Podcast Transcript

Bénédicte Good afternoon, welcome to our Allen & Overy podcast. We will be talking about capital call financings today. I am Bénédicte Kurth, I am a Counsel in our Luxembourg Banking department specialising in finance law and advising regularly on capital call financings. I have the pleasure today to share this podcast with two of our fund experts: Yannick Arbaut who is a Partner in our Investment Funds team. Yannick, he specialises in the structuring, setting up and registration of regulated and unregulated funds and we also have Joanna Pecenik, she is a Counsel in our Investment Funds team and she also has extensive expertise in fund structuring, fund setting up as well as investor advice. Both Joanna and Yannick are regularly involved in capital call financings. In this type of financings our Investment Funds team works hand-in-hand with our Banking team.

Now, what is capital call financing about? It is a short-term financing provided to a fund, typically to bridge investments made by a fund. It provides the fund with quicker access to cash and to illustrate that point let me just explain how it usually works from a fund perspective. The time period that a fund typically needs to get the cash from its investors is generally between 10 to 15 business days, sometimes even longer. With a capital call financing in place, this time period is reduced to 1 to 4 business days, which is of course very relevant for the fund and which can make a difference when an investment opportunity arises for the fund. Another important point to note, is that the financing itself (the facility) will then ultimately be repaid through the capital contributions made by the fund's investors.

Another key feature of capital call financings is the specificity of the security package. A capital call financing is secured by the undrawn commitments of the investors, meaning the cash that the investors have committed to inject into the fund. Therefore, the actual recourse of the lenders is to the investors and not to the underlying fund assets or investments. In terms of nature of the security that can be taken by the lenders, it slightly varies from one jurisdiction to another. However, in the presence of a Luxembourg fund, Luxembourg law would apply and it would typically take the form of a pledge over the undrawn commitments of the investors and over the right to call these undrawn commitments together with a pledge over the bank account into which these undrawn investor commitments will be paid from time to time. It is worth mentioning that this pledge over the undrawn investor commitments is taken over all the undrawn investor commitments from the investors from time to time.

The key features presentation of capital call financings would not be complete without talking briefly about the borrowing base. What is the borrowing base? The borrowing base is actually a calculation method which is used in the context of capital call financings to determine and limit the amount of cash that a lender will ultimately need to make available to the fund and this is actually what the lender will be lending against (so, the borrowing base). In this context, the lender will make a due diligence on the investors and in particular check their creditworthiness. As a result of that due diligence, the lender will then determine whether the investor is included (or eligible) or excluded and only the undrawn commitments of included investors will be taken into account for the borrowing base calculation and will count towards the amount that the lender will be lending against, unlike the security which will be taken over all the undrawn investor commitments.

So, let us maybe move ahead and it is time for the first question.

Yannick, can you tell us why capital call financings are considered to be attractive for funds. I already mentioned the quick access, or quicker access, to cash point but beyond, can you tell us more about the advantages for funds.

Yannick Sure, thank you Bénédicte. Of course you mentioned it, the first element is quick availability of cash but more essentially capital call facilities are really a cash flow or liquidity management tool that benefits funds but also their investors. Improving competiveness of funds in bids and auctions is of course the first thing that comes to mind in private equity strategies, but more generally it is a reduction of administrative burden for funds and their GPs. Capital call facilities enable a fund to group capital calls in larger batches, or less frequent batches rather than having multiple calls from investors for small amounts. In certain strategies, it may be necessary to call a lot of capital for small investments, now with a capital call facility, this enables you to group these and conversely that benefits investors because investors are able to manage their own liquidities. Some investors even request capital call facilities because it enables them, if they have many commitments in many different funds to just properly

organise their capital call needs. In addition, in the current environment and for many years there is a relatively low financing cost in capital call facilities and it is certainly a low risk, or at least perceived low risk, financing for both funds and lenders.

Bénédicte Thank you Yannick, maybe I can jump in on that point. For lenders there is indeed a perceived low risk because this type of capital call financing comes with very low default rates. The credit risk of the lender is not dependent on the value of the underlying fund assets but rather on the undrawn investor commitments and further one should note that these investors commitments generally and typically involve commitments from, let's say, "high quality" investors. So perceived low risk for lenders but there are also other advantages for the lenders in this type of capital call financing. These deals are perceived as relationship building deals by the lenders of course and the funds, so the lenders and the fund pursue a common goal which is to address the funds borrowing needs whilst at the same time of course protecting and preserving the lender's position and they create also cross-selling opportunities. There is another advantage, which is a higher relative return for the lenders as compared to a typical investment grade product. In addition, the commitment of the lenders in this context is generally a short-term commitment, typically between two to five years. And if the fund size is large then the lenders can club together and there is generally then a syndicate of banks or of lenders which can enter into the relevant facility.

Now, based on our discussion so far it seems fair to say that capital call financings are attractive for funds and for lenders, but since a capital call financing typically involves a triangular relationship between the lender, the fund, who is typically the borrower, and the investors, who play a key role in this type of financings (and whose undrawn commitments constitute the actual recourse of the lender), it would be interesting to know what investors actually think about capital call financing. So, Joanna, can you tell us more about this please.

Joanna Sure. So, as you mentioned, now that the subscription facilities have become more and more widespread, investors generally accept them and recognise the benefit of using such facilities, because ultimately it is also a liquidity and cash management tool for investors, which allow them to, not only to reduce the administrative burden of meeting capital calls and meeting all the internal requirements they may have for that, and also to better anticipate their capital deployment and would allow them to invest their cash in other assets pending the unique capital call to reimburse the facility. That being said, there are of course some concerns for them. Those concerns are twofold: one is the financial aspects of the credit facilities, the other key consideration is the privity that they may create with the lenders. As to the financial aspect, the first issue or concern is the related cost and expenses of a facility. Of course, the issue is not the interest rate because, as we've mentioned earlier, the interest rates are quite low right now, but rather the incremental cost, such as the legal expenses, the agent fees, the syndication, and the reason for that is because the facilities merely defer the timing for the capital call and do not, unlike leverage, increase the amount which is invested by the fund, and therefore is not expected to derive additional profits that could cover those additional costs and expenses related to the facility. The other financial aspect which might be of concern for investors is the impact on the IRR and how to measure it. The other key aspect for investors is also the relationship the subscription facility may create with lenders. As you know lenders will conduct a rather intrusive due diligence on investors to assess their creditworthiness and to determine the borrowing base, and as a result of such due diligence lenders will typically require investors to make various acknowledgements, reps and warranties and undertakings in order to be included in that borrowing base. Such reps and warranties can range from providing periodic information, obligation to fund capital commitment into a specified bank account pledged to the lenders, acknowledge the lender's right to call capital in lieu of the managers, waiver of any right to set-off or counterclaim or any other defences. Therefore, these aspects are of a concern for investors.

Bénédicte Okay. Thank you very much, Joanna. So it seems that the feedback is rather mixed on the investor side. However, let us now move again to the fund's perspective. Yannick, when considering the entry into a capital call financing, what are in your view the key points that the fund will need to address upfront in the relevant fund documentation and the key pitfalls, let us say, to be avoided here.

Yannick Sure. As always, it is important for a fund or a sponsor of a fund to think about the use of capital call facilities early, ideally at inception of the fund, and to avoid typical pitfalls. Very basic information is, of course, to provide in the fund document that a fund may borrow to finance investments and other needs, like fund expenses and to be able to rely on capital call facilities for that purpose. Another element that seems obvious is that the fund should have the ability to grant security over undrawn investor commitments and that it is allowed to call undrawn commitments to repay those facilities. These are of course basic points, but sometimes they lack in fund documents. Typically, lenders will look at and review fund documents to ensure they have certain rights and the fund documents do not provide for extensive restrictions in terms of how they enforce their rights. For example,

lenders will look at the ability to step into the shoes of the fund or the fund manager or the GP to be able to draw from investors directly these undrawn commitments. What they will look for in these circumstances is that they are able to call directly without the need to go to the fund manager and that they are able to call into potentially an account that is not the account of the fund, but an account as directed by the lender. There should not be restrictions, as well, on their ability to enforce, for example, any right of set-off for investors. Now, the pitfalls are often that some arrangements may be in other documents, such as side letters, and when we review fund documents we are careful not to overlook these pitfalls and restrictions that essentially will result in certain types of investors being excluded from the borrowing base by the lenders. These may be things such as restrictions to call investors directly but also things such as immunity for certain types of investors. These are the things you need to look for as a law firm, as a lender, to identify them early in the process.

Bénédicte Okay, interesting Yannick, thank you very much. And on the investors' side Joanna, in light of the mixed investor feedback that we discussed already, what kind of investor friendly provisions do you typically come across in the relevant fund documentation to address the investors' concerns with respect to capital call financings.

Joanna First of all, the bottom line is to achieve the right balance between the risk and the obligation of the fund, the lenders and the investors and to take into account their respective concerns. This would be part of the negotiation of the fund documents, including the side letters, but also of the credit agreements and all the related documents. Typically, what investors would like to see is, first of all, because the duration of the credit facilities may impact the financial aspects of the fund, they would typically request the duration of the facility to be rather short, up to 12 months, and generally what we also see is cap on borrowing. Most of the investors is the large institutional investors who have actually internal requirements as to the cap they would like to impose on fund managers. The other aspect is to avoid any direct relationship with the lenders. Historically lenders were requesting investors to provide them with investor's letter or opinions from investors. This is now included under the form of reps and warranties in the fund documentation, so there is no direct relationship, contractual relationship, between the investor and the lender. The other aspect is confidentiality of information. Investors generally want to maintain the confidentiality of information regarding their financial aspects, the size of their commitment, and any other information which might actually be relevant for the lenders, and the way it will be achieved is that generally they will request the information to be provided to lenders to be limited to publically available information, and this is something which has to be discussed with the fund manager upon implementation of the credit facility. Another aspect is transparency. Therefore, they would like to receive information regarding the deployment of the credit facility, the related costs and to receive basically any additional disclosure which might be relevant for them. This would be generally achieved through a regular reporting, let us say the quarterly report, which will include information in that respect.

Bénédicte Okay. Thank you very much, Joanna. So, many interesting insights here. Maybe let me summarize the key takeaways for our audience today. I think there is no one size fits all solution when it comes to the borrowing needs of a fund during the lifetime of a fund. That being said, I think that capital call financings constitute one of the fund-level financing key products where, indeed, the borrowing needs of the fund are accommodated but at the same time protecting the lender's position. This is probably also, why they are so popular. The lender's decision to make a facility available to the fund is mainly based on the creditworthiness of the investors, as we have seen. It is key to have the investors on board. So, what does the lender get from the investors, as Joanna mentioned; ideally and the advisable approach, in my view, is that, indeed, adequate provisions should be included upfront in the fund documentation and the investors would then typically only be notified of the creation of the security over their undrawn commitments. The level of involvement from the investors the lender will ultimately get is very often a key discussion point, as mentioned by Joanna, when negotiating a capital call financing. So, it is crucial that funds and lenders get relevant advice not only when they are contemplating to enter into this kind of capital call financing, but also that the fund is adequately advised upfront on these aspects, meaning typically the, let's say, "expected lender protection points", and this should happen already at fund setup and fund documentation stage. Therefore, the fund, in other words, should get ready on the fund documents early in the process.

Thank you very much, and have a nice afternoon.

Allen & Overy is an international legal practice with approximately 5,500 people, including some 550 partners, working in over 40 offices worldwide. **Allen & Overy** means Allen & Overy LLP and/or its affiliated undertakings. Allen & Overy LLP is a limited liability partnership registered in England and Wales with registered number OC306763. Allen & Overy LLP is authorised and regulated by the Solicitors Regulation Authority of England and Wales. The term **partner** is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications. A list of the members of Allen & Overy LLP and of the non-members who are designated as partners is open to inspection at our registered office at One Bishops Square, London E1 6AD. © Allen & Overy LLP 2020. This document is for general guidance only and does not constitute definitive advice. ROW

CS2010_CDD-61494