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Credit Funds: Direct Lending as an Investment Frontier

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This article discusses legal, compliance, and structuring considerations related to direct lending funds and gives an overview of key considerations in forming a direct lending platform. It first addresses direct lending strategies, and why they have become popular and then discusses common platform-wide considerations and the fundraising process. The article wraps up with a focus on one of the most common types of direct lending funds, privately offered closed-end funds, and their terms.

Direct Lending as an Asset Class

Private debt has come into its own as a standalone asset class. In 2018, 163 private debt funds raised a total of $110 billion, while the beginning of 2019 saw 395 private debt funds targeting a combined $168 billion in commitments.[1] In addition, the largest investors, including US state pension investors and sovereign wealth funds, now include an allocation to private debt as part of their long term investment strategy and the allocations of institutional investors to private debt strategies are expected to increase.[2]

Within private debt there are a number of different sub-strategies to choose from, but direct lending strategies—that is, strategies that involve directly lending to borrowers—have surged in popularity in particular as banks have stepped back from lending. In a recent survey of 100 credit managers, two-thirds of the respondents currently manage a direct lending strategy and almost half of the respondents (49 percent) indicated that they were interested in increasing their direct lending product offerings in line with the increased interest of investors in originated debt due to the return profile as well as the diversification benefits of the asset class.[3] This trend is continuing in 2019, with direct lending funds raising $19.4 billion as of the first quarter of 2019.[4]

Direct Lending Platforms and Structures

Unfortunately, in direct lending there is no perfect fund structure that meets all manager and investor needs. As a result, many managers with direct lending strategies in private funds also establish multiple sources of capital—often seeking a combination of temporary and permanent capital, such as a business development company (BDC), as well as managing privately offered funds.

Other managers commonly supplement their platform by raising separately managed account platforms that are ideally off-cycle to their main funds, although the size of these separately managed account tickets varies from manager to manager. All of the 100 credit managers surveyed manage single investor or separately managed account (SMA) platforms, although approximately two-thirds of these had five or less such accounts. Of course, these so-called SMA platforms have some down sides. Managing many separate accounts and funds is more costly and time consuming from an operational stand point than managing one large pooled vehicle. SMA platforms also raise compliance issues such as allocation issues and cross-trade issues. As a result, credit managers increasingly have invested heavily in operational support as well as legal and compliance resources. In turn, institutional investors increasingly have understood the importance of strong back-office support, as they increase their focus on back-office due diligence in assessing direct lending managers.[5]

Private Direct Lending Funds

Overall Structure

One of the most common approaches to raising capital for direct lending is raising a main or flagship pooled investment vehicle, as this gives economies of scale and generally is less operationally burdensome than many separate accounts and funds, although, as discussed above, many credit managers will have a main pooled investment fund as well as separately managed accounts or single investor funds that invest alongside the main fund.

These private pooled investment direct lending funds share many common features. The predominant fund structure in which they are raised is as a so-called closed-end private fund. This type of "closed-end" fund refers to privately offered funds issuing securities exempt from registration under the Securities Act of 1933 under Regulation D or Regulation S, with a fixed fundraising period and a term life. Fundraising periods are commonly in the range of 12 to 15 months during which time period investors make capital commitments to the fund. During the investment period, which usually is three to five years in duration, capital is drawn down from investors for investment purposes. It is common for direct lending funds to have broad ability to reinvest during their investment period.

Following the end of the investment period, direct lending funds may have some additional ability to invest or reinvest for purposes of follow-on investments or other investments that support or refinance earlier investments, but on a more limited basis. These types of mechanics are similar to the most commonly known type of closed-end private fund—the private equity fund. However, practitioners should ensure that these mechanics are aligned to the fund strategy of direct lending. For example, unlike equity investments, loans may have delayed funding features. As a result, a direct lending fund's ability to draw down after the investment period should be flexible enough to cover loan assets such as delayed draw loans or revolvers.

Fundraising

Fundraising documentation, timeframe, and process for a private debt fund is similar to that of a private equity fund. Because investors expect similar types of documentation and side letter negotiations to private equity funds, the process, cost, and level of negotiation in a private closed-end fund fundraising is similar to a private equity fund. However, in negotiating side letters, practitioners again should be careful to make sure that side letter requests fit the asset class. For example, some environmentally and socially responsible (ESG) requests from investors may require a fund to make efforts that are not practical when they are positioned as a lender and not an equity holder of a company. Similarly, some investors in closed-end funds that typically are equity investors may request information or exclusion rights related to types of portfolio companies, where the direct lending fund normally may not have the right to such information or may not have visibility as to the issue from typical due diligence. While there may be a greater ability to negotiate such rights as a direct lender, doing so may put the fund at a disadvantage against other lenders, but also may not be possible if the direct lending fund is not the lead lender.

Investment Period and Process

Direct lending funds typically deploy capital over an investment period that ranges from three to five years, with a term life ranging from seven to ten or more years depending on the flexibility of the manager to extend the term life of the fund. Many investors view the shorter duration of a loan strategy—resulting in a shorter investment period and term life for the fund—as a benefit of the asset class versus other types of closed-end funds. Investors cannot withdraw capital from "closed-end" funds before the end of their life, although most funds do provide quarterly distributions of current income. Sometimes there also are opportunities to sell fund interests in secondary sales to interested buyers in private secondary sales.

Private "closed-end" fund structures are useful for assets such as private loans as they align with the "lend and hold" strategy of many direct lending platforms and do not require fund managers to produce liquidity off-cycle to meet redemption requests. At the same time, the locked up nature of the product means that investors seek to heavily negotiate the terms of the fund documentation as in a typical closed-end fundraise.

However, there are some aspects of the typical closed-end fund model that do create challenges. For example, it is important to provide corporate borrowers with reliable and continuous capital, but the ebb and flow of the private fundraising cycle can be a challenge in this regard. Furthermore, the relatively short structure and duration of private closed-end funds means that private debt managers often almost continuously are in fundraising mode—a process that is both expensive and resource heavy. This has been true particularly in recent years as some funds have deployed capital rapidly, although a cycle where deployment slows down may reduce some of the fundraising strain on managers. Similarly, more active investors have found the prospect of re-considering a successor fund not long after underwriting the prior fund as being a strain on their investment process and personnel. As a result, we have seen increased interest in "evergreen" fund structures among both investors and managers who are seeking a structure that does not require them to re-underwrite new fund investments frequently. These "evergreen" structures could take the form of privately offered vehicles without a term life and that have continuous or periodic offerings. However, to date, these structures have gained more traction in separately managed account or single investor products. In contrast, we have seen some interest among managers and investors alike in pooled investment funds addressing these issues by lengthening their investment and reinvestment periods.

Fund Structuring and Investment Management

Perhaps the primary issue that comes up in structuring a private fund that engages in US loan origination is whether the fund product can be offered in a way that generates appealing returns to non-US investors on a post-tax basis. Directly investing into funds that generate effectively connected income (ECI) from US loan origination can lead to disadvantageous tax rates for non-US investors. Generally, US managers that can provide tax-efficient ways of accessing US direct lending investment opportunities for non-US investors may have a step up on their competitors. However, tax-efficient structures can be complex for both managers and investors and raise the cost and time of fundraising.

One of the most common tax-efficient structures is a "season and sell" structure. The previously mentioned survey of 100 credit managers showed that 42 percent currently were using season and sell type strategies. While there are different forms of the "season and sell" structure, the most common involves two parallel funds, one of which originates loans and the other which purchases loans from the originating fund after a stated time period. US taxable investors and other investors that are not sensitive to ECI invest in the originating vehicle and investors that are sensitive to ECI, such as non-US investors, invest in the purchasing vehicle. In addition to the complexity of managing two parallel funds, there are downsides to this structure, including a performance differential between the two funds because the purchasing fund often has lower performance since it is not participating in the direct origination of loans. The originating fund, on the other hand, must make the full investment in the originated loan before syndicating to the purchasing fund, meaning investors in the originating fund are over-weighted in loans during this initial period and bear the full risk of the entire loan until it is syndicated. From a fundraising perspective, this also means that it is critical in a season and sell structure to have sufficient capacity of investors in the originating parallel fund to support the structure. Managers will want to carefully consider their prospective investor base and their relative interest as among these parallel sleeves to ensure the structure can be supported.

Of increasing interest to both non-US investors and managers are fund structures that rely on "independent agent" or "treaty" status of either the investors in the fund or the fund itself. Unlike season and sell, many of these structures seek to pool investors into one main fund, which has large operational advantages. Due to the number of technical requirements of these structures, including establishing that the manager is sufficiently independent of the fund and that the investor base meets certain jurisdictional requirements, these structures can be complicated to implement. Some of the structuring considerations also are unusual, such as limitations on the manager's ability to invest capital into the structure in the typical manner. However, overall "treaty" structures are becoming increasingly common in the direct lending market and increasingly are accepted by both managers and investors. We expect to see the numbers of these vehicles only increase in the future. The credit manager survey results indicated that 64 percent of survey respondents were considering using independent agent or treaty structures for the first time.

While the approaches discussed above are among the most common to address the tax issues encountered by funds with significant US loan origination, other structures also exist to address such tax issues. However, no approach offers the perfect "silver bullet" solution that gives full flexibility and meets every investors' needs; therefore, managers should consider their full range of options as the best structure is fact dependent, including the mix of likely investors in the fund.

Use of Leverage

Another complicating factor in determining an appropriate direct lending fund structure is that unlike some other types of closed-end fund structures, such as private equity where usually there is not fund-level leverage, investor appetite for leverage in the direct lending space, and the boost it can give returns, varies widely. Some investors, particularly traditional fixed income investors, for example, continue to find the risk-reward profile of non-levered direct lending strategies to be an attractive alternative to fixed-income. In contrast, other investors, due to the lower return profile of unlevered direct lending, would prefer levered returns, often ranging from one to two turns of leverage. As a result, some managers increasingly are offering investors both levered and unlevered fund options.

Many "unlevered" strategies still use short-term leverage such as subscription facilities where capital commitments are pledged on a short-term basis. Subscription facilities can be particularly critical in credit funds as direct lending strategies can be operationally challenging for institutional investors given that the amount of time to deployment often is much shorter, and the frequency of deploying capital much higher, than in other types of private draw-down funds. Therefore, it often is critical to have subscription lines to decrease the operational burdens on investors for numerous capital calls with short time horizons.[6] Given that many credit strategies also use portfolio level leverage, subscription lines also may be another piece of portfolio leverage in addition to being used for administrative convenience purposes. This means that use of subscription lines can be very different in credit strategies than in traditional private equity and should be evaluated accordingly.

For direct lending funds using more long term leverage, this is commonly achieved through borrowing from bank lenders via a special purpose vehicle (SPV) created as a subsidiary of the private fund. Usually banks lending to private funds will want all assets of the SPV pledged as part of the credit facility to meet collateral requirements. These leverage facilities are often non-recourse to the fund itself. In planning their fund structures, managers should be aware that usually banks will not permit assets that fall outside of their collateral requirements to be held in these SPVs, so managers should be prepared to hold assets at both the fund-level and through one or more SPVs. Historically many of these SPVs were created as bankruptcy remote Delaware limited liability companies, however, managers should consider using vehicles such as partnerships, due to non-US tax considerations.

Bank lenders to private credit funds generally want some portfolio diversification before lending, which means that in the early life of a private debt fund it may not be able to achieve leverage on its investments, and that it can only put on leverage once a diversified portfolio meeting a bank lender's minimum requirements is achieved. Asset requirements can be a particular challenge for smaller size funds and it is important for managers to balance their leverage expectations with a clear understanding of the fundraising forecast and lender requirements around collateral as well as the opportunity set for investments.

Another interesting feature is that it is common in the market for these lending facilities to be term loans and not revolving facilities. In contrast, many private credit funds have wide discretion to reinvest during their investment period, meaning managers should carefully consider their investment strategy and reinvestment ability as compared to their financing facility terms and how this will impact returns and use of leverage.

Finally, managing levered and unlevered strategies alongside each other raises specific challenges, including determining allocations and rebalancing between the levered and unlevered sleeves, as well as issues around divergence in portfolio composition between vehicles. From a compliance perspective, managers also need to consider the performance track record as between levered and unlevered strategies, including disclosing differences in leverage limitations and how leverage is used.

Manager Compensation and Fees

Managers usually are compensated by direct lending funds through a management fee based on invested capital. While the calculation of invested capital varies among funds and managers, usually invested capital concepts remove valuation challenges that would arise from using a metric such as net asset value or gross value of assets. At the same time, not charging on capital commitments in the beginning period of the fund, similar to private equity funds, means that managers are incentivized to deploy capital but also reflects the lower return profile of direct lending as compared to private equity, for example.

Direct lending managers are also compensated through receiving a share of profits through a distribution "waterfall." Upon receiving cash from investments, such as from the repayment of loans, managers will distribute cash to investors. For purposes of calculating the manager's share of those profits, capital usually is first returned to investors along with a preferred return and then part of the profits are shared with the manager after a catch-up distribution to the manager. As a result, unlike funds such as hedge funds, managers are aligned with investors in that they receive profits based on cash actually realized by the fund instead of based on valuations. However, this does mean that managers in direct lending funds tend to have to wait a number of years before a loan portfolio has matured enough before they begin receiving profit distributions. This can be a challenge for compensating employees—another reason why debt managers often find multiple sources of capital to be appealing.

A common additional source of compensation for direct lending managers is loan administration fees. In the early years of a direct lending platform, borrowers may hire a third party loan servicer, although mature direct lending platforms have found it beneficial to offer an in-house loan servicer to their borrowers. Some managers have chosen to build out full loan servicing platforms through an affiliate, while others outsource some or part of the loan servicing activities to a third party, meaning that their loan servicer primarily is for administrative convenience of the borrowers, and also may provide better terms with the third party administrative agent. Where affiliated loan servicers are used, because these services are outside of the typical investment management services and offered at third-party rates, managers and their affiliates often keep these loan servicing fees as additional compensation above management fees that they receive for typical investment management services.

Conclusion

In closing, fund structuring for direct lending funds continues to be a challenge, but one that credit managers are addressing through numerous different approaches and creative solutions. Structuring direct lending platforms can raise complex considerations as managers attempt to offer structures that are able to appeal to the most investors while taking into consideration cost and operational efficiency. However, even though direct lending can be complex to structure, private credit managers continue to find direct lending a valuable component of their business growth due to investor demand and diversification benefits. Investor demand for direct lending continues to drive creative solutions and structuring options in the rapidly changing market.

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NOTES

1 Preqin Alternatives in 2019: Private Debt Fundraising Sees Strategy Shifts.

2 C. Williamson, "Institutional Investors Flock to Private Credit, Pensions & Investments" (Feb 2018).

3 "Driving Success: Challenges and Opportunities in Credit Fund Platforms," *Ropes & Gray LLP and Debtwire* (2018).

4 "Direct Lending Fundraising Hits Record Pace in Private Debt Boom," *Bloomberg Business* (April 2019).

5 PFM's 2018 survey of credit manager CFOs indicated that 33 percent saw a large increase in investor interest in back office functions in the last three years while 53 percent have seen a small increase in this interest.

6 Ropes & Gray's survey showed that 45 percent of credit fund managers used subscription lines for short-term leverage purposes while 38 percent use them for both short-term liquidity as well as longer-term investment purposes. Only 5 percent of credit manager respondents indicated that their funds did not use subscription lines.

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