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Overuse of credit adds to PE crunch for pension funds

Institutional investors say credit is being used to delay capital calls, inflating internal rate of return numbers and making it harder to put PE commitments to work

Dietrich Knauth | 17 Nov 2017

Public plan sponsors, already facing an overheated market for private equity investments, have to contend with a new obstacle in evaluating private equity managers and putting their money to work: the increasing use of credit lines.

General partners (GPs) are increasingly turning to subscription credit lines, which use limited partners' (LPs) capital commitments as collateral to secure a line of credit from a bank, to fund acquisitions and delay calling on partners' commitments. The approach began as a short-term tactic that benefited LPs, by giving them more time to meet cash calls instead of forcing them to pony up on a "just in time" basis. But institutional investors say the tactic has been expanded to delay capital calls in a way that could inflate a private equity fund's internal rate of return (IRR), making it more

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difficult for investors to evaluate potential partners and potentially triggering carried interest fees that would not have been warranted if the GPs put their partners' money to work in a more timely manner.

"It's like a baseball player taking human growth hormone and steroids – it can make an average player look terrific in terms of home runs, batting average, and slugging percentage," **David Fann**, president and CEO of **TorreyCove**, a private equity and real assets consultant, told *MMR*. "It can make a mediocre fund look terrific on an IRR basis."

Pensions are already feeling crowded out of private equity, with soaring demand for funds managed by top general partners. Entry prices for assets remain high, and dry powder has reached record levels – $906bn according to **Preqin**'s latest quarterly report on private equity, making for a challenging environment for managers looking to put capital to work. Credit only makes their jobs tougher.

Less-experienced institutions clamoring to join the PE party are at the greatest risk for the most serious of subscription lines' negative effects – the inflation of reported IRRs, Fann said. GPs that delay calling on LPs' funds can artificially shorten the investment holding period and make the returns look higher on a per-year basis. The effect can boost a private equity fund's quartile rankings, making it look better than its peers, even as the cost of debt eats into the funds' returns.

Credit's carried-interest bonus

Credit can also boost IRR-based incentive payments to GPs and make it easier to earn carried interest. For most funds, the carried interest calculation is based on capital calls and an assumed 8% compounding of the capital calls, Fann said.

"If I made a capital call today, it starts the clock on that 8% compounding," Fann said. "I'm much better off if I delay that capital call for as long as I possibly can, because I don't have that 8% compounding effect if I borrow from that line of credit."

Delaying capital calls also increases the risk to the overall fund if an investment starts to go south. Limited partners whose cash hasn't yet been put to use might get cold feet, or might be facing their own financial distress, if the fund is suffering due to larger economic factors like a recession, Fann said.

Because of credit use, LPs will have to worry more about the creditworthiness, solvency and responsibility of the other limited partners participating in a fund when considering their downside risk.

"There's a scenario where the investments that are made go bad and limited partners are asked to make a capital call," Fann said. "The worst-case scenario is that certain limited partners don't make that capital call."

Institutional investors push back

LPs have begun to object to the practice, and the **Institutional Limited Partners Association** (ILPA) has called for more disclosure and more limits on general partners' use of credit. Private equity agreements might limit subscription facilities to 15-25% of all uncalled capital, or limit the period of time for which such lines can be utilized, ILPA said in a white paper published in June.

"ILPA wants to ensure that LPs have access to the necessary information regarding GPs' use of these facilities, and how they impact the alignment of interest between the two parties," ILPA managing director for industry affairs **Jennifer Choi** said in a statement. "Therefore, our recommendations are centered on a fundamental commitment to transparency and disclosure."

The trend even impacts larger, experienced investors who know better than to be fooled by pumped-up IRRs, like the **Washington State Investment Board** (WSIB). WSIB, which manages $120.4bn on assets and has an aggressive 23% target for private equity, has found it difficult to pour as much money into the asset class as it would like, and it is concerned that subscription lines are exacerbating that challenge. The tactic also makes the state's investments less effective, since the board ends up holding liquid assets for longer, even after committing funds to a private equity partner.

"One of the headwinds that we have is that private equity partners are doing more around subscriptions lines, where instead of drawing my capital, they're borrowing money and using my commitment as collateral with a bank in order to borrow that money," Washington State CIO **Gary Bruebaker** told *MMR*. "Therefore I'm not putting as much money out to work. They're waiting a while, then they'll draw the capital, so that's set us back a little ways."

The use of credit increases the pressure on limited partners' due diligence efforts, Fann said.

"They need to fully understand the sources of investment return of a manager, and if performance is being enhanced by the use of subscription lines of credit, they need to fully understand that," Fann said. "It's very much about due diligence and the analysis required to fully assess a manager. Nothing should be taken at face value."

While low-cost borrowing has driven the trend to date, few observers expect the practice to disappear as soon as interest rates rise.

"From a theoretical and practical framework, so long as the borrowing costs are lower than the preferred rates of return, we believe this activity will persist," Fann said.

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