June 2019

PREQIN SPECIAL REPORT: SUBSCRIPTION CREDIT FACILITIES

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Contents

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CEO's Foreword

Subscription credit facilities: angels or demons? A legitimate and valuable tool for managing liquidity and streamlining transactions in a competitive market, or a cynical ploy for massaging IRRs? The debate continues in private equity and wider private capital circles.

As is often the case, historical perspective is helpful. Private capital operates in a dynamic and competitive environment, as GPs and LPs strive to achieve superior net returns, through good times and bad. Completing deals and generating the positive returns that LPs expect has never been more challenging than it is today, given the availability of capital and the appetite for attractive assets in the market. Innovation and dynamism have long been an integral aspect of the private capital industry's arsenal of tools, comprised of alignment of interest; close attention to operational excellence and value add; over-allocation in order to meet exposure targets; new investment structures to meet LP requirements, including co-investments and separate accounts; secondary transactions to increase liquidity; and yes, the intelligent use of leverage.

Most of these tools have pluses and minuses. Used appropriately and to the right extent, they have been proven to increase the LP's risk-adjusted net returns; used indiscriminately or to excess, and they can be a recipe for problems. As humans we tend to proceed not by 'grand design,' but by trial and error, which by definition tends to 'overshoot' before settling on the most favourable equilibrium.

Where are subscription credit facilities today in terms of this 'optimal equilibrium'? Are they still a positive development for the industry, or have they passed that point and are being used to excess? The honest answer is none of us truly knows at present. But we do know the tools that we need in order to find the answers: transparent data, combined with thoughtful communication and debate.

Mark O'Hare
CEO, Preqin

Preqin's raison d'être is to support and serve the alternative assets industry with the best available data. We have therefore been gathering data on subscription credit use by private capital funds, the first tranche of which is now available to customers on the **Preqin Pro** platform. At this stage the information is limited to a binary 'yes/no' as to whether each fund uses subscription credit facilities or not. Over time we will be adding further information using, as always, a combination of public data and information shared by our customers and contacts across the industry. Thank you in advance for your support in helping us generate the data to help the industry.

We hope that you will find this brief report helpful in understanding the growing role of subscription credit facilities in the industry. The report contains a summary of some of the headline data drawn from **Preqin Pro**, combined with the perspectives and insights from three partners from across the industry: McGuire Woods, ILPA and Fitch Ratings. We are grateful to them for their insights.

Subscription Credit Facility Usage in Private Capital

Very few developments in alternative assets have attracted such a mixed response as subscription credit facilities (also known as equity bridge facilities, subscription line facilities or capital call facilities).

Although they are nothing new, both sides of the LP/GP divide – and even inside their respective camps – have wide-ranging views on their usage. With labels ranging from 'window dressing' to 'operational excellence,' there is a clear disconnect between intention and perception across the board.

As defined by Preqin, in the context of private capital funds and how they impact investments in the industry, subscription credit facilities are short-term loans provided to alternative asset fund managers to cover transactional costs, suppressing the need to immediately call up capital from limited partners.

Let us examine how they would impact GPs and LPs.

Why Use Subscription Credit Facilities?

- **Reduce risk of transactions falling through:** capital is fully covered by a single loan as opposed to capital calls from multiple LPs.
- **Enhance competitiveness:** credit facilities are requested and deployed rapidly, which is particularly important for time-sensitive transactions like co-investments. LP capital calls are a lengthy procedure by comparison.
- **Cash flow management:** GPs can use credit lines to smooth out the cash flow, meaning that LP capital calls can be requested in larger batches as opposed to smaller, more frequent ones.
- **Reduce administrative burden:** managers can use bridge facilities to prevent capital calls if investments do not come to fruition.
- **Improve liquidity:** distributions can be paid to LPs before the liquidation of an asset. This is important for open-ended vehicles that stand to lose assets if an LP makes a large redemption request.

What Are the Drawbacks of the Service?

Subscription credit facilities were initially provided as short-term instruments, but in recent years **repayment terms have become much longer**. The internal rate of return (IRR) – although by no means the only measure of fund performance – is heavily valued by private market investors, insomuch that a manager's incentive award can be determined by achieving certain IRR thresholds.

The downside for screening potential managers predominantly using IRR is twofold:

- **IRR calculations are heavily influenced by timing**. By using credit lines to delay the capital call for long periods of time, IRRs can be manipulated to appear larger than if the capital call was made as soon as possible to cover the loan.

> **The use of credit lines makes it loud and clear that IRR is completely and absolutely 'IRRelevant'**

Ludovic Phalippou
Professor of Financial Economics, Saïd Business School

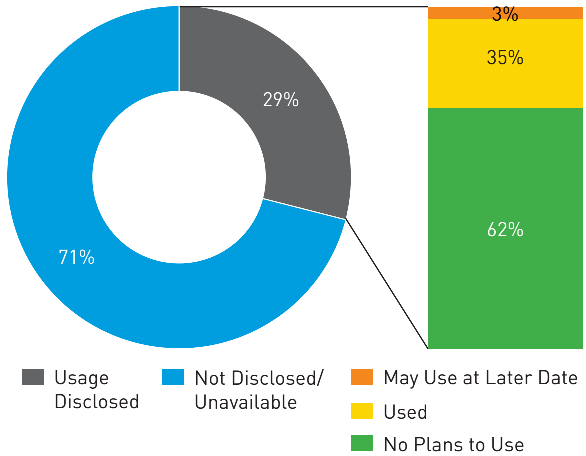
- For an LP evaluating a fund, prior performance is one of the important criteria – if not the most – for making an investment. Managers often raise capital for a new fund during an early stage of their existing vehicle's lifespan, and **this early-life IRR is more susceptible to manipulation from credit facility usage**.

Complicating matters further is how different the methods and sophistication of due diligence and return analysis are among players in the industry. While many consultants and institutional investors look beyond IRR, many also lack the expertise, time or resource to analyze not just one fund, but large, multi-asset portfolios of varying strategies, risk/return profiles and managers.

Markets may have been relatively stable, but one investor we spoke to does warn against extrapolating these advantages to times of greater difficulty: "[subscription credit facilities] increase the risk of default by other LPs as capital calls are fewer and larger. During periods of stress, this would stress some LPs. It encourages too much overcommitment as LPs are getting fewer dollars invested."

This view is shared by Ludovic Phalippou, Professor of Financial Economics at Saïd Business School when he discusses the impact facility usage may have had at the height of the financial crisis. He says that "many LPs could already not pay capital calls arriving at a normal and expected pace, [expecting] them paying one-year's worth of capital calls would be fatal in many cases."

Fig. 1: Private Capital Funds Using Subscription Credit Facilities* (Vintages 2000-2019)



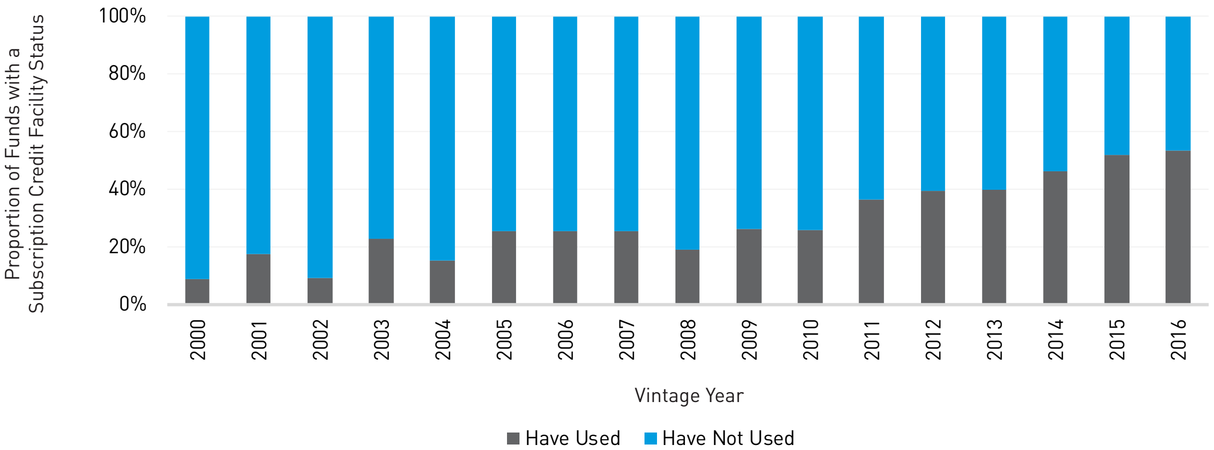
Source: Preqin Pro

What Does Usage Look Like Today?

There are no requirements for GPs to submit information on subscription credit facility usage besides the pressure from LPs to do so, or GPs' voluntarily compliance with ILPA guidelines. The sensitivity of this information and divergent opinions on their usage may prohibit widespread disclosure. Of the approximately 8,500 vehicles of vintage 2000 and onwards with net-to-LP performance data, only 29% of vehicles have a disclosed status.

Looking at this sample with subscription credit facility status, nearly two-thirds of vehicles have not used a credit facility (Fig. 1). Anecdotal evidence does suggest that the majority of funds – particularly those in more established asset classes of private equity, real

Fig. 2: Private Capital Funds Using Subscription Credit Facilities



Source: Preqin Pro

**Only includes funds with performance data.*

estate and infrastructure – do currently use, or have previously used, credit lines during the lifetime of their vehicles.

However, the sample also confirms anecdotal evidence of rising usage: in the past decade, the proportion of funds using credit lines peaked at 53% for vintage 2016 funds (Fig. 2). The increase in active alternative lenders in the wake of the crisis was a significant contributory factor for this growth, as it filled the gaps left behind by banks. While banks and investment banks are still a significant component of debt financing, private credit has grown into an asset class in its own right since 2010. The net result is a more competitive marketplace and cheaper, more freely available debt to GPs.

Private real estate vehicles were the early adopters of credit lines, although comparing pre- and post-crisis years shows very little change in our sample (Fig. 3). Most of the growth derived from the uptake of credit lines into private equity & venture capital funds, alongside the advent of direct lending as a viable institutional asset class.

A Double-Edged Sword

Credit facility usage is not new to private markets, and fund managers will continue to use them for the aforementioned advantages. According to Phalippou, many investors have benefitted from the extra leverage during the prolonged bull market seen in the past 10 years. Most of the arguments against subscription credit facility usage are based on the predisposition to use just one metric (IRR) to determine both performance and compensation; this bias subtly adjusts the behaviour of participants to report and meet these thresholds in order to gain new capital or compensation from existing partners.

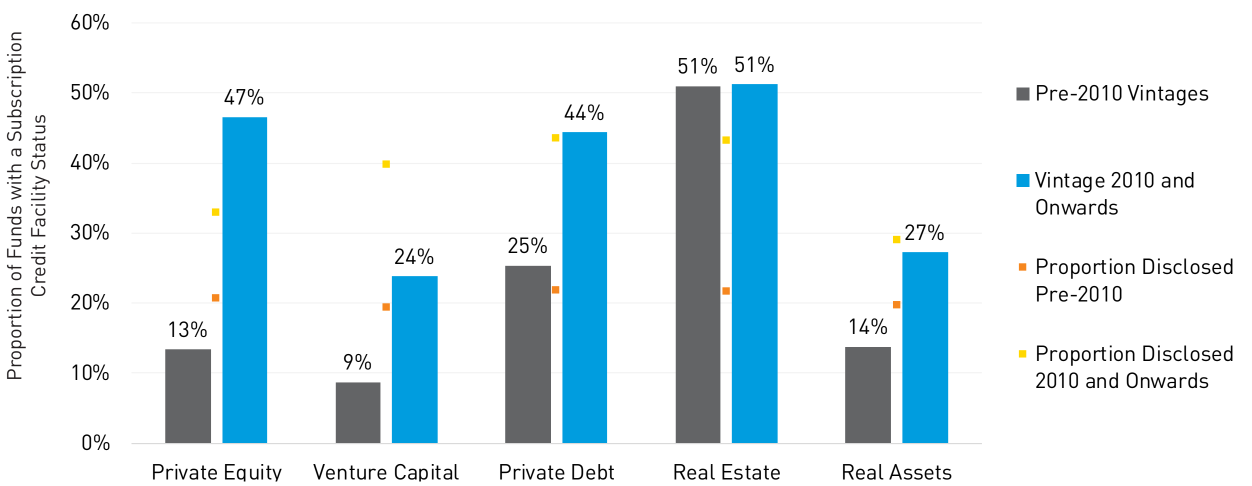
Top Five Investor Concerns in Subscription Credit Facility Usage:

1. Fund Performance Comparability
2. Additional Expense
3. Liquidity Risk
4. Clawback Issues
5. Tax Considerations

We anticipate that the rising sophistication of investors in private funds and reporting standards – as ILPA have introduced on page 7 – as well as increased transparency from GPs will help alleviate most of the concerns levelled against credit line usage. Some investors already require GPs to conform to ILPA's guidelines to receive commitments and ask for specific cash flow details, including unlevered and levered returns at all reporting periods.

Ultimately, though, it requires shifts from both parties in order to alter perception of credit lines: investors must look beyond headline IRRs and conduct thorough due diligence at every opportunity, while GPs have to be open to more detailed reporting.

Fig. 3: Private Capital Funds Using Subscription Credit Facilities by Asset Class, Pre-2010 vs. 2010 and Onwards Vintages



Source: Preqin Pro

Subscription Lines of Credit and LP-GP Alignment: ILPA's Recommendations

Jennifer Choi

Managing Director, Industry Affairs, ILPA

Subscription lines, short-term financing bridging the gap between a deal close and the eventual calling of capital from investors, have been utilized in private equity for years. Recently, the practice has expanded in prevalence and scope. Subscription lines have evolved beyond a short-term bridge to serve as a liquidity management tool, with repayment terms often extending beyond 90 days.

Investors are concerned with the potential impact of this evolution with concerns surrounding alignment of interests and cumulative liquidity risks. To address these concerns, ILPA released guidance on Subscription Lines of Credit: Considerations and Best Practices for Limited and General Partners in June 2017. Among its recommendations, ILPA put forth that LPAs should delineate reasonable thresholds for subscription line use and managers should disclose to investors the firm's official policy on credit lines, including the intended use of proceeds from current or anticipated utilization of subscription lines as well as their impact on reported performance and on net returns to LPs.

In addition, ILPA recommended the quarterly disclosure of:

- The amount on the subscription line facility, as well as what percent of uncalled capital draws from the facility represent; such disclosures should be provided as part of a holistic reporting of the total debt/credit in use by the fund
- The number of days outstanding of each drawdown
- Net IRR with and without the use of the credit facility
- Terms of the line (upfront fee, drawn and undrawn fees, etc.)
- Costs to the fund (interest and fees)

LP views on the use of subscriptions lines of credit diverge. Some GPs have offered separate tranches to accommodate investors with different preferences. ILPA has heard from both investors and GPs concerned with the impact of subscription lines on IRRs and performance reporting (quartile rankings in particular) and how the preferred return is calculated. There is desire for standardized disclosure and reporting formats, particularly around levered vs. unlevered returns and quarterly reporting on the percentage of a fund's unfunded commitments drawn on subscription lines.

About ILPA

ILPA is the only membership organization dedicated exclusively to limited partner investors into private equity, with more than 500 member institutions representing over $2tn in private equity assets under management. ILPA's mission is to engage, empower and connect its members to maximize their performance, through executive education, best practices, advocacy and events.

Are Subscription Facilities Oversubscribed?

Meghan Neenan
Managing Director, Fitch Ratings

Subscription facilities have been around for some time, but they have come into greater focus in recent years as usage has grown. Fitch Ratings believes these facilities can provide operational efficiency, investment flexibility and potentially enhanced returns, but can also increase fund expenses and accelerate incentive fee recognition in an upside scenario, both of which can pose potential reputational risks for investment managers.

Subscription facilities have grown in popularity, primarily, given LPs' desire for the enhanced liquidity management and operational efficiencies offered by reducing the number and frequency of capital calls for a given fund. However, subscription facilities can also provide the investment manager with the flexibility to move more quickly on a transaction, as borrowing availability on these facilities can provide sellers with greater comfort around the certainty and timing of a deal close. Calling capital from LPs can delay that certainty by 10 days or more, which could lead a seller to go with another bid. Therefore, these facilities can be a useful tool in an increasingly competitive investing environment.

Dry powder (uncalled capital commitments) in private equity buyout funds has expanded at a 4.3% compound annual pace since the onset of the financial crisis, according to Preqin, while valuation multiples have steadily risen. This combination has sparked a debate about the future path of fund returns and whether they can stand up to historical performance. Utilizing subscription facilities is one way to potentially enhance internal rates of return (IRRs). Statistical data around return enhancement due to the use of subscription facilities is relatively limited, but generally points to only modest improvements in IRRs. Still, market conditions have been relatively benign over the past decade, while facility usage has expanded meaningfully.

Subscription facilities can also accelerate the recognition of incentive income for the manager in an upside scenario, as LP capital calls can be delayed and investment returns can be generated on borrowed money, leading to higher IRRs which can put fund returns over high-water marks sooner in the fund life. Earlier investment 'wins' may lead some investment managers to realize incentive income sooner in the fund life, increasing the risk that those returns could be clawed back (returned to LPs) at a later date if fund investments ultimately underperform expectations. Additionally, there is a borrowing cost on the subscription facilities (albeit modest) that is borne by the funds which can make mediocre fund returns look modestly worse.

Unless LPs clearly understand these cost and incentive dynamics, it could lead to reputational damage for the fund sponsor and impair their ability to raise future capital around a particular strategy or even more broadly across the platform, as many LPs are invested in multiple products. Meaningful declines in assets under management would reduce an investment manager's fee-earnings, scale and incentive income potential, while inflating its cash flow leverage metrics and impairing its liquidity profile. These combined elements would likely put pressure on the investment manager's corporate credit rating.

Fitch does not publicly rate private equity funds, but does maintain corporate credit ratings on nine alternative investment managers that are responsible for investing fund capital. While Fitch believes that the primary risks associated with subscription facilities are at the fund level, we do consider the reputational impact these facilities could have for the management company. Facilities with specific parameters regarding the duration of borrowings and the timing of capital calls are viewed more favourably by Fitch. Borrowings on subscription facilities were historically limited in term (90 days or less) but have lengthened to multi-year facilities in certain cases. Maintaining borrowings on capital call facilities for over 90 days, in Fitch's view, would indicate a greater focus on return enhancement rather than liquidity management.

There are non-public disclosure requirements to LPs around funds' usage of subscription facilities. Some firms may also publicly disclose the percentage of capital invested for a given fund vs. the percentage of capital drawn, which can provide some insight into the amount of subscription line borrowings. That said, Fitch believes broader and more consistent public disclosure of this information would be beneficial, in order to allow a wider audience to assess relative usage and potential impact on fund returns and risk.

Fitch generally views the risk of loss to the subscription facility provider as being mitigated by the relatively short tenor of the loans (in most cases) and the fact that repayment is typically supported by capital commitments from high-quality LPs. Additionally, failure on the part of an LP to fulfil its capital call obligation would yield significant reputational risk for that investor and would likely impair its ability to invest in future funds of that manager or its competitors. It could also result in that LP forfeiting some of the capital it had already invested in the fund.

Rating a subscription credit facility would entail an in-depth analysis of the credit profiles of the LPs whose capital commitments are pledged to the facility, combined with an analysis of the diversity of the collateral (i.e. the number of LPs pledging their uncalled capital), the level of enhancement provided (i.e. overcollateralization levels) in the facility, the permitted length of borrowings and how advance rates may change as capital is drawn and uncalled capital pledged to the facility diminishes. To date, subscription facilities ratings have been rare, given information limitations regarding the financial profiles of the LPs.

In summary, the widespread adoption of subscription facilities post-crisis confirms many of their perceived benefits, but Fitch expects that through a full market cycle, some of the accompanying risks may come to the forefront. The extent to which this impacts funds' performance and/or investment managers' reputations will determine whether subscription facilities have been oversubscribed.

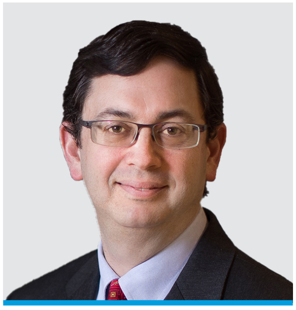
About Fitch Ratings

Meghan Neenan is a managing director in Fitch Ratings' financial institutions group and the North American head of Non-Bank Financial Institutions. Her coverage includes alternative and traditional investment managers, pension funds, securities firms, business development companies, consumer and commercial finance companies, and leasing companies.

Prior to joining Fitch, Meghan was an equity analyst at Morningstar, Inc. covering financial institutions and she began her career as a bank examiner at the Federal Reserve Bank of New York.

Meghan earned a BA from Mount Union College and an MBA from the University of Notre Dame. She is a Chartered Financial Analyst (CFA) charterholder.

Subscription Finance Market



Mark A. Kromkowski
Partner, McGuireWoods LLP

Subscription-backed facilities, also known as 'capital call' or 'capital commitment' facilities (each a 'subscription facility'), provide for the financing needs of private investment funds. Funds can strategically utilize subscription facilities on a short-term or long-term basis to deploy capital more quickly, and potentially generate returns without the need to call on capital commitments from limited partners. Even though the market for subscription facilities has bifurcated to provide both short-term and long-term facilities, there are considerations common to both which lenders and funds alike should consider.

Short-term subscription facilities tend to have maturity dates of less than 365 days. These facilities are often unsecured. Short-term subscription facilities are typically only available to a single fund, as opposed to a family of funds.

Long-term subscription facilities tend to have maturity dates of up to three years, but sometimes have even longer terms. These facilities are often secured by all or some of: (i) the unfunded capital commitments of investors in the fund; (ii) the general partner's rights to initiate and enforce capital calls; and (iii) a pledge of the collateral accounts. The fund's underlying investments can also form a part of the borrowing base, under certain circumstances.

There are issues common to both short-term and long-term subscription facilities with respect to the lenders, the funds and the diligence associated with a successful closing.

Non-traditional lenders are attracted to subscription facilities because of greater flexibility in structure, the value of the uncalled capital commitments and the creditworthiness of the institutional investors. These investors traditionally include high-net-worth individuals, pension and insurance funds, family offices and sovereign funds. Because non-traditional lenders value these lending opportunities (regardless of the duration of the facility), subscription facilities provide access to new sources of capital.

From the fund perspective, covenants and reporting requirements to the lender are often consistent with existing reporting requirements to a fund's investors required by the fund's own governing documents; consequently, the costs of compliance with the terms of a subscription facility can be relatively low regardless of the length of the term.

From a diligence perspective, any subscription facility requires careful review of a fund's structure, its governing documents and the subscription agreements and side letters of its investors. Because a fund's creditworthiness for a subscription facility depends on the strength of its investors and the fund's ability to call capital from those investors, special attention must be paid to these diligence issues regardless of whether the subscription facility is short term or long term.

The subscription credit practice team at McGuireWoods LLP is dedicated to keeping clients advised of new legislative and business developments as they occur. If you have any questions regarding these issues, please feel free to contact Mark A. Kromkowski (312.849.8170) (mkromkowski@mcguirewoods.com), Benjamin B. Iselin (212.548.2158), Donald A. Ensing (312.849.8111), or Yuan-Ying Hsu (312.849.8174).

About McGuireWoods

Mr. Kromkowski represents lenders and investment funds in all types of private equity and corporate transactions. He counsels fund managers in all aspects of fund formation and administration. He is among a small group of lawyers in the United States who have significant transactional and regulatory experience with SBIC, RBIC and other unique AIV fund structures. He represents lead arrangers, administrative agents and lenders in connection with subscription credit facilities throughout the United States. Mr. Kromkowski leads the firm's Fund Formation Group, SBIC Practice as well as its Community, Alternative and Regional Banking industry team.

McGuireWoods is a full-service firm with 1,100 lawyers in 22 offices, providing legal and public affairs solutions to corporate, individual and nonprofit clients worldwide.

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