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Article

The Advantages of Subscription Credit Facilities

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The market for subscription-backed credit facilities, also known as “capital call” or “capital commitment” facilities (“Subscription Facilities”), continues to grow rapidly, expanding into a broader range of Funds,[2] with constantly evolving features and mechanics. As the Subscription Facility market continues to grow, the functionality of Subscription Facilities has also grown beyond its roots of bridging capital calls. Funds are now realizing a variety of benefits beyond bridging capital calls, several of which are briefly discussed below.

Bridging Capital Calls and Other Financings

Traditionally, the primary function of Subscription Facilities has been to bridge capital calls and other types of permanent financing, creating a number of benefits including the following.

First, Subscription Facilities offer Funds fast access to capital, allowing Funds to move quickly with respect to time-sensitive investments. In the governing documentation of typical Funds, investors must be given at least 10-15 business days notice prior to funding a capital call. In contrast, the terms of most Subscription Facilities permit Funds to receive borrowings with as little as one business day notice, avoiding the long lead time required in calling capital from investors. The faster access to capital afforded by a Subscription Facility may give Funds a competitive advantage over rivals, especially with respect to quickly developing opportunities. Additionally, by having a Subscription Facility available, Funds may be able to avoid making anticipatory capital calls for investments that are ultimately not consummated resulting in an administrative burden of returning the capital to the investors.

Second, Subscription Facilities provide a means for Funds to “smooth” capital calls made to investors in terms of size and frequency. Without a Subscription Facility in place, Funds may need to make frequent capital calls in small amounts in order to provide for working capital and similar expenses, including payment of management fees. With a Subscription Facility in place, Funds are able to borrow for these smaller capital needs and subsequently call larger amounts of capital at more regular intervals to repay such borrowed amounts. By utilizing the Subscription Facility to “smooth out” capital calls, Funds and investors are relieved of the administrative burden caused by small and frequent capital calls, meaning cost savings for both Funds and investors.

Finally, Subscription Facilities offer a means for Funds to bridge permanent asset-level financing. In a scenario where a Fund is unable to secure asset-level financing prior to the consummation of an investment, the Fund may be able to rely on the Subscription Facility to bridge the gap. Proof of access to capital via the Subscription Facility may be a means for the Fund (as a bidder) to show the seller of an asset that it has access to funds for purposes of finalizing the transaction prior to the Fund being able to secure commitments from asset-level lenders. This bridging function gives Funds a stronger bargaining position when negotiating asset-level financing with lenders, since the Fund's hand is not forced by the ticking clock of the impending investment closing. Additionally, incurring debt under the Subscription Facility may be a cheaper alternative to the asset-level financing available, with less burdensome reporting requirements, in which case the Fund may be incentivized to leave Subscription Facility debt outstanding for a longer period of time.

Access to Letters of Credit and Alternative Currencies

Another benefit of Subscription Facilities is providing Funds access to letters of credit and alternative currencies. Access to letters of credit can provide a valuable financial instrument to Funds, particularly in the development phase of projects. Additionally, as Funds expand globally, the ready access to alternative currencies often provided in Subscription Facilities can be an advantage for Funds. Such ready access to alternative currencies eliminates the need for Funds to call capital in one currency and convert it to another, improving the speed of capital access, lessening the impact of exchange rate exposure and reducing administrative burden. In the event a Fund needs access to new alternative currencies, typical Subscription Facility mechanics generally permit Funds and lenders to readily add new alternative currencies to the Subscription Facility.

Facilitates "True Up" of Capital

Typical governing documents of Funds require investors "true-up" capital contributions when new investors are admitted to the Fund. These true-up mechanics ensure that capital contributions made by prior investors are rebalanced so that new investors have their pro rata interest in the Fund. Such mechanics typically require contributions from new investors and return of contributions to prior investors, which is burdensome and adds back-office costs for both the Fund and the investors. By utilizing a Subscription Facility for the Fund's capital needs prior to the Fund's final investor closing, the Fund may be able to eliminate or lessen the need for this true-up requirement. Rather than calling for additional contributions or returning prior contributions each time new investors enter the Fund, the Fund may be able to front the purchase of investments with proceeds of the Subscription Facility until the final investor closing.

Hedging and Swaps

The inclusion of hedging and swap collateralization mechanics into Subscription Facilities offers a means for Funds to secure "foreign exchange forwards" and "foreign exchange swaps" (collectively, "Eligible Swaps")[3] under the Subscription Facility, rather than posting cash or other collateral with hedge and swap counterparties. These mechanics, in short, permit the Fund to request that Eligible Swaps be allocated a portion of the borrowing base on a pari passu basis for purposes of collateralizing such agreements. In the event the applicable Eligible Swap moves against the Fund, the Fund can typically request that additional collateral be allocated to the borrowing base. These mechanics are extremely valuable to Funds as they avoid either the borrowing expense of posting cash or the drag on return caused by the Fund keeping cash or other liquid collateral on hand.

So too, in light of certain margin regulations scheduled to take effect in many jurisdictions around the globe, most other types of swaps and hedges (hereinafter, "Ineligible Swaps") will now be required to be collateralized by cash or highly rated securities. For these Ineligible Swaps, Subscription Facilities offer crucial and quick liquidity for Funds needing to post cash to secure such swaps at relatively inexpensive borrowing and carrying costs.

Qualified Borrowers

Subscription Facilities often include an option for Funds to add Qualified Borrowers to the Subscription Facility. Typically, "Qualified Borrowers" are portfolio companies or their holding companies that are controlled by the Fund, do not provide any security or credit support with respect to the Subscription Facility, are only liable for their own borrowings (and not the borrowings of the Fund or any other Qualified Borrower), and are included in the Subscription Facility without the lenders conducting an in-depth review of their financial health. Qualified Borrowers provide Funds the flexibility to incur indebtedness at different levels of their organizational structure, primarily for tax and accounting purposes. This function may be particularly valuable when a Fund wishes to incur debt at the holding company level but is unable or delayed in obtaining its own financing or the Subscription Facility provides a cheaper alternative.

Distributions and Redemptions

Subscription Facilities may enhance the ability of Funds to pay distributions to investors and honor redemptions on behalf of Investors. The liquidity provided by Subscription Facilities allows Funds to make distribution payments to investors prior to the liquidation of such Funds' investments. This function can smooth distributions for investors and prove particularly valuable in a scenario where a Fund owns appreciating assets that do not generate large cash flows. With respect to open-end Funds, Subscription Facilities can likewise provide liquidity to Funds in honoring redemptions by investors, allowing Funds to avoid liquidation of investments at inopportune times. Effective use of a Subscription Facility for the foregoing distribution and redemption functions may make Subscription Facilities more attractive to investors.

The foregoing provides only a brief overview of some of the advantages of Subscription Facilities. As the features and mechanics of Subscription Facilities continue to grow, the utility of Subscription Facilities to Funds continues to grow. As more Funds realize the benefits associated with Subscription Facilities, we expect greater market penetration and higher utilization of Subscription Facilities.

Endnotes

1 Kiel Bowen is a partner in Mayer Brown's Banking & Finance practice, where his practice centers on fund finance. Todd Bundrant is a partner in Mayer Brown's Banking & Finance practice.

2 "Fund" is used herein to describe any real estate, private equity, infrastructure, debt and similarly focused investment funds.

3 The term "foreign exchange forward" means a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange. The term "foreign exchange swap" means a transaction that solely involves: (a) an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (b) a reverse exchange of the two currencies described in subparagraph (a) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 721(a), 124 Stat. 1376, 1661 (2010) (codified at Commodity Exch. Act § 1a(24)-(25); 7 U.S.C. § 1a(24)-(25)).

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