aegon asset management

Introduction to Capital Call Finance

For professional investors only. This is a marketing communication.

Capital call facilities, often referred to as subscription lines, have become an important financing tool for private equity funds. These credit facilities enable fund managers to bridge capital needs before calling down fund commitments from Limited Partners (LPs). The investment opportunities are characterized by: short maturities of 3 to 12 months, gross spreads of around 200 bps over Euribor combined with a high investment grade credit profile.

Given these attractive features, the asset class has been gaining traction with institutional investors in recent years.

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What is capital call finance?

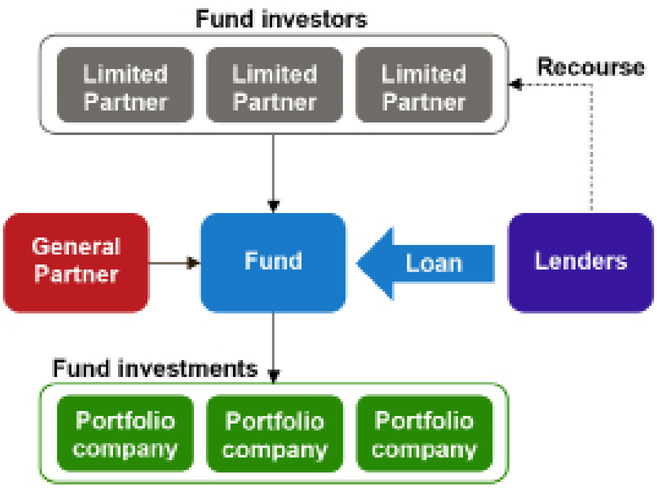
Market growth and outlook

The global private equity market has experienced significant growth in recent years. As of mid-2023, the total market capitalization of private equity reached $8.2 trillion[i]. The majority of private equity funds use liquidity to pursue investment opportunities while bridging LP capital contributions. The extensive growth in both number and volume of private equity funds is a primary driver of demand for capital call facilities.

Currently, the market for capital call finance is estimated at around $800 billion[ii]. While banks have traditionally dominated this space, there is growing interest from institutional lenders. This increased interest is driven by the attractiveness of the asset class for investors, as well as changing (regulatory) dynamics for bank lenders, and the increasing private equity financing needs. This shift has created substantial opportunities for alternative lenders to step into the market.

Capital call finance has proven to be a stable market with attractive returns versus the risk profile. Looking ahead, we believe the outlook for capital call finance is set to remain equally robust. As private equity continues to attract significant investments, the demand for capital call facilities is expected to grow even further. For institutional investors seeking yield, portfolio diversification, and short duration, capital call finance can be an attractive alternative to traditional fixed-income investments.

Capital call finance explained



Capital call finance is defined as providing short-term loans to private market funds where the loans are secured by the uncalled capital commitments of the fund LPs. When a fund identifies a new investment opportunity, short-term liquidity is typically required to complete the transaction. Instead of calling capital from LPs, which may be time-consuming, the fund typically employs a capital call facility, allowing the fund manager to accelerate the investment process and act quickly and efficiently. In addition, the use of capital call facilities can enhance the fund's return to investors.

In capital call facilities, the private market fund, managed by the fund manager or General Partner (GP), is the borrower. The main security to the lenders is in the recourse to the uncalled commitments of the LPs. As such, the credit quality of the LP base is a critical factor in the risk assessment of capital call finance. In this structure, the lender has a security interest to the LPs' legally binding commitments, ensuring that if the loan has not been repaid, the fund can be forced to call on these commitments to repay the loan

Aegon AM Capital Call strategy key facts

Investment purpose	Working capital to prefund LP commitments
Target yield	Euribor + 200 bps
Rating (implied or explicit)	AA/A
Maturity	3 to 12 months
Target Aegon AM Loan participation	EUR 25 to >150mn
Structure	Floating rate loan with bullet repayment

Source: Aegon AM as at September 2024

Types of capital call facilities
Borrowers in capital call finance can choose between committed and uncommitted facilities.

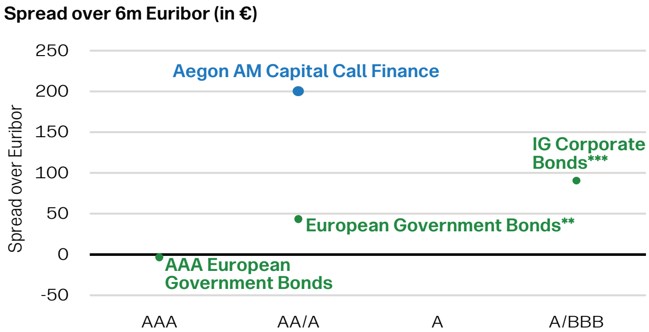
- **Committed Facilities:** provide borrowers guaranteed access to capital, ensuring liquidity for investment opportunities. However, borrowers must pay commitment fees on undrawn portions, increasing the overall cost of funding.
- **Uncommitted Facilities:** offer flexibility with lower upfront costs, as no fees are charged on undrawn commitments. This option is more cost-effective for borrowers who can manage liquidity without guaranteed funds. For lenders, uncommitted facilities allow better management of liquidity, credit risk, and allocated capital.

> "Borrowers in capital call finance can choose between committed and uncommitted facilities."

Why invest in capital call finance?

Attractive Risk-Adjusted Returns

Capital call facilities, in particular the uncommitted type, offer a yield premium over traditional short term and highly rated fixed-income instrument. Spreads on these loan facilities typically range between +175 to +225 bps over Euribor. These facilities usually have a high investment-grade credit profile. The loans can be rated and typically have a A or AA rating.



Data as of December 2024. All yields in € and gross of fees. Source: Aegon Asset Management, Bloomberg * Euro AAA Government Bond Index, ** Euro Government Bond Index, *** Euro Aggregate Corporate Bond Index

Portfolio Diversification

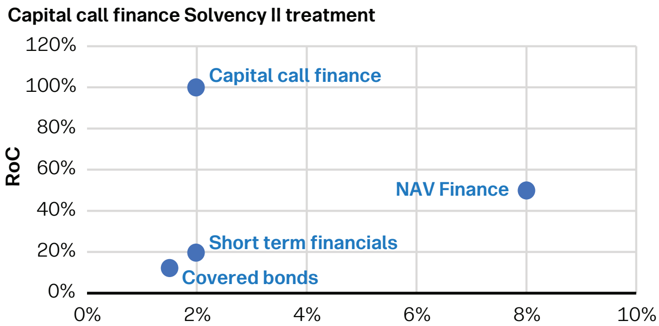
Capital call finance provides diversification compared to public markets, as it offers investment opportunities linked to different risk drivers. As illustrated above, key risk drivers are tied to private equity LP commitments. These commitments are typically made by a diverse range of high-quality institutional investors with relatively low correlation to public market movements.

Liquidity and Short Duration

The short maturity of capital call loans (typically 3 to 12 months) ensures regular repayment and frequent capital redeployment, providing investors with liquidity in what is otherwise considered an illiquid asset class. This makes capital call finance particularly appealing to investors seeking to balance yield with liquidity.

Solvency II Treatment

Under Solvency II regulations (standard formula), capital call loans benefit from favorable capital treatment, with a low Solvency Capital Requirement (SCR) of 1.1% to 1.7% for loans up to 1 year rated AA to single A, respectively. This leads to a high Solvency II Return-on-Capital which exceeds many comparable public market investments.



Return-on-Capital is approximated by net spread (corrected for expected losses) over swaps divided by Solvency II required capital Source: Aegon Asset Management, Bloomberg.

Key Risks
While capital call finance offers attractive risk-adjusted returns, there are several risks and mitigants that should be considered:

- **Lending to funds with a diversified, high-quality LP base:** Lenders usually focus on funds with a diversified pool of institutional LPs, including pension funds, insurance companies, and sovereign wealth funds. These LPs are typically of high credit quality and provide diversification, which helps reduce the overall credit risk. Transparency regarding the list of eligible LPs is crucial and is a key factor during the underwriting process.
- **Structural risk mitigants:** Several provisions and mechanisms help minimize credit risk related to the LPs:
  - **Default provisions in LP agreements (LPAs):** If an LP fails to meet a capital call, severe consequences are triggered through default provisions in the LPA. General Partners (GPs) can take actions such as selling the defaulting LP's stake in the fund or withholding distributions (such as dividends and proceeds from asset disposals) to recover the amount owed. These actions can be severely detrimental to the entitlement of the defaulting LP, to the value in their LP stake, and, as such, will incentivise LPs to honour commitments.
  - **Cross-collateralization:** Uncalled capital commitments must exceed the amount of outstanding capital call loans (typically by a factor of 1.3x or more). This is called the LP cover ratio which ensures that sufficient capital is available to call from LPs. This mechanism allows LPs to be called upon to contribute more than their pro-rata share of commiments in the event of failure to adhere to their obligations by other LPs, albeit that LPs are typically only obligated to meet capital calls up to their commitment. This cross-collateralization ensures that LPs effectively support each other, adding a layer of protection for the lender.
  - **Recourse to the fund's assets:** In the rare event that a fund cannot repay the capital call loan through capital calls or available funds, the lender can take action against the fund itself, triggering a default. In such a scenario, the lender would have a senior claim in the liquidation process with unsecured recourse to the fund's assets. However, this is highly unlikely given the quality of the LP base and the various risk mitigants already in place.
- **GP track record:** A well experienced and reputable GP will have the ability to create attractive value for the fund investors. As such, there is a strong willigness to honour any capital commitments made to the fund. These high-quality GPs typically attract a high-quality LP base as investors.
- **Operational Risk:** The fund, through actions of the GP might engage in operational errors or misconduct, potentially leading to losses for the lenders. This risk is considered low and can be mitigated by selecting experienced managers with sufficient scale and track record. Hence, this operational risk is deemed to be low.

Why Aegon AM?

The Aegon AM approach

Strong track record
Aegon AM has a dedicated team of investment professionals based in Europe who have a strong track record of investing in Fund Finance. The team has invested more than €3 billion across 100+ transactions in fund finance since 2018. In capital call finance, the team has achieved consistent average spread return of 200+bps over risk free rates through uncommitted facilities with no credit risk migration and no credit losses to date[iii]. The investment team is supported by extensive European and US based Aegon AM investment teams active in Private Equity, European and US Leveraged Finance and Global Research. Assets under management (including commitments) for capital call finance have increased to €1 billion, and continue to grow due to strong captive and third-party interest.

Sourcing and alignment
Aegon AM has established an extensive sourcing network with banks thereby seeking alignment of interest with key lenders in the market. Aegon AM has consistently been a preferred partner of choice for these bank partners based on longstanding relationships, transparency and execution certainty. In addition, Aegon AM offers strategic alignment with its large strategic and captive (insurance) balance sheets, a key differentiator to our competitors.

ESG integration
Drawing upon 19-strong global Responsible Investment professionals Aegon AM has fully integrated its proprietary ESG framework into the investment process. Following the in-house developed Fund Finance ESG Framework, the ESG analysis for each capital call facility results in an overall score. These scores range from 1 to 5, with 1 being the best score and 5 being the lowest score. Only borrowers with a score of 1 to 3 are eligible for investment. This methodology results in adequate selection of potential investment opportunities which allow for adherence to the risk tolerances that Aegon AM believes are fundamental to its business approach as well as proper integration of ESG risks in the investment process.

Conclusion

Capital call finance offers an attractive investment opportunity

- The strategy provides institutional investors with an alternative exposure to private equity funds and their LPs while delivering an attractive risk-adjusted yield and return on capital.
- The strategy is characterised by low credit risk exposure with (implied) A / AA assets driven by strong and diversified LP base and strong structural protection.
- The strategy has a short duration profile which ensures high velocity of capital, despite the illiquid nature of the private market asset class.
- Aegon AM offers investors the ability to co-invest alongside large strategic (insurance) balance sheets while satisfying their ESG needs.

i Source: McKinsey
ii Source: Fitch
iii Source: Aegon Asset Management

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