GP SUBSCRIPTION CREDIT LINES

- Steve Standbridge, **Capstone Partners**

It is inevitable that as a capital market matures, practitioners develop innovative new products that create efficiencies within the market. Private equity as an asset class is a great example as it started as a cottage industry with a relatively small number of practitioners where terms were relatively opaque and investor liquidity was limited. As the asset class grew and more sophisticated investors entered the market, terms became more standardized and reporting, while not uniform across the industry, began to follow general guidelines. The evolution of the secondary market brought more efficiency as liquidity increased and investors can now dynamically manage their portfolios by selling out of or buying into LP positions. The latest innovation in the market, which is not really a new concept, is the rapidly expanding use of subscription credit lines. Over the last six months there have been several articles a week on their use and potential risks. I am obviously piling onto the myriad of press, but thought it would be worth providing a view from a neutral corner.

Subscription credit lines are not a new phenomenon, as sophisticated GPs have used them for many years as working capital lines to smooth capital calls and to bridge short-term deal funding needs. More recently the credit lines have become standard fare for most GPs, and increasingly we are seeing GPs use them to significantly delay capital calls to lessen J-curves, manage preferred return hurdles, and increase near term IRRs. There is some concern in the industry that this new application of the credit lines is introducing incremental risk to investments and they may be used to artificially boost IRRs resulting in higher carry payouts to GPs.

Financial risk is most commonly created by high levels of leverage on a structure and/or creating a situation where liquidity is compromised. Subscription lines, unlike leverage on a fund, do not provide incremental capital to invest and are just a temporary loan against expected LP capital calls, so GPs are not introducing higher levels of leverage to their structures. Liquidity issues could occur if specific LPs are unable, or refuse, to fund capital calls. Even in the depths of the Global Financial Crisis the level of defaults on capital calls was relatively immaterial and close to non-existent among institutional investors. Despite the limited risk, as part of their diligence LPs should ask questions about the expected use of credit lines and their structures as it relates to periodic paydown provisions and advance rates on LP commitments. Overall, if credit lines are structured prudently and disclosed properly, they should not create incremental risk to LPs.

Using credit lines to boost IRRs can be a potential issue for investors, but GPs that consistently abuse the use of credit will face the detrimental impact of overall lower distributions and the risk that LPs will not be supportive in future funds. LPs investing in private equity have thorough due diligence processes designed to underwrite a GP's ability to generate consistent returns by executing a differentiated strategy that creates value in their portfolio companies. Successful and responsible GPs that use credit lines to improve capital efficiency will be rewarded with LPs reupping to their funds. Those that need to use credit lines to, on the margin, exceed a hurdle rate to move into a carry situation will likely struggle to raise follow-on funds, not because they abused the availability of these lines, but rather because they failed to successfully execute their strategy.

Many LPs will welcome a lessening of the J-curve in a fund, but if a GP extends the use of a credit line for too long, there will be some backlash as investors have allocated capital to a GP with the expectation that their commitments will be drawn and generating returns. Higher IRRs on lower average capital deployed is problematic for most LPs as it forces them to contemplate over-commitment strategies, which have historically created other types of issues. Lastly, GPs that take a long-term approach to the business understand that any cash fees and interest expense paid to banks ultimately decreases the total amount of capital returned to the fund, which results in lower absolute dollars of carry. If interest rates should ever return to historical levels this impact becomes more acute and it is likely we will see the use of credit lines decrease.

The bottom line is that the proliferation of subscription credit lines is part of the natural evolution of private equity, and provided that transparency is maintained, the market will determine which managers are deserving of long-term support.

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