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Summer 2013 Subscription Credit Facility Market Review

By Ann Richardson Knox[1]

Despite continued challenges in the fundraising market for sponsors of real estate, private equity and other investment funds (each, a "Fund"), the positive momentum capital call subscription credit facilities (each, a "Facility") experienced in 2012 has continued and perhaps accelerated in early 2013. And for good reason: on all the panels at the Subscription Credit Facility and Fund Finance Symposium in January of 2013 in New York City (the "SCF Conference"), mention by panelists of institutional investor funding delinquencies could be counted on one hand.

This type of historical investor (each, an "Investor") funding performance of course translated to near perfect Facility performance through and coming out of the financial crisis. Yet despite the excellent Facility performance and the measured growth of the Facility market generally, there is growing recognition that certain trends in the market are creating very real challenges. Below we set out our views on the Facility market's key trends, where they intersect and the resulting challenges and opportunities we see on the horizon.

Key Trends

There are four key trends in the market we see creating material impact: (i) the general maturation of the Facility product and market; (ii) the continuing expansion of Facilities from their real estate Fund roots into other Fund asset classes, and particularly, private equity; (iii) Fund structural evolution, largely responsive to the challenging fundraising environment and Investor demands; and (iv) an entrepreneurial approach among Funds to identify new Investor bases and new sources of capital commitments ("Capital Commitments"). We analyze each below.

The Maturing Facility Market

Many Facility lenders (each, a "Lender"), Funds and other Facility market participants have for a long time benefited from the under-the-radar nature of the Facility market. While the market was certainly sizeable—for example, in 2011 Mayer Brown LLP alone worked on Facilities with Lender commitments in excess of $16 billion—it remained a niche in which only a subset of Lenders participated and was largely unknown to the greater financial community. That has certainly changed. The Facility product and its market recognition have matured and are continuing to grow rapidly for a variety of reasons, not the least of which was the publicity created by the sale of the WestLB AG, New York Branch Facility platform to Wells Fargo Bank, N.A. in 2012. Five years ago, the Facility market was operating in virtual obscurity; today it is a common staple familiar to nearly the entire finance community. DBRS has published rating criteria, an insurance company has approached Lenders offering to write credit enhancement on transactions or even individual Investor Capital Commitments and 400 people registered for the SCF Conference, up from 60 in 2010.

There are certainly benefits to being in a more recognized market, but there are also growing challenges. On the plus side, management now fully understands the product, and has context when considering requests for resource allocations. A Fund sponsor's (each, a "Sponsor") CFO no longer needs to explain the product to his partners; they now understand the timing and internal rate of return benefits. Credit personnel analyzing Facilities now have a better grasp of both the embedded risks and the practical performance, leading to better structured and more accurately priced Facilities. But challenges abound. New entrants (Lenders, law firms, etc.) are eager to join the market, some with extensive understanding from lateral hiring and others with more limited degrees of experience. This creates pricing pressure (a positive or negative, depending on your side of the aisle), as new entrants are often forced to compete on price when they cannot credibly demonstrate execution capabilities. It also tends to lead to Facilities being consummated with security structures and collateral enforceability issues that are different or weaker than what has traditionally been deemed "market," as newer participants are less tied to historical structures. Further, as the product matures and garners increased managerial attention, the inherent channel conflict at certain Lenders as to where within the institution to house the product often surfaces. Such channel conflict often leads to centralization of execution, as management realizes the disparities of credit standards and structures in different areas within the institution. Centralization of course leads to challenges, as both Fund relationships and execution experience are critical to a successful overall platform. Finally, a number of Lenders have become quite adept at providing Facilities, and have amassed impressive portfolios. In connection with these increasing exposures, these Lenders have rightfully garnered increased attention from the credit and risk management departments within their institutions. This increased attention often results in the creation of policies and procedures setting guidelines for what a Lender is able to do for the product and what items are outside of policy and require special considerations. Not surprisingly, these types of policies are being tested by the next several material trends.

Continued Expansion into Private Equity

Facilities are sometimes seen as a commodity product in the real estate Fund space, as some real estate Sponsors have been using the product for many years. This extensive experience has lead to provisions in limited partnership agreements ("Partnership Agreements") that tend to adequately contemplate a potential Facility and incorporate the Investor acknowledgments and agreements that a Lender would like to see for a Facility. As real estate Fund Sponsors form new Funds, the precedent Partnership Agreement typically already has these provisions, they carry forward, and the new Fund is ready for a Facility upon its initial Investor closing. But other asset classes are different. As private equity, mezzanine, infrastructure, energy, venture and other Funds (and especially buyout Funds) have traditionally enhanced returns with asset level leverage and less so with Fund level debt (if they used leverage in the first instance), their predecessor Fund Partnership Agreements are frequently less explicit or developed with respect to a Facility. And, of course, when the next Fund is to be formed, Sponsors naturally want to keep revisions to the precedent Partnership Agreement as limited as possible so as to minimize the changes that need to be presented to prospective (and in many instances recurring) Investors. This often leads to a minimal language insertion authorizing the incurrence of debt and the pledge of Capital Commitments; language far less robust compared to what Lenders are traditionally used to seeing and relying on from real estate Funds. Further, Sponsors outside of real estate have more frequently included overcall limitations and other structural complexities, which prove challenging for Lenders.[2] Thus, as

Lenders continue to expand Facilities into Funds focused on private equity and other asset classes, they are increasingly challenged by Partnership Agreements that are less conducive to the Facility structure Lenders have grown to expect. This challenge is presenting almost weekly and standard setting for acceptability is going to be a key element for any Lender in the near future.

Fund Structural Evolution

Depending on your data source and region, 2012 fundraising was between flat globally and at best up just incrementally, especially in the United States. And while our fund formation practices have certainly seen some robust activity in early 2013, we remain guarded as to whether 2013 fundraising will materially outpace last year. The increased negotiation leverage of Investors derived from a difficult fundraising environment and their increased coordination facilitated in material part by the formation and advocacy of the Institutional Limited Partners Association is resulting in significant structural evolutions for Funds (especially outside of the real estate space, where traditional structures seem to be holding more firmly). Funds are increasingly structuring more tailored options for particular Investors (often to accommodate their particular tax or regulatory needs), leading to more Fund entities and more complicated Fund structures. We continue to see Investors making larger commitments to fewer, more seasoned Funds, increased use of separate accounts, sidecars and other co-investment vehicles, Investors committing through special purpose vehicles (each, an "SPV"), formation of Funds as open-ended or evergreen, and extensive concessions provided to material Investors. We have seen structures where certain parallel funds are "funds of one" that cannot be cross-collateralized, where Investors have cease-funding rights in the event the Sponsor fails to fund a capital call (a "Capital Call"), and where an Investor invests directly into a separate, newly formed SPV, created specifically for such Investor on a deal-by-deal basis. These are just a few examples of some of the trends.

To a Facility Lender, of course, "fund structural evolution" means: "Your collateral package is changing." And, when you have a Lender-led trend toward the centralization of the product and the establishment of policies and guidelines, combined with a Fund trend of increased structural complexity designed to accommodate Investors (i.e., not accommodate Lenders), you have a natural tension. Thus, Lenders are working on getting their arms around things like the credit linkage between an SPV and the actual creditworthy Investor, how to efficiently add alternative investment vehicles as borrowers, and how to handle withdrawal rights related to violations of placement agent regulations. So an emerging challenge—and opportunity—is how to best manage this natural tension. How do Lenders develop policies that incorporate optionality into their product suite to accommodate a rapidly evolving Fund structural environment? For example, how does a securitization group tackle a Facility with a parallel fund of one that cannot be joint and severally liable but which has an investment grade Investor? How do Facilities with tight overcall limitations price compared to standard Funds without overcalls? How do you structure a Facility to an open-ended fund?[3] And while these issues are certainly challenging, they clearly trend away from a commodity product, and, thereby, create opportunity. Bespoke structures require customized solutions, and because customized solutions cannot be provided by all, they afford the potential for attractive returns.

New Sources of Capital

As Sponsors have sought to expand their sources of capital, the private wealth divisions of the major banks have not missed a beat and have created a variety of product offerings to bridge the gap between high net worth individual Investors ("HNWs") and Funds. Many major banks have created or are creating feeder funds

(“Aggregator Vehicles”) whereby a large number of HNWs can commit directly to the Aggregator Vehicle (or make an upfront one-time investment in the Aggregator Vehicle) and the Aggregator Vehicle in turn commits to the Fund.[4] This enables the HNWs to obtain exposure to Funds whose minimum Capital Commitment threshold they could not otherwise meet. In certain circumstances Aggregator Vehicles can even offer more liquidity than a traditional investment in a Fund by including redemption and transfer rights that would be atypical at the Fund itself. The banks sponsoring Aggregator Vehicles customize the opportunity to the wishes of the Sponsor and the HNWs, and Aggregator Vehicles may be structured to facilitate participation by the HNWs in a single Fund, in a series of Funds sponsored by the same Sponsor, or in multiple Funds sponsored by unrelated Sponsors. There are Aggregator Vehicles being marketed with minimums as low as $50,000. The Aggregator Vehicles often make material Capital Commitments to Funds, and hence their inclusion or exclusion from a Facility’s borrowing base can have a material impact on Facility availability. While Aggregator Vehicles are not rated institutions and can be challenging for traditional Facility underwriting guidelines with respect to Investors (including for those Lenders that advance against HNWs that commit directly), they clearly have inherent value worthy of some level of advance or overcollateralization benefit. In fact, it could be argued that in some ways they could be more creditworthy than a traditional institutional Investor, as their source of funds comes from a diversified pool, typically with overcall rights to cover shortfalls created by any particular HNW’s failure to fund. Figuring out the right level of advance rate and concentration limit for Aggregator Vehicles is clearly an emerging challenge and opportunity. And the development of similar vehicles and concepts that deliver HNW Investor Capital Commitments to Funds is likely to continue and increase.

Along similar lines, we expect that the continuing shift from defined benefit plans to defined contribution plans will ultimately lead Sponsors and their advisors to create products that allow defined contribution plans and related individual investor savings accounts access to Funds. While the challenges are real: the lack of redemptions does not sync well with the portability of 401(k)s, the accredited investor standard, etc., we believe the challenges are not insurmountable. And while we do not anticipate a sudden change anytime soon to open access to this source of funds, it does seem that the historically favorable rate of return provided by Funds, combined with the sheer size of long-horizon assets invested in IRAs and 401(k)s, makes their eventual connection somewhat inevitable over the long term. Whether the ultimate vehicles and structures formed to facilitate this source of funding involve Capital Commitments or something similar that would enable application for a Facility remains to be seen.

Conclusion

The Facility market is maturing and evolving in ways that create challenges and significant opportunities. We expect that the Facility market will continue to grow at a solid clip as fundraising improves, Fund formation increases and the product further penetrates the various private equity and other asset classes. But we expect that the evolution of Fund structures and new sources of Capital Commitments will challenge the historical Facility structures, leading to more customized and tailored and less standardized Facility constructs. Those Lenders nimble enough to move with these tides will have significant opportunities.

Endnotes

1 Ann Richardson Knox is a partner in the Banking & Finance practice at Mayer Brown and oversees the Fund Finance team in the New York office.

[2] For an in-depth review of overcall limitations, please see Mayer Brown's Legal Update, "Subscription Facilities: Analyzing Overcall Limitations Linked to Fund Concentration Limits."

[3] Sponsors tend to refer to these HNW vehicles as "feeder funds." We prefer to refer to them as "Aggregator Vehicles" to avoid confusion with traditional feeder funds formed by a Sponsor itself.

[4] For further information about open-ended funds, please see Mayer Brown's Legal Update, "Structuring a Subscription Facility for Open-Ended Funds."