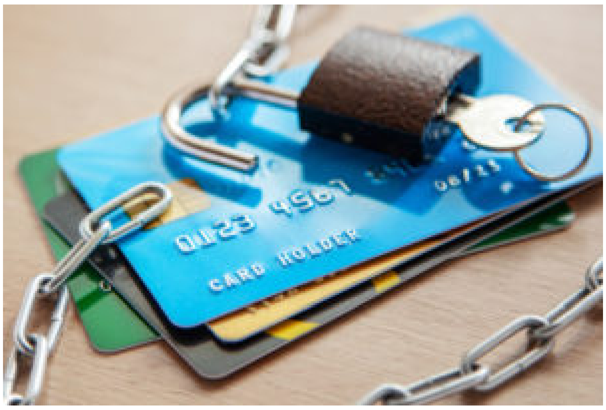
Fund financings and SMAs: Bespoke considerations

privatefundscfo.com/fund-financings-and-smas-bespoke-considerations

9 June 2020



Variations of fund structures and underlying investor pools prompt differing lender considerations in fund-level financings, and typically require complex loan documentation customized for each specific case. In this article, we look at the need for bespoke terms of subscription facilities (ie, facilities where the amount a lender is prepared to lend is determined by the available uncalled capital commitments of the investors in the underlying fund) in the context of separately managed accounts (which may have only a single investor).

Separately managed account

The number of SMAs has increased dramatically over the last decade, finding particular popularity among large institutional investors such as state and private pension funds, educational endowment funds, insurance companies and sovereign wealth funds. SMAs offer institutional investors the ability to create an individualized investment program that is managed by the sponsor of the fund on terms tailored to the needs of the investor and may provide economic terms that are more favorable than those of a fund with a diversified investor base.

Kathryn Cecil

From a financing perspective, SMAs present some specific challenges due to the concentrated investor base on which the lender to an SMA will rely for repayment. However, market participants have worked together and developed subscription facilities that work for both lenders and borrowers and, notwithstanding the current environment, the fund finance market (including subscription facilities and subscription facilities for SMAs) continues to be very active and we are not aware of any lenders resorting to the exercise of remedies under subscription facilities to SMAs.

Investor composition

The investor composition of the fund is a key factor for a lender in establishing how much it is willing to lend to that fund under a subscription facility. When there is only one investor, as is the case for SMAs, unique considerations for the related subscription facility arise, including those stemming from an increased concentration risk. As compared to subscription facilities for multiple-investor funds, advance rates (ie, the percentage of an investor's commitment that a lender will lend against) for the single-investor SMAs tend to be more customized and negotiable.

Lenders generally lend based on the creditworthiness of each investor, and while an investor may receive a certain advance rate if it were investing in a commingled fund, other factors may necessitate a different approach by a lender when lending to an SMA of that same investor. For example, in an SMA scenario, lenders cannot rely upon a diversified investor base that, in the aggregate, reduces the exposure to an individual investor's funding failure or weakness in its credit rating. Further, in many subscription facilities for commingled funds, the uncalled capital commitments of investors who do not qualify for inclusion in the borrowing base are nevertheless provided as collateral and provide additional security for the lender's loan advances.

Organization documents and investor consent letters

Like any other fund, the terms of the organizational documents of an SMA must satisfy the general requirements of the subscription facility lender. To the extent, however, that some or all of those provisions are not addressed in a manner satisfactory to a lender, it may be easier for a sponsor and investor of an SMA to revise the provision than it would be for those in a multi-investor fund, because the revision process for the latter requires a consent solicitation from multiple investors.

As an alternative or an addition to incorporating such provisions in the organizational documents, it is fairly common for lenders to request that the investor in the SMA enter into an investor consent letter to address any other specific issues which may arise in a particular context, for example to provide for additional information rights or address issues arising from withdrawal rights of, or transfers of SMA interests by, the investor. Understandably, the treatment of such issues requires a highly individualized analysis that needs to be performed on a case-by-case basis.

Jons Lehmann

Exclusion events and events of default

There may be other terms in SMA subscription facilities for which lenders may seek a stricter regime as compared to commingled fund subscription facilities. For example, certain exclusion events (ie, events that, if they were to occur with respect to an investor, would trigger removal of such investor from the borrowing base) under a commingled fund subscription facility may be characterized as events of defaults (ie, events that give the lender a right to accelerate the amounts outstanding under the facility and pursue remedies) under an SMA subscription facility.

There is sound rationale for this approach for a number of exclusion events. For instance, if the only investor in an SMA defaults on its obligation to fund a capital call, the lack of any other investor commitments to fall back on makes it reasonable to characterize such an occurrence as an event of default. However, if the same failure to fund capital were to occur in a commingled fund, the typical subscription facility would simply no longer give credit for such investor's commitment in the borrowing base. Only if investors with material capital commitments (above agreed-upon thresholds) defaulted would an event of default be triggered under a commingled fund's facility.

Jan Sysel

Conclusion

The steady increase of the usage of SMAs in the fundraising context has led to a corresponding increase in related subscription facilities for SMAs. While providing financing to SMAs raises some specific challenges, and the current environment may further focus lenders on the underlying provisions of the fund and finance documents, cooperation of the participants in devising and implementing customized solutions can address all the parties' needs and requirements.

Kathryn Cecil, Jons Lehmann and Jan Sysel are partners at Fried, Frank, Harris, Shriver & Jacobson