

Subscription Lines of Credit and Alignment of Interests

Considerations and Best Practices for Limited and General Partners

June 2017



Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners

June 2017

Background

Short-term financing to bridge the time between a deal closing and the eventual calling of capital has been a tool utilized by private funds for many years. But in recent years, the practice has been expanding in prevalence and scope. Traditionally, these subscription lines of credit were unsecured, with maturities under one year but typically cleared within 90 days. Today, fueled by low interest rates after the financial crisis, subscription lines¹ have evolved beyond a short-term bridging function, to serve as a broader tool used to manage the overall cash of the fund, with repayment terms often extending beyond 90 days.

The rationale for the use of these lines from the GP's perspective is multi-faceted. The ability to delay calling capital enhances the manager's flexibility to execute deals and shortens the J-curve, enhancing the fund's Internal Rate of Return (IRR), particularly early in a fund's life, and therefore its competitiveness on a quartile basis. From an LP perspective, the use of these lines helps smooth cash flows and eases the administrative burden of responding to capital calls.

Impacts of the Use of Credit Lines

Of concern to investors, however, is the potential impact on alignment of interests and the prospect of cumulative liquidity risk related to inadequate visibility into LPs' total exposure through these lines. The following represents a number of matters that the PE industry should take into account when considering the use of these credit lines.

Comparability of Performance

Because the use of such lines is not universal, the distortive effects on reported returns makes the comparability of performance more challenging. A simplified notional example illustrates the effect of delaying the first capital call below:

Year	Transaction Type	Cash Flows (no facility)	Cash Flows (w/ 1-yr. facility)	Cash Flows (w/ 2-yr. facility)
1	Investment	-100		
	Management Fees	-2		
2	Investment		-100	
	Interest		-4	
	Management Fees	-2	-4	
3	Investment			-100
	Interest			-8
	Management Fees	-2	-2	-6
4	Management Fees	-2	-2	-2
5	Management Fees	-2	-2	-2
6	Management Fees	-2	-2	-2
	Realization	162	162	162
	IRR	6.62%	7.14%	7.98%
	TVPI	1.45x	1.40x	1.35x

¹ For the avoidance of doubt, also referred to as subscription facilities, subscription line financing, capital call facilities, bridge lines. The term "back leverage" may refer specifically to use of such lines that allows the manager to increase leverage on investments without adding debt at the portfolio company level later in the life of the fund.

The impact of use of a line of credit on IRR will be greatest early in the life of the fund, and will naturally diminish later in a fund's life. Yet, it will never exactly equate to the level of an unlevered IRR, i.e., the IRR had the fund not utilized its credit facility to temporarily finance the transaction and instead called capital immediately from its LPs.²

Clawback Issues

Due to the compressed J-curve, there is the potential for the GP to receive carried interest in cases where the unlevered IRR may not meet the preferred return hurdle, but the use of the line of credit could cover the margin. Such effective lowering of the hurdle may lead to clawback issues later in the life of the fund.

Expenses

These lines pose a direct partnership expense to the fund, including an upfront fee and interest expense, which can nullify any positive leverage impact on the IRR should the deal not perform well, in addition to causing a decrease in the multiple on invested capital (TVPI) to the LP.

Tax Considerations

For tax-exempt institutions, the extension of the maturities of these lines to 1 year or more presents potential unrelated business taxable income (UBTI) exposure. Conventionally, such lines were cleared every 90 days to prevent against this exposure, but increasingly these lines remain open for up to one year or more. Additionally, should the line be structured on the fund's assets, and not solely on the uncalled commitments of "Included Investors,"³ tax-exempt investors may find themselves subject to UBTI recognition.

Liquidity Risk

The rapid rise of this practice has brought forward questions about cumulative institutional liquidity risk. In particular, LPs have raised concerns about the ability for the lender to recall the line in the case of an Event of Default (EOD) with the manager. Additionally, in the unlikely event of a market event triggering the simultaneous calling of capital across multiple lines at once, liquidity pressures could impede an individual LPs' ability to meet accumulated larger calls as these lines mature. Due to the unevenness of disclosures, many LPs are not fully aware of their cumulative exposure through these facilities.

Legal Risks

Finally, unchecked use of these lines poses legal risk for LPs. For example, the terms of the subscription facility may grant the lender excessive discretion over fund management decisions or assignment. This may extend to covenants that limit transfer rights, inhibiting GP approvals of secondary sales by "Included Investors." Additionally, "Included Investors" may be compelled to submit to extensive documentation and other requirements by the lender. There may also be implicit joint and several liability for LPs should there be an outstanding balance at the end of the fund's life, obligating LPs for more than their *pro rata* share of the balance should another LP default on subsequent capital calls. Finally, credit lines may pose a regulatory risk for managers in markets where a higher level of regulatory requirements are

² A Cobalt analysis of 498 funds found that delaying the first cash flow by up to one year yielded higher IRRs provided TVPI was above 1.0x, whereas delaying capital calls one year decreased IRR for funds with TVPI under 1.0x. The median IRR increase was 206bps by year 3, falling to 35-45 bps by the end of the fund life for the funds studied. Source: CobaltGP.com.

³ Investors whose uncalled commitments are used to underwrite the line. Note: lines are typically secured by all uncalled commitments in the fund, not solely the commitments of a select subset of LPs.

applied based on fund-level leverage. It is unclear how regulators will ultimately classify the use of these facilities.

Recommendations

ILPA believes that the use of lines of credit should accrue to the benefit of the LP. As such, GPs and LPs must agree to clearer thresholds for the reasonable use of such lines, and LPs should be provided greater transparency related to their impact.

Specific recommendations are detailed below:

1. Within partnership agreements, waterfall provisions should specify that the date used to calculate the GP's preferred return hurdle aligns to when the credit facility is drawn, rather than when capital is ultimately called from the LPs.
2. Managers using credit lines should disclose to their LPs the following as part of quarterly reports:
 - The balance and percent of total outstanding uncalled capital. Such disclosures should be provided as part of a holistic reporting of the total debt/credit in use by the fund
 - The number of days outstanding of each draw down
 - The current use of the proceeds from such lines, i.e., solely to bridge capital calls (and the nature of those capital calls), or for other purposes (such as accelerated distributions)
 - Net IRR with and without the use of the credit facility
 - Terms of the line (upfront fee, drawn and undrawn fees, etc.)
 - Costs to the fund (interest and fees).
3. Managers are advised against using these facilities to cover fund distributions in anticipation of, but prior to, a portfolio company exit.
4. LPs sitting on Advisory Committees should consider adding a discussion item on the use of credit lines to LPAC meeting agendas, potentially to include an assessment of whether the terms of facilities in use are considered "market".
5. Disclosure of investment details in the underlying portfolio should not lag the execution of a deal due to capital calls delayed by use of these facilities. Reporting should be on a mutually agreed and reasonable basis, regardless of the timing of the capital call.
6. Managers are encouraged to include the firm's official policy on credit lines as part of the due diligence packet provided to LPs, including the intended use of proceeds from current or future utilization of such lines, and how the impact will be disclosed to LPs.
7. During due diligence of a prospective manager, LPs should request that managers provide the impact of lines of credit on track record, i.e., levered and unlevered IRRs, as well as any tax impact.
8. LPs evaluating relative benchmarked performance of GPs should take into consideration the potential impact of these lines on quartile rankings, as well as vintage year classifications tied to the dates of first net cash flows versus first investment LPs should also consider that all commercially-available peer benchmark providers are very likely to include both the returns of funds with credit facilities and those without.

9. Provisions addressing use of subscription facilities within partnership agreements should delineate reasonable thresholds for their use, such as:
- A maximum percentage of all uncalled capital, e.g., 15-25%. Subscription facility exposure should be considered and reported holistically, taking into account the more traditional limitations on fund borrowings for any other purpose.
 - A maximum of 180 days outstanding
 - Maximum period of time for which such lines can be utilized, aside from agreed upon parameters related to the maturity of such facilities.

Other suggested parameters include:

- Advance rates applied to “Included Investors” should be based on uncalled capital, rather than a fixed percentage of NAV.
- Lines should be secured only by LP commitments to the fund, not by the underlying assets of individual LPs or the invested assets of the fund. Cross-collateralization of these lines is to be avoided.
- Lines with stated maturity dates, rather than payable on demand, are preferred.
- LPs may elect to consider an agreed upon cap on total interest expense payable by the partnership.

Such provisions should also make clear the manager’s responsibility to disclose the terms of the line itself to all LPs, including:

- The specific assets being used to service the line; the name and contact information of the lender; a description of the loan covenants
- Documentation or other burdens placed on the LPs whose commitments are used to secure the line. Such requirements should be limited to acknowledgements as to the LP’s capital commitment, and in accordance with the partnership agreement provisions related to books and records, e.g., limited to disclosure of publicly available information, etc. LPs should not be expected to make representations to the lender.
- In cases where certain LPs seek the ability to opt-out of such borrowings, confirmation of the availability of prefunding rights, shorter durations or similar mechanisms for exemption where requested.
- Terms of the line itself that may introduce additional risk, e.g., payable on demand, lender discretion over management decisions or exposure beyond unfunded commitments, syndication among multiple lenders, cross-default provisions.

ILPA will continuously reflect member feedback and new market conditions into this document and will publish, as needed, updates to this guidance on the ILPA website. This guidance, reflecting any revisions subsequent to its initial release, will also be incorporated into the forthcoming revised ILPA Principles (version 3.0) to be released by early 2018. For more information, please contact Jennifer Choi at jchoi@ilpa.org.

Recommended Questions for GPs Regarding the Introduction or Expanded Use of Subscription Facility Lines of Credit

- What is the stated purpose and intention of using the line?
- When is use of the line expected to end? When is it contractually required to end, i.e., expiration?
- What are the terms for the line? Covenants, coverage, reset, negative provisions?
- What was the initial size of the line and by how much could it be increased?
- How many current LPs cover the line, i.e., "Included Investors"?
- What is the cost to initiate the line, and how are those expenses reported to the LPs? What is the cost to renew the line at the end of the term?
- Does the line cross-default in the event one of the LPs defaults?
- Will performance (IRRs) be calculated with and without use of the line?
- Will leverage (e.g., in the case of real estate funds) be disclosed with and without use of the line?
- In the event that an LP whose commitment was used to secure the line needed to sell their commitment on the secondary market, how would that impact the line, the ability of the LP to sell, and the overall partnership?
- What impact if any will the use of the line have on UBTI exposure for ERISA or other tax-exempt investors?
- Under what circumstances, e.g., regulatory changes, could the facility be pulled by the Bank?
- Is LPAC approval required to open or extend the line? Does initiating or extending the line require any amendments to the LPA?
- In an event of default (EOD), what recourse does the lender have to the uncalled commitments or assets of included investors?
- What process was followed by the GP in the selection of a lender?



Washington, DC | Toronto

ILPA.ORG | @ILPAORG

For questions, contact Jennifer Choi, +1-202-683-6018 or jchoi@ilpa.org.

© 2017 Institutional Limited Partners Association. All rights reserved.