April 28. 2020

FINANCING FACILITIES

Alternative Financing Facilities: How Management Company Facilities Offer Liquidity for Sponsors' Working Capital Needs

By Rorie A. Norton, *Private Equity Law Report*

Perhaps more than ever before, the omnipresent desire among PE sponsors for liquidity is dovetailing with a suite of techniques for sponsors to attain that result. At a transactional level, this accounts for the recent growth in GP minority stake transactions, among others. In the fund-financing realm, that helps explain the rising popularity of management company facilities that provide short-term working capital for sponsors in exchange for pledges of the management fees paid to their GPs by their underlying PE funds.

To better understand the value, function and future of management company facilities, the Private Equity Law Report recently interviewed Simpson Thacher partners Mary B. Touchstone and Julia Kohen. This article summarizes the features and uses of those facilities; explains the driving forces behind them; describes key negotiation points with lenders; and highlights issues PE sponsors should consider when deciding whether to put a management company facility in place.

For more on alternative financing facilities, see "Streamlined Borrowings and Longer Loan Durations With Hybrid Facilities" (Mar. 3, 2020); and "How GP and Co-Investment Facilities Increase Sponsors' 'Skin in the Game'" (Feb. 11, 2020).

PELR: Please begin by providing a summary of management company facilities, how they work and where they fall on the spectrum of financing options available to PE sponsors.

Touchstone: Typically, a PE sponsor receives management fees as compensation for advising and managing a fund and its portfolio of investments. That management fee is usually payable by the investors in a fund based on a percentage of the capital commitments made by the investors to that fund. That management fee may be paid indirectly by LPs through the fund or directly to the sponsor, and it is typically set forth in a limited partnership agreement (LPA) or similar management agreement.

A management company facility often takes the form of a revolver that can be borrowed and repaid numerous times during the term of the facility. A management company facility provides liquidity to smooth cash flows and bridge expense obligations between quarterly or semiannual payments of the management fee to the PE sponsor. Loan proceeds and letters of credit may be used by the sponsor for various working capital purposes, including meeting payroll obligations; paying operating and administrative expenses; and satisfying lease obligations, among others.

PELR: How widely adopted are those financing facilities relative to the other types of facilities available to sponsors (*e.g.*, subscription facilities, hybrid facilities, etc.)?

Touchstone: At this point, almost every PE sponsor in the marketplace either already has a subscription facility in place or is considering one. That is not the case with management company facilities, as they are not as widely adopted as subscription facilities and other forms of fund-level leverage.

[See "Characteristics and Benefits of NAV Facilities for Secondary Funds" (Sep. 10, 2019); and "Financing Facilities Offer Private Funds and Managers Greater Flexibility (Part Two of Three)" (Jun. 9, 2016).]

This is likely due, in part, to the limited number of lenders offering those facilities. In some respects, it is similar to where the subscription finance space was ten years ago when lenders were unfamiliar with the fund structures, uncalled capital and gauging the creditworthiness of investors. There has been a huge increase in the number of subscription facility lenders over the past ten years, and I think similar growth is entirely possible in the management company facility space as well.

With that said, management company facilities are growing in popularity, as there's more marketplace knowledge about the different liquidity offerings by lenders. The growth of the facilities has also resulted from the enhanced relationships between lenders and sponsors. For example, a subscription facility lender may already have a good understanding of a sponsor's businesses and assets; the investors in its underlying funds; and its overall fund strategies. As a result, that lender may be more willing to provide the management company facility.

Finally, it's worth noting that management company facilities are also growing in size because sponsors have larger and more funds under management, which results in an increase in the size of the available management company facility.

PELR: What are the particular contexts in which – and specific types of sponsors for whom – management company facilities are most appropriate?

Touchstone: I wouldn't say there are particular types of fund sponsors that are more likely to have a management line. In the subscription facility context, for example, real estate funds were the early adopters, but that has really changed over time such that you see subscription lines in place across different platforms (*e.g.*, PE, real estate, credit, energy, infrastructure, etc.).

On management company facilities, sponsors are now managing a wide variety of funds for which they are collecting management fees. They are not particularly concentrated in a single platform or asset class. If anything, you see a bit more differentiation by the size of a fund sponsor. Established sponsors with larger funds are collecting more management fees, which makes the approach more viable for them than for emerging managers. Although, you do occasionally see small management lines for newer sponsors.

[See "Emerging Managers Need Appropriate Infrastructure – Not Only Solid Performance – To Attract Investors" (Feb. 25, 2020).]

PELR: What are some of the process and timing considerations of which PE sponsors should be aware if they intend to put those facilities in place?

Touchstone: Sponsors will want to be mindful of the fact that lenders need to perform diligence before offering management company facilities. Among other things, that diligence will often include:

- reviewing each of the LPAs and associated documents;
- understanding how the management fees are calculated and when they are paid;
- identifying which fund entities are receiving the management fees;
- determining whether the aforementioned fund entities can somehow be captured as credit parties; and
- considering the composition of the assets being managed by the funds.

That diligence is also affected by whether the sponsor intends for the management company facility to apply only to its enumerated funds or also to its future funds. If the latter, then the lender will need to drill down on what that entails. All of which is to say that there is a fair amount of lead time required for lenders to diligence the transaction.

Also, as management fees are deposited into bank accounts by their funds or LPs, as appropriate, those deposit accounts will need to be pledged to the lender as collateral and subject to their control in an event of default. It can take a while for those accounts to be opened, particularly because of the know-your-client review undertaken by the depository institutions.

Beyond diligence and deposit accounts, the timing is really impacted by a number of different factors. For example, the process is typically much faster in bilateral arrangements with a single lender versus a syndicated financing involving several lenders. Also, it is usually quicker to put a management company facility in place if a sponsor already has another line in place with the same lender, as the sponsor can leverage off that precedent to complete things in a more streamlined manner.

PELR: What are the typical types of collateral that PE sponsors are expected to pledge to lenders in support of management company facilities, as well as any associated issues that can arise?

Touchstone: Sponsors typically need to pledge the management fees earned from their PE funds, as well as the bank accounts into which those fees are deposited. There tends to be discussion, however, around the pledge of the right to receive the management fees. Lenders typically ask sponsors to pledge their right to receive management fees under the LPA in support of the facility.

Instead, sponsors often take issue with that request based on the standard anti-assignment provisions in their fund LPAs. Naturally, investors expect the fund to be managed by an affiliated fund manager, rather than an assignee. This is why sponsors are uncomfortable pledging their rights under the LPA, even if a lender would not want to actually use it to step into the shoes of the sponsor in a default scenario. Further, most sponsors are reluctant to go back to their investors to get amendments to the anti-assignment provisions.

[For more on default risk and financing facilities, see "Operational Challenges for Private Fund Managers Considering Subscription Credit and Other Financing Facilities (Part Three of Three)" (Jun. 16, 2016).]

In light of that, sponsors with anti-assignment provisions in their fund LPAs will often ask lenders to limit their liens to paid management fees and a covenant from the sponsor to put those management fees into the pledged deposit account. On the other hand, lenders may counter those requests by pointing to some provisions in the Uniform Commercial Code that override those anti-assignment provisions for the purpose of facilitating a financing.

Ultimately, there's a bit of a dance between a sponsor and a lender on this point. To address this, sponsors are increasingly considering whether to include language in the anti-assignment provision in their fund LPAs to expressly allow a pledge of the right to receive management fee income for the purpose of facilitating a financing. Accompanying disclosures would also be made to LPs about that ability. That type of carve-out from an anti-assignment provision generally gives sponsors more comfort around granting a lien to the bank.

PELR: What are some recent trends with respect to the terms (*e.g.*, borrowing base, negative covenants, etc.) and structure of those facilities of which PE sponsors should be aware?

Touchstone: The fundamental borrowing base is based on the management fee income stream of the associated funds. That really varies, however, based on the relationship between the sponsor and the lender, as well as the lender's model.

The lender will want to ensure nothing impairs, or is otherwise an impediment to, the calculation of the borrowing base and the payment of those fees. To that end, there are increasing discussions about sponsors pledging their right to receive management fees versus lenders just receiving the cash fees that are deposited into the pledged account.

Aside from that, a lot of conversations happen around various covenants in the credit agreement that are intended to protect lenders' interests in the management fees and the borrowing base, including:

1. a prohibition on any LPA amendments that would reduce the payment of those management fees;
2. limitations on postponing, canceling or suspending the payment of management fees; and
3. a financial covenant requiring the sponsor to maintain minimum assets under management or a minimum amount of management fees that are payable in any given year or period.

In addition, lenders typically have a fund's GP sign an acknowledgement that the management fees payable by the fund to the sponsor have been pledged, as well as a consent that the GP will deposit those funds directly into the pledged account. If the sponsor is in default, that acknowledgement and consent enables the lender to go directly to the fund and request payment of any management fees that are then due and payable.

Again, the fund is not obligated to pay management fees that are not due and owing. Further, the fund is paying for services rendered by the sponsor, rather than guaranteeing any part of the sponsor's financing. This is merely an agreement that any due management fees will be paid directly to the pledged account, or the lenders can directly request payment during a default.

Kohen: Despite those covenants and protections, this has not been a major issue in practice because, at the end of the day, these are still relationship deals. The banks have done their diligence but are ultimately comfortable with how the sponsor operates and its relationship with the funds it manages.

Also, a trend we have seen is that sponsors are being a bit more forward-thinking about the facilities and are beginning to anticipate certain problems that can arise. In some ways, it's similar to what happened in the subscription facility market, where funds started putting much more detailed language into LPAs and much more disclosure in their offering documents to allow for subscription lines.

We are starting to see a similar trend with how sponsors approach management company facilities. For example, as discussed earlier, sponsors are beginning to put language into their management agreements to allow the assignment of their management fees for financing facilities. That also includes a disclosure to investors that the fee income stream has been, or can be, pledged.

PELR: Having addressed the benefits of those facilities, what are some of the downsides or difficulties that PE sponsors can face with management company facilities – both in terms of arranging the facilities and having them in place?

Touchstone: We have talked about how having a subscription facility with a lender can give that lender more knowledge about a sponsor, its funds under management and the quality of those assets. There is also a tension and a potential difficulty, however, in the interplay between a management line and the subscription line. Specifically, subscription lenders may want to subordinate the payment of management fees from a fund to its sponsor if that fund is in default of its obligations under its subscription facility.

Subscription lenders understandably want to be repaid first in that situation before distributions are made to LPs and before fees are paid to affiliates of the fund. There's a fundamental difference, however, between a distribution on the equity to LPs and a payment for services rendered to a management company, so we advise our fund clients to consider resisting any subscription facility limitation on the payment of management fees.

[See our two-part series on trends in the use of subscription credit facilities: "Advantages for PE Investors and Sponsors Have Led to Adoption by Some Hedge Funds and Credit Funds" (Jan. 24, 2019); and "Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions" (Feb. 7, 2019).]

On the other hand, lenders under management company facilities worry about looking to the underlying funds to pay management fees, yet those same funds may be contractually prohibited under their subscription facilities from paying those fees under certain circumstances. That is further exacerbated by those funds also being asked, as we discussed before, to acknowledge the pledge of the fees and consent to pay them into the pledged account despite a simultaneous restriction in the subscription facility on that payment.

PELR: What future trends and developments do you foresee in the terms, adoption or application of those facilities in the next several years?

Touchstone: Management company facilities are going to grow in popularity in the same way subscription facilities have grown in popularity in recent years. That will be prompted by an awareness that this tool is available in the marketplace, as well as the broader use of tools generally to enhance liquidity (*e.g.*, subscription facilities, net asset value (NAV) facilities, etc.). There seems to be a growing awareness of those different tools and how they can be used in a fund sponsor's toolkit.

[See our two-part series on NAV facilities: "Common Structures, Applications and Trends in the Use of NAV Facilities by Secondary Funds" (Mar. 17, 2020); and "Five Obstacles When Negotiating NAV Facilities and Potential Ways to Overcome Them" (Mar. 24, 2020).]

PELR: What are the three to five most important things for an in-house GC or CCO at a PE sponsor to think about if he or she were considering putting a management company facility in place?

Touchstone: First, sponsors need to decide if they are comfortable granting a lien on the right to receive the management fees and with opening the associated deposit accounts. As it relates to the right to receive the management fees, sponsors should also consider whether to include an express carve-out to the anti-assignment provision in their fund LPAs to expressly permit a pledge of the right to receive management fees as part of the financing.

A second item to think about is that we have seen lenders request a personal guarantee from one or more of the founding partners or members of a sponsor when putting a management company facility in place. Sponsors need to consider the exposure of those individuals, their comfort with providing credit support, how many individuals are being asked and, if there are multiple people, the relative responsibilities of each of them. As a general rule, people push back on personal guarantees, and they are far less common than they had been a number of years ago.

A third consideration is the topic of GP consent that we addressed earlier. Again, lenders will ask the underlying funds to acknowledge and consent to the pledge. Sponsors need to think about whether a subscription facility is already in place and, if so, whether that limits the payment of those management fees. Also, funds should not covenant to paying those fees except to the extent that they have been earned because they are not stepping in as guarantors of the facility.