2023 OSLER LEGAL OUTLOOK

Private equity: developments in subscription line lending

DECEMBER 11, 2023 5 MIN READ

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Authors: Chris Barnett, Brett Anderson, John Groenewegen

In recent years, subscription line facilities have become a well-accepted tool used by private equity sponsors to manage their liquidity, reduce and bring a regular cadence to capital calls, and enhance investment returns.

Subscription lines, which are also referred to as capital call facilities, are revolving credit facilities that are secured not by a traditional collateral pool, but by the undrawn capital commitments of investors in a fund. Although these facilities are now an established fixture of private equity funds across all asset classes, their use is broadening as a result of challenging fundraising, credit and M&A markets. We anticipate that their use will continue to evolve.

We review five developing trends that we expect to shape the fund finance market in 2024.

Lender protections

Since the inception of subscription lines, facility lenders have sought to include provisions in core fund documents to afford these lenders maximum flexibility to step into the shoes of the general partner of the fund, make capital calls directly to limited partners, require funding directly to a lender account and limit the availability of excuse rights when calling capital to fund a debt repayment. Although these types of protections in fund documents for the benefit of lenders have continued to advance, there have historically been limits on lenders' ability to introduce new protection features in successor fund partnership agreements.

However, two factors are motivating change. The first is the increasing demand for capital call facilities; the second is the stress lenders felt during the pandemic as funds drew down on facilities to enhance their liquidity positions. Lenders are now negotiating more strenuously (and often successfully) to include the latest protections in fund documentation.

Financing open-ended funds

Subscription line facilities have traditionally been a fixture of closed-end funds, in large part because of their defined lifespan and relatively static investor base. Redemption rights and the perpetual turnover of investors characteristic of open-ended funds create uncertainty in the "borrowing base." This uncertainty has traditionally challenged lenders, given their desire for security over fund commitments.

However, the more acute need for liquidity that open-ended funds face in today's high redemption environment has driven many lenders to enter the market and provide subscription lines to open-ended funds. In these cases, lenders manage the risk profile by charging higher interest rates and insisting on more rigorous reporting requirements and monitoring rights over the borrowing base.

Subscription line facility transparency

Subscription line facilities have become broadly accepted by investors in recent years. Many investors welcome the more predictable cadence of capital calls from funds that are able to use such a facility. Fund sponsors also benefit by being able to market more favourable internal rates of return (IRR) by virtue of a shortened J-curve. However, a number of investors have raised concerns about the negative consequences of funds relying on subscription lines. Chief among these are the liquidity challenges the investors face as a result of the less frequent, but significantly larger, capital calls, as well as the distortive effect subscription line lending can have on reported fund performance figures.

The Institutional Limited Partners Association (ILPA) has seized on these concerns and issued guidance on best practices for subscription line disclosure. ILPA recommends sponsors disclose net IRR to investors on a quarterly basis, both with and without reliance on the subscription line facility. Disclosure should also include the total size and outstanding balance of the subscription line facility.

With the size of and reliance on subscription facilities continuing to grow, we anticipate sponsors will increasingly be expected to make information about their subscription line usage available to investors.

NAV-based hybrid facilities

A commonly cited limitation of subscription line facilities is that their borrowing base is tied to uncalled capital commitments. In a closed-end private equity fund, where a finite amount of investor-committed capital is drawn down over the fund's investment period, this has the effect of correspondingly reducing the amount of capital available to be drawn by the fund on the subscription line facility. This can create a liquidity crunch for later-stage funds, or funds with a platform strategy involving a significant follow-on investment component.

To address this limitation, some funds have begun to complement their subscription line facilities with net asset value (NAV) facilities. These are revolving facilities that are secured against the fund's portfolio assets. These so-called "hybrid" facilities are naturally complementary insofar as the borrowing base of the NAV facility naturally increases as the fund acquires portfolio assets over the course of its investment period, filling the borrowing base gap left by the ensuing reduction in uncalled capital commitments.

We expect fund sponsors will increasingly avail themselves of hybrid subscription line facilities, particularly with the current slow-down in M&A activity. This slow-down has prompted many funds to hold portfolio companies longer and seek approval to extend their lifespan.

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ESG-linked financing

As funds continue to search for ways to integrate ESG principles into their investment platforms, many funds have begun to adopt “ESG facilities.” Under such facilities, bank lenders provide performance-based pricing and other benefits to funds that meet agreed ESG targets. Fund performance of these targets is typically monitored and assessed by third parties. Failure to meet targets typically only results in a loss of incentives and generally would not amount to an event of default.

Certain ESG facilities extend beyond providing performance incentives, requiring funds to deploy borrowed funds to investments that meet agreed ESG goals and targets. This type of ESG facility has seen less take-up, in part because their use case is limited to funds with ESG as a primary component of their investment thesis.

We expect that increasing pressure on funds to incorporate ESG principles into their investment decisions, together with rising interest rates, will encourage funds to gravitate towards ESG facilities that offer favourable lending terms to funds that satisfy reasonable ESG targets.

The evolution of the use and terms of subscription lines, together with their hybridization with other facilities, is a trend we expect to continue in 2024.