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Introduction

Private credit asset managers continue to originate and utilise fund finance products. Investor appetite for private credit, particularly private investment-grade asset-based finance ("ABF"), has fuelled origination of net asset value-based ("NAV") transactions across middle-market lending, bespoke credit, royalties, private equity, secondaries and GP stake strategies. As banks retrench from certain parts of the real economy and increase lending to non-depository financial institutions,[1] borrower demand also contributes to the growth of private ABF.[2] Separately, fundraising by private credit asset managers from private wealth channels continues to impact fund structures and the liquidity needs of those funds. This chapter discusses how these private credit developments are impacting fund finance products.

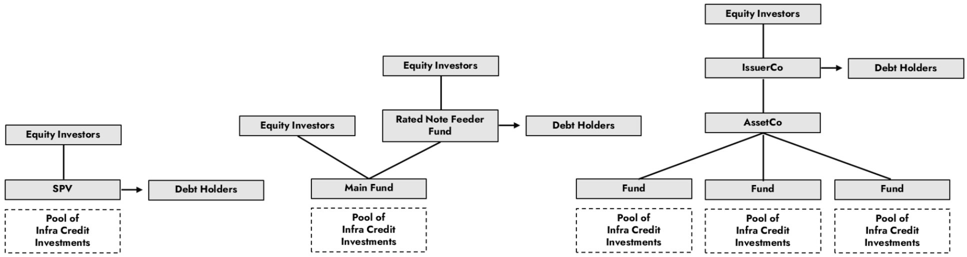
NAV-based offerings

Private credit has driven tremendous diversity in NAV-based financing structures, further blurring the lines between fund finance and structured finance, including esoteric asset-backed securities ("ABS"). For example, an investor who finds private infrastructure credit appealing may have the option of investing in infrastructure ABS, a rated note feeder fund into a master fund with an infrastructure credit strategy, or a collateralised fund obligation ("CFO") made up of primarily infrastructure credit funds.

As originators or allocators of NAV-based investments, private credit asset managers may obtain the desired risk and illiquidity premium for their investors while, from the borrower or issuer's viewpoint, remaining cheaper than the cost of equity. Indeed, it is this flexibility to match investors, with a broad range of fixed-income appetite, to borrowers that makes private credit-originated NAV-based investments so powerful. For example, private equity broadly as a consumer of NAV-based products continues to generate use cases for this flexible financing, including follow-on investment, acquisitions of new investments (whether portfolio companies, secondary limited partnership interests, or capitalisation of continuation vehicles), distributions to investors, and capital raising for GP commitments. In particular, the use of NAV-based products to finance the acquisition of secondaries is likely to follow the trajectory of the secondaries market generally, which is projected to grow to $400–$500 billion in the next five years and is broadly believed to be undercapitalised given demand.[3] Similarly, a range of investors are using

NAV-based products to generate liquidity and rebalance their otherwise illiquid investments, driven in part by the overall growth of private markets.[4]

As consumers or issuers, private credit asset managers may use the flexibility of NAV-based products to obtain leverage on credit assets, create liquidity for redemptions or raise capital for current or future fundraises. A broader range of credit and esoteric cashflow-producing assets are now being levered, such as GP stakes,[5] music royalties, NAV loans and even subscription loans, discussed in more detail below. The growth in evergreen and semiliquid structures[6] has increased demand for asset-based loans for potential redemptions and driven innovation with respect to rated note feeders into evergreen master funds.



Private credit NAV-based investment structures can vary based on (i) use of proceeds, (ii) underlying source of repayment or collateral, (iii) leverage profile, (iv) fees, (v) form and documentation of the investment, and (vi) credit rating. Private credit NAV products (as compared to bank loans) can take a variety of structural forms – such as preferred equity, loans, or debt securities – with a corresponding range of documentation including purchase agreements, note purchase agreements, indentures, and credit agreements. A notable development over the last year has been the concurrent offering of different structures and documentation to meet investor preference. These investments may be bilateral arrangements, small clubs or private placements or more akin to large capital markets offerings.

The borrower or issuer of the private credit NAV investment can take a range of legal entity forms, from orphan Cayman special purpose entities to evergreen Delaware limited partnerships. The legal and economic terms of these private credit NAV products also exist on a spectrum, which again reflects the matching of investor preference to issuer need. Revolving, delayed draw and fully funded at close structures are all prevalent, with fee structures ranging from equity-like (no commitment fees, facility fees, or make-wholes) to more similar to traditional debt (potential inclusion of all such fees). Leverage in private credit NAV products can span from 10% (such as in single-fund NAV financings) to upwards of 75% (such as in CFOs and horizontal rated note feeders) to 90% (such as in vertical rated note feeders).

One distinguishing driver of terms in private credit NAV products is whether the investor requires a credit rating. This could be driven by investment restrictions on the investor or, in the case of U.S.-domiciled insurance companies, to purchase an investment that is exempt from filing with the U.S. National Association of Insurance Commissioners ("NAIC") Securities Valuation Office ("SVO"). The legal form and structure of the issuer, combined with the broad range of underlying collateral, can present challenges in obtaining a credit rating, which in this context is typically a private credit rating. To provide a credit rating, a credit rating agency must have a methodology that can be applied to the private credit NAV product. These private credit NAV products typically do not fit within established private collateralised loan obligations or ABS methodologies. Over the last several years (for example, KBRA notes ratings since 2018),[7] credit rating agencies have used various rating methodologies, including debt of investment funds and more recently NAV and CFO-specific methodologies. However, even these methodologies do not cover the breadth of current investment design. In such cases, a credit substitution rating methodology may be available, often based on bond insurance.

Separate from obtaining a private credit rating and specific to U.S.-domiciled insurance companies, private credit asset managers may design these private credit NAV products such that their U.S. insurance company investors feel comfortable reporting the investment as a "bond" under the Statements of Statutory Accounting Principles ("SSAPs"), which are developed by the NAIC.[8] On January 1, 2025, a "principles-based" bond definition took effect in SSAP No. 26, and bonds generally have favourable risk-based capital ("RBC") factors for the insurance companies that hold them. Under the revised SSAP No. 26, an insurance company should determine whether a "creditor relationship" exists and whether the investment qualifies as an "asset-backed security". The insurance company should have a process for making such determinations and document its analysis with respect to the specific investment.[9]

Other investors may be subject to different regulatory bodies that drive private credit NAV investment structure, such as the Bermuda Monetary Authority or the United Kingdom's Prudential Regulation Authority.[10]

We expect the confluence of various types of investors seeking access to investment-grade private ABF with an increase in demand for financing in various parts of the real economy to continue to drive NAV-based product innovation.

Subscription facilities

Subscription facilities traditionally have a private commingled fund vehicle (or affiliate) as the borrower, have a bank or syndicate of banks as the lender, and take unfunded capital commitments as the core collateral. It is a form of asset-based lending, and the asset is financial in nature. All of the assets are typically created by the combination of subscription agreements (the terms of which are generally substantially similar) and a limited partnership agreement (or group of related limited partnership agreements), and that limited partnership agreement is infrequently amended after fundraising concludes given the often large number of counterparties to the agreement. Generally speaking, the asset diversification needed to support a rating on the subscription facility comes from the investors themselves because the limited partnership agreement itself does not change from investor to investor (other than through the impact of side letters, which is beyond the scope of this chapter). While properly structured subscription facilities are widely viewed as low risk, enforcement has meaningful nuances[11] compared to, for example, enforcement to take title to a middle-market loan asset.

The core benefits of subscription facilities, immediate access to liquidity for investments so that capital calls to investors can be planned and paced, remain relevant for private credit strategies. If a private credit manager desires to lever its investments, in some asset-based lending, warehouse and forward-flow arrangements, that leverage will be limited to anywhere from 65%–85% of the asset, necessitating a 15%–35% equity check that may be facilitated by a subscription facility.

Separately, as noted above, private credit managers expect to fundraise more from private wealth channels. While some evergreen funds invest directly in loans, others act as funds of funds and invest in other private credit commingled vehicles that themselves have subscription facilities. However, unlike in traditional funds of funds in which investors have a capital commitment, evergreen funds may not have capital commitments from their investors, who in some structures may fund all of their capital upon their initial investment. The ability of an evergreen fund to satisfy its unfunded capital commitment to a private credit commingled vehicle is therefore entirely dependent on such evergreen fund's balance sheet or liability management. Thus, there is currently variability in how subscription facility lenders view the eligibility and advance rate for evergreen fund investors.

Market developments with respect to rated note feeder funds also continue to impact subscription facilities. For U.S. insurance companies, the combination of the NAIC "bond" definition and the application of a 45% RBC factor to the residual tranches of ABS has pushed more private credit asset managers to raise rated note feeder funds utilising a "horizontal" structure, meaning that the senior tranches and junior tranches (including any subordinated note or equity tranche) have different investors. Debt commitments in horizontal rated note feeders, as compared to "vertical" rated feeders (in which an investor holds both senior and junior tranches), present specific challenges to inclusion in subscription facility borrowing bases. However, the growth in private credit asset managers fundraising through horizontal rated note feeder debt commitments has pushed subscription facility lenders to innovate given that the core need for the subscription facility, to bridge capital calls, remains unchanged. For example, if a significant portion of a fund's overall committed capital has been raised through horizontal rated note feeders, then it becomes operationally challenging for a fund to manage the timing needs of investments and the capital call timing expectations of investors if the fund's subscription facility is not sized for all such commitments.

Unlike limited partnership agreement provisions relevant to subscription facilities, which have become standardised over the last decade, documentation with respect to the debt commitment in both vertical and horizontal rated note feeder structures, including provisions that govern the nature of borrowing and, if applicable, the recalling, recycling, and overcalling of capital with respect to the debt commitment, remains varied. This necessitates bespoke analysis of legal risk.

Lastly, the growth in reinsurance transactions means subscription lenders may see an increase in reinsurance trusts as investors in borrowing bases. Reinsurance trusts may require exceptions to customary excluded investor provisions. For example, a reinsurance trust often includes a backup grant of a security interest by the grantor in favour of the trust beneficiary (the cedent in the reinsurance transaction) in the trust assets, which may include the limited partnership interests and rated notes. In many subscription facilities, the grant by a fund investor of a lien on such fund investor's investment in the fund is an exclusion event. The perceived risk of such liens on fund investors, that the fund investor will be disincentivised to honour capital calls, may be mitigated in these situations because the secured party is the trust beneficiary instead of an unrelated creditor to the fund investor.

Conclusion

The continued growth of private credit and private ABF, which itself includes traditional fund finance products as a type of esoteric asset class, will drive innovation in fund finance.

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Endnotes

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