

PAUL HASTINGS

Capital commitment-backed subscription line credit facilities

A subscription line is a useful cash management tool that provides benefits to both fund managers and their investors, writes **Thomas Rao** and **David Wasserman**.

Closed-end private investment funds are increasingly using subscription-secured credit facilities as a relatively inexpensive means to quickly obtain capital for investment opportunities and working capital needs. A subscription-secured credit facility (also called a “subscription line”) is a revolving line of credit that is provided by one or more lenders to a private investment fund and collateralized by a pledge of the right to call and receive capital contributions from the fund’s investors.

BENEFITS TO FUND MANAGERS AND INVESTORS

The ability to draw, repay and redraw upon a subscription line provides several important benefits to a private investment fund, its manager and investors. First, subscription lines provide relatively low-cost financing. Typically, at the time that the fund makes each draw under the facility, the fund may elect for the applicable loan to accrue interest at a “base” rate or LIBOR-based rate. The base rate is usually the greater of the administrative agent’s prime rate plus 100 basis points, one-month LIBOR plus a pre-determined “applicable” margin (currently in the 150-175 basis point range) or the federal funds rate plus 50 basis points. LIBOR-based loans would accrue interest at the applicable LIBOR rate (the fund could select one, two or three month LIBOR) plus the applicable margin. If desired, most subscription lines also provide that the fund may cause the lenders to issue letters of credit on the fund’s behalf. In addition to a fronting fee (usually 12.5 basis points), the lenders earn a fee equal to the applicable margin on



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the outstanding but undrawn amount under each line of credit.

Generally, loans under the facility may be repaid at any time without penalty and reborrowed. Subscription lines usually mature several months prior to the scheduled expiration of a fund’s investment period, but may be extended if the fund’s investment period is extended or if the fund’s constituent documents clearly provide that capital commitments may be called following the investment period to repay fund indebtedness.

“A SUBSCRIPTION LINE PROVIDES THE OPPORTUNITY TO REDUCE THE NUMBER OF CAPITAL CALLS MADE TO FUND INVESTORS”

Although all of the investors’ unfunded capital commitments serve as collateral for the subscription line debt, the facility borrowing base is typically calculated as the lesser of (a) a stated maximum amount and (b) a set percentage (usually 90%) of the aggregate unfunded capital commitments of the fund’s most credit-worthy investors (such investors are called “included investors”).

Another benefit afforded by subscription lines is that they provide funds with relatively quick access to capital. Depending on the type of loan selected by the fund, most subscription lines provide that loan requests will be funded on one (typical for base rate loans) to three (for LIBOR-based loans) business days’ notice, as opposed to the ten to fifteen business days that are typically afforded to fund investors to contribute capital in response to a capital call notice under the fund’s constituent document. In the absence of a subscription line, the relatively long call period provided to most funds’ investors could jeopardize a fund’s ability to act on a quickly-developing investment opportunity.

Additionally, a subscription line provides the opportunity to reduce the number of capital calls made to fund investors, since a fund that has the ability to pay expenses and de minimus contributions to investments via subscription line drawdowns will not be faced with the choice of either maintaining working capital reserves (negatively affecting the fund’s internal rate of return while the preferred return accrues on such cash) or issuing a capital call notice each time that

it needs any funds. Many large institutional investors and funds of funds appreciate the fact that a subscription line will often free these investors from the administrative burden of funding multiple small capital contributions.

Lastly, in the event that a fund has a subscription line in place prior to the first time at which the fund has any need for capital, the fund manager may consider relying solely upon the subscription line indebtedness through the date of the fund's final closing, eliminating the need to utilize the subsequent closing "true-up" provisions of the fund's constituent documents to account for newly-admitted investors.

BENEFITS TO LENDERS

Financial institutions have actively pursued subscription line opportunities due to their investment grade credit profile, strong relative return, and ancillary relationship business. Historically, subscription lines have had very low occurrences of defaults of any kind with no recorded losses of principal.

Typical subscription lines have strong credit profiles which are directly related to the underlying investors, each of which typically have significant balance sheets, ample liquidity to cover all contingent and short term liabilities. Many included investors have additional third-party credit providers (ERISA and municipal pension Plans often have statutory and collectively bargained provisions that bind the sponsoring entities) which further enhance an investor ability to meet its obligations under a facility.

A key credit concept in subscription lines is the over-collateralization that the capital commitments provide. A typical subscription line can be sized from 25-50% of total capital commitments. In the event that any investor defaults on its obligation, the fund and lender have the ability to call additional monies from all of the fund's investors (up to their respective capital commitment amounts), not just those included in the borrowing base. However, because the



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penalties of not funding a capital commitment are steep, investor defaults have been rare. Additionally, from a credit perspective, the fund itself is a strong source of repayment since a subscription line is full recourse to the funds itself. As a fund calls capital and makes investment, the net asset values and net cash flows of these investment often are considerable and are independently creditworthy.

With investment grade spreads below 100 basis points, subscription lines provide a higher relative return when comparable municipal and corporate credits are examined. After the over-collateralization and diversification is considered, subscription lines present an opportunity for financial institutions to deploy shorter term commitments (2-5 years) and allow for a high quality way to start or enhance a relationship.

POTENTIAL ISSUES

Since drawdowns on a subscription line accrue interest at a lower rate than the preferred rate that accrues on investor's unreturned capital contributions, the potential exists for a fund to rely on subscription line indebtedness to the virtual exclusion of capital calls from investors. Additionally, the incurrence of debt at the fund level may

raise concerns for investors sensitive to unrelated business taxable income, such as non-governmental pension plans, foundations, endowments and other tax-exempt entities.

However, it is becoming much more common for a fund's constituent documents to limit the use of subscription line indebtedness to relatively short-term borrowings (such as 90 to 120 days), in an effort to address both of these concerns. Additionally, sophisticated fund counsel and subscription line lenders are experienced in fund structuring techniques (such as the use of feeder funds, parallel funds and other alternative investment vehicles) that also serve to address tax and regulatory concerns of private tax-exempt, governmental and foreign investors.

At a relatively nominal cost and with a degree of planning on the part of a fund manager, a subscription line can be an attractive cash management tool that provides benefits to both fund managers and their investors. ■

Thomas M. Rao is a partner at Paul Hastings LLP, where he concentrates his practice on the representation of private investment fund sponsors and investors, specializing in fund formation, private REITs, capital commitment-backed subscription line credit facilities and executive management participation in carried interest distributions. Paul Hastings has a sophisticated Private Investment Fund practice serving, among others, fund sponsors, institutional investors, investment bankers, lenders, placement agents and investment advisors in all facets of fund structuring, offering and operation.

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