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TABLE OF CONTENTS

Introduction

Wes Misson
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Industry Viewpoints

1 **Morganization: origins and evolution of private equity and fund finance**
Dr. Mick Young
JPMorganChase

11 **The end of Fund Finance?**
Mike Mascia
EverBank, N.A.

Expert Analysis Chapters

16 **NAV and hybrid fund finance facilities**
Leon Stephenson
Reed Smith

29 **Collateral damage: what not to overlook in subscription line and management fee line facility diligence**
Anthony Pirraglia, Peter Beardsley & Richard Facundo
Loeb & Loeb LLP

41 **Derivatives at fund level**
Jonathan Gilmour, Joseph Wren, Nicholas Baines & Nick Morgan
Travers Smith LLP

51 **Oh, what a sweet life it is with subscription facilities!**
Kathryn Cecil, Jons Lehmann & Jan Sysel
Fried, Frank, Harris, Shriver & Jacobson LLP

60 **Fund finance in the secondaries context – liquidity breeds financing needs**
Katie McMenamin, Mimi C. Cheng & Edward Ford
Simpson Thacher & Bartlett LLP

68 **NAV facilities – the investor's perspective**
Patricia Lynch, Patricia Teixeira & Justin Gaudenzi
Ropes & Gray LLP

75 **Enforcement: analysis of lender remedies under U.S. law in subscription-secured credit facilities**
Ellen G. McGinnis, Richard D. Anigian & Emily Fuller
Haynes and Boone, LLP

94 **Use of preferred equity in private equity net asset value facilities**
Meyer C. Dworkin, David J. Kennedy & Kwesi Larbi-Siaw
Davis Polk & Wardwell LLP

101 **Financing evergreen funds: the growth of individual investors in the private equity secondaries market**
Brian Foster, George Pelling, Michael Newell & John Donnelly
Cadwalader, Wickersham & Taft LLP

105 **Umbrella facilities: pros and cons for a sponsor**
Richard Fletcher & Yagmur Yarar
Macfarlanes LLP

115 **Side letters: pitfalls and perils for a financing**
Thomas Smith, Margaret O'Neill & John W. Rife III
Debevoise & Plimpton LLP

125 **Fund finance lending in Cayman, Luxembourg and Ireland: a practical checklist**
James Heinicke, David Nelson, Jad Nader & Laura Holtham
Ogier

138 **Assessing lender risk in fund finance markets**
Robin Smith, Alistair Russell, Nick Ghazi & Holly Brown
Carey Olsen

152 **Fund finance meets securitisation**
Richard Day, Blake Jones & Julia Tsybina
Clifford Chance LLP

160 **Fund finance facilities: a cradle to grave timeline**
Bronwen Jones, Kevin-Paul Deveau & Brendan Gallen
Reed Smith

169 **Rated subscription lines: welcoming a new era of fund finance**
Danny Peel, Charles Bischoff, Laura Smith & Adam Burk
Travers Smith LLP

179 **Bespoke ABF and ABS liquidity structures of Cayman Islands funds**
Dr. Agnes Molnar & Richard Mansi
Travers Thorp Alberga

189 **NAV and holdco back-levering financings – practicalities of collateral enforcement by asset class**
Sherri Snelson & Juliesa Edwards
White & Case LLP

199 **Collateralised fund obligations**
Christopher P. Duerden, Caroline M. Lee, Anthony Lombardi & Lindsay Trapp
Dechert LLP

211 **Innovative rated note structures spur insurance investments in private equity**
Pierre Maugüé, Ramya Tiller & Christine Gilleland
Debevoise & Plimpton LLP

220 **Financing secondary fund acquisitions**
Ron D. Franklin, Jinyoung Joo & Allison F. Saltstein
Proskauer

228 **Any preference? Preferred equity as part of the financing toolkit**
Ravi Chopra, Robert Emerson & Ed Saunders
Goodwin

237 **Fund manager M&A: finance considerations and trends**
Matthew Bivona, Corinne Musa & Trevor Vega
Akin

244 **Understanding true leverage at the fund level: a European market and sector approach**
Michel Jimenez Lunz & Antoine Fortier Grethen
SJL Jimenez Lunz

252 **Institutional investors: the final frontier of net asset value-based finance**
Charlotte Lewis-Williams, Ryan Moreno, Soumitro Mukerji & Mei Mei Wong
DLA Piper

257 **The fund finance market in Asia**
James Webb Travers Thorp Alberga
Ian Roebuck Baker McKenzie
Benjamin Masson Natixis Corporate & Investment Banking

267 **Securing success: key considerations for account security in fund finance transactions**
Benjamin Berman, Jeremiah Wagner, Donald Cooley & Dan Marcus
Latham & Watkins

274 **Private credit trends impacting fund finance**
Sarah Kessler, Daniel Durschlag, Mark Proctor & Allison Tam
Willkie Farr & Gallagher LLP

282 **Financing for continuation funds: a practical guide to market trends, opportunities and issue spotting**
Fiona Cumming & Parisa Clovis
A&O Shearman

Jurisdiction Chapters

289 **Australia**
Tom Highnam, Rita Pang, Jialu Xu & Nick Swart
Allens

300 **Bermuda**
Matthew Ebbs-Brewer & Arielle DeSilva
Appleby

308 **British Virgin Islands**
Andrew Jowett & Johanna Murphy
Appleby

317 **Canada**
Michael Henriques, John J. Oberdorf III, Kenneth D. Kraft & Tim T. Bezeredi
Dentons Canada LLP

324 **Cayman Islands**
Simon Raftopoulos & Georgina Pullinger
Appleby

333 **England & Wales**
Michael Hubbard, Samantha Hutchinson, Nathan Parker & Sukhvir Basran
King & Spalding International LLP

340 **France**
Philippe Max & Meryll Aloro
Dentons

347 **Guernsey**
Jeremy Berchem & Leona Maharaj
Appleby

356 **Hong Kong**
James Ford, Patrick Wong & Natalie Ashford
A&O Shearman

368 **Ireland**
Kevin Lynch, Ian Dillon, David O'Shea & Ben Rayner
Arthur Cox LLP

384 **Italy**
Alessandro Fosco Fagotto, Edoardo Galeotti, Valerio Lemma & Giorgio Peli
Dentons

393 **Jersey**
James Gaudin, Paul Worsnop, Simon Felton & Daniel Healy
Appleby

398 **Luxembourg**
Vassiliyan Zanev, Marc Meyers & Maude Royer
Loyens & Loeff Luxembourg SARL

409 **Mauritius**
Malcolm Moller
Appleby

416 **Netherlands**
Gianluca Kreuze, Michaël Maters & Ruben den Hollander
Loyens & Loeff N.V.

425 **Scotland**
Andrew Christie, Dawn Reoch & Ruaridh Cole
Burness Paull LLP

432 **Singapore**
Jean Woo, Danny Tan, Tao Koon Chiam & Hanyin Huang
Ashurst LLP

440 **Spain**
Jabier Badiola Bergara & Adelaida Torres Rovi
Dentons

448 **USA**
Jan Sysel, Duncan McKay & Yvonne Ho
Fried, Frank, Harris, Shriver & Jacobson LLP

Fund finance facilities: a cradle to grave timeline

Bronwen Jones
Kevin-Paul Deveau
Brendan Gallen

Reed Smith

Introduction

This chapter looks at the different types of fund finance that may be available to funds at the various stages of a fund's life. The following diagram sets out in linear form the typical life cycle of a closed-ended private equity fund, although the diagram would equally apply to closed-ended funds of most asset classes, albeit possibly on a different timeline.

As mentioned, we have picked a private equity fund as the fund on which to base this chapter. The other common asset classes – credit funds, real estate funds, infrastructure funds and secondary funds – are mentioned where relevant.

Start of fund life

The period before first closing of a fund is characterised by management time spent on investor negotiations coupled with the structuring and financing of pipeline transactions expected to complete shortly after closing. This period can be as short as six months for established funds, but would be typically longer for nascent, early-stage fund managers – or in more challenging economic times, as has been the case in the last few years. The fund will typically have a capital-raise period of 12–18 months following first close. Increasingly, funds have built-in mechanics in their legal documents to permit an extension to the capital-raise period, typically for an additional six-month period at a time, with the consent of investors, whether that be a majority of those investors represented on the fund's advisory committee, or investors collectively representing more than a certain percentage of committed capital. We have seen a number of extensions to the capital-raise period exercised in recent times. Whilst there are funds managed by more experienced management teams that are able to hold a "one and done" closing, these situations are becoming less common in the current fundraising market. At first close, undrawn commitments will be equal to total commitments. The first drawdown date following first close may depend on whether a transaction needs to be consummated shortly following first close and the extent to which financing is in place to enable speedier execution of that transaction. The fund will also need to pay formation expenses, service provider costs and often the first quarter management fee to the general partner (as the management fee/general partner share is commonly payable quarterly in advance) in addition to due diligence costs on pipeline deals.

Subscription line facilities

These fees and costs are funded by drawing investor commitments or by debt, which will most likely be made available by way of a subscription line facility, also often called a capital call facility. This type of facility will be made available to the fund as borrower in an amount calculated – in general terms – by reference to the amount of the undrawn commitments and the creditworthiness of investors. This calculation provides the borrowing base for the fund's debt, and it allows the fund to access debt during its investment phase, before it owns significant assets, by allowing it to use investor commitments as collateral for debt. Whilst the amount of undrawn commitments is a purely empirical and straightforward question, the determination of investor creditworthiness – the other half of the borrowing base calculation – leads to more variation in the subscription line market. Typically, the lender will determine investor creditworthiness either on a per-investor basis or by reference to the overall investor base of the fund. In the former case, a discount (called an "advance rate") is applied to each investor's undrawn commitments, and that discount is inverse to that investor's creditworthiness. In other words, the more creditworthy an investor is, the lower its discount rate will be.

Fund and Fund Financing Life Cycle
Typical PE Fund

YEARS	Fund Stage	Remaining % UCC	Investments	Financing
-1	First Close Start of Investment Period	100%		
0	Final Close Investment Period	100–90%	None	Sub line
	Investment Period	90–70%		
2.5	Investment Period	80–60%	Some (4–8)	Sub line/hybrid
	Investment Period	50–60%	Probably as many as going to have (e.g. 10–15)	NAV/hybrid
5	End of Investment Period Divestment Phase	20/15%	10–15	NAV
	Divestment Phase	15%	8–10	NAV
7.5	Divestment Phase	15%	6–8	Concentrated NAV
	Divestment Phase	10%	4–6	Concentrated NAV
10	Original Fund Termination Date Divestment Phase	5/10%	2–4	Very Concentrated NAV/Continuation
11	One-Year Extension Divestment Phase	5/10%	2–4	Very Concentrated NAV/Continuation
12	One-Year Extension Divestment Phase	5/10%	2–4	Continuation

Where an investor is not rated, or does not publish financial information that the lender can access and verify, the discount is total (or very high), and the undrawn commitments are zero (or very low) for the borrowing base calculation. This per-investor approach to determining the borrowing base accordingly looks in detail at the creditworthiness of each investor on a reasonably granular basis and can be sensitive to investor-specific events. Where the borrowing base is calculated by reference to the overall investor base of the fund, the lender applies a single advance rate against all of the investors, taking into consideration a blended metric of the creditworthiness of investors and the likelihood of investor defaults.

As a result, the investor base is critical at this stage of the fund's life, and the undrawn commitments and the bankability of the investor base will dictate the availability and quantum of finance. Accordingly, the subscription facility market tends not to distinguish significantly between the different types of funds – private equity, private debt, venture capital, etc. – because the facility is granted and sized principally by reference to the strength of the investor base. However, certain types of fund, such as earlier stage venture capital funds, may encounter greater difficulties than, for instance, well-established private equity or private credit funds, as they will often have a less sophisticated or less institutional investor base. A private equity fund could quite easily have a subscription facility that looks broadly similar to that of a private credit fund. The fund assets do not drive the lending terms for subscription facilities to any significant degree.

The key documentary variations in the subscription facility market are primarily driven by (1) borrowing base methodology and other investor metrics as described above, and (2) variations in fund structures, such as parallel funds and feeder funds (which could result in some degree of documentary complexity to ensure, for example, that the lender has access to the uncalled capital of the actual investors, rather than pass-through vehicles). Other variations emerge where lenders provide debt products that move away from the typical feature of a subscription line described above – i.e. away from a facility calculated by reference to the undrawn commitments of a diverse (or reasonably diverse) investor base. For example, some lenders are able to make available multi-fund facilities, which aggregate undrawn commitments across funds managed by the same manager and provide a framework financing solution to managers, whilst other lenders provide facilities for single-investor funds (also known as separately managed accounts, or "SMAs") that invest alongside a manager's other funds.

Across the subscription facility market, however, facilities are fundamentally calculated by reference to undrawn commitments and investor creditworthiness, and it is this key feature that has contributed to the increasing popularity of subscription facilities amongst lenders in the last 20 years or so, particularly in the European and (more recently) Asian markets. Lenders take risk not on fund assets, but on a clearly ascertainable and quantifiable amount that investors – often highly rated entities, such as development finance institutions, pension funds and insurance companies – are contractually obliged to make available to the fund and which can be applied to repay the lenders. Lenders typically take a secured position in relation to undrawn commitments in the form of security over the rights of the fund to issue (and enforce) drawdown notices to investors and security over the bank account to which commitments are paid by investors. In the event of an enforcement or work-out situation for lenders, which is rare in the subscription line market, the lenders are protected by this secured position against the contractual obligations of investors to fund their uncalled capital, and lenders are further protected in a default scenario by the discount mechanism described above, which should be largely insulated from asset value or market movement fluctuations. In an overall lending market affected by increasing volatility and ever-growing valuations and EBITDA multiples, the subscription line market continues to prove very attractive to lenders.

Midway through the investment period

On final closing, the fund will have a fixed commitment level that will correlate to the size of the deals that the fund may undertake, subject to investment restrictions, whether based on deal size as a proportion of total commitments, geography or asset class. A private equity fund will typically terminate its investment period on the earlier of the five-year anniversary of the final closing date (or the six-year anniversary of the first closing date) or the date on which the fund manager starts to invest in and earn a management fee on a successor fund (within permitted parameters under the fund limited partnership agreement, or "LPA"). In a normal market, when assets are trading readily, one would expect at least 40–50% of commitments to be deployed, committed or allocated for deployment by years three to four. Successor fund formation restrictions are usually relaxed when 70–80% of commitments have been drawn and/or reserved for investment and expenses (or otherwise on termination of the investment period). Consequently, by year four or five, the key executives of the fund manager may begin thinking about the appropriate time to gear up for the next fundraise within that strategy. The fund manager will also focus on ensuring that commitments are deployed or allocated to a sufficient level before the close of the investment period whilst being mindful of the extent to which follow-on investments may be desirable or required thereafter. The fund manager will be on the lookout for exit opportunities and consider divestment structures for current fund assets.

Hybrid facilities

At this stage, a subscription facility could very well continue to satisfy the fund's need for finance, but as investor capital is deployed, the borrowing base would start to reduce in line with the reduced undrawn commitments, which could have the effect of restricting borrowings. The manager might consider moving to a net asset value ("NAV") facility, which (as described below) would have a borrowing base or financial covenants based on the NAV of the fund's assets. Another option could be to obtain a hybrid facility, which combines elements of a subscription facility and a NAV facility, with the borrowing base being calculated by reference to a combination of (1) undrawn investor commitments, and (2) the NAV of the underlying assets acquired by the fund. A hybrid facility (and a NAV facility) typically applies diversity and concentration limits to the asset value element of the borrowing base calculation in order to ensure that debt is not made available by reference to a small number of assets concentrated in a particular region or industry.

Whilst this combination of borrowing base contributors spanning both uncalled capital and underlying assets would seem a sensible way to increase access to finance, hybrid facilities that are put in place at the start of a fund's life remain less common – and less popular – than might be expected, other than for private credit funds. This results from a combination of factors. It is difficult for some banks to combine subscription lines and NAV facilities, particularly where those product groups sit in different parts of the bank. More significantly, managers continue to have doubts about the economics of a hybrid facility. Suspicion remains that the margin for a hybrid facility is not a "pure" blend of that for a subscription facility and for a NAV facility, but rather results in the fund paying a margin that is higher than it should be during the initial period where it relies principally on the uncalled commitments of highly rated investors, without sufficient compensation in the form of lower margin for the period when the hybrid facility relies principally on the underlying assets of the fund. Also, for managers who have managed to raise multiple funds, and who have tried and tested subscription facility and NAV facility products agreed with lenders, the prospect of combining those products into a hybrid facility for the benefit of a slight degree of convenience or better pricing has not resulted in a significant move in the market toward hybrid facilities used early in a fund's life.

That being said, hybrid facilities have become a bigger element of the market for funding private credit funds, which reflects that the life cycle of such funds can be shorter and that the time it takes to deploy investor capital can be much shorter for private debt than private equity. These shorter time horizons make a hybrid facility more attractive. It simplifies the documentary process by only needing to negotiate and agree one facility agreement (and related documents), not two. It can reduce spend on bank fees and legal costs. And it can mitigate financing risk for the fund over its investment life. A manager of a private credit fund is more likely to take the view that a hybrid facility is more attractive than putting in place a subscription facility in the first instance only to find, maybe as soon as 12 months later, that the fund needs to move to an asset-backed NAV facility. The window for moving from one to the other could be very limited, and failing to execute a NAV facility in that period could risk either (1) the fund not having access to sufficient bridge facilities to facilitate completions (which can be essential where a private credit fund is buying into private equity-backed acquisition facilities that require "certain funds" on short time schedules), or (2) deploying investor capital too quickly without the ability for strategic short-term investment opportunities and the ability to reinvest capital commitments.

One final observation is that, in uncertain economic times, hybrid facilities are seen more frequently in the late mid-stage of a private equity fund's life. At this point, whilst remaining uncalled capital may be low, the pool of investments may be larger than expected as a result of slow exits.

Termination of the investment period

On termination of the investment period, 70–80% of commitments should be drawn down, or allocated to service existing assets and costs. The private equity fund will typically have acquired between 10 and 15 underlying assets, depending on its strategy. Following termination of the investment period, fund LPAs usually only permit drawdowns to complete new investments that were secured (i.e. by way of letter of intent or legally binding undertaking) before termination of the investment period, to make follow-on investments and to satisfy liabilities, including fund financing and guarantees, management fee payments, ongoing partnership expenses, taxes and indemnification expenses. The fund LPA typically enables 15–25% of commitments to be drawn down to make follow-on investments that are intended to preserve or enhance the value of the fund's primary assets.

NAV facilities

NAV facilities are facilities made available to a fund with secured recourse to the portfolio of assets of the fund, and no recourse to the uncalled commitments of the investors of the fund. What that portfolio of assets is will depend on the strategy of the fund in question. At one end of the asset class scale, a credit fund will have a pool of possibly several hundred loans and bonds. At the other end of the scale, a private equity fund will have a pool of what may be as few as a dozen private equity assets. The original popular asset classes for NAV facilities were credit funds and secondary funds, but NAV facilities in the real estate, infrastructure and private equity asset classes have increased significantly over the last few years as well. This is in part due to exit opportunities across the asset classes becoming more challenging over the course of the last few years, and fund managers seeking ways to access (and return) capital to investors.

At this point, the different fund structures become important again. In the same way that, for a subscription facility, the fund structure as it relates to investors is important (so bringing in parallel funds, feeder funds, etc.), for a NAV facility the fund structure as it relates to assets is important. Are the fund assets owed directly by the fund or through a series of holding companies – and if so, do those holding companies each hold several assets or only one each? In the case of a private equity fund, the fund will often form chains of three or four (or more) special purpose vehicles ("SPVs"), the "top" SPV being owned by the fund and the "bottom" SPV being the entity that buys a single private equity asset. The private equity fund will therefore have a separate chain of SPVs for every asset. In the case of a credit fund, however, the underlying loan assets are very often held by one or a small number of holding companies, each of which holds a pool of loans. Real estate funds, infrastructure funds and secondary funds also all have varying asset structures.

The asset structure determines how the asset security is most efficiently taken. A typical credit fund structure is perhaps the most simple. Assuming the credit fund has a single holding company that it owns directly, and that holding company owns all the loans, the security package will normally be security from the fund over all the shares in the holding company, and security from the holding company over all its assets, which will include all the loans and all its bank accounts. This gives the lender the ability, on enforcement, either to sell the holding company through a straightforward share sale, taking with it all the underlying loans, or to sell the loans individually or in bundles. Plus, of course, it will have access to the bank accounts of the holding company where proceeds from the underlying loans, whether of principal, interest or fees, are paid in the meantime.

A typical private equity fund is often the most complex in terms of the necessary security structure. Whilst not unheard of, it is not usual for private equity funds to use common holding companies through which they hold their assets, preferring instead a chain of SPVs for each asset with each chain held directly by the fund as described above. This gives rise to two possible security structures. First, the fund can grant share security over each of the "topco" SPVs, giving rise (using our private equity fund example) to a dozen separate share charges. Each share charge needs to be granted under the jurisdiction of the relevant topco SPV, i.e. a Luxembourg share charge for a Luxembourg topco SPV, an English share charge for an English topco SPV and so on. This would allow the lender on enforcement to sell each of the assets separately through individual sales of the topco SPVs, or a bundled together sale of all 12 (or however many) topco SPVs at the same time to the same purchaser.

Alternatively, the fund sometimes carries out a restructuring exercise before the NAV facility is put in place, to insert one, or sometimes two, common holding companies between the fund and each of the topco SPVs. The security package would then be (1) a share pledge over the shares in the new common holding company that now owns all the topco SPVs (the "common asset holding company"), whether that company is a direct subsidiary of the fund or has the second common holding company between it and the fund, (2) bank account security over the accounts of the common asset holding company and/or the bank accounts of the fund (and/or the second common holding company), depending on where distributions from the underlying assets are paid – it is often logistically easier to leave the bank accounts at fund level even though the assets move down to below the common asset holding company, and (3) all asset security from the common asset holding company over the topco SPV in each chain of SPVs. This security structure would allow the lender to sell the shares in the common asset holding company on enforcement, taking with it all the underlying assets, or the direct sale of the individual assets through sales of their respective topco SPVs. Even if security is not taken from the common asset holding company over each topco SPV, as is sometimes the case, a sale of individual assets could be achieved on enforcement by taking control of the common asset holding company (rather than immediately selling it) and through that control selling the assets individually or in bundles. That said, this sort of restructuring to include a common asset holding company at the time of agreeing a NAV facility is not common.

The loan-to-value ("LTV") covenant in NAV facilities is critical to lenders, and the constituent elements are usually heavily negotiated and very specific to the asset class concerned. Eligibility criteria, concentration limits and related "haircuts" are usual when calculating the "value" side of the covenant. The valuation methodology, frequency of valuations and the ability to challenge and to require third-party valuations are also heavily negotiated.

A further feature of some NAV facilities, which is frequently seen for asset classes such as private equity, is a mandatory prepayment sweep of disposal proceeds if assets are sold at a time when the LTV is above a certain level. The sweep may not be 100% of net proceeds, or may be at a lower percentage at a lower LTV and rise in steps to 100% if a higher LTV arises.

The lenders in the market who offer NAV facilities to funds overlap with, but are not identical to, the lenders who offer subscription line facilities. And the NAV lenders vary from asset class to asset class, there being, as you would expect, more active lenders in the credit fund NAV facility market than in the private equity fund NAV facility market. Pricing, and LTV levels, are very different across the asset classes too, as, in reality, what was a broad single product at subscription line facility level, agnostic to asset classes, splinters into different NAV facility markets for each asset class. As a result, pricing and LTV comparisons between asset classes are not particularly helpful.

Midway through the liquidation period

The main focus following termination of the investment period, alongside active monitoring of the portfolio and ongoing engagement with investors, is maximising exit opportunities for the underlying assets so that the general partner can generate a positive distribution curve and therefore carried interest. By this time, assuming the current fund has performed well, the fund manager will likely have formed and may well have started to already invest a successor fund. The original fund may make follow-on investments during this phase to protect or enhance the value of the underlying assets, subject to the typical limitations noted above. One would expect 80–90% of commitments to be drawn down as the fund life nears its close.

Concentrated NAV facilities

Continuing the theme of our private equity fund, as it moves through its divestment phase and successfully sells assets, it will reduce from having a pool of perhaps a dozen assets to a smaller pool of perhaps only five or six assets. At this point, the original NAV lenders may wish to be repaid because the concentration risk with only five or six assets is too high for them, and new NAV lenders who are more comfortable with increased concentration risk will step in to provide a concentrated NAV facility. The small number of assets, which will continue to reduce as divestment continues, becomes a strong focus for the lender.

Valuations become more critical, and the lender will usually have stronger rights to challenge and require third-party valuations, at the cost of the fund. A cash sweep for asset distribution proceeds is more likely to be required, and more likely to be 100% or 75% of net proceeds rather than the lower percentages found for earlier fund life NAV facilities. The lender will have a more granular view of each of the assets, and may require full repayment upon a sale of the most valuable one or two assets. The lender will probably also require more asset-level reporting, and more frequent face-to-face meetings with the private equity executives in order to better understand and remain close to the asset disposal plans, process and progress.

End of fund life

Nearing termination of the fund’s fixed term, typically 10 years following first closing, albeit fund terms are gradually becoming longer and contain multiple extension rights, the general partner in most cases will be unable to draw down commitments from investors to fund further follow-on investments and can probably draw those uncalled commitments solely to meet expenses and liabilities relating to the fund and its assets. Leading up to expiry of the fund term, the general partner will be considering whether to extend the life of the fund to maximise its ability to source exit opportunities and create value.

Very concentrated NAV facilities

At this point, the number of remaining assets is very low, perhaps only one or two. NAV facilities at this time are much less available in the market, or at least not at a price and LTV attractive to the fund. The facilities at this point broadly fall into two categories. It may be that all that is needed is a small working capital line to continue to fund the ongoing costs and expenses until the assets are sold. There will usually, at this end point in a fund’s life, still be a small amount of uncalled capital that can, as indicated above, be called for these costs and expenses. Security over these uncalled commitments, when teamed with security over the underlying assets, can be sufficient for a hybrid facility with a very low LTV to be implemented.

The other type of facility at this point is where some limited partners do not want the assets to be disposed of just because the fund life happens to be ending, whilst other limited partners do want such a disposal. If a NAV lender can be found willing to provide a facility, this can be used to fund the final return of capital to the “want to leave” investors whilst the “want to stay” investors can remain. There are lenders that will provide these facilities, but they are typically relationship-driven lenders who will be very focused on the remaining assets. They will require considerable asset diligence, assuming they are not already familiar with the remaining assets, more akin in some respects to the diligence exercise required by a leveraged finance lender. They will want to understand in detail the rights of any remaining asset-level (acquisition finance) lenders, and the rights of any joint venture partners or minority equity holders.

Leveraged preferred equity facilities

It is at this point, when concentrated NAV facilities become more difficult to implement, that another product seen in the market may make an appearance – a leveraged preferred equity facility. A preferred equity provider will provide an additional limited partnership interest to a fund in return for a preferred limited partner position, ahead of the "ordinary" limited partners, as and when further distributions from the remaining assets are received. The position is akin to the position of a preferred shareholder in a company. It is possible for that preferred equity position itself to be leveraged, with security over that preferred equity position granted by the preferred equity provider to its lender. Whilst sometimes seen implemented at other stages of the life of a fund, leveraged preferred equity facilities can also make an appearance in place of the second form of concentrated NAV facility referred to above – i.e. when you have "want to leave" and "want to stay" investors.

Fund extensions

Most fund LPAs empower the general partner to extend the life of the fund by 12-month increments. Whilst the subject of investor negotiation, it is common for the first 12-month extension period to be solely at the general partner's discretion, with further 12-month extensions available after that, typically with the consent of the investor advisory committee for the next extension, followed by some form of investor consent thereafter, e.g. a majority or super majority of investors. The decision whether to opt for the first extension will have been made before expiry of the term so, during the first extension year, the general partner will be monitoring divestment opportunities and the activities of the portfolio companies to assess whether a further extension may be required. If the general partner is of the view that opportunities cannot be maximised during the extension period, then it may seek to run a general partner-led secondary process. This can take the form of: (a) a tender offer of limited partner interests or of one or more of the fund's portfolio companies; or (b) a more complex secondary transaction, such as a stapled secondary transaction where investors in the fund are given the option to cash out their interests in the existing fund or elect to have their in-kind interests in the fund transferred to a new continuation fund, which may also be coupled with a refinancing and new capital being injected into the continuation vehicle, and the admission of new investors who are particularly interested in the one or two remaining portfolio assets.

Continuation facilities

Facilities that are available at this late stage of a fund's life are very bespoke and provided by only a few lenders who, for relationship reasons, are comfortable with these facilities. In respect of the second option mentioned above, a stapled secondary transaction, a facility could be provided to the continuation fund, which could be a hybrid facility if the continuing investors and any new investors have provided additional uncalled commitments or a simple NAV facility based purely on the asset value of the assets transferred to the continuation fund. The proceeds of this type of facility are used to repay those original investors who do not wish to participate in the continuation fund. The terms of this kind of facility are essentially the same as any very concentrated NAV facility: much asset diligence or pre-existing familiarity for the lender; details of the proposed exit plans for the assets; mandatory prepayment on disposals; and low LTV.

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Bronwen acts for banks and other financial institutions, sponsors, general partners and fund managers on the whole range of fund finance matters including capital call (subscription line) facilities, NAV facilities, hybrid facilities and general partner and co-investment facilities. She is co-head of the Funds Finance practice at Reed Smith.

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Kevin-Paul is a banking and finance partner with Reed Smith in London. He advises clients on a broad range of domestic and cross-border debt finance transactions, including fund finance, acquisition finance, real estate finance, project finance, general corporate lending, and restructuring. Kevin-Paul regularly advises private credit funds on financing matters, including bridge and gearing facilities, intra-fund finance and structuring issues, and finance considerations related to fund formation. He has extensive experience in emerging markets, including advising on market-leading transactions in Central and Eastern Europe, Turkey, the Middle East, Africa, and Asia.

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Brendan's practice focuses on advising clients on the structuring, establishment and operation of (and investment into) alternative investment funds across all major asset classes including credit, private equity, infrastructure and real estate. ESG is an increasingly important part of Brendan's practice, with a particular focus on the European regulatory requirements in this space. Brendan also advises in relation to spin-outs, secondary transactions, GP-led restructurings, managed accounts, carried interest and other co-investment schemes.

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