Cash flow management by investment fund managers: considerations when setting up subscription credit facilities

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Subscription credit facilities have become a popular tool to increase flexibility in managing an investment fund's cash flows. However, these instruments are not always well understood by all parties. The popularity of these facilities has also led investors associations, such as the Institutional Limited Partners Association ("ILPA"), to raise concerns about the unrestricted use of such facilities. This article summarizes the main considerations to take into account when setting up subscription credit facilities and describes some of the best practices in this area, as recommended by the ILPA in June 2017.

Background

It has become customary for general partners ("**GPs**")[1] of private equity or venture capital funds to set up credit facilities for their funds. Most of the time, the main or sole purpose of these facilities is to provide bridge financing to fund portfolio transactions (and other expenses) in anticipation of future capital calls. A bridge facility simplifies the management of drawdown requests to limited partners ("**LPs**") by allowing the GP to limit the number of those requests and schedule for them (often quarterly). The GP will then manage the fund's cash flow between capital calls by drawing on the facility.

However, such facilities create somewhat of a misalignment of the LPs' and the GP's interests. This misalignment results from the added ability provided to the GP by such facilities to delay capital calls and the fact that such a delay may indirectly impact the moment when the GP's carried interest is paid and even perhaps the amount of such carried interest. The distribution waterfall of most investment funds is typically structured in such a way that LPs are favoured over the GP in the allocation of distributable cash until the cash distributed to the LPs provide them with an internal rate of return ("**IRR**") equal to their hurdle rate.[2] Given that the IRR is affected by the timing of cash inflows and outflows, LPs generally wish for the GP to call on their capital as soon as possible.[3]

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Earlier cash inflows put pressure on the GP to cause the fund to make distributions earlier (or in greater amounts) to achieve the targeted IRR and allow the GP to receive its carried interest earlier. In the usual set up, the factors that can affect the IRR are mostly out of the hands of the GP (i.e. it can postpone the timing of the capital calls until it requires the funds to complete a portfolio investment or cover expenses, but no further).

However, with a bridge facility, the GP benefits from the ability to delay capital calls, which indirectly favours a higher IRR and thus its chance of being entitled to a carried interest.[4] Even if the initial objectives of implementing a subscription credit facility are not to influence the IRR or the payment of the carried interest, such an operation nevertheless allows the GP to control at least one of the factors impacting the IRR, and therefore slightly alter the initial equilibrium between the interests of the LPs and those of the GP set out in the fund's limited partnership agreement ("**LPA**").

ILPA's best practices

In June 2017, the Institutional Limited Partners Association (the "**ILPA**") released a document entitled "Subscription Lines of Credit and Alignment of Interests – Considerations and Best Practices for Limited and General Partners" (the "**ILPA's Best Practices**"). The document generally highlights what the ILPA perceives to be adverse effects of a wide and unrestricted use of subscription lines of credit by investment funds as well as some of the best practices for dealing with such credit facilities. According to the ILPA and as noted above, one such adverse effect is a distortion in the application of the conditions related to the carried interest. The ILPA also demonstrates that the impact of the use of a line of credit on the IRR will be greater early in the life of the fund[5] and describes two of the effects of this impact, i.e. the potential for the GP to receive a carried interest in cases where the unlevered IRR may not meet the preferred return hurdle and the associated clawback issues.

Clawback issues arise when a GP is paid a carried interest during the life of the fund while calculations of the IRR later in the fund's life reveal that no such carried interest should have been paid. Most funds' LPAs contain clawback provisions forcing the GP to reimburse the carried interest previously received if paid unjustly based on the subsequent performance of the fund.[6] However, depending on how the LPA was negotiated, clawback provisions may lose their grip where the cash has in fact been distributed by the GP to its shareholders. This is why LPAs sometimes provide for escrow provisions or personal guarantees in support of the clawback undertakings.

To avoid this distortion and the risk of such issues arising, the ILPA recommends that the distribution provisions in LPAs specify that the date of cash inflow used to calculate the IRR should be the date at which the credit facility is drawn upon to make a portfolio investment or pay fund expenses rather than that when capital is called from the LPs to reimburse the amount drawn on the facility. Seeing how this recommendation is a departure from what is typically found in most investment funds' LPAs, the ILPA is probably attempting here to influence change in existing standards.

Typical restrictions found in LPAs

LPAs generally limit the ability of a GP to use leverage in the management of the fund, including in the context of the aforementioned bridge facilities. Restrictions are typically imposed on the amount of indebtedness (and guarantees of indebtedness) that can be incurred by the fund. The potential exposure of the fund is typically capped by a percentage of the undrawn capital and/or of the fund's aggregate capital (lenders also impose similar limits for reasons explained below).[7] The LPAs also often restrict the purpose for which a credit facility can be used, limiting it to bridging portfolio investments or, depending on the type of fund, to providing letters of credit to facilitate the negotiation and acquisition process of portfolio investments or to hedging purposes. It is to be noted that those two other types of facilities are structured differently than facilities for bridging capital calls and our comments herein may not apply to such types of facilities.

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Another typical restriction found in LPAs is a requirement for the GP to reimburse the lender and complete the required cash calls within a predetermined time period (often around 90 days after drawing on the facility). The ILPA proposes that such period should be no longer than 180 days. This restriction is meant to reduce the distortion in the application of the conditions related to the carried interest described in the previous section.

Considerations when negotiating with lenders

One of the first concerns of a GP looking to set up a line of credit for its investment fund is to find a lender that has experience with those types of facilities. While most Canadian banks now have teams that are dedicated to this sector and have experience in negotiating these types of facilities, it may be worthwhile to have an in depth discussion with the lending team regarding their level of experience and knowledge: the structure of a subscription credit facility for investment funds differs greatly from that of a standard commercial credit facility. Here are a few of the particularities of those facilities.

The borrowing base and the collateral

Most facilities rely on a borrowing base, i.e. the mechanism used to determine the amount that can be borrowed by the fund under the facility. Such borrowing base is calculated using a percentage of the undrawn capital committed by eligible investors. The relevant percentage of the undrawn capital generally depends on the rating attributed by predetermined rating agencies to eligible investors. The parameters for the calculation of the borrowing base are therefore crucial and attention should be paid to how they are defined in the agreements governing the facility.

As the borrowing base is typically limited to undrawn capital, the security should be in line with same, i.e. be limited to an assignment and pledge of the undrawn capital and of the rights of the GP to make capital calls. The assignment and pledge are sometimes coupled with a power of attorney granted to the lender, allowing it to make capital calls to investors on behalf of the GP following a default under the credit facility. In addition, the lender may request that a blocked account be set up and be subject to a security interest. The account will be used to receive the funds of investors following a capital call and the lender may trigger control over the account (or daily sweeps)[8] following a default under the credit facility.

The ILPA's Best Practices recommend that lines of credit should be secured solely by LP commitments and not by the underlying assets of individual LPs or the invested assets of the fund. Based on our experience, this recommendation reflects the current market standards for such facilities. Granting security over the LPs' assets (even if only on the units of the fund held by them) is generally not an option for a fund looking to raise capital from Canadian pension funds as they are usually prohibited from borrowing money (except in limited circumstances). Such LPs are thus often concerned that the creation of certain types of obligations on their part in favour of the lender may result in a violation of such prohibition. For this reason, they often impose restrictions (by way of side letters signed with the GP) on the ability of the GP to offer any such security on the pension funds' interest.[9] Granting security over the fund's investment is generally not an option either as prohibitions on assignments, among other difficulties, are usually attached to the investments.

Master-feeder and parallel fund structures

Investment funds that use master-feeder structures or have parallel funds may need to invest additional time in making sure that such structures and their impacts on the fund and the lender are well understood by all parties involved in setting up the line of credit . The complexity of the issues

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raised by such structures increases with the level of complexity of the structure of the fund. For example, the question of whether the other funds in the structure should act as co-borrowers or guarantors will probably be raised by the lender, especially if the borrowing base includes undrawn capital of those other funds. However, if those assets are part of the borrowing base, one cannot avoid them being part of the collateral. A careful analysis of the terms of the LPAs as well as of the economic impact of decisions regarding the liability of the other funds (including whether such liability is joint or joint and several (solidary in Québec)) is crucial. The GP must ensure, as part of such analysis, that the rights granted to the lender under the facility will not result in some LPs being favoured over others in the investment fund structure. Such a situation, even if it was not intended by the GP and solely results from a lender exercising its rights, could potentially cause the GP to become liable to the disadvantaged LPs in certain situations.

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These are only a few of the examples of the particularities associated with credit facilities tailored for investment funds. Further, a good knowledge by the lender of the standard structures used by investment funds will facilitate the due diligence process and the understanding of the various concerns or issues that may arise in the context of such facilities. For example, the GP typically wants to limit the documentation or requirements that a lender imposes on the LPs (to avoid unnecessary delays and costs but mostly because LPs often impose restrictions, in side letters signed with the GP, on documents they can be required to execute for the benefit of a lender). In many cases, the lender requires that investors be notified of the security given by the fund and the GP on the account or claim that constitutes their undrawn capital. The lender may also request, instead of a mere notice, that the investors acknowledge and acquiesce to the lender's security and its rights in case of a default under the credit facility. In some cases, the lender may also be justified in obtaining confirmations from investors as to the amount of their undrawn capital. Parties should be well aware of the various consequences of such requests.

In all cases, in order to simplify negotiations and structuring of credit facilities, the GP should also have initially ensured that it has sufficient flexibility in the fund's LPA and in the various side letters it entered into with LPs to avoid either amending the LPA or seeking consents from the LPs.

Reporting to LPs

Notwithstanding the foregoing, subscription credit facilities remain an effective fund management tool. As such, restrictions imposed by LPs should aim to ensure that such facilities are used by the GP in an effective and appropriate manner (and that rights granted to the lender do not overly expose LPs). One important concern for LPs, however, should be to ensure that the GP's reporting on the use of the facility is adequate. GPs should also be forthcoming in that regard. The ILPA's Best Practices recommend that detailed quarterly reports be provided to LPs as to the following information: the number of days outstanding for each drawdown, the current use of the proceeds of the lines of credit, the net IRR with and without the use of the credit facility, the terms of the credit facility (term, upfront fee, standby fees, etc.) and costs to the fund (interest and fees). They also suggest that advisory committees include discussing the lines of credit as part of the meetings' agenda to allow investors sitting on such committees to assess whether the terms of the facilities are considered consistent with "market" practices.

The ILPA also proposes that detailed information on the terms of the facilities be disclosed to LPs, including, for example, terms that may introduce additional risks to the fund (e.g. any provision providing lender discretion over management decisions, or providing exposure beyond the amount of unfunded commitments).

GPs should also ensure that the right to use such credit facilities is well described in the offering or

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private placement memorandum distributed to investors.

Conclusion

Subscription credit facilities for investment funds must be tailored to this very specific industry. Applying the principles of traditional lending to such facilities will result in the inadequacy of the facility and will not serve any party's interest. For all parties involved, one essential rule remains: the economics of a fund and the mechanisms of the facility must be well understood by all so that the credit agreement, the LPA and the side letters are aligned and operate without conflicts. What you want in the end is a well-oiled machine.

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1. Most private equity and venture capital funds are structured as limited partnerships whereby the manager is acting as general partner of the fund.
2. For more information on the method of determination of the distribution waterfall, see our article entitled "Private equity fund economics in Canada: an overview of the essentials" published in December 2014 in the Lavery Capital newsletter No. 3.
3. In addition, given that LPs must ensure that their capital is readily available to answer cash calls, such capital would generally produce low returns (or no returns at all). This is one more reason why LPs prefer to have their capital used by the fund manager as early as possible to generate returns.
4. This is also why GPs would never simply call the capital of LPs regularly in advance in anticipation of future portfolio investments solely to simplify the management of drawdown requests.
5. We refer you to the ILPA's Best Practices for the financial demonstrations.
6. Some LPAs will provide for a single clawback mechanism triggered at the time of the dissolution of the fund, while others will also provide for an interim clawback mechanism after a certain number of years.
7. The ILPA's Best Practices recommend that the maximum amount that can be drawn on a facility should equal a maximum percentage of the uncalled capital rather than being based on the fund's aggregate committed capital.
8. The terms and conditions of a blocked account agreement may vary but will ultimately give the lender control over the funds deposited in the account in case of a default under the credit facility.
9. For more information on restrictions applying to pension funds, see our article entitled "Pension Plans and their investment rules: investing in alternative investment funds in full compliance" published in October 2016 Lavery Capital newsletter No. 12. For the same reason, Canadian pension funds will sometimes want to restrict the ability of the GP to grant the lender rights allowing it to require reimbursement of the facility directly from the LPs.

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