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FUND FINANCING

Uncommitted debt: How to avoid getting stung in a downturn

GPs can avoid potential liquidity issues by drawing down loans early and performing greater due diligence on their lenders

Uncommitted capital call facilities have taken the private markets by storm, but fund managers should be cognisant of the potential for lenders to withhold financing during a liquidity crunch.

The notional value of debt facilities provided on an uncommitted basis is estimated to have grown 12 to 15 times over the past decade, Zac Barnett, managing partner at debt advisory Fund Finance Partners, told *Private Equity International*. These facilities mean the lender has agreed to provide capital at set terms when asked but is under no obligation to do so.

Such loans are often cheaper than committed facilities as banks don't need to set capital aside to meet liquidity requirements, according to a 2017 report from Mayer Brown.

"Private fund sponsors have eaten up uncommitted debt, which is where the bubble would pop, if anywhere," Barnett said.

Subscription credit lines have grown in popularity as they enable capital to be called in one lump sum, often only on an annual basis, rather than relying on LPs to act quickly to finance each individual investment. Capital calls can take up to 12 business days to provide, making debt a useful tool in completing investments in a timely fashion.

The Fund Finance Association, an industry trade group, estimates that existing subscription line commitments have grown to approximately half a trillion dollars, reports sister title Private Funds CFO.

Terms of endearment

For committed lines, GPs pay an upfront commitment fee, a margin on drawn capital and a fee on undrawn capital, according to Matt Hansford, head of UK fund finance at Investec. Uncommitted lines only charge a margin on what is committed, meaning a GP only pays for what they need.

This debt can sit on top of a committed facility, much like an expansion valve. A GP could, for example, arrange an $80 million committed facility with an optional additional $20 million portion that can be accessed if required, provided the bank approves the request.

"People have gotten comfortable with uncommitted capital call facilities because the conditions under which a bank is lending will remain pretty constant, provided the fund hasn't faced any major changes like a secondaries transaction or the loss of a key person," Hansford said.

"There's also the potential for reputational impact to the lender if they veto a utilisation request."

That uncommitted lines can be withheld – however unlikely – could be problematic in a downturn if GPs are unprepared. Liquidity constraints due to macroeconomic conditions could limit the speed or ease with which LPs can meet a capital call, placing undue pressure on their relationship or potentially delaying an investment if the GP can't access leverage.

"You've had around 40 new entrants to the capital call space in Europe alone in recent years," Hansford noted. "There was a big pullback from the capital call space in the last crisis, so there's a risk that the field would narrow again in the next downturn."

One solution is to ask banks to commit the loan in advance of when it's needed so that the money can be called from investors in due course if necessary, he added. Borrowers also need to consider how large the lenders' capital call business is and whether they continued to be active during the last downturn.

Some uncommitted lines in the US are provided on demand, meaning a lender has the right to call in debt at any time in exchange for a cheaper fee. An untimely demand from a lender could force a GP to call capital or exit certain assets to repay debt when they're not ready, Barnett said.

Committed to the cause

FFP was launched in late 2019 as a negotiator of more favourable credit terms for GPs. Barnett, an 18-year veteran of Mayer Brown's bank-

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ing and private investment fund practices, co-founded the business with Richard Wheelahan, a former general counsel at private credit manager Capitala and fellow Mayer Brown alumnus.

The firm, which operates from Chicago, Illinois and Charlotte, North Carolina, is sector-agnostic and has worked for private credit, real estate and multi-strategy fund sponsors globally. Although subscription lines are its core business, FFP has also arranged NAV lines, hybrid lines and advised on GP-interest deals involving private and bank debt, as well as sales of equity stakes.

Barnett and Wheelahan say moving from an uncommitted to committed facility impacts returns by as little as 0.1 percent. The pair also advocate greater due diligence on potential lenders to ensure they're able to weather a recession without calling in loans.

"Everyone professes discipline," Wheelahan said. "But they've got to maximize and justify returns in a valuation environment that's gotten more exuberant every year, and nobody wants to see tears when the correction comes."

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