

# FUND FINANCE FRIDAY

## When Is Enough Enough?

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As the Cadwalader European Fund Finance team commented at the end of 2022 (following an [industry-wide survey](#)), 2023 was predicted to be a challenging environment for subscription line financing given increased regulatory requirements, higher interest rates and liquidity constraints, among a number of other factors.

In the final quarter of 2022 and at the start of 2023, we have seen a number of these themes play out as predicted, with liquidity constraints clearly playing into pricing.

Spreads across all sizes of managers and asset classes are widening. This, coupled with the rising rate environment making the all-in cost to utilise subscription lines at an all-time high, has prompted a debate: at which point does subscription finance become uneconomical for GPs?

In our respective roles as Head of GP Solutions and as a European Fund Finance Partner, we spoke with a number of Sponsors who regularly utilise subscription lines to discuss the current pricing environment and the impact this may have on their demand and usage of such products.

What was abundantly clear from speaking with the borrower community is that there are any number of considerations for private market managers when weighing up the advantages and disadvantages of utilising subscription lines that reach far beyond pricing alone.

Starting with perhaps the most pertinent matter of dilution of returns for managers, sponsor attitude towards approach in this regard very much depends on the underlying investment strategy and target IRR.

For private credit managers, the current rate environment has already started to have an impact on approach to how subscription lines are utilised, with the duration of drawings already being shortened and their purpose of utilisation purely for operational efficiencies. One large cap sponsor in particular noted that the current level of all-in costs (benchmark/margin/upfront fee), assumed to be around 4.74% (using 3 month EURIBOR as at 24.02.23), is close to the level that it becomes unattractive for them to borrow.

Some secondaries managers felt there was some way for interest rate and margins to go before their stance on subscription finance would alter significantly, with one particular manager mooted 8% on an all-in costs basis as the ceiling. Quantum of borrowings has started to decline to address the rising costs, with one sponsor suggesting they have reduced their facility size in some vintages by c.20% - 25%.

Private equity sponsors have far more flexibility given the level of IRR they tend to target, and a number of sponsors in this space noted that the j-curve is far more accentuated in this asset class, so the benefit of subscription finance outweighs the detriment of rising rates. One large cap sponsor suggested cleaning down the facility more frequently (every 6 months) if rates continued to increase.

One manager highlighted the difficulty in marketing new strategies to LPs, with some investors (mainly pension funds) having a preference for their capital to not be called for the first 12 months. However, the challenge for GPs is generating an appealing net IRR with prolonged drawings under subscription lines when rates are rising, whilst appeasing the LPs looking to manage their own liquidity positions.

A topic that was common across Managers, regardless of underlying asset class, was the operational efficiencies that subscription finance brings, and the unquantifiable monetary value of these. This included providing speed of execution, limiting the number of capital calls made to investors as well as multicurrency facilities aiding FX. For one real asset manager, the ability to issue letters of credit was a fundamental part of some asset acquisitions and would always necessitate the need for fund level finance.

In summary, and perhaps reassuring for the fund finance community, whilst the approach to fund finance is likely to vary amongst managers when the cost of finance is rising, there is expected to be continued demand for subscription finance. But at the very least, we expect to see behavioural changes and, potentially, particularly for private credit managers, serious sensitivity to further pricing increases on subscription facilities. Watch this space as we continue to see how the next few months play out – having had an (albeit brief) period of confidence, we might be at the peak of rate increases, and fund managers will be paying close attention.