PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

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FUNDS

Choosing a subscription line provider

Finding the right financing partner can be challenging. MUFG's head of fund financing, Ben Griffiths, explains the factors GPs should consider and how they can make themselves lender-friendly

Subscription lines of credit have been consistently growing in popularity over the last five years – even more than the popularity of private equity itself. At this point, as many as 75 percent of the PE firms we speak with are already using or looking to use subscription lines.

As a result, the market for providing subscription lines of credit now has many players, including big banks and niche lenders, which leaves managers with the choice of who they should partner with.

PICKING A PARTNER

The decision to use a subscription line of credit is generally motivated by the cashflow requirements of a closed-ended fund. The choice of lender can be more complex and is often driven by several factors including the lender's risk appetite and collateral calculation methodology, the borrower's preference to work with large banks or smaller players and whether or not the size of a proposed facility is better structured as a bilateral or syndicated transaction.

As the number and size of facilities has increased and the marketplace has become more competitive, some lenders have elected to take on a higher level of risk by loosening underwriting standards to become more borrower-friendly. Other lenders have chosen to focus on a specific area of the market; some choose to work in partnership with a smaller number of fund sponsors in arrangements, which also include administration and other transaction banking services. Some may restrict their lending to participating in syndicated or club deals rather than bilateral transactions. Some have geographical preferences or counterparty limitations to their financing businesses. Articulating the specific needs and parameters of your fund financing objectives is key to finding the right, long-term lending partner(s).

Managers looking for financing should ensure their limited partnership agreement and offering documentation has the requisite lender-friendly language and should be asking themselves what they want their borrowing base to look like. They should also consider the likelihood their investors will be institutional, and therefore enjoying the benefits of high advance rates in collateral calculations.

High advance rates in collateral calculations potentially allow managers to borrow more and therefore have additional flexibility in managing their portfolio. Presumably the facility can be of use for longer as the capital is called down.

Other considerations involve the fund's overcall provisions or side letters, cross-collateralisation of collateral pools, concentration limits on investors and accordion options, which allow borrowers to increase the size of the loan up to a certain point. The borrower's counsel needs to balance the requirements of the fund with the knowledge of what may create challenges to a lender; for example, overcalls can inhibit the potential amount a lender can recover in a default scenario.

KEEPING IT SIMPLE

In terms of operational and cost efficiencies, there are advantages for managers which can work with current partners for the subscription lines, such as their fund administrator or providers of other transaction banking products. This can allow for additional data capture in complex products and, for example, processing drawdowns and repayments can be streamlined when the lender can see the borrower base as the fund's administrator and transfer agent.

Additional operational efficiencies include streamlining payments within the same group – for example, MUFG Investor Services is increasingly taking on significant middle office roles for clients, which means we could deal with aspects of the fund such as the treasury flows and loan management as well. This can make for a stronger partnership by considering the relationship across multiple business lines.

A NEW FRONTIER

As this already mature product grows further, we expect to see managers considering hybrid financing, or 'whole life trades', where a portion of the facility is secured against the portfolio assets. Because many banks have separate teams for subscription line financing and for net asset value-based financing, they have historically been offered separately. There is increasing demand for the flexibility to use both uncalled capital and portfolio assets to facilitate the fund financing needs through the entire lifecycle of a fund. These innovations will help the future growth and development of lending products, so private market firms have the best possible tools to support their businesses.

Ben Griffiths *joined MUFG Investor Services as global head of fund financing in October and is based in the firm's London office. His team provides financing for private equity, real estate, debt and infrastructure funds via subscription lines of credit.*