Equity bridge financing
Reaping the benefits of liquidity and flexibility

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In the sophisticated world of private equity, what is the role of equity bridge financing, and how can it improve returns to investors? Despite some recent claims that such financing can be regarded as a “trick”, in reality there is a great deal to commend equity bridge financing as a key tool for investors to smooth the process of private equity investing to the benefit of both investors and the market as a whole.

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How does such financing work? Equity bridge facilities (EBF), also known as "subscription line facilities" or "capital call facilities", are short-term loans leveraged on the limited partners' commitments of infrastructure, private equity, real estate or other funds, and usually take the form of revolving facilities.

These facilities are granted at fund level (subject to applicable legal and regulatory limitations) or through a special purpose finance vehicle held by the fund with an accompanying guarantee from the fund. In this short note, we summarize a number of key features of EBFs. Bridges continue to be built between private equity firms and providers of subscription lines for financing acquisitions and for add-on acquisitions. Some subscription lines are also now used as a structuring tool for the financing of an add-on acquisition or for small to mid cap PE/VC acquisitions. The current themes are very much the same over the last years, but with different variations depending on the jurisdictions involved in the cross-border financing and the size of the acquisition.

Benefits to fund managers

One of the key features of EBFs is that they allow capital calls to be delayed, thereby providing greater flexibility to the fund's management company to control profitability. EBFs are used by the fund to

finance projects, or if necessary to pay any costs incurred upon a failed acquisition (e.g., advisory fees). The delay to call capital from investors improves the IRR at exit due to the costs of the EBF being less than the rate anticipated by investors. For example, an EBF of one year may reduce the amount of time between capital calls and the sale of an asset from five years to four years, thereby reducing the time denomination employed in calculating and improving the IRR.

If we take a recent example, the CFO of a recent major European buyout firm performed an analysis on how the IRR on their funds could have been improved if they had used such facilities. **The analysis showed a 5 percent improvement in the IRR from improved timing around investments acquisition and disposals, and a 2 percent improvement in the IRR just from the timing of the fund manager's own fees to the fund.**

A second notable feature is that the due diligence conducted by lenders is generally limited to the powers of the manager or general partner under the fund's documents, any side letters agreed with investors, and subscription agreements. The core of the due diligence is conducted on the commitment period, any limits applied to borrowings and the security and, if applicable, the guarantee that may be granted by the fund, the rights of the limited partners to transfer their commitments to third parties and excuse rights—as the main security is the right of the lender to call undrawn commitments in accordance with the fund's documents as well as any (future or present) claims, receivables, rights or benefits of the fund, acting through its manager or general partner arising out of or in connection with the fund's documents. Such security varies from one jurisdiction to the next. For example, for English borrowers, power of attorney is granted by the general partner to the lender. For Luxembourg borrowers, an assignment by way of security is granted by the manager or general partner and the fund to the lender, together with a pledge over the fund's bank account and an assignment of all undrawn commitments of its investors with an express right for the lender to request direct payment of any sum due under the EBF from the investors of a French fund.

If we look at the results of such financing, continuing with the example of France, where one of the banks introduced equity bridge financing for private equity funds three years ago, it is clear that the solution has become increasingly popular—due to the growing private equity market, as well as the fact that it meets the needs of fund managers and end investors by staggering and reducing the number of calls for funds. Over 40 transactions were concluded in the first three years. It has noted that, beyond using EBFs to improve a fund's IRR, such financing enables management companies to be reactive when negotiating investments and provides the fund's investors with greater visibility regarding future calls for funds. **Furthermore, it has been noted that EBFs do not create leverage since they do not increase the fund's investment capacity.**

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The economic contribution of EBFs

In practice, there is a significant variation in loan size, ranging from €50m to over €500m. Lenders generally compute the maximum potential borrowing amount as a percentage of the commitments of "qualifying investors" (e.g., 80 percent of AAA-rated investors' commitments) subject to a "haircut" (e.g., 20 percent typically applied to those investors with a participation greater than 20 percent of total commitments). Cases where an investor may be excused or transfer its commitment are therefore crucial to the lender. Qualifying investors include financial institutions, public or private pension plans, investors with assets valued greater than an amount determined by the lender, investors meeting rating agency requirements (as set out in the facility agreement), and such other investors as the lender may determine in its discretion given that, from the lender's perspective, the quality of the investor base should remain unchanged for the duration of the EBF. The costs of borrowing depend on the fund's size and investors' level of risk (the main trends in Europe are stable over the last two years, showing a margin between 1.85 to 2.70 percent for EBFs granted for a period of one to three years), a commitment fee ranging between 0.25 and 0.50 percent, and an arrangement fee between 0.25 and 0.75 percent.

In addition:

01. Capital calls are usually sent to investors 10 to 20 days prior to the repayment date of the facility
02. The margin is made by reference to the interest period, i.e., it may be one, two or three months' interest, or any other such period as agreed with the lender. The margin is payable at the end of the interest period, or alternatively, is capitalized
03. Borrowers generally prefer an uncommitted facility rather than a committed facility to limit borrowing costs; and
04. Financial covenants are frequently set with a debt-to-qualifying-investor-undrawn-commitment ratio of 1:1.1/1.5, and a debt-to-aggregated-NAV-and-qualifying-investor-undrawn-commitment ratio of 1:2.0/2.5, with the facility to be covered at all times by 1.5x the unfunded commitments of the fund's investors

The figures are sufficiently compelling that key players across the private equity market are now known to be using such financing on a regular basis, with executives at firms including Blackstone, Carlyle, and KKR reported as saying that their funds have begun relying on borrowed money at the beginning of their lives to varying degrees[1]. In practice, it is very common to negotiate an EBF to be signed at the first closing of the fund.

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1. https://deloi.tt/2M9KBNN

Specific representations and undertakings

Borrowers or guarantors will represent that the "excused" undrawn commitments of the investors do not exceed the total undrawn commitments of investors, and that there are no other creditors of the fund or borrower SPV other than the manager. Other specific covenants include:

01. The manager's or fund's obligation to call a minimum amount from the fund's investors on an agreed frequency
02. The manager's or fund's obligation to provide information on the investors' commitments (e.g., failure to pay, exclusion events, key man events, excused investors)
03. Subject to the security package, the manager's or fund's obligation to provide all information necessary to allow the lender to issue drawdown notices (e.g., amount of undrawn commitments by the investor, contact details, copies of applications)
04. No distribution by the fund while amounts are outstanding under the facility or in the case of a default on payment
05. No borrowing during a key man event and where a change of manager control has occurred
06. A negative pledge over the undrawn commitments of the investors;
07. An obligation to pay the undrawn commitments on a pledged bank account; and
08. an obligation to pursue defaulting investors and to request payment of the shortfall to the other non-defaulting investors

Specific events of default

As with the representations and warranties, events of default will depend on the type of fund, but generally include:

01. The removal of the manager upon its insolvency;
02. The termination of the fund;
03. A cancellation threshold (usually 5 to 20 percent of undrawn commitments being cancelled);
04. An insolvency threshold (usually 5 to 20 percent of investors becoming insolvent);
05. A defaulting investor threshold (where investors fail to comply with their obligations to fund their undrawn commitments)
06. A transfer threshold (where an investor's undrawn commitments are transferred to a third party after the execution of the facility agreement); and
07. An excused investor threshold (where investors are excused from complying with a drawdown notice)

Striking the right balance

While equity bridge financing has much to commend it, it has increasingly become an important discussion point between sponsors and limited partners. Given the extent of the use of EBFs by most funds, investors are asking more questions about the details of these arrangements and are starting to request specific reporting, projections and terms in side letters where, for example, certain financings are restricted or information on investors is limited, thus changing the fund documentation to deal with their concerns. In June 2017, the Institutional Limited Partner Association (ILPA) issued a publication to its members that included nine points of guidance. The ILPA also outlined some concerns that they have in relation to lines of credit, such as the difficulty in comparing the performance of funds that use these facilities with those that do not (as the use of a credit line can increase a fund's IRR), the expenses incurred as a result of a credit line (both upfront costs and ongoing interest), how longer-term facilities may cause UBTI issues for U.S. tax-exempt investors, as well as the liquidity risk to investors if a market event triggered a large number of capital calls from managers to repay the outstanding facilities. This being said, there is a general consensus that subscription lines take various forms, adapt quickly to the market and are useful, if only for providing flexible and creative financing to GPs enabling them to react quickly to market opportunities and maximize returns.

Looking at the impact of the ILPA guidelines, some legal advisers have identified two major trends in negotiations between fund managers and investors on the use of such funding facilities[2]. The first is greater disclosure, with fund managers increasingly providing investors with two IRR calculations, one reflecting the usage of the relevant fund's subscription facility, and the other backing this usage out. They have also identified that there is also more disclosure of the costs associated with a fund's subscription line, in particular interest and fee rates, and of mandatory prepayment triggers and events of default, especially any events outside a fund's control that could trigger early repayment. This is not the case for the majority of limited partners. In a competitive market, nobody disagrees that investment funds need access to financing to support their operating costs and help grow their investments. While the conditions of the financing are considered by limited partners, they do not generally take any action when negotiating the fund documents that would somewhat restrict access to that financing, which benefits the fund as a whole; the trend is generally to request transparency on the calculation of the IRR.

The length of time that advances under subscription facilities remain outstanding is an issue. It is generally accepted that the ILPA's guidelines were initially designed to promote a dialog between sponsors and limited partners. They are not a list of points to be included in the constitutive documents or side letter of every fund. More generally, fund managers are likely to continue to provide investors with greater disclosure about the terms and use of these facilities, including, increasingly, by providing calculations of both a levered and an unlevered IRR.

It should also be noted that limited partners, in some cases, benefit themselves from some form of financing in their favor and in respect of their investment in a fund. There is in most cases, an alignment of interests where the sponsor and limited partners can enjoy the benefits of a subscription line facility. Limited partners want to see their commitments being put to use and do not typically expect to fund investments 12 or 18 months after they have been made (once the subscription line can no longer be used for that investment).

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2. https://deloi.tt/2vr19ah

Conclusion
A detailed analysis of the investment structure and the investor is always critical in determining the key terms of the EBF to be granted to a fund, especially in light of the potential impact on the third-party lender's capital costs.

In addition, due diligence around fund terms and the investors that secure the credit is necessary to assess whether an EBF is a preferred option for private fund managers.

To the point:

- Equity bridge financing is an acceptable means of improving both IRR and liquidity for investors in closed-ended funds
- Given evolving investor standards and requirements, the use of EBFs and impact on IRR and returns needs to be transparently and fully disclosed
- The improvement in returns to investors from the use of EBFs to improve cash flow timing around investments and fees outweighs the cost of the facilities
- EBFs also enable fund managers access to deploy capital and move quickly when needed on pre-emptive deals that increase returns to investors