FFA ANALYSIS AND RECOMMENDATIONS ON THE ILPA GUIDELINES FOR SUBSCRIPTION CREDIT FACILITIES

Introduction

In June 2017, the Institutional Limited Partners Association ("ILPA")[1] published a guidance paper titled: "Subscription Lines of Credit and Alignment of Interests—Considerations and Best Practices for Limited and General Partners" (the "Guidelines"). A copy of the Guidelines is available on ILPA's website at https://ilpa.org/wp-content/uploads/2017/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf. As the title implies, the Guidelines provide background on subscription credit facilities ("Facilities"), discuss their benefits and potential risks, and give a list of recommendations and questions that limited partners ("Investors") may wish to consider and ask of their private fund sponsors ("Fund Sponsors").

The Fund Finance Association (the "FFA") is a non-profit industry association in the fund finance market. Its mission is to educate market participants, build consensus around key issues and otherwise support the fund finance industry. The FFA has reviewed the Guidelines in detail and discussed their substantive recommendations extensively with market participants. The FFA believes its constituents, as direct market participants in fund finance transactions, have in-depth knowledge and experience with Facilities and their usage that could provide a helpful perspective on the Guidelines. This article presents the FFA's views on the Guidelines and sets forth recommendations for IPLA's consideration in subsequent versions thereof.

The Guidelines

I. Background and Context.

As the fund finance market continues to grow and mature, there has been an increasing focus on our industry's primary product – the Facility. This increased focus is understandable as Facility needs have grown rapidly alongside the growth of private equity funds and related alternative investments. By one estimate, the aggregate level of committed Facilities held by banks and other financial institutions across the globe is approximately $400 billion. Originally created to satisfy the financing needs of real estate funds almost thirty years ago, Facilities are now utilized by all manner of private funds ("Funds"), including private equity (buyout), private debt, energy, infrastructure, secondary and other committed capital fund structures.

The efficiencies and utility of Facilities, now well-known to market participants, have enhanced the market's growth. Today, Fund Sponsors view Facilities as a standard tool in their fund management tool kit and believe that the lack of a Facility would put a Fund at a competitive and operational disadvantage. However, now more than ever as the market for Facilities and Fund

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[1] ILPA is a global, voluntary association dedicated to advancing the interests of private equity limited partners through education, research, best practices, networking opportunities and global collaboration. Its over 400 members include public pensions, corporate pensions, endowments, foundations, family offices and insurance companies.

Sponsors' funding needs have increased, so has the focus on the product and its broader impact to the overall private equity community.

In the past year, we have seen articles and publications from Oaktree's Howard Marks, the Financial Times, Bloomberg, the Wall Street Journal, Reuters, Private Equity International and most recently, ILPA – all largely focused on the prevalence of Facilities. While the combination of media attention and the Guidelines have encouraged the dialogue between Fund Sponsors and Investors about the use of Fund-level debt, certain writings have perpetuated a number of misperceptions and inaccuracies. The FFA, as a representative of the fund finance industry, has noted on multiple occasions that many of the press reports on Facilities have included inflammatory headlines and a lack of understanding of Facilities, how they are used, and their benefits to Fund borrowers and Investors. The Guidelines however are different; they are a constructive and productive attempt to analyze the benefits and detriments of Facilities and an effort to define best practices. This memorandum seeks to give the FFA's views on the Guidelines and contribute additional information to both ILPA and the Investor community to assist in consideration of the issues. The FFA welcomes discussion with ILPA to ensure that ILPA's suggestions and best practices for Facilities will be fully informed.

The FFA believes that the prudent and appropriate use of both Facilities and traditional Fund-level leverage are important to both the long-term health and the financial performance of the private equity industry. The FFA believes that each Fund is inherently unique and that Facility and debt needs should be tailored to the particular business plan and risk/return profile of each individual Fund. We also believe that continued open and frequent communication between Fund Sponsors and Investors on Facilities, as well as Fund leverage generally, is essential to their relationship and should be encouraged. We hope that ILPA will ultimately refine the Guidelines in a manner that recognizes that "one-size-does-not-fit-all" and will enable Fund Sponsors and their Investors to continue to obtain the benefits and utility of Facilities (while taking into account valid concerns and preferences of Investors). Lastly, it is important to note that the role of the FFA is not to interfere or intervene in the Fund Sponsor/Investor relationship. Those relationships are paramount and proprietary to the Fund Sponsor and the Investor and are outside of the FFA's purview.

II. The Guidelines' Primary Focus Points.

The Guidelines broadly cover three areas:

a) Increased transparency, disclosure and reporting around the use of Facilities – covered by Recommendations No. 2, 4, 5, 6, 7, 8 and 9;

b) Recommendations placing limitations around Facilities, including limiting the maximum facility size, the acceptable uses of proceeds of a Facility, the time limit in which individual loans under the Facility need to be repaid (a "Clean Down") and the type of collateral which is pledged to secure a Facility – covered by Recommendations No. 3 and 9; and

c) Economic impact to the Investor – covered by Recommendation No. 1.

This article addresses each in turn.

A. **Transparency and Disclosure**.

The Guidelines include extensive recommendations covering disclosure and encourage greater transparency from the Fund Sponsors in their reporting to Investors (Recommendations No. 2, 4, 5, 6, 7, 8 and 9). The FFA fully supports transparency and disclosure from Funds to their Investors generally. In fact, Facility lenders often insist on explicit provisions authorizing a Facility in a Fund's partnership agreement (each, a "Partnership Agreement") as a condition to entering into a Facility. The FFA believes that the vast majority of Funds already provide extensive disclosure around Facilities and other Fund-level indebtedness and we believe the great majority of sophisticated Investors are educated about and well-informed by their Fund Sponsors as to the use of the product. While the FFA does not believe there is a pervasive problem in the industry around disclosure nor have we ever witnessed attempts by Funds to keep information from Investors, there is always room for improvement. For example, the FFA generally supports the disclosures suggested in Recommendation No. 2 around the terms and use of a Facility and believes that drawings under a Facility to make an investment (each, an "Investment") should not result in a lag in reporting the Investment details to Investors on a reasonable basis.[2] While supportive of greater transparency, the FFA views any decision to enhance disclosure and reporting as ultimately a matter best agreed to between a Fund Sponsor and the Investors (preferably in a manner that does not unduly burden Funds to report additional information of only marginal value to the Investors).

B. **Specific Facility Parameters**.

1. **One Size Does Not Fit All.** Recommendation No. 9 is the primary focus of the FFA. Among other things, it suggests a 180-day Clean Down and a maximum Facility size of 15% to 25% of overall Fund size. The fundamental concern of the FFA is that the Guidelines provide a "one-size-fits-all" approach which is not appropriate in an industry with many thousands of distinct Funds, each with highly customized investment strategies and circumstances. The Recommendations do not take into account the individual investment strategies, the availability of asset-level financing and Fund-specific timing considerations, all of which may drive the use of a Facility. Put differently, a buyout Fund may utilize less leverage at the Fund level (because it levers extensively at the portfolio company level) than a private credit Fund or secondaries Fund (which typically needs to lever a portfolio of Investments). At the same time, the liquidity and leverage needs of that private credit Fund are different from the needs of an infrastructure Fund.

The "one-size-does-not-fit-all" concern seems heightened when you consider that the specific Facility parameters articulated in the Guidelines seem to be targeted at a concern that Fund Sponsors are using Facilities to enhance IRRs (and in turn accelerate their carry). While Facilities of course can have a positive effect on IRRs and carry (especially in a Fund's early years), the actual effect of Facilities on IRR diminishes over time and is quite small over the life of a Fund. The data cited in the Guidelines themselves suggest Facilities with a one-year Clean Down only have a median IRR increase of 35-45 basis points by the end of the life of a Fund. This

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[2] In Recommendation No. 2, the Guidelines suggest Fund Sponsors should disclose to Investors "[t]he number of days outstanding of each draw down." This is not practical. Funds make a large number of individual draws under a Facility, not only to consummate Investments but also to pay expenses, fees and other obligations. Tracking and reporting a day count on each individual draw would be burdensome for Funds and information of marginal practical value to Investors. Disclosing the date of acquisition of each Investment seems more appropriate.

is just simply not very much. Thus, from a practical perspective, the majority of Funds are using Facilities responsibly and are not receiving any meaningful compensation differential for Fund Sponsors at the expense of Investors. With that in mind, the Guidelines should exercise care to target any excessive or abusive Fund Sponsor behavior, but recognize that the majority of Funds are currently using Facilities in a responsible and productive way. This responsible use should not be prohibited in an effort to constrain any behavior that, if it exists at all, is limited to the extreme fringe.

The concern with a one-size-fits-all approach can be illustrated in the below examples:

- A Fund Sponsor may put a Facility in place as an initial bridge when asset-level financing is not readily available until the time permanent financing can be obtained. In this instance, the 180-day Clean Down and 25% size limitation may not fit the Fund's specific needs.

- Similarly, a Fund Sponsor may finance the Fund's Investments using the Facility until the Fund has sufficient diversity for asset-level financing. Such may be the case for a private credit Fund seeking to do an asset-level financing in the form of a CLO. Depending on conditions in the asset-level financing market, and more importantly, the Fund's investment pace, the 180-day Clean Down and 25% facility size limitation again may not be sufficient to address the needs of the Fund.

- Certain Funds acquire large Investments and then look to syndicate portions thereof as a co-investment, or potentially divest a portion of a company. This is done more efficiently via use of a Facility. Calling capital, selling down and distributing capital back to Investors is operationally cumbersome and unnecessarily obtrusive for Investors. If applied literally, the Recommendations could reduce this potential Facility benefit to the Fund and its Investors.

- Some Funds, such as a commercial real estate Fund, intend to use commercial mortgages on their Investments, using the leverage to achieve their return targets. A Facility is typically lower cost indebtedness than a commercial mortgage, and could be used in lieu of a mortgage while an investment is being repositioned until it achieves a credit profile to achieve optimal permanent financing. A Clean Down requirement could compel a Fund to transition from lower cost financing to higher cost financing sooner in its life cycle. This would be detrimental to both the Fund and its Investors.

2. **Specific Recommendations.** The FFA makes the following specific Recommendations with respect to Facility parameters:

- The Recommendations should recognize that Funds have different Investment strategies and that different parameters are appropriate in different contexts. What might be appropriate for a venture capital Fund may be overly restrictive for an infrastructure Fund.

- Letters of credit should be carved out of any Clean Down requirement. They do not coincide with, for example, a 180-day period.

- A Clean Down should not apply during the period from the Fund's initial closing ("Initial Closing") to the Fund's final closing so as to allow the Fund to eliminate the need for subsequent Investor true-ups. Avoiding rebalancing between the initial and final Investor closings is one of the ways a Facility may be used that brings tangible benefits to Investors as well as the Fund, and should not be unintentionally removed by a Clean Down requirement.

- Any cap on Facility size during the fundraising period should be based on the anticipated Fund size – not actual size. Otherwise, the Facility during the fundraising period may be too small to finance even the initial Investment.

- The Recommendations should be clear that Investments structured by the Fund in the form of guarantees of portfolio company or holding company indebtedness or other Fund-level credit enhancement are not subject to the same restrictions. Such guarantees are more akin to Investments and, even if structured through a Facility, should not be conscripted.

- Recommendation No. 9 suggests a "[m]aximum period of time for which such lines can be used." We note that, post-Investment period, a Fund's need for capital may come in frequent and small increments and that Investors do not want to be subject to frequent, small capital calls. Allowing a Fund to draw under a Facility after the end of the investment period aligns well with the liquidity needs of the Fund as well as the Investors' expectations. Frequent small capital calls do not seem to be of administrative preference to Investors, particularly when the Fund is primarily in the harvest period. A reduction in Facility size post-investment period occurs naturally.

- The Recommendations should articulate that the 180-day Clean Down is a guideline – not a rule. An annual Clean Down may make sense for a Fund that intends to call capital from its Investors at least annually. A Clean Down requirement may not work at all for other Funds (for example, a debt Fund), depending on their Investment strategies, pace of Investment activity and liquidity needs.

3. <u>**Understanding Various Fund Finance Products**</u>.

The FFA believes that, in several instances, the Guidelines seem to blur the distinctions between Facilities and other fund finance leverage and liquidity products. For example, in Recommendation No. 9, the Guidelines provide that "Advance rates applied to "Included Investors" should be based on uncalled capital, rather than a fixed percentage of NAV" and "Lines should be secured only by LP commitments to the fund, not by the underlying assets of individual

LPs or the invested assets of the fund."[3] Facilities, in their traditional and most prevalent format, are not secured by Investments and do not provide an advance against NAV. The blanket guidance these recommendations provide, if applied literally, would prohibit other very viable and needed fund financing tools with no obvious corresponding benefit to Investors. For example, a levered debt Fund or a levered secondaries Fund's entire business model by definition contemplates leverage at the Fund level, not just the Investment level. For these type of Funds that makes total sense – debt is more optimally available at the Fund-level based on the portfolio of Investments, rather than at the individual Investment level. Alternative financing options are typically more expensive, less flexible and riskier to the Fund and the Investors. These type of facilities almost always have advance rates based on NAV and may be secured by Investments, in direct contrast with the current Guidelines. These are entirely appropriate uses of leverage, are well-disclosed by Fund Sponsors and should not be prohibited as a general rule. Similarly, the strict application of the Guidelines would reduce Fund Sponsor flexibility in other ways that might be sub-optimal for a Fund and its Investors. For example, if a Fund Sponsor was able to get an improved interest rate on a Facility by also giving a security interest to the lender in its Investments (and the giving of that security interest did not negatively affect the particular Fund's ability to incur other debt or run its business), why would Investors necessarily want a default rule that prevented the Fund from obtaining optimal financing terms? Additionally, at the end of a Fund's life when uncalled capital is exhausted or near-exhausted, a Fund may want to borrow against its NAV to meet liquidity needs, pay management fees or Fund expenses, or to position an Investment for disposition. Similarly, a levered debt Fund might negotiate a customized solution that includes both uncalled capital and Investments in its borrowing base and collateral package (a "Hybrid Facility"). If the Fund determines that a Hybrid Facility is an optimal financing structure, we do not see why Investors should be guided to prevent a Fund from entering into such financing structure (which can be very efficient in certain contexts). Certainly Investors may not be comfortable with this occurring in all Funds, but it is a very legitimate and appropriate use of debt in many circumstances.

<u>Recommendations</u>

- The Recommendations should clearly distinguish between Facilities and other Fund-level leverage and indebtedness. For example, a 180-day Clean Down does not work for a secondaries Fund seeking to finance its portfolio as is customary via either a deferred purchase price or traditional leverage. Secondaries Funds can be highly diversified with regular cash flow. Thus, there can be benefits to Investors to have permanent financing in place to manage capital calls and distributions. The Recommendations should clarify the specific contexts in which they apply.

- The Recommendations should not prohibit advance rates based on NAV and security interests in Investments. A Hybrid Facility may provide an excellent solution for a particular Fund and the Guidelines should encourage each Funds

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[3] Facilities are loans to Funds, secured by the uncalled capital commitments the Investors make to the Fund. The collateral is an asset of the Fund, not an asset of the Investor. The FFA is not aware of any lenders in the market that ask for any collateral from an Investor in connection with a Facility. We think the ILPA recommendation that Facilities not be secured "by the underlying assets of individual LPs" is distracting. In our experience, this is a non-existent issue and we worry Investors could be unnecessarily alarmed by the implication.

access to the optimal way of financing itself, particularly if a Fund needs to lever its Investments to meet its target return threshold.

4. **Dividend Recaps Might Be Appreciated by Certain Investors.**

Recommendation No. 3 advises against using Facilities to make distributions to Investors. This use of a Facility is not highly prevalent in the market. It does occur, albeit infrequently, in at least a couple of scenarios. First, a Fund may have disposed of an Investment (or committed to sell an Investment) but, due to regulatory or other requirements, the proceeds may not be readily available for distribution to Investors. A borrowing under its Facility can enable a Fund to make such a distribution to Investors. Second, a Fund may have a nice portfolio of performing Investments but has Investors that would like a current return of capital. The FFA understands that certain Investors may prefer to wait until Investments are disposed of to receive the liquidation proceeds as distributions. However, in certain contexts, dividend recaps are seen as an effective tool to bring value to an equity holder. Certain Investors may value the liquidity this type of use of a Facility might provide and certain Investors might appreciate a return of cash. Finally, this use of a Facility may be used to best manage year end timing mismatches. We believe the particular Fund Sponsor and its Investors should agree on whether these uses of a Facility are appropriate under the particular circumstances and that a blanket prohibition on borrowings to make distributions seems unnecessarily restrictive.

C. **Calculations of Internal Rates of Return**.

In the Guidelines, Recommendation No. 1 suggests carry for the Fund Sponsor should be calculated from the time the Facility is drawn instead of from the time capital contributions are funded by the Investors. As with disclosure and transparency discussed above, the FFA believes that this issue is best addressed between the Investors and Fund Sponsors (and is outside of the FFA's primary focus area). However, we have a difficult time fully understanding this Recommendation being put forth by ILPA. We find this Recommendation somewhat inconsistent with the Fund Sponsor/Investor relationship and the actual history of how carry has been described and calculated for decades across virtually all private Funds.

IV. Liquidity Risk.

In the Guidelines in the section titled "Liquidity Risk", ILPA raises a concern that "liquidity pressures could impede an individual LP's ability to meet accumulated larger calls as these lines mature." The FFA feels strongly that Facilities do absolutely nothing to negatively impact the ability of Investors to honor their capital commitments. Based on our discussions with Investors, we do not believe institutional Investors are actually concerned at all about their ability to fund their capital calls and there is no empirical evidence to support this concern from the recent global financial crisis. The FFA knows of no loss taken by any lender on a Facility during the downturn. In fact, the market saw a near 0% default rate on capital calls to institutional Investors during the financial crisis. Additionally, according to Preqin data, there is currently over $85 billion of dry powder in secondaries Funds, which is approximately five times greater than what existed at the start of the financial crisis. If any Investor does face a liquidity issue, there is now a large amount of capital available to bid on that Investor's position, furthering the unlikelihood of Investor defaults.

Perhaps more importantly, Facilities simply do nothing to change or increase an Investor's contractual funding obligations. In virtually every Fund, the Fund Sponsor could call down 100% of the Investors' uncalled capital on any given day. Having a Facility in place does not change that risk or increase its likelihood at all: no more capital is callable and the timetable for calls is unchanged. In fact, the opposite: a Facility allows a Fund Sponsor to smooth out capital calls and better forecast to its Investors the prospective timing of upcoming capital calls. Ironically, if used in such a way by the Fund Sponsor, a Facility actually gives Investors better timing information to help Investors manage their liquidity.

We believe that suggesting that Facilities make Investors more likely to default on capital calls is an unfortunate implication that is not grounded in fact or practical reality. Concerns such as these, when reduced to writing, have a tendency to lead to inflammatory press headlines. If Investors have concerns about their ability to meet their capital commitments, they should focus on their own liquidity management practices. We believe that ILPA should reconsider whether the "Liquidity Risk" section in the Guidelines is accurate and if it is even appropriate for inclusion in the Guidelines.

Conclusion

In conclusion, as the Facility is one of the least expensive forms of financing available to a Fund, the FFA believes that strict limits on Facilities (such as the 180-day Clean Downs and 15% to 25% maximum size recommended by the Guidelines) are not necessarily in the best interest of the Investors. Both Investors and General Partners agree, generally speaking, that a higher IRR Fund is a better investment than a lower IRR Fund. Circumscribing Facility usage by the means suggested by the Guidelines would result in an IRR reduction and deprive Funds of the opportunity to employ cost-effective financing that is beneficial to both the Funds and their Investors. Those benefits including bridging capital calls and other sources of financing that may not yet be available, smoothing out capital calls, avoiding rebalancing during fund-raising, and supporting portfolio activities. Moreover, the FFA believes that the Guidelines should resist a one-size-fits-all approach to Facilities and, instead, promote a solution-oriented approach that better reflects the broad range of Funds, the diverse group of Investors and their respective investment strategies. Both General Partners and Investors benefit from creative solutions that only they are equipped to negotiate. No two General Partners, Funds or Investors are alike. As very sophisticated parties that are advised by both legal and tax experts, they are sufficiently equipped to represent their best interests in the areas of what is and what is not appropriate when it comes to a particular Fund's borrowings and the use thereof.

We believe that the Guidelines should not be viewed as 'fixed' and 'absolute' principles for Facilities but, rather, should be used to foster greater dialogue and awareness within the Investor and Fund Sponsor community. As the use of Facilities has become an accepted tool in Fund management today, we encourage the continued open and frequent communication between Fund Sponsors and Investors as to how each Fund will be managed.

We applaud ILPA for its efforts to learn about Facilities and to educate its constituents. The FFA is always available and actively welcomes the opportunity to discuss these issues with ILPA and any member of the Investor community in an effort to find solutions that are in the mutual best interests of all market participants.