KEYNOTE INTERVIEW

Beyond the investment period

Growth in fund finance has overwhelmingly stemmed from subscription lines of credit to fund LP commitments during the first five years of a fund's life. Pierre-Antoine de Selancy of 17Capital discusses what finance is available after the investment period

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Fund finance has developed rapidly over the years since the global financial crisis, with much of the focus centred around subscription lines of credit (SLCs), a form of bridge loan used by GPs to reduce the number of capital calls to their LPs. Indeed, the use of this type of finance has increased markedly, with a 2019 academic study finding that, in its sample of North America-focused buyout funds, the total amount of SLCs employed by GPs in 2014 (adjusted for inflation) was just $86.1 million on an aggregate basis; in the first three quarters of 2018, the figure stood at $5.3 billion.

Yet this type of finance is applicable only during the investment period of a fund – typically the first five years of its life. Far less well known is finance provided to portfolio companies beyond initial investment. We caught up with Pierre-Antoine de Selancy, managing partner at 17Capital to find out more about this corner of the private equity market.

Q How has the fund finance market evolved over the past few years?

By far the largest volume of capital goes towards SLCs and it's easy to understand why. Banks have become very comfortable with these instruments because they are backed by AAA investors, they can charge 1.5 percent to 2 percent and never lose money. It's now a $500 billion market and it's highly attractive. In the first five years of a fund, the limited partnership agreement limits the amount of capital each fund can borrow and over what period of time and if you can call on, say, the government of Singapore, that's as good as it gets.

That means a lot of people have moved into this space and it has become commoditised. You have managers trying to push to use more of this kind of leverage, while investors are pushing back because they want their cash invested and they don't want their names used as guarantees. The ILPA guidelines have helped investors work through the balance between the use of SLCs as a genuine cashflow management tool and what is abusive. Yet, while investors don't particularly like this form of finance, they do like the boost to IRR it can achieve.

So, the SLC market has matured very quickly. What's less mature and harder to finance is company development beyond the initial five-year investment period.

Q So why is this type of finance – that's offered beyond the investment period – so hard to secure?

The banks have to allocate their capital very differently for this type of finance – after all, an SLC is backed by AAA-rated investors; if you're looking at portfolio company finance, it's backed by a guarantee of an investment in portfolio companies, which has a very different profile. That's why preferred equity is used – it's a form of loan without a maturity that is repaid when a portfolio company is sold.

Q How is the finance used?

Sometimes, it may be used to buy out a co-investor, but often it will be used to develop a portfolio company further, such as through an acquisition. Overall, the investment has to generate more than cost, but it should do more than that – it should be used to create value in portfolio companies and ultimately for investors. If you have a portfolio of 15 companies and one needs further capital, we can work with four or five of the portfolio companies and we are repaid when they are sold using the fund cashflows.

It's a way of optimising the fund structure – you're using the structure of the fund to raise capital. If you think about it, by year seven, you've already drawn around 14 percent of a fund for fees, leaving just 86 percent for investment. By using this finance, you can invest 100 percent of a fund, which gives the GP an advantage. The industry is so competitive now, you need to use investors' capital in the most efficient way possible.

Q Given the trend for buy-and-build strategies among GPs, is this where the finance is most likely to be used?

Buy and build is the most obvious use for this type of finance. For example, we helped a US fund with four companies. The GP had selected four industries and was using a platform for each to make acquisitions every quarter. That would be very difficult for banks to fund because the size of the business in question is constantly changing – raising company-level funding is therefore a challenge. Using fund-level finance allows GPs to be more agile and move faster.

As fund managers become increasingly operational in their approach to portfolio companies, this finance comes into its own. If they are targeting an aggressive buy-and-build strategy, they may deploy 75 percent of their capital, leaving 25 percent in reserve. That can be deployed quite quickly and once that's the case, this finance can help them grow the company further.

Q How do LPs view this type of finance?

There is still quite a bit of education needed among LPs but also the wider market. For LPs, as a funder, we have to ensure that their risk isn't increased – that the funding has to be used for value creation. I think one concern among LPs is that, if fund finance is used, then there is no segregation between portfolio companies – so if one business goes wrong it might affect all the investments. However, the preferred equity structure can take this segregation into account. One of the advantages of financing at this stage is that in years five to seven, you have a good visibility on which companies are doing well and which aren't.

As for GPs, they tend to be quite conservative people. They don't tend to want to be the first to do something new, yet they are acutely aware of the high competition in the market. So they tend to want to be the second (and not the third, fourth, etc). The market – and understanding of it – is developing gradually, but it needs to be executed well, so that finance advances results in a win-win-win for funders, GPs and LPs.

> *"By using this finance, you can invest 100 percent of a fund, which gives the GP an advantage"*

Q Can you tell me about the due diligence process?

Each situation is bespoke – it's about as far away from commoditised finance as it's possible to be. That means our due diligence processes have to be rigorous so we understand how to structure the finance optimally. We use a combination of primary and secondary processes. So, we always look at the manager, track record, the size of the team, for example, in much the same way an LP would. On top of that, we overlay the secondaries process, where we undertake detailed portfolio company due diligence. We also want to understand how the capital will be used. None of this is new – we're using processes that already exist.

Q How do you expect the market to develop over time?

We're at the beginning of the development of this part of the industry. We've been doing this, alongside LP finance as well as GP management company finance, for 12 years. In the portfolio company finance part of the business we've now completed 23 full exits, and that teaches you a lot about what works and what doesn't work so well – GPs like the experience we have in this space.

But I'd expect more players to come into this space. It's a bit like the GP-led secondaries part of the industry. That was originally developed to solve a problem – that LPs wanted liquidity at the end of a fund life – and now it's used as a tool to create further value.

If you think about company finance more generally, there are many instruments to choose from – from debt through to convertible finance and preferred equity. Yet at the fund level, there's generally just debt for the first five years through SLCs and then all equity beyond that. That's not flexible enough for the needs of 15 different companies in a portfolio that are all at different stages of development. There will be innovation in fund finance beyond the investment period and the choice of available tools will increase. ■