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Funding a Fund

The growth of the Capital Call facility

MAY 2015

The Australian corporate debt market is primed for growth, with an increase in the number of funds providing direct lending as an alternative source of financing to the traditional lending dominated by domestic banks.[1] In this paper, **Partner Tom Highnam** and **Senior Associate Rita Pang** examine the growth of one of the methods by which funds use and raise debt – the capital call facility.

1 For background on this topic, see Allens Focus: Growth of Debt Funds.

Background

A capital call facility, also known as a subscription credit facility, is a form of financing provided by one or more lenders to a fund. These facilities gained much popularity in the US and European markets after the financial crisis for lenders and funds alike, and the growth in deal volumes in these markets has been strong. While there is no standard industry data-reporting source tracking this type of facility in Australia, we have seen the domestic market here picking up quite significantly in this area in the past 12 to 18 months, and we think there is opportunity for further growth.

Lenders' confidence in this asset class is fuelled by the fact that capital call facilities have a track record of having near zero default rates and no known payment defaults in recent years.[2] This product is also attractive to lenders, as they rely on the strong credit of select ultimate investors of the fund rather than the assets held by the fund.

This article will explore:

- What is a capital call facility?
- What are the benefits of capital call facilities for funds?
- What are the key legal issues in putting in place capital call facilities?
- What are the likely trends in the area of fund financing in Australia for the future?

What is a capital call facility?

The defining characteristic of the capital call facility is the security package, which comprises the fund granting security over:

- the rights to call the unfunded capital commitments of the fund's investors and to enforce the associated rights under the fund documents to call capital; and
- the deposit account into which the investors deposit their capital call proceeds.

Security is not typically taken over the underlying assets of the fund. The specific security is usually supported with an express power of attorney granted by the general partner of the fund in favour of the lender. This allows the lender to exercise capital call rights in a default scenario.

While term and revolving loans are the norm, lenders are also open to provide letters of credit and bank guarantee facilities to meet the financing and investment needs of the fund. These facilities are mostly committed, although some lenders also make uncommitted facilities available. The obvious driver for uncommitted facilities is that it means that commitment fees need not be payable. However, this needs to be balanced with the risk the fund bears for funding uncertainty.

Funds are usually in the form of a limited partnership. However, the fund may also be a trust, a stapled vehicle of a limited partnership and a trust, or other combinations. For illustration purposes, we will assume the fund is a limited partnership.

2 See Mayer Brown, 'Fund Finance Market Review – Trends and Developments in the Subscription Credit Facility and Fund Finance markets Winter 2015'.

Why do funds like them?

'Capital Call Facilities are becoming increasingly popular as global fundraising activity continues to demonstrate strong post crisis growth. Fund managers have always seen the benefits of these facilities for administrative purposes, but more and more we are seeing funds use the facilities to improve the performance of the fund in IRR terms by reducing the time period between investment and a capital call being made on investor capital. We expect that this trend will continue.'

[Quote from a capital call facility lender]

'Typically we see funds utilise capital call facilities for two primary reasons. Firstly, for those funds that have longer term investments, such as infrastructure, property or private equity, the facility is used to provide certainty of funding during the asset acquisition phase. Secondly, funds that have shorter term investments or are more likely to have prepayments, such as Mezzanine Debt, prefer to use the facility to provide an IRR boost for the fund.'

[Quote from a capital call facility lender]

The increasing interest of funds in capital call facilities is mainly driven by the following:

Liquidity and funding certainty

Traditionally, if a fund needs to raise capital to meet investment needs, it issues a call notice to all its investors to draw upon its respective unfunded capital commitment. This can take 10 business days or more. This delay in funding can be a problem when there is a fast-moving bid to settlement process.

A capital call facility can provide liquidity to a fund in a timely fashion because typically a drawdown notice can be issued to the lender at relatively short notice. Capital call financing allows the fund to maintain a healthy amount of dry powder to enable it to quickly capitalise on investment opportunities.

Simpler and quicker access to funds

To access funds, the fund needs only to deal with the lender rather than calling on each individual investor for payment, which is particularly helpful for managing cash flows. For instance, if a fund anticipates needing to make a distribution to its investors for one investment, but also requires funding for another prospective investment, it avoids the need to call on capital to make distributions to investors. This can reduce the frequency of calls, as well as alleviate the administrative burden on both sides, which suits both investors and the fund.

Availability of other debt instruments

Lenders can offer cash advances as well as a letter of credit or a bank guarantee line to help the fund meet working capital and investment needs. This can be helpful in an acquisition situation when a prospective seller requires a letter of credit to secure potential acquisition break fees that are payable by the fund.

Cost of debt funding

Given the quantitative easing by many central banks around the world, as well as the low interest rate environment in Australia, funds can take advantage of the 'cheap credit' as pricing on debt continues its downward trend.[3]

Greater access to credit

A fund could achieve the above by accessing credit from a lender with a borrowing base calculated off its NAV. However, the credit quality of its purchased assets is likely to be less attractive than the uncalled capital commitments of its higher credit rated investors. On that basis, a capital call facility can give a fund greater access to credit.

The Borrowing Base calculation and variables used

> *'The quality of the Limited Partners is key to the size of the capital call facility. The Borrowing Base will be predominantly determined by the underlying credit quality of the Limited Partners committing the capital, as this is the collateral supporting the facility. As such Limited Partners with a higher credit rating will derive a higher Borrowing Base and higher absolute $ facility.'*
>
> **[Quote from a capital call facility fund borrower]**

A lender will size a facility based on the 'Borrowing Base' of that fund. We commonly see the Borrowing Base at 90 per cent of the total uncalled capital commitments of all 'Eligible Investors'. Accordingly, it is essential to determine what constitutes Eligible Investors. The following are common features for determining what is 'Eligible':

- a good credit rating, typically BBB+ or above;
- the investor is not insolvent or subject to winding up;
- the investor has complied with all capital calls and has not defaulted under any fund documents; and
- the capital commitment of the investor has not been excused, cancelled or reduced.

A lender's due diligence on each individual investor may reveal certain risk profiles that will result in that investor's commitment being further discounted, or excluded in its entirety.

The advance rates may be further adjusted by imposing concentration limits on the Borrowing Base. This may be a cap on any investor's total unfunded committed capital, or a percentage reduction based on the risk profile of the investor's place of establishment. In addition, the Borrowing Base will also account for the extent to which an investor has restricted the level of commitment that can be attributed to certain types of investments that will impact on their obligation to meet call notices.

3 CBA, Thomson Reuters LPC.

Key legal issues

With the distinct security structure and bespoke credit underwriting that is required on the fund and its investors, various legal issues will need to be addressed in order to put in place a capital call facility. Some of these are explored below:

Due diligence – Fund documents and key considerations

In this type of facility, careful due diligence of the fund documents is paramount. As a minimum, the following documents should be reviewed:

- the limited partnership agreement;
- any management deed;
- each subscription agreement in respect of each limited partner; and
- any side letters that exist between individual investors and the fund.

The key matters a lender or its legal counsel should ascertain include:

- Structure of the fund – The fund may comprise a limited partnership, parallel trusts, stapled entities, discrete trusts, co-investment vehicles or others.
- Term of the fund and commitment period – This can dictate when capital can be called and the appropriate maturity of the facility.
- Powers of the general partner – The limited partnership agreement should be checked for general powers, including the express power to grant security and borrow, as well as whether these have been delegated to another person, such as the manager.
- Transferability of interests of investors – The ability of investors to transfer their commitments is obviously a key risk for the lender.
- Ability to call capital – Is there a general ability to make calls and are there overcall limitations? An overcall limitation occurs where an investor has defaulted and the general partner is not able to call upon the remaining non-defaulting investors for the shortfall. This will need to be considered to the extent a lender considers an eligible investor's capital commitments as collateralising other investors' commitments.
- Disappearing capital commitments – Are there any circumstances where an investor's capital commitment may be excused, reduced or otherwise withdrawn?

Given the credit ultimately rests with the investor, the lender should also obtain copies of investors' financial reports or other information necessary to assess an investor's creditworthiness. Where the investor is itself a fund or a feeder fund, the lender will require further analysis of the investor's right to obtain funds to meet capital calls, including any limitations of liability and rights of indemnity that an investor has against its own fund.

Security structure

The general security structure is outlined in the 'What is a capital call facility" section above. Where the fund is Australian or is otherwise subject to the *Corporations Act 2001* (Cth), the specific security may be accompanied by an all-assets security interest that operates as a 'featherweight' security to minimise moratorium risk. Whether this is provided depends on the nature of fund and the credit requirements of the respective financier.

Security is typically granted by the fund and the general partner, as they will hold the deposit account, the rights to call capital and related rights. Where the borrower is a portfolio special purpose vehicle of the fund, a guarantee from the head fund may also be required. If there is a delegation of the power to call capital by the general partner to a manager, or a custodian arrangement is put in place, security should also be sought from the manager and custodian, as applicable.

The lender will need control over the deposit account to enable it to secure capital call proceeds upon a default. The deposit account may be required to be opened with the financier on day one of the facility, but this is not always mandated. Where it is to be held by another bank, an appropriate account control arrangement will be required, such as an account bank deed.

Where the funds are organised in offshore jurisdictions, or the bank accounts are held outside of Australia, it is necessary to seek advice from foreign counsel regarding the fund documentation and security arrangement.

Transferability and the ability for investors to be excused or withdrawn

Because the lender provides the capital call facility based on the investor pool at the inception of the facility, it is important to review the circumstances in which an investor may subsequently transfer their interest in the fund. When a transfer requires consent from the general partner, a lender can control this by requiring the general partner to seek prior consent and provide notice for any proposed transfer.

Another category to consider is the circumstances under which an investor may be excused from all or part of its capital commitment or withdraw from the fund. For instance, an investor subject to the ERISA regulation (the *US Employee Retirement Income Security Act of 1974*, which regulates pension plans in the US), may have special provisions in the limited partnership agreement that allows them to withdraw without general partner consent if the actions of the fund or continuing contribution by the investor will contravene ERISA. This can be partly addressed in the eligibility criteria for determining which investors form the Borrowing Base.

Waiver of rights of set off and sovereign immunity

The fund documents may provide for an investor to exercise rights to set off any amount they are owed by the fund against their payment obligation under the documents, including contribution of capital. It is prudent to seek a waiver of this from the investor in favour of the lender, at least so long as there is a default under the financing.

As well, if the investor is a sovereign wealth fund or another foreign or domestic government body, the lender needs to analyse whether such investors possess any sovereign immunity rights that may protect them from enforcement action or shield them from liability in its entirety. When there is uncertainty regarding recourse to investors, the lender could discount or otherwise exclude them from the Borrowing Base. However, this may be difficult for funds where such sovereign entities comprise a substantial part of their investor base. In FY2014, sovereign wealth funds overtook superannuation funds and fund of funds as the largest source of new commitments for funds.[4]

4 Australian Private Equity and Venture Capital Association Limited, '2014 Yearbook – Australian Private Equity and Venture Capital Activity Report – November 2014'.

One avenue to address the issue of sovereign immunity rights is via an investor consent letter between the investor, the Lender and the fund, in which the parties acknowledge the sovereign immunity of the investor but the investor waives such immunity rights in relation to their obligations under the limited partnership agreement, subscription agreement and side letters.

Investor consent letters – should you need them?

Given that the key to repayment of the facility is recourse to the investor's uncalled capital commitment, lenders will often seek a written consent letter from the investor before the investor can be counted as part of the Borrowing Base. An investor consent letter serves three main purposes:

1. The fund gives notice to the investor of the loan facility, the security over the general partner's rights to make a capital call against that investor and, upon a default, the ability of the lender to make such a call to the exclusion of the general partner.
2. The fund directs the investor to pay any capital calls at the direction of the lender upon a default under the financing.
3. The investor acknowledges such arrangements in favour of the lender, giving the lender privity of contract and, accordingly, the ability to have direct recourse to that investor.

The letter can also be the instrument under which the investor agrees to waive certain of their set-off rights and sovereign immunity rights.

In some situations, funds may be sensitive about approaching investors to obtain such a letter because of the administrative burden. The investors may themselves be reluctant to provide such acknowledgment. In this situation, the lender needs to evaluate the reputation and creditworthiness of the underlying investor to see whether the uncalled capital commitments remain commercially 'bankable' despite the lack of a direct acknowledgment.

Some more sophisticated funds (particularly those established in the Cayman Islands and British Virgin Islands) have investor acknowledgments built into the fund documents, which avoids the need for separate investor consent letters.

In Australia, as a minimum, notice of the assignment and security interest granted in favour of the lender should be given to the investors to satisfy the common law rule in *Dearle v Hall*[5], which provides that where there are competing equitable interests, the person to first give notice to the debtor gets priority. Depending on the governing law of the security document, the security perfection requirement of that jurisdiction should also be adhered to.

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The bells and whistles and maturing of the market

'An emerging trend that we're seeing in the market is the use of subscription agreements as credit enhancements to traditional non-recourse asset financing. The benefit to the borrower being potentially more favourable pricing than you might be able to obtain solely on a non-recourse basis.'

[Quote from a capital call facility lender]

So where to from here? As lenders become more familiar with the product, as well as the relevant client fund, the lender may be asked to explore meeting the financing needs of the fund. This may push the envelope further along the credit continuum.

Hedging

Lenders may need to consider providing hedging to the fund, or ensure that its portfolio companies be collateralised by the same security as the capital call facility. This must be determined on a case-by-case basis.The fund documents must also contain reference to any limitations, the maximum exposure that may be incurred under the hedging, and the value of the collateral supporting the total liability.

Hybrid facilities

'Hybrid facilities are provided on a more specialised and bespoke basis, due to the increased complexity of the structure and greater reliance on the performance of the fund's investments for repayment. The purpose of these facilities varies depending on whether the manager is using it as a source of liquidity or to implement a level of gearing post investment period.'

[Quote from a capital call facility lender]

As a fund goes through its usual lifecycle, the pool of unfunded capital commitments will progressively shrink and be replaced by interests in investments. The ability for lenders to rely solely on unfunded commitments is therefore limited. A hybrid facility is another product that can address the liquidity concerns for more matured funds. Such a facility is a hybrid in two respects:

1. the Borrowing Base will comprise a percentage of the unfunded capital commitment of Eligible Investors and be bolstered by a set percentage of the net asset value of the fund itself; and
2. the same security for a capital call facility applies but security may also be taken over the specific investments of the fund.

Therefore, there will need to be thorough due diligence of not only the investor base but the underlying investments as well. Issues of transferability and assignment of those fund assets need to be critically analysed to determine the effectiveness of security and the actual underlying value of the investments in an enforcement situation. Cross-jurisdictional considerations also need to be taken into account, depending on the location and nature of those investments.

Open-end funds

In the past, lenders have been more inclined to lend to closed-end funds, where investors are locked in, rather than to open-end funds, where investors have the ability to cash out and eliminate further funding obligations. While the certainty of the investor base is fundamental to a capital call facility, this may potentially be an area for development, as long as appropriate parameters are set out in the documentation.

Conclusion

The uptake of capital call facilities in the Australia market has lagged the rapid upward trajectory of the market in the United States and, to a lesser extent, Europe. As lenders become more familiar with the different fund structures and the methods for assessing credit risk on investors, and as funds awake to the benefits that a capital call facility can bring, the Australian market has great potential to grow. Given the different fund structures and range of investors in those funds, lenders and their legal advisers will need to conduct careful due diligence and analysis of fund documentation and the credit risk of the investor pool to formulate a bespoke financing solution for funds.

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