Private Debt Intelligence – 6/10/2019

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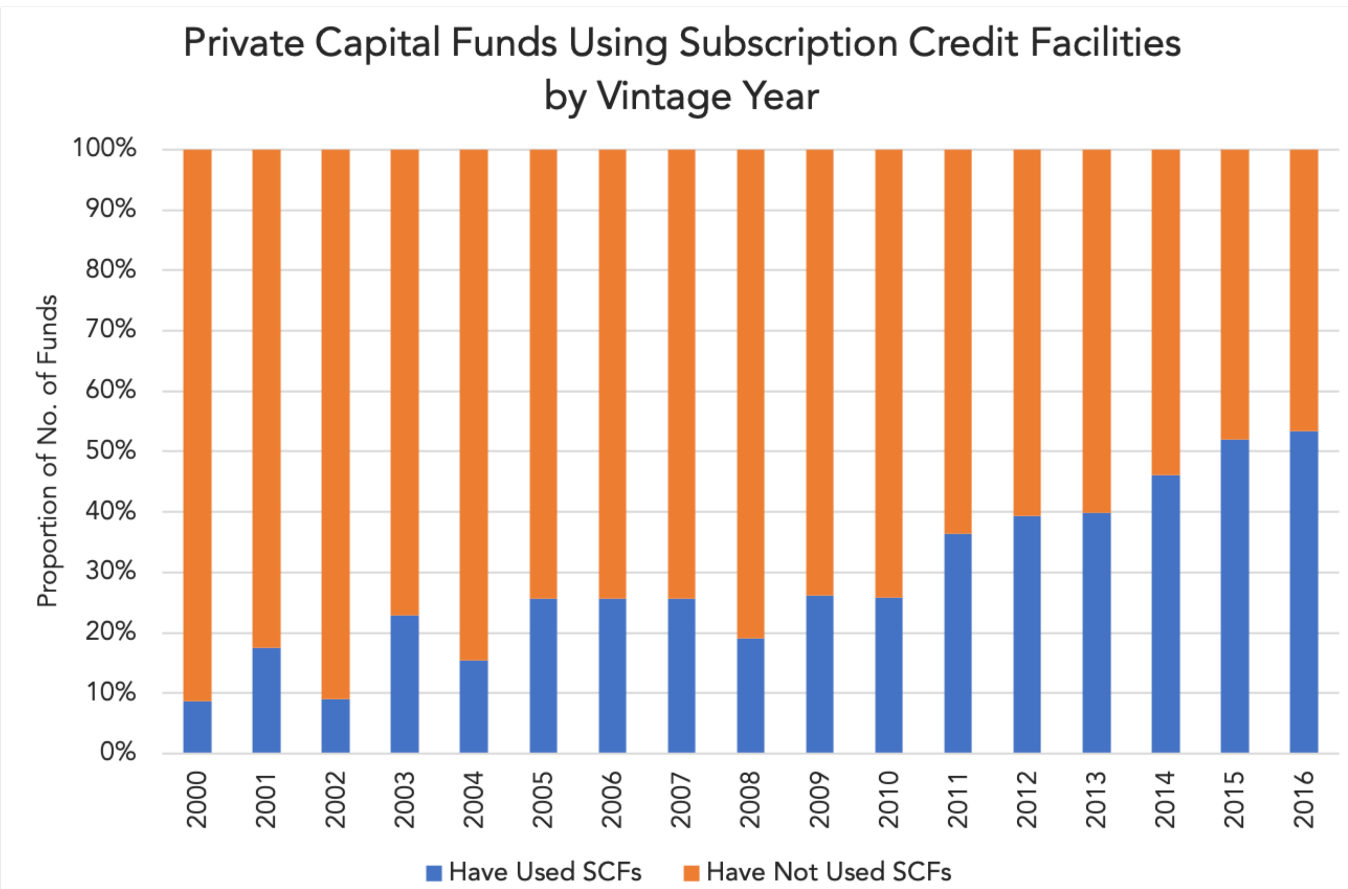
Subscription Credit: Angel or Demon?

Chart



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Private capital funds are using subscription credit facilities – bridge loans made to fund deals in lieu of making capital calls – more than ever. Usage has jumped from 13% in pre-2010 vintages to over 50% of 2015 and 2016 vintage vehicles. But the industry remains divided as to whether they are a legitimate means of managing cash flow, or a cynical ploy to artificially boost IRRs.

Those who support the use of SCFs rightly point out that investors' portfolios are more complex than ever. As they invest in a greater range of asset classes, and more complex financial products, the challenge of maintaining smooth cash flows and adequate liquidity becomes more complicated. In that light, SCFs are a fantastic tool to regulate cash flows and keep liquidity more predictable – no small feat in an industry known for its illiquidity.

The opposing view says that SCFs are making it ever harder to fairly judge fund returns. Many fund managers return to market and raise new vehicles before their previous funds have finished investing, let alone liquidated. Investors evaluating those funds will look closely at the IRR of the predecessor to gauge the fund manager's performance, and could be mislead by SCFs boosting that figure. Equally, investors in the predecessor fund may be monitoring the vehicle alongside funds in their portfolio which have not used SCFs, obscuring a like-for-like comparison.

What SCFs certainly demonstrate is that IRR figures on their own are an imperfect way of measuring fund performance. They must be taken alongside other performance metrics, and detailed cashflow data, for investors to get the full picture. This issue may be becoming less widespread, though, as investors becoming more sophisticated and knowledgeable about alternative assets. We may see objections from investors about SCFs fade as time goes by.

Bodies like ILPA are helping to shed more light on this pocket of the industry, by producing guidelines for fund managers on how to report their SCF usage to investors. This represents a big step forward in increasing dialogue and understanding, and we are already seeing some investors insisting that their portfolio funds adhere to these guidelines. But adoption is voluntary and not universal, so it remains to be seen if this method of reporting will become standard for the industry.

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