its scope, treatment and disclosure, including appropriate escrow and claw-back mechanism. Hurdles should be set appropriately and on an informed basis for such financing.

Lowering of standards applied to investments
Funds are answerable to a number of ‘interested parties’ (first and foremost their investors) and they have a number of concerns to meet when it comes to implementing their investment policies. Although there are exceptions, it is true that, in a subscription line, a Lender will not generally impose particular parameters or covenants around the funds’ investments; however, given the investor scrutiny now being applied to funds (in addition to the level of competition between funds), we see limited potential for a lowering of standards.

It is also our experience that funds and investors will usually impose strict limits on the amount of investor commitments that can actually be the subject of financing (often no higher than around 30%), so it is difficult to see how the availability of this type of credit would substantively change either fund or manager/GP behaviour in this way. Deviations from the fund’s investment policy might come about as a result of factors entirely unrelated to the financing itself, for example from the macro environment, increased competition, excess dry powder and shortage of high-quality assets at sensible pricing.

Increased UBTI (unrelated business taxable income) risk
Our experience is that investors and funds are well aware of this risk and, for many years, they have specifically ‘structured around’ it in any financing, for example through the use of UBTI ‘blockers’ in the fund or finance structure and/or by including ‘clean downs’ in the LPA or private placement memorandum to mitigate any such risk.

Increased risk around investor transfers
This may be more of a theoretical risk, rather than a practical one, depending largely on the type of funding available. Subscription financing tends to be divided between fairly well-defined ‘borrowing base’ funding for investors (based on ratings or equivalents) and a more ‘discretionary’ or ‘leverage’ model. With a borrowing base model, the parameters should mean that transfers are unlikely to significantly affect the availability of the financing. If they do, it will create a timing issue for the period, meaning that the banks will need to analyse the new LPs for their potential inclusion in the borrowing base. With a more discretionary or leverage base, there are usually ways to structure around this, for example by ensuring that all current investors in a fund are approved. It is also important to note that in the majority of financings (although not all), the base of investors is relatively broad, so in the absence of significant transfers between numbers of investors, it is unlikely that there will ever be a real issue. It is also worth emphasising that, generally speaking, lenders do not look to control transfers in any way over and beyond whatever controls (or discretions) are contained in the fund documentation itself.

Desire for greater ‘transparency’ from investors and disparity between investors
Lenders have sought more detailed information both on and from investors – something that investors have pushed back on. The recent trend in both the US and Europe is for more limited information to be provided by investors to lenders, and for investors to be less ‘involved’ in any funding issues. For example, the use of investor letters (once very common, particularly in the US) is increasingly rare, except for those funds with highly concentrated investor bases. In general, there is an acceptance among lenders that they will have only limited access to investor information and, again, this is limited by what is generally set out in the LPA. When it comes to investor appetite for different forms of borrowing, we see this as an issue, which needs to be structured around. Often this can be resolved through the use of parallel or feeder funds and alternative investment vehicles, whereby investors can choose between a ‘borrowing’ vehicle or a ‘non-borrowing vehicle’.
Distortion of fund metrics

The use of subscription lines can clearly enhance IRR simply by using debt where investor commitments would otherwise have been required. However, IRR is only one metric and, by itself, doesn’t necessarily determine ‘good’ or ‘bad’ performance by a fund. In addition (as stated above), properly informed investors (most investors in these funds are more than well informed) are often well aware of the potential enhancements and will ensure that these are taken into account. The perceived improvement in IRRs and reduction of the J-curve at the outset will then be balanced out by lower multiples over the longer term. As a result, the focus will be on the impact of such financing at the start of the fund’s life, rather than throughout its life, which is normally long-term in nature. The ILPA paper referenced at the beginning of this article makes sensible recommendations as to how a particular fund’s investors – as well as the market more generally – can be made aware of what effect a subscription line may have on fund performance.

A ‘race to the bottom’ by lenders of subscription lines and funds

On this point, the concern is that it leads to looser terms and, in effect, encourages bad decisions by fund managers and executives; however, we see no evidence of this in the last 30 years of the subscription finance market. We do see evidence of increasing price competition (including on pricing), a fund is quite a complex animal and lenders who have been through both the experience of the 2007–2008 financial crisis, as well as many years of increased focus both internally and externally on credit, are simply not in a position to take big risks on subscription lending. The second relates to the nature of subscription financing (where it is used to delay or postpone the need for the fund to call capital directly from investors, sometimes for a significant period of time and sometimes across several investments). The concern is that when the investor is finally called (often to repay the subscription facility), they may not be in a position to pay and/or the amount called from the investor will be a significant amount of (or all of) that investor’s total commitment. How real a risk is this? We have already been through one great financial crisis and, as far as we know, there were no defaults in this particular industry during that time, despite some clear issues with many funds’ investments; many of the funds that did suffer these types of issues actually repaid their facilities in full around that time. We are also anecdotally aware that over the 20 to 30 years that this type of financing has been available, there have been similar low or non-existent default levels, despite three or four significant recessions during the same period. On the related point of investor commitments ‘stacking up’, we see a number of methods being used by lenders (as well as funds and investors) to mitigate that risk, including regular clean-downs, semi-annual or annual capital call requirements, plus the inclusion of certain fund performance triggers (often negotiated by the investors themselves and included in the LPA or side letters).

Systemic risks

The two key issues here can be summarised in two parts: firstly, the concern that, when called, investors will not be in a position to pay. The second relates to the nature of subscription financing (where it is used to delay or postpone the need for the fund to call capital directly from investors, sometimes for a significant period of time and sometimes across several investments). The concern is that when the investor is finally called (often to repay the subscription facility), they may not be in a position to pay and/or the amount called from the investor will be a significant amount of (or all of) that investor’s total commitment. How real a risk is this? We have already been through one great financial crisis and, as far as we know, there were no defaults in this particular industry during that time, despite some clear issues with many funds’ investments; many of the funds that did suffer these types of issues actually repaid their facilities in full around that time. We are also anecdotally aware that over the 20 to 30 years that this type of financing has been available, there have been similar low or non-existent default levels, despite three or four significant recessions during the same period. On the related point of investor commitments ‘stacking up’, we see a number of methods being used by lenders (as well as funds and investors) to mitigate that risk, including regular clean-downs, semi-annual or annual capital call requirements, plus the inclusion of certain fund performance triggers (often negotiated by the investors themselves and included in the LPA or side letters).

Subscription lines and their future

As with all forms of financing, too much is not necessarily a good thing and not enough may be a bad thing. There are legitimate concerns being raised by investors (Howard Marks and ILPA, among others, have both very effectively analysed those concerns) and we believe these are well understood. Funds and their lenders should all be aware of the concerns and take them into account in any financing proposition.

As stated at the beginning of this article, we believe that the increased scrutiny on these subscription facilities (particularly by investors), alongside greater transparency – along the lines set out in the ILPA paper – will be a welcome development. Properly used, subscription financing is a product that enhances the funds market and the investment market. It is absolutely right that all those involved should be aware of the terms and the risks; it is not for everybody and it is not a panacea, but, when properly and openly used, we are confident that the product will continue to develop to fulfil market needs and help the market grow.
Fi is a Relationship Director within Barclays' European Private Equity Funds team, based in London. The team provides finance, derivatives, trade finance and onshore and offshore banking for funds in the buy-out, real estate, infrastructure, debt and secondaries sectors.

Fi has nearly a decade of banking experience across operational risk, credit analysis, structuring and origination in the UK and Middle East. Fi was the first member of the PE specialist coverage team at Barclays and has supported financial sponsors in structuring facilities in the US, Europe, Asia and Africa.

Prior to joining Barclays in 2011, Fi worked for a number of governments in nation-branding projects, particularly around media relations, attracting foreign direct investment and crisis management. Fi holds a BA (Hons) in Public Relations from the London College of Communication, University of the Arts London, a Diploma in Fine Arts and a Professional Diploma in Banking Practice & Management.

Jeremy is a vastly experienced funds finance lawyer and has been active in the UK funds finance market (acting for both lenders and funds) for over 14 years. During that time he has worked with most of the major lenders in the market, including Royal Bank of Scotland, Lloyds Banking Group, Barclays Bank, Wells Fargo, Bank of America, National Australia Bank, CACEIS and CBA, along with a number of other banks, non-bank financial institutions and funds. In addition to his “UK” experience, Jeremy has also worked frequently on “US” funds financing structures and documentation.

Chambers UK lists Jeremy as a leader in the field of Banking & Finance, described as "a highly intelligent and commercial figure". Legal 500 has recommended the "very commercial [Jeremy Cross]". He is also recommended in Bank Lending, noted as "very commercial and has the ability to explain in simple language often difficult concepts". Jeremy was included among the “Hot 100” Lawyers by The Lawyer in 2013.

He was awarded an Exhibition to and received his MA in Law from Cambridge University. Jeremy is admitted to practise in England and Wales.