KEY POINTS

- Borrowing requirements will vary depending on fund strategy and the life cycle/stage of the fund.
- Capital call/subscription line facilities are primarily dependent on uncalled capital commitments so are prevalent at the start of a Private Fund's life, continuing into its midlife.
- The NAV facility is particularly useful for a fund that either has no remaining or diminished uncalled commitments or no or limited ongoing distributions from its investments. The security package will differ depending on the structure of the fund and type of borrowing.

Authors Kevin Lynch and Ian Dillon

Structures, security and finance products: the increasingly sophisticated world of investment fund focused borrowing

In this article Kevin Lynch and Ian Dillon consider the most commonly utilised funds finance facilities, how the borrowing needs of various funds and available facilities may be different depending on the type of fund strategy, inflection points in its life cycle, lenders security requirements and some trends to watch.

INTRODUCTION

Ireland is regarded as a key strategic location by the world's investment funds industry. As of August 2020, there were over 7,800 Irish domiciled funds with assets of over €3trn.

In common with the other major global fund formation jurisdictions Ireland offers a range of potential fund vehicle types to meet the needs of managers and investors. There is no one size fits all but certainly something for everyone. Ireland is a key jurisdiction for both UCITS (retail focused, "mutual" funds) and for AIF (institutional, sophisticated, private "alternative" funds) establishment, but for the purposes of this discussion on financing within Irish fund structures, given the regulatory restrictions on leverage inherent in UCITS vehicles, we will focus more on AIF structures where financing transactions are more common. The principal vehicles available in Ireland are as follows.

REGISTERED FUND STRUCTURES

- **ICAVs:** since its introduction in 2015 the Irish collective asset management vehicle (ICAV) is now the most commonly used fund structure in Ireland and provides more administrative flexibility than its corporate vehicle predecessor, the variable capital investment company. In addition, it may also be eligible to elect to be treated as a transparent entity for US federal tax purposes (it can "check the box") which makes it attractive for many US focused structures.
- **Investment Companies:** established as a public limited company, existing structures set up prior to 2015 are commonly established as variable capital investment companies. Whilst still a suitable fund vehicle, they do lack some of the more specific advantages of an ICAV, including around producing accounts and checking the box and as such are less common for newly established vehicles.
- **Unit Trusts:** it is a contractual fund structure constituted by a trust deed between a trustee and a management company, useful for particular jurisdictions where trusts provide investors with beneficial tax or reporting treatment.
- **Common Contractual Fund (CCF):** similar to a Unit Trust it is established by contract under a deed of constitution giving investors the rights of co-ownership of the assets of the CCF. It was developed initially to facilitate the pooling of pension fund assets efficiently from a tax perspective and a CCF may be treated as transparent for tax purposes.
- **Investment Limited Partnership (ILP):** a partnership between one or more general partners and one or more limited partners and is constituted by a partnership agreement. Partnerships are commonly used by private equity managers as the most efficient manner in which to manage carried interest and allocation of investments.

UNREGULATED FUND STRUCTURES

- **Limited Partnership:** As with the regulated ILP it is constituted by partnership agreement between one or more general and limited partners. Although limited partnerships are used as unregulated AIFs into which a limited number of investors can invest, we more commonly see them being used as underlying holding vehicles within an ICAV or other fund structure, where the regulated fund utilises the partnership to hold assets, separate and distinct from other assets held within the regulated fund's pool structure.
- **Section 110:** Section 110 is a reference to s 110 of the Taxes Consolidation Act 1997. Special purpose vehicles established as s 110 companies are typically funded through the issuance of debt securities and are most commonly used as securitisation vehicles. Most commonly established as a type of company called a Designated Activity Company (DAC), they were originally used almost exclusively on structured finance deals but are also now commonly seen used as investment vehicles in various regulated structures.

These type of structures can assist a regulated umbrella fund by saving on the set up and ongoing cost of a new sub fund for each project (where you would wish to segregate them, for example, for different lenders) and instead using an LP or s 110 company as its investment vehicle on a ring fenced, project by project basis.

TYPES OF FUNDS AND STRATEGIES

As is evident from the above, there are a wealth of fund vehicle options available to sponsors and managers. While the referenced legal entity types are Irish, each of the main fund formation jurisdictions will have a variety of vehicles available to meet the needs of investors. While the legal entity type then may vary on a jurisdiction by jurisdiction basis, the strategies that the funds deploy, the asset classes they invest in and therefore the manner in which they raise, draw, utilise and return capital, are very much global.

In our experience, the funds that typically utilise third party finance to meet their objectives and manage their operations, typically fall into three main categories of alternative investment fund as follows.

Private Funds

The term, "Private Funds" covers a broad array of asset classes and investment types but typically refers to funds that invest in private, illiquid markets. These funds are typically closed ended, where investors cannot redeem their investment by choice but rather hold for a defined period with a view to receiving a return of capital only at the end of the fund's life (anything from five to ten years is typical). These structures include private equity, private credit/debt, direct lending and funds that invest in secondaries of all of the above. They typically raise capital in the same way, through a gradual draw down of capital over a defined period at the start of the fund's life cycle, from a pool of commitments given at the launch of the fund by investors. This is usually because the nature of the private market investments often means that sourcing, due diligencing and closing on investments often takes time, time during which the investment manager does not want to be sitting on a pile of unused, un-allocated cash.

Real estate/property funds

Though similar to Private Funds in their private market, illiquid and typically closed ended nature, real estate funds are very much a category of their own, with specific needs regarding financing and security, income flows, capital expenditure and development financing. All being considerations that affect real estate funds in particular ways not similarly experienced in most Private Fund structures.

Hedge Funds

Finally, the term Hedge Funds is used to describe alternative structures that invest in more liquid markets. They typically allow redemptions on perhaps a quarterly or even more frequent basis, the assets they invest in are usually realisable more easily than those in the private markets and they often have a greater use of sophisticated financial instruments such as derivatives to achieve their objectives. They are typically for more sophisticated investors given their higher risk and often utilise leverage to achieve greater returns, albeit with greater risk.

CRADLE TO THE GRAVE: BORROWING REQUIREMENTS AND SECURITY PACKAGE

The borrowing requirements of funds and the facilities that are most appropriate for them will vary depending on the type of fund and the stage it is at in its life cycle. The principal types of facilities available in the market are:

- Capital Call/Subscription Line Facilities;
- Net Asset Value/Asset Based Facilities;
- Hybrid Facilities.

CAPITAL CALL/SUBSCRIPTION LINE FACILITIES

This is structured as a revolving credit facility to a fund where the amount that is available to be borrowed will vary depending on the identity, strength and rating of the investor base, that is, the quality of the parties who have committed capital to the fund and the likelihood that they will follow through, or not, on those commitments. The lender will due diligence the investors, the subscription and fund documents and establish eligibility criteria and concentration limits for a single investor or categories of investors. Equally, certain events will be specified the occurrence of which will remove investors from the borrowing base for example, the insolvency of such investor.

This requires lenders to conduct a detailed credit risk assessment of the investors and for lender's lawyers to carefully due diligence the subscription and fund formation documents to ensure a binding and irrevocable commitment to fund the uncalled commitments exist.

Security is almost always limited to security over the uncalled capital commitments of investors coupled with security over related ancillary rights including the right to make calls and security over the proceeds of the call and each bank account into which proceeds are lodged. This is further complemented by side letters and potentially powers of attorney from any service providers that have a role in the call process.

A control agreement in respect of the account into which subscription proceeds are lodged, is either in the form of a formal control agreement or the execution by the relevant account bank of an acknowledgment of the creation of security over the relevant account.

Local law specific issues and market practice will also need to be factored in when agreeing the security structure.

In a master/feeder structure, for example, where the borrower is not Irish but an Irish fund vehicle is part of the structure and is expected to give security, there will often be a need for cascading security to provide a solution to the Irish vehicle being restricted in certain circumstances from giving guarantees. Where a s 110 company or other special purpose vehicle is involved, a common fund side request is that limited recourse and non-petition clauses are included, which is typically acceptable in the market but should be flagged preferably at term sheet stage by the fund.

As the availability of this type of facility is primarily dependent on uncalled capital commitments, it is very prevalent particularly at the start of a Private Fund's life, continuing into its midlife, and diminishing towards the end of the investment period when much of the capital commitments will have already

Feature

Biog box

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been drawn. At the start it might for example be used to fund set up costs and upcoming deal costs. The main advantage of the availability of this type of facility is that it can be utilised on as little as three business days' notice affording the fund a lot of flexibility to close multiple deals and make multiple payments during a short period and on short notice rather than having to go through the more involved capital call process on a frequent basis with investors.

Some criticisms from an investor perspective may include that utilising the facility to make investments rather than drawn capital can extend the time during which investors capital is unutilised, and therefore not making a return for that investor and that, even though the funding costs are modest, they are still a cost. This type of facility will broadly look the same for all types of funds but, as it is dependent on undrawn capital commitments, usually only works for Private Funds and Real Estate Funds where the commitment and drawdown mechanic is used. As the fund reaches the end of its investment period when commitments can be drawn, it will need to look to a NAV/ asset backed facility or a hybrid facility to meet continuing borrowing needs.

NAV FACILITIES

Unlike capital call facilities where lenders look upwards to the investors for credit support, with a Net Asset Value or NAV facility credit support comes from the fund's underlying investments and cash derived therefrom. Unlike the capital call facility, the amount that can be borrowed is calculated by reference to the underlying investments and eligibility criteria and concentration limits will be applied in determining the amount that can be borrowed. As with a capital call facility certain exclusion events will be included which result in an investment being removed as an eligible investment, for example an insolvency event with respect to a portfolio company invested in or default in respect of any debt held. A commonly negotiated point is the inclusion of a mandatory prepayment clause in relation to disposal proceeds and perhaps prohibitions on disposals if agreed concentration limits would be breached.

It is a particularly useful type of facility for a fund that has either no remaining or diminished uncalled commitments or no or limited ongoing distributions from its investments. This type of facility is popular with fund of funds, credit funds and secondary funds but is typically used to effectively leverage invested capital and to increase the pool of investments, rather than to facilitate speed of acquisitions or reduce administration due to numerous capital calls.

It is very much a part of any fund's investment strategy, rather than an operational feature, and not every fund, even those who utilise the short-term leverage afforded by a subscription line, will utilise the more long-term leverage of a NAV facility.

The factors that will be relevant for lenders in reaching a credit decision will vary depending on the fund strategy. For example, with a direct lending fund, lenders will assess the pool of underlying loans and for example apply exposure limits for loans advanced to categories of borrowers, the sector in which the borrowers operate or indeed the countries in which they are located. As is somewhat implied by the name of the facility valuations are very important for this type of facility and the frequency of conducting the same and whether third party valuations will be required can be keenly negotiated. Unlike the capital call facility, a loan to value covenant will be included.

In terms of the security package again much will depend on the type of fund and its structure. Using the direct lending example, if the fund had relatively few underlying loans the lender might decide to take security over and diligence each individual loan. This approach is a lot less feasible if the fund holds a more diversified pool of loans where, for complexity and cost reasons, lenders will likely lean towards taking floating charge security over the pool. Even if it is the case that security is not to be taken over each loan, there is an advantage in holding copies of all such loans if enforcement was ever required.

As with capital call facilities it is important to due diligence how cash flows within the structure, in this case flowing into the fund as income from distributions rather than as investment from investors. This will include an analysis of where the account bank is located, do distributions pass through a chain of accounts, and who has signing rights. Once the above is determined the lenders will put in place agreed controls over these accounts. This may just be with the fund and the account bank but if others, for example a fund administrator or regulated fund depositary have signing rights, appropriate arrangements will need to be put in place to extend the agreed controls to deal with such signing rights.

Where security is being granted over the interests in the fund itself, the constitutional documents of the fund need to be checked to see whether they require the consent of the fund to the creation of security or are there any other transfer restrictions that might become relevant on enforcement. Consideration will need to be given to whether the lenders will require amendments to the fund documents to modify any provisions. If the issue is caught early enough in the formation phase of the fund, structural solutions can be devised to mitigate the risk. For example, the shares that are held could be transferred to an SPV and then security is taken over the shares in the SPV rather than over the underlying shares in the underlying funds themselves. Such a transfer could require consent, but it could be an easier consent to obtain.

With private equity funds due diligence is no less important. The terms of any shareholder or joint venture agreement should be carefully reviewed to check for transfer restrictions or pre-emption rights that could be relevant on a future share enforcement by the lender over shares held by the fund in the relevant company. Any debt facilities at the underlying company level should also be checked to verify if mandatory prepayment clauses could be triggered by future enforcement. Again, if caught early enough these can be available structural fixes.

For hedge funds where assets are more liquid, they are commonly registered in the legal name of a depositary who will hold them for the hedge fund as beneficial owner. The security in this case will involve security over the securities and/or cash account held by the fund with the depositary, coupled with

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a control agreement with the depositary that will allow the lender to issue directions to the depositary related to the investments cash credited to securities cash account on any future enforcement.

The reasons why a fund might use a NAV facility will vary but major factors include the stage the fund is at in its life cycle and whether the strategy envisages leveraged returns. For example, as the fund moves into mid-life it might use the facility for investments and at the end of its investment period it might use the facility to fund follow-on investments and meet its costs. During its liquidation period the fund will be disposing assets. As the investments become less diverse there may be fewer providers interested in lending in such a structure. At the end of its life the fund could use the facility to fund the exit of investors who may wish to leave in a scenario where others wish to stay or roll into a continuation fund.

HYBRID FACILITIES

Although interest in hybrid facilities is increasing, they remain the least prevalent of the three types discussed here. As the name implies, it is a hybrid of a capital call and a NAV facility where the amount that can be borrowed is calculated by reference to a combination of undrawn capital commitments and the net asset value of the underlying investments.

Many of the features we have previously mentioned will be included, for example an LTV covenant and eligibility criteria whether they relate to the investor base or the characteristics of the underlying collateral, eg strength, diversity and concentration.

These are somewhat more complex in their operation as the nature of the assets against which the facility is drawn (and therefore the security) changes through the life of the fund where, in the initial stages, the lender relies heavily on the investor's commitments for security but, as these commitments are drawn, that reliance shifts to the assets purchased and held by the fund.

One of the main attractions of this type of facility for a sponsor is that it eliminates the need to negotiate separate capital call and NAV facilities, either at the same time or at different stages of the life cycle of the fund. In addition, as the lender is the same, it avoids clashes between the facilities and the related security. On the flip side, some commentary suggests that doubts remain regarding the pricing that can be obtained for these facilities versus that negotiated for separate capital call and NAV facilities.

From a lender perspective given the mix of collateral it can also be a more challenging underwrite and potentially will involve lenders from different parts of the bank in this process. On balance, the continued growth of this type of facility is a positive trend adding to the toolbox available to funds to maximise investor returns but may take some time to become a significant part of the fund financing landscape as lenders and funds determine the best way to implement them within their structures.

TRENDS

Standalone v umbrella facilities

Most of the facilities we see are for a standalone borrower with relevant additional parties included for example where it is a master/feeder structure. In more recent times, we have seen an increase in deals using an umbrella facility which is structured to have a day one borrower(s) and also facilitates the accession of new borrower(s) and other pledging entities. Primarily, we see these umbrella facilities made available for funds managed by the same manager. As with hybrid facilities the main advantage is the flexibility that this type of facility could give a manager with multiple strategies and funds. Conversely this type of document can be unwieldy, requiring a lot of negotiation and while a lot of effort will go in day one to baking in clauses to deal with all eventualities and the addition of new borrowers, types of borrowers and pledging parties, amendments can still be required for example to deal with local law issues. In addition, global managers often have fund structures in multiple jurisdictions, with clashing regulations which can lead to the inability for some of the funds to accept the same terms upon which other funds acceded to the facility.

Environmental, social and corporate governance (ESG)

Sustainable loans are credit facilities where the terms of the financing offer the borrower some form of incentive to achieve targets for improving their environmental, social and governance or sustainability performance. The use of such loans in the general finance markets has been growing at pace for a number of years. This trend is now rapidly expanding into fund finance. There are many notable examples. The standout at the time of writing was the announcement in June 2020 by the Swedish Investment Group EQT that it had entered into a credit facility of up to €5bn related to its private equity business where pricing is designed to incentivise the performance of its portfolio companies in the area of gender equality on the board of directors and a renewable energy transition supported by a fundamental sustainability governance platform. This is a welcome trend.

CONCLUSION

The borrowing requirements of funds and their managers are growing and becoming more innovative and, in some cases, more complex. The global funds industry including lenders have kept pace with these needs and have a diverse and sophisticated toolbox available to funds and their managers to assist funds in meeting and hopefully exceeding its and its investors' expectations. ■

Further Reading:

- Liquidity of private fund interests: an investor perspective (2020) 3 JIBFL 173.
- Subscription credit facilities: implications for lenders and investors where there is a fraud by the fund (2019) 6 JIBFL 380.
- LexisPSL: Financial Services: Practice Note: Private equity investment – firms and funds.