Fund Finance Insights

A Brief History and Evolution of Fund Finance – Europe

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Introduction

It was the Greek historian Polybius who emphasised the instructive power of history when he said **"the knowledge of past events is the best guide for the future".** The history and evolution of fund finance as an asset class within Europe offers an impressive narrative within the broader evolution of the financial sector.

The market is now estimated to be in the range of hundreds of billions of euros annually and progressed in sophistication.

In this paper we explore the history of fund finance in Europe, with a particular focus on private equity, and draw out the critical milestones that have shaped the market and prevailing trends. The focus is on offering a broad understanding of the industry's evolution, emphasising key developments and trends, rather than providing an in-depth analysis of the specific structures, strategies and mechanisms that funds employ to achieve their investment objectives.

Early Development

Fund finance encompasses a range of financing mechanisms tailored to investment funds – including those in private equity, real estate, credit, infrastructure, and hedge funds – specifically structured to address the distinct liquidity and capital requirements of funds throughout their operational lifecycle.

The development of fund finance is generally attributed to the emergence of a distinct private equity asset class in the late 20th century – this itself was rooted in the financial techniques pioneered by the industrialists of the late 19th and early 20th centuries, the beginnings of venture capital in the 1940/50s, and the growth of leveraged buyouts in the 1960/70s.

The asset class experienced significant expansion in parts of Europe during the 1980s and 1990s, leading fund managers to increasingly seek innovative strategies to effectively manage capital calls and finance investments. The imperative for adaptable financing solutions became evident as funds encountered challenges when bridging the timing gap between capital commitments and investment opportunities.

Emergence of Subscription Facilities

A seminal advancement in the development of fund finance was the advent of subscription facilities, also referred to as capital call facilities, which emerged in the 1980s and gained significant traction in the 1990s. These facilities empowered investment funds to obtain financing collateralised against the capital commitments of their investors, giving immediate liquidity to capitalise on investment opportunities without needing to await the fulfilment of capital calls. This financial innovation was particularly advantageous for private equity funds, as it facilitated the streamlining of operations through a flexible source of efficiently priced financing.

Within Europe, subscription facilities rapidly gained prominence as fund managers discerned their strategic advantages. Financial institutions began to develop expertise in offering these facilities, with law firms helping to document and customise them to meet the distinct requirements of various fund types. The proliferation of subscription facilities represented a critical juncture in the evolution of fund finance, laying the groundwork for further innovation and expansion within Europe.

Expansion and Diversification

As the private equity and investment fund sectors experienced continued expansion, there was naturally an increase in the demand for diverse financing solutions. The 2000s marked a period of significant diversification in fund finance, extending beyond subscription facilities to encompass a variety of innovative products, including net asset value (NAV) facilities and hybrid facilities.

NAV Facilities

These facilities (which gained prominence in the early 2000s) enable funds to secure loans against the net asset value of their investment portfolios. They are particularly advantageous for funds that have already allocated a substantial portion of their capital and require additional liquidity for follow-on investments or operational purposes.

Hybrid Facilities

By integrating features of both subscription and NAV facilities, hybrid facilities (which gained prominence in the mid-to-late 2000s) provide funds enhanced flexibility, permitting them to borrow against both uncalled capital commitments and the value of their extant investments.

GP Financing

These facilities provide financing secured on the assets of the General Partner (GP), including fee streams and/or the GPs share of fund assets, to support GP co-investment, M&A or other strategic actions.

How these products fit into a common fund lifecycle is illustrated further below.

Fund and Financing Lifecycle

Formation → Fundraising → Investment → Management → Exit/ Distribution → Wind-Down

The lifecycle of an investment fund, such as a private equity fund, commonly follows several key stages. The above represents a simplified lifecycle. Throughout the fund's lifecycle, the choice and use of financing facilities will depend on the fund's strategy, the nature of its investments, and its liquidity needs. For example:

- Early in the **Investment** stage, a subscription facility might be used to enable the fund to bridge capital calls from investors, providing immediate liquidity to make investments or cover expenses without waiting for capital to be drawn from investors, thereby allowing the fund to act quickly on investment opportunities. Such facilities might also be used to issue letters of credit or guarantees. GP financing may be utilised to support GP fund co-investment.
- Later in the **Investment** stage, a hybrid facility might be used, combining features of both subscription facilities and NAV facilities, allowing the fund to borrow against both uncalled capital commitments and the net asset value (NAV) of the fund's investments. This can provide flexibility in managing liquidity and financing needs as the fund builds its portfolio.
- At the **Management** stage, the fund focuses on managing and adding value to its portfolio companies or assets. Financing needs may arise for operational improvements, add-on acquisitions, or other strategic initiatives. As the fund's portfolio matures and its NAV increases, a NAV facility can be utilised. This facility allows the fund to borrow against the value of its existing investments, proving particularly useful when the fund has limited uncalled capital but significant asset value.
- At the **Exit/Distribution** stage, the fund seeks to exit its investments through sales, IPOs, or other liquidity events, with proceeds distributed to investors. During this stage, the focus is on realising returns and distributing capital to investors, so financing facilities are less commonly used. The **Wind-Down** stage completes the fund lifecycle, finalising distributions and closing out remaining obligations.

The diversification of fund finance products is indicative of the evolving requirements of fund managers and the increasing complexity of investment strategies. Market participants in Europe have responded to these developments by cultivating expertise in the structuring and documentation of these sophisticated funding solutions.

Resilience and Stability

The fund finance asset class has consistently demonstrated remarkable resilience, even amidst economic volatility. In relation to subscription facilities, such resilience is largely attributed to its inherent structural safeguards and its reliance on diversified pools of capital commitments from creditworthy institutional investors. These investors, such as pension funds and insurance companies, typically possess strong credit profiles, which significantly contribute to the exceptionally low instances of default. Moreover, the alignment of interests between fund managers and investors plays a crucial role in enhancing the stability of these facilities. Fund managers are incentivised to act in the best interests of their investors, fostering a collaborative environment that prioritises prudent risk management and sustainable growth. This alignment not only strengthens the trust between parties but also makes subscription facilities a reliable option for achieving liquidity and capital efficiency across various market cycles.

NAV facilities too have significantly bolstered market resilience and stability by providing funds with flexible and reliable access to liquidity, especially during periods of market stress. By allowing funds to borrow against the net asset value of their portfolios, these facilities enable fund managers to manage cash flow effectively, meet redemption requests, and seize investment opportunities without being forced to sell assets at depressed prices. This flexibility helps maintain operational stability even in challenging market conditions and supports the strategic management of portfolio assets, allowing funds to retain investments with strong long-term potential. Consequently, NAV facilities contribute to overall market stability by preventing disruptive asset liquidations and enhancing investor confidence through proactive liquidity and risk management.

Recent Trends

In recent years, the fund finance market in Europe has undergone significant evolution, propelled by several salient trends:

Competition

The sector has witnessed a surge in competitiveness, characterised by an expanding array of banks, financial institutions, and alternative lenders offering a diverse spectrum of products. This heightened competition has spurred innovation in product offerings.

Sustainability and ESG

The integration of environmental, social, and governance (ESG) criteria has gained prominence within fund finance. Both lenders and fund managers are increasingly embedding ESG considerations into financing arrangements, mirroring the heightened focus on sustainable and responsible investment practices.

Innovation

There is increasing application of capital markets tools to support lender balance sheet optimisation and attract institutional capital, including capital call facility securitisations, collateralised fund obligations and significant risk transfer trades. These innovations provide a greater depth of capital to support the investment community as private markets grow or through market cycles and periods of dislocation.

Market Challenges

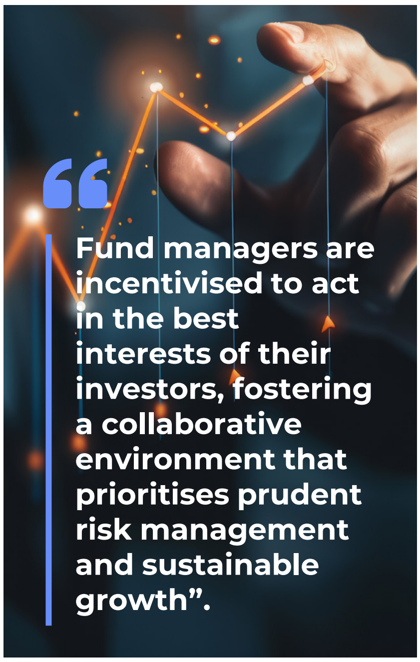
The COVID-19 pandemic posed unprecedented challenges to the market, testing its resilience. Nevertheless, the market exhibited remarkable adaptability, with financial institutions extending support through flexible financing solutions and modifications to existing facilities.

Technology

Technological advancements have enabled more efficient management of fund operations, including capital calls, investor communications, and portfolio monitoring. These technologies have introduced new players to the fund finance ecosystem, while facilitating the development of more sophisticated fund finance products, allowing for greater innovation and responsiveness to market conditions.

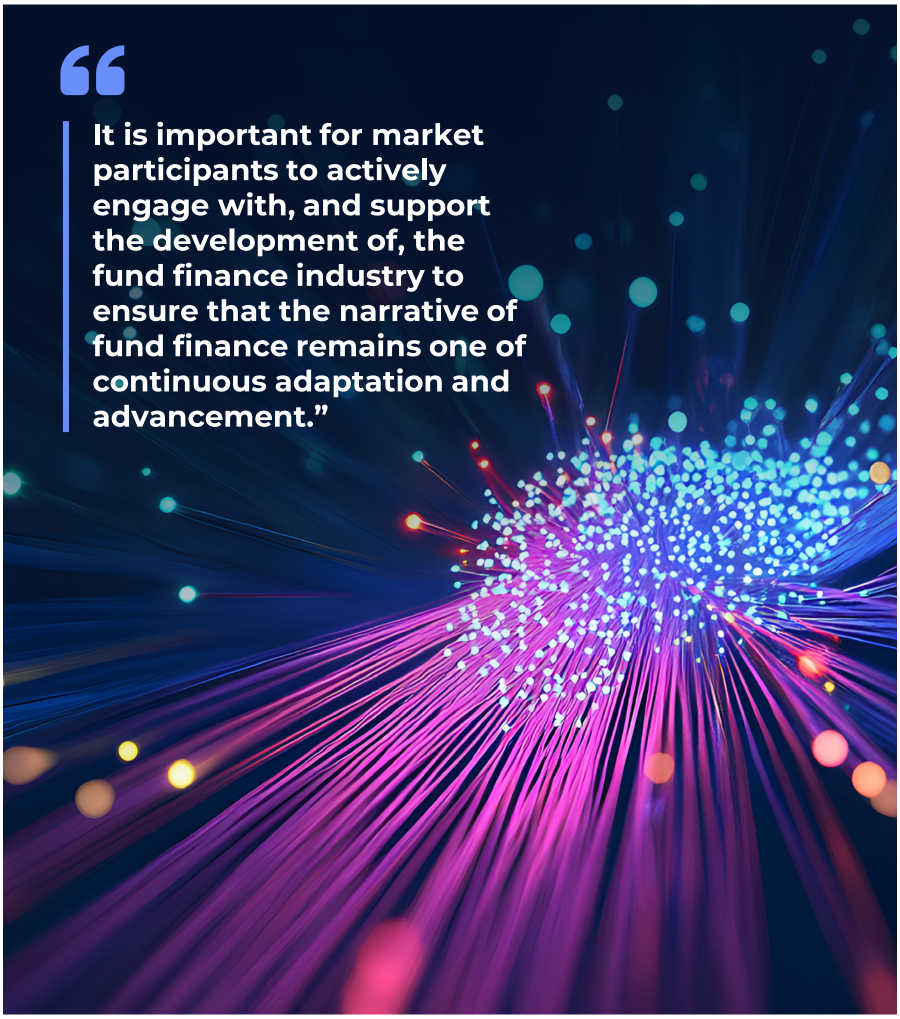
Regulatory

Regulatory frameworks in Europe are significantly influencing the fund finance market by advancing transparency, risk management, and sustainability. Although adhering to these regulatory mandates can lead to greater operational complexity and increased costs, they concurrently bolster market stability and enhance investor confidence. Market participants will need to remain agile and proactive in adapting to regulatory changes, leveraging them as opportunities to innovate and differentiate their offerings in a competitive market.



Future Outlook

Looking forward, the fund finance industry in Europe is well-positioned for sustained growth and innovation. As investment funds develop new strategies and venture into different markets, the demand for bespoke financing solutions is expected to remain robust and market participants will need to be responsive to the evolving requirements of fund managers. In light of this dynamic environment, it is important for market participants to actively engage with, and support the development of, the fund finance industry to ensure that the narrative of fund finance remains one of continuous adaptation and advancement. By embracing innovation and fostering collaboration, stakeholders can ensure that the asset class continues to meet the complex and emerging demands of the investment community, thereby reinforcing its pivotal role in the broader financial ecosystem.



Authors

Mick Young,
Executive Director & Assistant General Counsel, Fund Finance –
JPMorganChase

Kam Hessling,
Managing Director –
LMA

LMA | Loan Market Association

To learn more about the LMA's work to support efficiency, liquidity and transparency in the fund finance market, please contact

kam.hessling@lma.eu.com