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FUND FINANCE FRIDAY

Analysis of the Technical University of Munich's Study on Subscription Facilities

August 30, 2019 | Issue No. 43

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Earlier this month, an extremely detailed academic analysis on the impact of subscription facilities on fund IRRs was published in Europe, titled “Distortion or Cash Flow Management? Understanding Credit Facilities in Private Equity Funds.” The authors, Pierre Schillinger, PhD Candidate and Research Assistant at Technical University of Munich, Reiner Braun, Professor at Technical University of Munich, and Jeroen Cornel, Director at BlackRock Private Equity Partners in Switzerland, are clearly highly competent in data analytics and have produced the most thorough analysis on the subject to date. They have also endeavored in good faith to analyze the data objectively, without the inflammatory bias that has been prevalent in a lot of media pieces. And, for once, it is nice to read something written by authors that understand the difference between subscription facilities and true leverage.

To conduct their simulation, the study takes 6,353 historical buyout deals and distributes them into hypothetical buyout funds. It then takes the cash flows from the deals and calculates the IRRs for the hypothetical funds. The influence on the IRRs is then tested by deferring the cash inflows as if the capital calls were fronted by borrowings under hypothetical subscription facilities, modeling the various impacts of six month, one year and two year tenors for each individual loan (among a variety of other assumptions they simulate). The results are not surprising. They found that “unless used extensively,” subscription facilities only have a modest effect on final fund performance and fund ranking. Under the six month deferral scenario, they found that median and mean net IRR is improved by 0.20 and 0.47 percentage points, respectively. The improvement was of course slightly higher in the one year and two year deferral simulations. Additionally, despite relatively high pricing assumptions for the costs of the hypothetical subscription facilities, the impact of a subscription facility on net multiples “is marginal, on average merely 0.02.”

There is not a lot in the study’s data analysis to take issue with. The data and math all seem professionally managed and directionally correct. Some of the assumptions about the terms of

subscription facilities are a little off market from a practical perspective, but not in a way that strikes me as material to the calculations or conclusions. The numbers all make good sense.

There are however a few qualitative assumptions and conclusions worth comment and some areas where additional research might be clarifying. The first involves their conclusion that if individual loan maturities are set at two years, "*if not properly understood by Investors,*" subscription facilities could mislead investors as to the investing skill of the manager. Two years is, of course, an off market long assumption. But leaving that to the side, what I think this conclusion misses is that, frankly, all of this is easy. It is just not very hard to understand that a fixed dollar return generates a higher IRR if your capital is deployed for less time. If an investor does not understand this basic concept, they are simply not ready to be investing in private equity. Subscription facilities are disclosed at length in PPMs and fund partnership agreements. A high school investment club could figure this out – private equity investors are not proverbial widow and orphan retail investors; they understand it. Note, of course, transparency of calculations to enable an investor to easily make what they deem an apples for apples comparison between funds is a different issue. And although the article does not say it, if what they mean is that transparency around financing in fund reporting is helpful for comparisons, I would certainly understand and agree. But that is not what it says. Rather, it suggests investors could be "misled," and we think the 'intent to deceive' connoted by the term 'misled' in this context is both inaccurate and inappropriate.

There is also a second premise in their conclusions that I believe rests on some suspect assumptions. The authors are of the view that, if investors do not understand how to account for a subscription line properly (again, they should), investors will improperly interpret the increase in IRR as "attributable to manager skill," making them more likely to invest with that manager over other, better alternatives. What this misses is that great managers are more than the equity cash multiples of their specific investments. They are great at regulatory compliance, they are great at investor relations, they are great at risk mitigation. And they are great at optimizing the capital stack of their funds. IRR is a function of investment and divestiture decisions, operational improvement and, yes, financial competence – the CFO's contribution is clearly a component of manager skill. No one would ever look at the return on a leveraged buyout investment and suggest that it should be deconstructed because the portion attributable to the financing is not a component of the manager's skill; quite the contrary, actually. And the same is true with subscription finance. While it needs to be transparent, understood and on terms consented to upfront by the investor, a higher IRR because the manager tied up an investor's capital for less time is clearly positive, not negative. That is, comparing fund IRRs based purely on each investment's equity cash flows without consideration of a subscription facility is not exactly an apples to apples comparison either. It neglects the extra time monies sit in the investor's pocket. Money in an investor's pocket earning a return from other sources is relevant – perhaps that reality should be included in future research.

We would also like to see further research on how subscription facilities allow fund managers to better forecast the time of upcoming capital calls and how that timing information allows investors to better optimize their liquidity. That optimization can help investors improve their aggregate returns. Also of interest would be how much money in interest expense a fund can save for a period of time by using a subscription facility instead of more expensive investment-level leverage. And how a subscription facility's letter of credit feature can save a fund the

expense of needing cash to secure an investment bid or an FX hedge. What about the quantifiable benefit of avoiding the need for subsequent close investors to true up original close investors during the fundraising period? These subscription facility uses (among others) all have IRR and return multiple benefits to a fund but get completely neglected in the IRR research. Future research should also probe the link between manager-reported IRRs and capital allocations. To sustain a conclusion that the subscription facility impact on IRRs "could effectively distort future fundraising concerns," the authors should establish that a meaningful segment of investors rely mostly or exclusively on trailing IRRs to make investment decisions. We think, in reality, the investor universe on the whole is more sophisticated than that assumption and makes decisions on a range of quantitative and qualitative considerations.

The article does positively advance the cause of a more informed discussion by: (1) making it clear that subscription facilities are not net leverage to funds; (2) pointing out that there are advantages to investors from facilities; (3) demonstrating that the cost component of a facility has little influence on IRRs; (4) quantifying the modest impact of a facility on median and mean IRR under "standard conditions"; and (5) acknowledging that facilities do not skew net multiples, PME and direct alpha, and that investors that use broader performance measures will have a more complete performance picture.

The article is available here. Fair warning: It is longggg... I felt like I deserved a medal for finishing it.

The press has picked up on the research. Despite a plethora of results in the data that shows that a subscription facility's impact on IRR is modest and the costs are not impactful to return multiples, *Institutional Investor*'s headline and tagline for its article on August 20 was: "The Private Equity Tool Distorting Returns: Long-term use of subscription lines of credit can "mislead investors with regard to the buyout industry's true skill and return opportunities," new research shows." The substance of the article is more balanced than the headline and is available here.

Barron's also picked it up in an article on August 22 titled "How Private Equity Funds Can Artificially Boost Their Returns," available here. We expect the press to continue to draw from this research in the future.