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Fund Finance Friday

Investor Transfers: Lender Considerations in an Everchanging Fund Finance Market

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Although transfers by investors of their interests in a fund have always been a feature of subscription / capital call facilities, as of late, there has been a palpable uptick in investor transfers and this trend is set to continue, due to a multitude of factors.

This article explores the driving factors for the increase in investor transfers, the implications for rated subscription facilities and securitisations, how loan documents customarily deal with investor transfers, and due diligence considerations.

Why the increase in investor transfers?

The recent increase in investor transfers is mainly attributable to the continued growth of the secondaries markets: 2024 was projected to be a record year for the private equity secondaries market with estimates ranging from $140 billion to $150+ billion in volume due to increased GP- and LP-led activity.

On the GP-led side, a muted fundraising environment – in part driven by fewer viable exit opportunities in a high interest rate environment and the consequent slowdown in distributions to investors – has resulted in GPs holding so-called "trophy assets" for longer to extract more value before exiting. The adoption of continuation structures is at an all-time high as GPs have looked to engineer liquidity for investors via such vehicles and reset holding periods.

On the LP-led side, investors increasingly use secondaries as a portfolio management tool to correct overallocations to private equity funds. As the secondaries market continues to grow, so too has its use as a legitimate source of liquidity and a viable means of active portfolio management for investors. Demand for liquidity across the secondaries market has seen the birth of innovative new strategies and structures for investors, with capital being raised by dedicated GP-led / single-asset vehicles, '40 Act / evergreen funds, and new entrants from multi-strategy alternative investment firms.

The increase in secondaries market activity has inevitably resulted in more investor transfers. Lenders are therefore having to dedicate an increasing amount of time considering these transfers and their impact on subscription facilities.

How do loan documents deal with investor transfers?

As most readers know, the identity of a fund's investors is crucial to a lender's credit assessment in a subscription facility: as the lenders' secured recourse is against the uncalled capital commitments of the investors in a fund, the fundamental credit risk is on such investors duly funding capital contributions.

The prudent lender therefore should ensure that transferee investors are reputable and will fund capital contributions to repay a subscription facility, if required. Typically, they will also seek the inclusion of some or all of the following protections in their loan documents:

- an information undertaking that requires the borrower to notify any full or partial transfer by an investor of its capital commitments in the fund (alongside a general obligation to notify the lenders of the occurrence of any Exclusion Events);
- an information undertaking that requires the borrower to provide key investor details for each transferee investor (e.g., name, contact details, amount of capital commitment transferred, etc.), together with all corresponding investor documentation (e.g., subscription agreement, side letter, transfer instrument, etc.);
- a confirmation by the borrower in each utilisation request that the identity of all investors remains unchanged and that there has been no investor transfer since the borrower's most recent confirmation of the investor base;
- a mandatory prepayment triggered upon an investor transfer to a sanctioned person that is in violation of applicable law, rule, regulation or any fund document;
- a mandatory prepayment triggered if an investor transfer results in a borrowing base deficiency, for such amount required to cure such borrowing base deficiency; and
- with respect to any cornerstone investor (i.e., any investor whose commitments represent a significant proportion of the total eligible investor commitments), a consent right in favour of the majority lenders or an event of default for any transfer of such cornerstone investor's capital commitments.

The composition of a fund's investor base has a direct impact on the creditworthiness of that fund. Clearly, this is of particular importance for providers of subscription finance, and so changes in the identity of investors (particularly the "eligible investors" whose undrawn commitments are taken into account for financial covenant purposes) typically impact the amount a lender will advance to such fund under a subscription facility.

How a subscription facility agreement treats an investor transfer depends on whether the facility employs either of the following approaches with respect to financial covenants:

(i) a coverage ratio approach (i.e., which presumes the inclusion of all "eligible investors", measured against the borrower's indebtedness) or a flat advance rate approach (i.e., which presumes the inclusion of all "eligible investors" and applies against them a lower, flat advance rate); or

(ii) a borrowing base approach (i.e., which includes certain investors as eligible investors based on them satisfying certain eligibility criteria (such as a minimum credit rating) and then applies a single or differing advance rates against those investors depending on how they are classified for the purpose of the borrowing base).

Regardless of the approach adopted, the default position under a subscription line typically will be that the transferred commitments are excluded for financial covenant purposes, subject to certain limited exceptions.

Where a coverage ratio (or flat advance rate) is used, the inclusion of a transferee investor and its capital commitment in the coverage ratio typically remains subject to lender discretion (subject to either all lender consent or majority lender consent), determined by reference to a lender's internal ratings and/or criteria. Whether, and the extent to which, a lender advances funds against a transferee investor therefore tends to be under more control by the lenders than may be the case where the facility employs a borrowing base approach.

Where a borrowing base is used, such inclusion will often be more "objective" as lenders customarily use a combination of external credit ratings and more "factual" internal criteria – accordingly, the approval and inclusion of transferee investors in borrowing base facilities may be (but is not always) automatic, subject to prior satisfaction of such "objective" criteria. However, in the European market, it not uncommon for lenders to push for complete discretion to veto the inclusion of the uncalled commitments of any transferee investor, even where a borrowing base model is used. Borrowing base facilities will also typically include concentration limits which restrict the percentage of total eligible investor commitments that can be held by any one investor or class of investor (e.g., rated investors, pension plans, HNWIs etc.). For this reason, lenders may be comfortable automatically giving borrowing base credit to the capital commitments that are transferred to a pre-existing eligible investor, to the extent such transferred undrawn commitments do not exceed any relevant concentration limits.

Irrespective of the approach taken by the subscription facility, the circumstances that trigger the transferred commitments being excluded for financial covenant purposes are generally the same – e.g., if there are any defects or other issues (such as cease funding rights, irresolvable sovereign immunity rights or heavy overcall limitations) in the investor documentation of the transferee investor. Similarly, in all types of facility, there is likely also to be an overarching "aggregate" limit on the amount of capital commitments that can be transferred, often set at around 15% or

20% of overall capital commitments and sometimes lower, before the cumulative transfers trigger a repayment obligation.

If the fund is an SMA, lenders generally will seek to prohibit all investor transfers, subject to all lenders' consent.

Due diligence considerations

Whilst LPAs usually prohibit investor transfers without the GP's prior consent and are subject to compliance with the transfer process set out in the LPA (which customarily requires the transferee investor to agree to be bound by terms identical to those binding on the transferor investor under applicable fund documents), LPAs and side letters often include provisions obviating the GP's consent right with respect to transfers to affiliates of an investor. Generally, such transfers should not be a cause for concern for lenders as, regardless of whether such transfer is permitted under the LPA or any relevant side letter, such transfer should still result in the commitments being excluded for financial covenant purposes. Whilst the ultimate beneficial owner of the investor may remain the same, some lenders may be uncomfortable lending against the commitments of any affiliated transferee that is fundamentally less creditworthy than the transferor (e.g., unrated subsidiary or SPV investor of a rated or well-capitalized parent entity). For this reason, lenders may require some form of credit support from the parent (or other creditworthy entity) of the relevant affiliate as a condition to the inclusion of the affiliate transferee as an eligible investor.

Irrespective of whether a transfer is to an affiliate of an existing investor or to a third party, lenders (and their counsel) should focus their legal due diligence on the following issues:

- have the transferor investor and the transferee investor entered into a transfer instrument (e.g., a transfer agreement);
- does the transferor investor have an existing interest in the fund that it can convey pursuant to that transfer instrument;
- does that transfer instrument duly document the transfer of the correct amount of the interest being transferred;
- does the transferee investor assume all rights and obligations of the transferor investor attached to the interest being transferred pursuant to that transfer instrument;
- are the names of the transferor investor and the transferee investor consistent with the other fund documents – it is critical to ensure the interest purported to be transferred belongs to the correct transferor investor and that the name of the transferor investor in the transfer instrument is consistent with the name stated in the relevant original subscription agreement;
- does that transfer instrument contain all requisite notice information for the transferee investor such that a lender or the security agent has all information necessary to issue a binding capital call on the transferee investor;
- has the transferee investor entered a side letter. If yes, customary legal due diligence needs to be conducted on that side letter; and
- has notice of the existing security over the uncalled capital commitments of the fund granted in connection with the subscription facility been duly delivered on the transferee investor?

Other considerations for lenders – rated facilities, credit risk insurance, and securitisations

Insurance: As established, the investor base of a fund directly impacts a lender's credit analysis of such fund in a subscription facility. Lenders therefore need to be alive to the impact of investor transfers on applicable credit risk insurance. Ordinarily, investor transfers do not result in a change in the price of insurance premiums, as customarily these are quoted based on a percentage of the margin the lender charges the borrower on the subscription facility. However, if a transfer concerns a cornerstone investor or other significant investor that materially impacts a lender's credit risk under a subscription facility, insurers usually expect (and may require) lenders to update their pricing so the insurer also benefits from higher insurance premium earnings alongside the lender. Hence, the prudent lender should be aware that insurers therefore usually require notification of all investor transfers.

Ratings: With the increased use of credit ratings for subscription facilities, lenders of rated facilities need to consider the impact of investor transfers on ratings. A key metric for all major credit rating agencies is the credit quality of the investor base, typically calculated by a credit rating agency assigning each investor in the collateral pool an individual rating. Changes in the investor base therefore impact a subscription facility's rating where the credit rating is a "monitored rating" (i.e., where the credit rating agency reviews the rating regularly and ad hoc if there is a material change to the investor base, as opposed to a "point in time" rating), particularly if the transfer concerns a cornerstone investor or another significant investor. Lenders originating subscription facilities with a view to syndicating to insurance providers and other ratings-sensitive lenders should be particularly alive to investor transfers as resultant ratings changes may impact the marketability of their subscription facilities.

Securitisations: With the growing market interest in subscription facility securitisations, originators of and investors in securitisations of subscription facilities, in particular, may query the impact of investor transfers on such securitisations. Transfers by cornerstone investors may result in a subscription loan in the reference portfolio no longer meeting the eligibility criteria (or the inclusion of such transferee investor may be deemed a material modification) such that the facility falls out of the reference portfolio. As cautioned by multiple major credit rating agencies, originators of, and original lenders under, subscription facility securitisations therefore need to ensure any eligibility criteria are sufficiently expansive and flexible to address any investor transfers (particularly for cornerstone investors) and to permit the replenishment of the reference portfolio to account for any subscription facilities which drop out of the portfolio due to a failure to meet eligibility criteria.

Conclusion

As secondaries markets continue to grow and investor transfers become increasingly common in a fund finance environment where the use of ratings and securitisations continues to grow, lenders need to be more alive to investor transfers now more than ever. In this environment, it is crucial that lenders strike the right balance and build into their loan documents sufficient flexibility to allow for investor transfers whilst retaining sufficient lender protections.