

# Fund Finance Friday



## Open-Ended Funds: A Few SCF Considerations

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Open-ended funds are gaining ground, particularly on the private credit and commercial real estate debt side. For the sponsor, an open-ended structure maximizes the return on the upfront costs associated with establishing a fund – those costs are amortized over a perpetual fund life. The tranching structure also suits certain asset classes well. Corporate loans or real estate bridge loans are most often structured with terms of five years or shorter, which may fit better within the class structure of an open-ended fund than in the traditional five-year investment period construct of closed-ended funds. Because investors are offered greater liquidity and a potentially shorter investment horizon, funds may have more flexibility in adjusting the mix of investor economics away from the 8% preferred return hurdle. For these reasons, we see the potential for material growth in open-ended funds.

While historically not a popular product, the opportunity may be ripe in the near term to provide new subscription facility offerings for open-ended and similar non-traditional funds. Despite the differences from traditional closed-ended funds, these facilities could be structured in a manner to provide the same protections to lenders as a traditional facility.

What are the key distinguishing factors of an open-ended fund?

- A perpetual or much longer-term fundraising period during which the fund can accept additional investor commitments, including to replace exiting investors.
- No investment period, or if one, a materially extended or perpetual investment period during which the fund can make capital calls.
- Increased flexibility for investors to redeem their interests and exit the fund in relatively short order. Closed-ended funds generally limit such a right to specific legal or regulatory issues, but investors in an open-ended fund are often free, at their election upon advance notice and timing restrictions, to redeem their interests in the fund and be paid out a final distribution (typically, less expenses).
- Many open-ended funds provide for a 1-3 year “lock-up” period during which investors shall remain committed and have no right to unilaterally elect for redemption. This is a key factor to consider in structuring a subscription line.

What are the important considerations for structuring a subscription facility for an open-ended fund?

- Diligence: Particularly understanding the who, what and when. For example, do redemptions apply to all classes of investors or just a certain subclass? How much of an investor’s interest can be redeemed at any given time? What is the process and timing for notice required for an investor to opt for a redemption? Is a redeeming investor still liable to fund any calls or to repay any indebtedness once the redemption date occurs (whether via the issuance of a final capital call or the netting of its final distribution)? It’s important to carefully review the fund documents and understand the answers to these questions.

- Facility tenor: Most often, it should initially be inside the lock-up period. This permits the facility to function much like a traditional facility for a closed-ended fund. Extensions that go beyond the lock-up period could then be set at the lender's option (to evaluate the new investor mix fully) or, alternatively, subject to particular collateral criteria, to ensure ongoing availability of new creditworthy investor commitments that meet a particular or similar credit profile as at the initial closing of the facility (or least to support an agreed-upon reduced borrowing base amount).
- Exclusion events: Should be tied to the delivery of a redemption notice. It's typically important that the event syncs to delivery of the notice (usually 45-90 days before a quarter end) versus the actual date of redemption so that there is plenty of time to make a pro forma borrowing base calculation and multiple calls to repay the excess, if needed, before the investor is released from the fund.
- Covenants to manage exposure and risk: Additional lender protection can be achieved via the use of clean downs (typically quarterly or annually in advance of redemption windows) to minimize outstandings in advance of anticipated redemptions. NAV tests should also be considered for additional comfort as a gauge on fund performance, the breach of which would trigger an EOD, mandatory paydown and/or early maturity before a potential resulting mass exit of investors (and unlikely entrance of replacement investors).
- EODs to manage collateral turnover and rapid change in the profile of the investor pool: In some cases, it may be necessary to include an EOD or other early maturity event if a large percentage of investors opt for redemption (and are not adequately replaced by similar incoming creditworthy investors in a time period satisfactory to the lender). The trigger could be tested cumulatively over the life of the deal or on a quarterly/per redemption event basis.
- Enhanced reporting: Lenders should expect and request prompt delivery of any redemption notices, documents for newly closed investors, updated borrowing base certificates including pro forma calculations for such events, and, if applicable, NAV or other fund-level reporting. The timing for delivery in most cases should track the LPA to give the lenders ample ability to monitor and react before a material depletion of collateral.
- Increased fees should be considered to offset the uncertainty of the collateral pool other than during a lock-up period and to compensate for additional administrative burdens around more frequent and heavier reporting and monitoring.

While we don't expect a swift or even noticeable increase in facilities for open-ended funds over the next year, it is an underserved population for subscription facilities and something to keep in mind in a competitive landscape as banks look for other avenues to grow their loan portfolios and offer additional bespoke products to key clients.