LOEB & LOEB LLP

Finance

APRIL 2017

ILPA Questions, Suggests Guidance on, Subscription Lines

An industry group representing institutions that invest in private equity funds has questions about how funds use subscription lines or other forms of leverage in their fund structures. The Institutional Limited Partners Association is in the process of formulating guidelines to ensure funds become more transparent about their actual use of subscription lines — credit facilities traditionally offered by banks to provide short-term liquidity to funds in advance of the funds' calling on investors to fund capital calls. While funds typically disclose in their offering documents their ability to borrow and pledge the unfunded capital of investors to secure such borrowings, the ILPA is concerned about overuse or undisclosed use of these lines, which may result in increased risk to the industry.

Subscription lines were originally developed to allow funds to move quickly when an investment opportunity arises and to allow funds to better administer their capital call process. Some funds have used subscription lines on a longer-term basis to provide leverage in their acquisitions. This use has the effect of increasing the funds' internal rate of return, or IRR, by having the investors' capital remain uncalled while the borrowing to fund the acquisition is outstanding. Since IRR is measured by the return on the investors' capital, the shorter the period that capital is outstanding, the higher the IRR. In fact, if an asset financed through a subscription line is sold before capital is called to repay the loan, the IRR for that asset is infinite. Although the IRR may be higher, the bottom-line return to the investors hasn't really changed. Nevertheless, IRR is a significant measuring tool to judge a fund's performance, so the higher it is, the better the fund's performance appears.

The utility of subscription facilities to the private equity industry is well-documented, and most investors will look at the prudent use of financing as a benefit to the fund. As limited partners look to evaluate fund performance, however, the move to more transparency in all areas, not just borrowing, will increase. The ILPA's guidelines are expected to call for disclosure of the amount of credit facilities, the percentage of fund investments funded by these lines of credit and the costs associated with the facilities.

Loeb & Loeb's Finance Practice

CURTIS W. BAJAK	CBAJAK@LOEB.COM	310.282.2024
DANIEL B. BESIKOF	DBESIKOF@LOEB.COM	212.407.4129
ROBERT CALDWELL	RCALDWELL@LOEB.COM	+852.3923.1115
MIRIAM L. COHEN	MCOHEN@LOEB.COM	212.407.4103
NICHOLE D. CORTESE	NCORTESE@LOEB.COM	212.407.4958
WALTER H. CURCHACK	WCURCHACK@LOEB.COM	212.407.4861
KEVIN M. EISENBERG	KEISENBERG@LOEB.COM	212.407.4123
RICHARD FACUNDO	RFACUNDO@LOEB.COM	212.407.4178
KENNETH D. FREEMAN	KFREEMAN@LOEB.COM	212.407.4086
JEFFREY S. FRIED	JFRIED@LOEB.COM	212.407.4987
SCOTT J. GIORDANO	SGIORDANO@LOEB.COM	212.407.4104
DOV GOODMAN	DGOODMAN@LOEB.COM	310.282.2238
WILLIAM M. HAWKINS	WHAWKINS@LOEB.COM	212.407.4126
NANCY S. JACOBSON	NJACOBSON@LOEB.COM	312.464.3160
STAN JOHNSON	SJOHNSON@LOEB.COM	212.407.4938
LANCE JURICH	LJURICH@LOEB.COM	310.282.2211
STEVEN M. KORNBLAU	SKORNBLAU@LOEB.COM	212.407.4217
DAVID B. KOSTMAN	DKOSTMAN@LOEB.COM	212.407.4196
CHERICE LANDERS	CLANDERS@LOEB.COM	212.407.4204
JADA SOYUN LEE	JSLEE@LOEB.COM	+852.3923.1150
JC LEE	JCLEE@LOEB.COM	+852.3923.1146
RICHARD A. NARDI	RNARDI@LOEB.COM	212.407.4009
JOHN J. OBERDORF, III	JOBERDORF@LOEB.COM	212.407.4190
BRYAN G. PETKANICS	BPETKANICS@LOEB.COM	212.407.4130
ANTHONY PIRRAGLIA	APIRRAGLIA@LOEB.COM	212.407.4146
EMILY RAKOWICZ	ERAKOWICZ@LOEB.COM	212.407.4867
DANA ROSENTHAL	DROSENTHAL@LOEB.COM	212.407.4156
P. GREGORY SCHWED	GSCHWED@LOEB.COM	212.407.4815
PETER G. SEIDEN	PSEIDEN@LOEB.COM	212.407.4070
PAUL W. A. SEVERIN	PSEVERIN@LOEB.COM	310.282.2059