Investment Funds: Monthly Digest

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SUBSCRIPTION CREDIT FACILITIES – IS IT TIME FOR AIFS IN INDIA TO EMBRACE SUBSCRIPTION CREDIT LINES?

BACKGROUND

One of the issues faced by investment managers is the time gap between when a call for unfunded capital commitment is made, and when such funds are actually received. This issue is particularly relevant in fast-paced deals where investment managers are required to invest capital quickly or lose out on the entire deal. In such instances, investment managers prefer that the fund have more liquidity in order to be able to invest in attractive investment opportunities that require immediate action. However, in a typical closed-ended fund structure, the investment manager generally draws down capital from the investors in multiple tranches. With respect to each such call for capital, it can take anywhere from 7 – 15+ days before the cash hits the fund's account and can be used to make an investment.

To bridge this gap investment managers, particularly in the United States, United Kingdom, and Australia, have the option of taking a revolving credit facility from a Bank or Financial Institution in order to meet their immediate capital requirements before the investment opportunity is lost.[1] These credit lines are known as Subscription-based Credit Facilities ("**SCF**").

In recent years, the market for SCFs has grown steadily.[2] In fact, an investment manager's need for multiple SCFs, and the complexities that come from managing the same, has led to the creation of Umbrella Credit Facilities (**"UCFs**"). A UCF is effectively a number of different subscription lines of credit for various funds managed by a single investment manager bundled together and governed by a single set of deal documents.

In this issue of the Fund Digest we will discuss the concept of SCFs and UCFs in detail, and focus on whether such facilities can be used by Alternative Investment Funds ("**AIF")** regulated under the Securities & Exchange Board of India (Alternative Investment Fund) Regulations, 2012 ("**AIF Regulations**").

SUBSCRIPTION CREDIT FACILITIES

The distinguishing feature of SCFs is that instead of using fund assets as security for the credit line, investment managers encumber their right to call for unfunded capital. In other words, in the event of default, the lender has the right to demand a call for unfunded capital and the repayment of the loan amount is executed from the contributions received from such call. Since the security for the line of credit is the right to receive unfunded capital commitments, the term of an SCF is typically linked with the termination of the fund's commitment period, as after the expiry of such commitment period, the lender would not have many opportunities to call for any remaining capital.

Types

While an SCF is generally a secured credit facility wherein the lender has a right over unfunded capital commitment, SCFs can be unsecured as well. Such SCF's are typically put in place after a fund's commitment period has ended. Further, there are hybrid SCFs that are secured by investors' unfunded capital commitments as well as by the underlying assets of the fund, which are pledged to the lender.[3]

Size of the Credit Facility

The credit limit of the SCF is directly linked with the borrowing base of the fund. For the purpose of calculating the borrowing base, the investors are divided into excluded investors and eligible investors. This segregation is usually done on the basis of creditworthiness of the investor and existence of any side letter provision which do not allow the investment manager to use unfunded capital commitment of the investor to secure the credit line. The borrowing base is calculated by multiplying uncalled capital commitment of each eligible investor with the Advance Rate[4] associated with such eligible investor and reducing this with the amount of haircut allowed by the lender.[5]

Documentation

A typical SCF would have the following documents governing the rights and obligations of the parties:

1. Revolving Credit Agreement

   This agreement is the principal loan document and provides the terms and conditions applicable to availing such credit facility and the repayment thereof. Investment managers / GPs should be cautious of lender friendly negative covenants which may dilute the investment manager's autonomy in determining which investment to execute or restrict distribution provisions.

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2. The Pledge and Security Agreement

   This is the primary document by which the lender gets a security interest in the unfunded capital commitments of the investors of the fund. The pledge agreement would generally provide the following:

   - the right to call capital from fund investors;
   - the right to apply the capital called from investors to repay obligations incurred under the facility; and
   - the right to enforce those rights of the fund and/or the investment manager against fund investors.

3. The Subscription Account Security Agreement

   Under this agreement, the lender also generally has a right over the account which is used by the investment manager to receive amounts capital contributions. The funds in this account are the collateral available to the lender.

4. Investor Letter

   These letters are issued by investors to the lender, whereby investors acknowledge the rights given to the lender under the SCF documents and undertake to contribute their unfunded capital commitment when capital calls are issued.

5. The Limited Partnership Agreement / Shareholder's Agreement

   While the Limited Partnership Agreement (LPA) or the Shareholders Agreement (SHA) of the fund does not form a part of the documentation for availing the SCF, it is necessary that the LPA or the SHA authorizes the fund to avail and enter into an SCF, and to pledge the right to call the unfunded capital commitment of the contributors as a collateral for such SCF.

6. The Subscription Agreement

   Similarly, while the Subscription Agreement does not form a part of the documentation required for the SCF, the Subscription Agreement should mirror the Investor Letter. It should also ideally provide that the investor has given an authorization in relation to incur indebtedness in connection with a facility as either borrower or guarantor, and should not have any terms which would restrict the investment manager from obtaining an SCF.

DRAWBACKS AND BENEFITS OF SCFS

SCFs are extensively being availed in many jurisdictions as they provide various benefits such as:

Ease of Management & Enhanced Action Time

In multi-tier fund structures the time between the initial capital call and the receipt of contribution is extended as multiple capital calls are initiated at different levels at different times. In such instances, SCFs can simplify the whole process by empowering the investment manager to take a loan in order to quickly invest and execute time sensitive deal, and thereafter issue the requisite capital calls.

Cost of Borrowings

It can be noted that the SCFs provide logistical and strategic benefits to the investment manager however, interest needs to be paid on the borrowed capital from the credit line. The high cost of borrowing can lead to lowered returns, especially if the term of the loan is long-term.

Further, Institutional Limited Partners Association ("**ILPA**") in its guidance released in 2017, and recently in 2020 has also identified the various issues faced by investors of funds availing SCFs. These concerns are that the (i) contributor's net asset value does not include an allocation of the amount that is to be paid from its commitment to the lender;[6] (ii) since all the funds do not avail credit facilities it is likely that some funds at any early stage may show inflated performance results;[7] and (iii) difficulty to meet accumulated capital calls, it is likely that the investment manager may call the entire capital at once or reduce the number of capital calls in order to pay back the credit to the lender. This could create an issue for the investor, who might not have sufficient liquidity to meet such accumulated capital call.[8]

The ILPA in its guidance has further provided how the disclosure related to IRR, and further terms of the SCF can be made in the Fund Documents in order to ensure transparency and minimise investor related concerns.

UMBRELLA CREDIT FACILITIES

A UCF is a type of SCF wherein multiple subscription lines of credit of different funds managed by the same investment manager are clubbed together. Such an umbrella facility is governed by one set of documents. The funds under the same group or umbrella are not cross -collateralized or cross-defaulted. This means that the unfunded capital commitments or any underlying assets pledged as collateral by one fund in the group (umbrella) would not be used as a collateral to support the credit of another fund in the same group. Similarly, the default by one fund does not entitle the lender to use the right to draw down or the assets of the other funds in the same group. UCFs reduce the transaction costs as the SCFs for the same group are governed by one set of documents, it further reduces the execution period and provides pricing benefits by enabling the investment manager to borrow a large sum.

Further, UCFs, also include a mechanism for new funds to be added to the facility as borrowers and for the existing borrowers to be released. This allows transfer of credit line to new active funds.

USE OF SCFS IN INDIA

Under the AIF Regulations, Category I and Category II AIFs can only undertake leverage to meet their temporary funding requirements. Moreover, the investment managers may only take advantage of this provision up to four times a year, and the aggregate loan amount cannot exceed ten percent of the investable funds of the AIF, and should be repaid within thirty days.[9] Accordingly, it should be possible for investment managers of Category I and II AIFs to subscribe to an SCF for immediate investment in viable opportunities as long as the loan amount availed and period

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for repayment are within the prescribed limits.

The main issue with SCFs in India is with respect to whether the loans would be considered secured or unsecured. Since there is no tangible collateral provided, and the only security is that of a *right* to call unfunded capital commitments of the fund, lenders may consider the SCFs on par with an unsecured loan, and accordingly be hesitant to grant such credit facility. In order to provide further security to the banks in India, the hybrid model can be adopted where both the underlying assets of the fund as well as the right to call unfunded capital commitment of the investors are provided as collateral.

Another important consideration is that LPs investing in India often add restrictive covenants in their side letters which could potentially restrict investment managers from securing SCFs. Such covenants prohibit investment managers from incurring any borrowing which may establish a lien against the investor and / provide that no borrowings or indebtedness of the AIF should constitute as a guarantee or other obligation by the investor to the lender. These covenants essentially have the effect of ensuring that the investment manager cannot enter into an agreement with any lender whereby the lender has the right to call unfunded amounts from the investor in case of default.

A possible work-around for such restrictive covenants can be that the investment manager separately obtains a written letter from each investor acknowledging their respective unfunded capital commitment amounts and re-confirming their obligation to fulfil any and all capital calls once issued by the investment manager. This letter can then be submitted to the lender to provide further comfort with respect to the total amount of unfunded capital that can be drawn down by the investment manager to meet repayment obligations under the credit facility agreement. In this way, while the lender does not have a right over the capital commitment of the investors, the letters should provide a certain level of comfort with respect to the ability of the investment managers to repay the loan in accordance with the terms of the agreement.

While SCFs are not currently popular in India, if GPs could negotiate SCF-friendly side letters and provide sufficient comfort to banks, this type of credit facility could be strategically used to bridge liquidity gaps which would otherwise prevent investment managers from making lucrative investments.

– Srishti Chhabra & Radhika Parikh

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You can direct your queries or comments to the authors

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2 Graham Bippart, Subscription Credit's Shifting Landscape, Private Equity International, *available at* https://www.privateequityinternational.com/subscription-credits-shifting-landscape/.

3 Hossain Kazemi, Subscription Line of Credit: Benefits, Risks, and Distortions, CAIA Association (Aug. 20, 2021 12:34 PM), https://caia.org/blog/2020/09/29/subscription-line-of-credit-benefits-risks-and-distortions.

4 Advance rate is the percentage of the unfunded capital commitment of each eligible investor of the fund.

5 Charlie Marlow, Trends in the Use of Subscription Credit Facilities: Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions (Part Two of Two), Private Equity Law Report *available at* *https://www.pelawreport.com/2683136/trends-in-the-use-of-subscription-credit-facilities-structuring-considerations-negotiated-with-lenders-and-important-lpa-and-side-letter-provisions-parttwo-oftwo.thtml*.

6 Enhancing Transparency Around Subscription Lines of Credit - Recommended Disclosures Regarding Exposure, Capital Calls and Performance Impacts (June 202) *available at https://cdn.lawreportgroup.com/acuris/files/private-equity-law-report/documents/2020%20ILPA%20Guidance%20on%20Disclosures%20Related%20to%20Subscription%20Lines%20of%20Credit.pdf.*

7 Id. at Page 4.

8 Id.

9 Regulation 16, Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, https://www.sebi.gov.in/legal/regulations/aug-2021/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-august-13-2021-_34621.html.