EXPERT COMMENTARY

Asking a few simple questions can reveal the essentials of a manager's leverage strategy and its ability to protect investors' interests, writes NXT Capital's Neil Rudd

Looking under the hood of fund-level leverage

Investors considering a new fund always investigate its risk and return characteristics, the manager's track record, deal sourcing and underwriting processes, and reporting and controls.

For levered funds, investors also evaluate the nature, use and terms of the fund-level financing.

Or do they? When it comes to levered funds, these factors tend to take a back seat to the maximum leverage outlined in the placement memo. Considering this 'sticker' leverage is certainly one important measure of risk, but it doesn't tell the whole story. Fund leverage deserves a closer look under the hood.

There are various forms of fund-level leverage and no single right way to use them. Each approach offers benefits, but also has inherent potential risks that investors should understand.

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Starting with the basics

There are two primary forms of fund-level leverage: asset-backed credit facilities and subscription facilities. Each is secured by different collateral and is often used for different purposes.

Today, a levered fund is likely to include both long-term subscription and asset-backed facilities.

Asset-backed credit facilities These are secured by a fund's loans. Borrowing availability increases over time, generally in lockstep with the size of the investment portfolio. There are two common types of asset-backed credit facilities that have some important differences:

Approval rights The credit facility agent reviews and approves each loan's eligibility as collateral. Once eligibility has been determined, the agent assigns it an advance rate based on the underlying risk, which is typically measured by leverage and debt service coverage. The agent retains the right to alter the advance rate as these metrics change over time.

Approval rights facilities have fewer and more generous portfolio-level tests – for example, high concentration limits – which can give managers added flexibility in constructing a portfolio. The ability to work with the agent can also be beneficial if loan-level performance declines, allowing the agent to consider all relevant facts and adjust advance rates as the loan is rehabilitated.

As added protection, the facilities typically have loan-level performance measures

that must be triggered before the advance rate can be reduced, rather than changes in the broader credit markets.

When considering a fund that uses approval rights leverage, it's a good idea to investigate the length and nature of the manager's relationship with the agent, and request details on historic approval rates and the nature of advance rate reductions.

Non-approval rights These facilities operate similarly to a CLO. A manager can contribute a loan to the pool at a defined advance rate if the loan meets specific characteristics. The pool of loans must also satisfy certain additional concentration tests and other collateral quality tests to obtain a full advance. These facilities can offer greater certainty, but they may also present obstacles to making investments or optimising leverage if they don't 'fit the box.' Similarly, if a loan runs into difficulty, reductions in advance rates or eligibility tend to be hard-baked and may not allow for consideration of additional facts.

Subscription facilities Subscription facilities are secured by the fund's equity capital commitments and are generally less expensive than asset-backed credit facilities. They are most helpful early in a fund's life when uncalled commitments are substantial, because the size of a subscription facility decreases as capital is called.

Today, many managers maintain a subscription facility to finance the portfolio's initial ramp, as it provides a lower borrowing cost and more immediate access to debt than an asset-backed facility. Once a larger diversified portfolio has been built and the amount of uncalled capital has declined, these loans are then rolled into an asset-backed facility.

As long as there is uncalled capital, managers often retain a subscription facility to avoid the time-consuming process of calling capital for short-term expenses or funding loans. Having a subscription facility available also reduces the need to maintain a large liquidity cushion, which could otherwise depress fund returns.

Recent press has put subscription facilities under the spotlight due to occasional abuses. Investors should definitely talk to a prospective manager about a fund's fee structure and the impact of the planned use of a subscription facility on manager fees or carried interest.

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NEIL RUDD

Understanding a fund's leverage strategy

Fund-level leverage facilities can seem complex, but by asking a few of the right questions, investors can quickly come to grips with the most important elements.

What fund-level leverage are you planning to use? Why is that facility best suited to the fund? What is your experience managing this type of facility? These questions may seem obvious, but in our experience, investors do not always ask them. Without this information, it's challenging to establish a full picture of a fund's potential risks and a manager's ability to mitigate those risks.

If more than one lender is required to round out the facility, what is your syndication strategy? Fund managers need to balance the certainty of having credit available with the costs of assuming debt before it is needed. Taking down debt on a real-time basis reduces costs and optimises returns, yet also creates the risk that lenders may be reluctant to provide expanded capacity when needed due to a shift in the cycle or other institutional reasons. Credit terms may also be less favourable than those available today. This can constrain a fund's capacity and leverage, and thus, its returns.

It's helpful to ask a manager about the size of its bank group, the quality of relationships with these lenders and whether they have established exposure limits for the manager that may come into play.

How will you avoid hitting a 'maturity wall'? A fund life of six years or longer is not uncommon, but most banks will not provide a credit facility for more than five years. In addition, managers may choose less expensive short-term financing with the intention of extending it throughout the fund life.

If the market changes materially, a lender may be unwilling to extend the financing and require the manager to accelerate amortisation or pay off the credit facility. This may reduce or even shut off cash flow to investors, force asset sales or require additional capital calls to avoid a payment default.

A discussion with the manager can help investors understand how it intends to mitigate the risk of a maturity wall and balance the fund life with the financing time horizon.

What systems and controls do you use to track and fulfill the facility's requirements? These facilities are complicated instruments with substantial compliance and reporting provisions. Many credit facilities require notification every time loans trigger certain credit thresholds (specified increases in leverage, for instance).

Financial reports and portfolio models are usually submitted every quarter. The facility may also require financial covenant certifications, all of which must be tracked and delivered in a timely manner.

Inadvertently failing to meet these requirements can trigger liability or even escalate to default. The risk may be higher for managers that have not operated levered funds in the past and have not built the infrastructure to manage the requirements, or for a manager that is working with a new lender that may have different processes.

Look under the hood

Each form of fund-level leverage offers benefits and risks. Asking questions about a manager's leverage strategy and ability to execute it effectively should become a standard part of investor due diligence. Looking under the hood to understand fund-level leverage is a prudent step in making fully informed decisions about levered funds and their potential returns. ■

Neil Rudd is chief operating officer at NXT Capital. He oversees NXT Capital's asset management platform and leads the company's strategy and corporate development effort, focusing on accelerating product development initiatives, M&A, strategic planning and expanding connectivity with other ORIX businesses.

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