The Global Subscription Credit Facility Market – Key Trends and Emerging Developments

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Introduction

Subscription credit facilities (each, a "***Facility***"), also known as 'capital call' or 'capital commitment' facilities, are credit facilities extended to real estate, private equity, infrastructure, debt and similarly focused closed-end funds (each, a "***Fund***") that are secured by the uncalled capital commitments (the "***Uncalled Commitments***") of the Fund's limited partner investors ("***Investors***"). Once a relatively obscure and niche component of the finance market, Facilities continued their rapid expansion in 2013 and had an excellent year as an asset class. Consistent with experience before, during and after the financial crisis, Investor funding performance on calls ("***Capital Calls***") on their Unfunded Commitments was near perfect in 2013. Correspondingly, Facility credit performance was excellent, and we are not aware of any Facility payment events of default last year. In addition to the very positive credit performance, the volume of consummated Facilities has continued to expand year-over-year as well, despite significant and increasing challenges and uncertainties for lenders ("***Lenders***") in the market. This chapter explores the state of the Facility market and the key trends and emerging developments likely to be relevant in the immediate future.

Facility Growth and Prospects

The Facility market enjoyed substantial tailwinds in 2013 from both the material uptick in Fund formation and the increased penetration into Fund families that have historically not utilized Facilities. In 2013 worldwide, 873 private equity Funds of all asset classes reached a final close and raised an aggregate of $454 billion in Capital Commitments. This represents the most successful fundraising seen in the market since 2008 and is a 19% increase on 2012.[1] But while this clear increase certainly provided additional collateral enabling more and larger Facilities, it was only part of the growth story. Facilities continue to gain traction beyond their real estate Fund roots and into buyout and infrastructure and other Fund asset classes that are relatively new to Facilities, as these Funds become increasingly familiar with the benefits and utility of having a Facility. Further, as a result of the excellent credit performance of Facilities over time (especially during the financial crisis), Lenders have become increasingly comfortable with certain Facility structures and Investors that historically would not have met credit underwriting standards. This expansion of underwriting has also enabled Facility growth.

While there is not presently an industry recognized data resource surveying and tracking Facilities, based on anecdotal data the market is covertly large. On the "*Subscription Credit Facilities and Fund Finance Strategies*" panel at the ABS Vegas conference sponsored by the Structured Finance Industry Group in January 2014, several panelists estimated that the current Facility market may well be $75-$100 billion in terms of global Lender commitments to Funds. Looking forward for 2014, we forecast continued incremental growth for the volume of Facilities consummated and the size of the market. As of January 2014, there were 2,081 Funds on the road fundraising (up from 1,940 in 2013 and 1,814 in 2012), and the vast majority of market sentiment predicts an increase in aggregate Capital Commitments to be raised in 2014.[2] This forecasted increase will certainly continue to seed Facility growth. There is also still a large universe of Funds and entire Fund families not utilizing Facilities, at least in the buyout and venture capital asset classes, which presents additional opportunity. Finally, Funds are now using Facilities much more frequently during their entire tenor (i.e., from their initial Investor closing through their liquidation of final assets), and this continuity of use of Facilities throughout a Fund's life cycle is keeping Facilities on the books for many years beyond their original tenor.

De-Commoditizing and the Increase in Bespoke Structures

Facilities are sometimes seen as a commodity product in the real estate Fund space, as some real estate Funds have been using the product for years in a largely consistent structure. However, a confluence of factors is driving significant change in Fund and Facility structures, and the product is in many respects de-commoditizing.

Fund Structural Evolution and a Changing Investor Universe

While Investor fundraising did show significant overall improvement in 2013, securing Capital Commitments from Investors is requiring more time and more structural accommodations than in the past. Funds continue to form more separate accounts (often called 'managed accounts'), parallel funds-of-one, blocker corporations to negate tax concerns and alternative investment vehicles, in each case to more precisely optimize the Fund for the specific preferences of particular Investors. These structural changes to Funds are increasing the complexity of Facilities, as additional Fund entities need to be incorporated into the Facility collateral package to ensure ultimate security in the Unfunded Commitments. Further, a number of Investor issues are challenging historical Lender underwriting guidelines. The single Investor exposure in separate accounts conflicts with the Lender

preference for a granular pool of Investors offering diversification and overcollateralization. Investor side letters from time-to-time include provisions that challenge or create ambiguity as to a Lender's unimpaired enforcement rights. Sovereign wealth funds and fund of fund Investors (which entities are typically unrated and without publically available financial statements) are increasingly significant and even flagship Investors in Funds. High net worth individual Investors, including those investing through a managed platform sponsored by an investment bank or advisor, are increasingly providing Funds material Capital Commitments. These trends can be challenging for those Lenders used to relying on credit ratings for Investor underwriting, but excluding them from Facility borrowing bases ("***Borrowing Bases***") may fatally impair the utility of a prospective Facility.

Overcall Limitations

Overcall limitations ("***Overcall Limitations***") are provisions in a Fund's partnership agreement that limit an Investor's obligation to fund a supplementary Capital Call made for the purpose of funding any shortfall created by another Investor's default or exercise of an excuse right. While a rarity prior to the financial crisis, Overcall Limitations seem to be permeating the market and increasing in both prevalence and grip, especially outside of real estate Funds. The initial 150% threshold is now sometimes as low as 120% and Overcall Limitations linked to a Fund's investment concentration limits sometimes provide no overcollateralization buffer at all for maximum size investments. This trend is of course problematic for Lenders and threatens the traditional underwriting criteria for Facilities. Overcall Limitations both undermine the general premise that one Investor's Uncalled Commitment over-collateralizes that of a defaulting Investor and broadens the Lender's credit exposure to Investors that were excluded from the Borrowing Base in the first instance. For a Fund with Overcall Limitations, the Fund's particular Investor constituency needs to be carefully analyzed as a whole and applied to the particular form of Overcall Limitation, and there are certain Facilities that are simply not viable because the particular Overcall Limitation does not afford sufficient overcollateralization for the Lender.

Facility Analysis

As each of these variables can combine in an infinite number of forms in any particular Facility, each Facility must be evaluated in the context of its whole and gone are the days of simply checking for a few sizeable rated Investors. In many cases, Lenders are now actively considering and implementing asset-level mitigants to attempt to offset any perceived shortcomings in the Fund structure, the Investor pool or the Fund's partnership agreement, including in certain circumstances minimum net asset value covenants and requirements to make periodic Capital Calls. The Facility market is simply not a commodity market at present.

Lender Border Crossings and Regional Lender Expansions

Facility structures are also evolving as new Lenders enter new sub-markets. While new entrants have for years endeavored to enter the Facility market, certain movements accelerated in 2013 that have the potential for better traction. Multiple European Lenders are making real investments to build their capabilities in the United States. Unlike some of their new entrant predecessors, these Lenders have real, demonstrable execution capabilities, if primarily in a different sub-market. Similarly and in reverse, many of the dominant US Lenders are increasingly attentive to Europe and Asia. Several US-based Lenders had real successes in 2013 and early 2014, at least in Europe. As Lenders emigrate, they bring their historical Facility structures and underwriting guidelines to the new sub-market. As a result, Funds are increasingly finding themselves with Facility proposals with significant structural variation (a traditional Borrowing Base versus a coverage ratio, as a simple example). Along a parallel path, multiple regional Lenders are expanding beyond their historical footprints, often in efforts to keep up with the growth of their Fund clients. Many regional Lenders have increased their Facility maximum hold positions significantly and several regional Lenders made impressive progress increasing their brand awareness and relevance in the market last year. As their Facility structures and underwriting parameters often differ from a traditional Facility, they are also altering the competitive landscape.

There are several areas where these developments are likely to have a meaningful impact in the near term. First, structural variations in Facilities have an immediate impact on syndication strategy, as certain Lenders have structural guidelines that may or may not permit deviation as wide as what is now being seen in the market. Thus, Funds need to determine Facility structures in hand with syndication preferences and needs. Additionally, the growing competitive challenges are stressing those Lenders that have historically only participated in, and not led, Facilities. Because Funds in the new environment are more likely to have multiple suitors, they are more frequently dictating their own syndicate members, making it far more challenging for Lenders that are used to seeing opportunities presented by a lead arranger. However, the Facility market has shown multiple times in recent years that if you add an experienced origination banker you can become relevant relatively quickly, it is likely that 2014 includes some lateral banker movement as Lenders seek to increase their direct visibility with Funds.

While these competitive changes are real and increasingly evident every day, we expect that the actual impact to the competitive landscape for incumbent Lenders to be largely contained to the margins. If 2014 Facility growth is just 5-10% of 2013 (which a number of reasonable factors seem to support), for a market as large as the Facility market, growth will simply consume a major portion of any new lending capacity entering each sub-market. But further, there are several factors that suggest changes will be incremental, not immediate. First, a number of the large incumbent Lenders in both the US and Europe have done an excellent job the last three years pivoting with the market and building out great portfolios. Because the switching costs in this product are real, not just when a Facility comes up for renewal (in which case they are very real) but also with successor Funds in the same Fund family, wholesale turnover in Lender groups across the market is highly unlikely. Further, if you look behind the aggregate fundraising numbers into which Funds are actually raising the capital, concentration and the continuing 'flight to quality' is evident. Investors are making larger Capital Commitments to fewer Fund sponsors ("***Sponsor***s") and this is resulting in larger Funds run primarily by top tier Sponsors. Preqin reports that only 7% of 2014 capital raised was by first time Sponsors. These established Funds are often deeply aligned with incumbent Lenders, further making a significant shift in the market unlikely. When you couple virtually any growth in the overall size of the Facility market with the incumbent Lenders' large existing portfolios, expansive origination reach and typically greater entanglements with top tier Sponsors in terms of financing the assets, a material 2014 volume downturn for them seems unlikely, despite the increased competition.

Credit Continuum

Supported by the excellent credit performance of Facilities throughout the financial crisis (and probably in part due to the increasingly competitive landscape), Lenders are now more willing to underwrite Facilities further down the risk continuum than they have in the past. For example, we are increasingly seeing Facilities consummated for Funds with partnership agreements with more general and less precisely tailored Facility authorization language. Lenders' tolerance for certain levels of Overcall Limitations has increased, at least for certain experienced Sponsors and Funds with strong and diverse Investor pools. Additionally, in many contexts, Investors are being included in Borrowing Bases that were historically excluded, including unrated Investors, Investors with sovereign immunity or side letter issues and high net worth Investors in managed platforms.

Based on the vast majority of Facilities we have seen to date, we think this downward trending has been largely rational and supportable based on the greater availability of extremely positive Investor funding and Facility performance data. Facilities are an asset class where the historical funding delinquency percentages of the excluded Investors – those where the Lenders provide a zero advance rate – is significantly lower than the delinquency percentage of the included assets in virtually any other ABL or securitization asset class. When you combine (i) that level of favorable Investor funding performance, (ii) a robust secondary market in Investor partnership interests eager to take out any financially stressed Investors, and (iii) Facilities being structured as full recourse loans likely to have some asset value sufficient to contribute to repayment if ever needed, some structural evolution designed to accommodate Funds seems supportable.

Additional Market Trends and Developments

There are a host of secondary developments in the Facility market worthy of note, including the following:

- ***The Regulatory Environment***. Similar to virtually every lending market, Lenders are facing an uncertain and challenging regulatory environment. Many of the regulations emanating from the credit crisis are now moving to the finalization and implementation stages, and Lenders are having to adapt. Moreover, additional regulations continue to be proposed. Lenders may evolve Facility structures, including potentially greater emphasis on uncommitted tranches, to adapt.
- ***Municipal Pensions***. Municipal pension funds in the United States, often flagship Investors, are under ever-increasing pressures. Despite the relatively robust performance of the equity markets and the significant rebound in many real estate markets in 2013, the outlook for many of these Investors is declining. As a result, the credit profile of many municipal pensions will continue to trend negatively going forward, stressing the underwriting for including them in Borrowing Bases.
- ***Cayman Limited Partnership Act Updates***. As many offshore Funds are organized in the Cayman Islands to achieve tax efficiencies, market participants should be aware of pending legislation that would overhaul their existing partnership law. The proposed changes, announced in February 2014, aim to, among other things, (1) synchronize the drafting of Cayman Islands partnership agreements, (2) declare that default penalties will not be unenforceable solely because they are punitive in nature, (3) confirm that the right to clawback distributions will only be required if the Fund is insolvent at the time the original distribution, and (4) streamline the procedure to admit new Investors and effectuate transfers of partnership interests. Additionally, the Contracts (Rights of Third Parties) Law, also pending, is designed to confer third party beneficiary rights via an opt-in requirement. Any changes in the partnership law of this key jurisdiction need to be monitored closely.

Conclusion

Facilities enjoyed a very positive 2013 from both a credit and growth perspective, but not without real and increasing challenges. With double digit performance returns for Funds in the majority of asset classes last year, Investors now have extensive 'skin in the game' and funding incentives across a wide swath of Funds supporting Facilities. Such increases in Fund net asset value certainly project well for 2014 Facility performance. But while the data suggests the positive trends for Facilities will continue, competitive, underwriting and regulatory developments are all likely to increasingly challenge Lenders, at least at the fringes, throughout the upcoming year.

Endnotes

1 See, Presentation Materials of Ignatius Fogarty, Head of Private Equity Products, Preqin, from the 4th Annual Subscription Credit Facility and Fund Finance Symposium, held January 16, 2014 in New York, NY.

2 See, *2014 Preqin Global Private Equity Report*; and *Global Private Equity Report 2014*, by Bain & Company.

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