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Subscription Credit Facilities — Where They Are Headed

Law360, New York (February 26, 2014, 1:19 PM ET) -- Capital call subscription credit facilities continued their positive momentum in 2013 and had an excellent year as an asset class. As in the recent past, investor funding performance remained as pristine as ever, and the only exclusion events we are aware of involved funding delinquencies by noninstitutional investors (in many cases subsequently cured).

Correspondingly, we were not consulted on a single facility payment event of default in 2013. In addition to the very positive credit performance, the asset class seemed to enjoy significant year-over-year growth. Below we set forth our views on the state of the facility market and the current trends likely to be relevant in 2014.

Material Growth and Its Drivers

While the facility market currently lacks an industry-accepted data collecting and reporting resource, making it difficult to pinpoint the exact size of the market, we are confident based on our experiences as well as anecdotal reports from multiple facility lenders that the facility market expanded materially in 2013.

As one available data point, the Mayer Brown LLP facility practice was up 66 percent in 2013 compared to 2012, measured by volume of consummated transactions. This positive growth for facilities in 2013 was driven by a confluence of factors, not the least of which was the uptick in the fund formation market (especially in the United States).

According to Preqin data for the U.S.-based fund market, 485 closed-end real estate, infrastructure and private equity funds raised an estimated $261 billion in gross capital commitments in 2013, which represents the highest levels seen in the market since 2008. This baseline growth in the number of prospective fund borrowers clearly seeded the facility market's growth, but other factors contributed extensively as well.

We believe the facility market would have expanded in 2013 even had the fund formation market remained stagnant, as penetration into funds that have historically not availed themselves of facilities increased. Growth in 2013 was also supplemented by an increased recognition by lenders of the quality of facility collateral and, in reliance on that collateral quality, a greater comfort with customized facility structures.

Lenders clearly consummated facilities in 2013, and included investor capital commitments in borrowing bases that would not have satisfied underwriting requirements previously. Similarly, funds extended many of their existing facilities upon their maturity instead of calling capital and paying them off, in

many cases even well after the termination of their investment periods. This continuity of use of facilities throughout a fund's life cycle clearly contributed to 2013 growth as well.

Challenges

2013 was not all roses and champagne for the facility market however, as certain very real challenges emerged. Fund formation was not up uniformly across the globe; Europe and Asia still report very challenging fundraising environments for funds, especially for relatively new fund sponsors.

These challenges resulted in the deferral and in some cases, impracticability of potential facilities. For lenders, spread tightening had a very real impact on internal returns, as virtually every amend and extend consummated in 2013 priced flat to down from its precedent.

And facility structures trending downward on the credit spectrum created challenges for virtually every lender in terms of internal credit approvals and policy adjustments. But on the whole and despite these challenges, 2013 was a very positive year for the facility market.

Key Trends

In our Summer 2013 Subscription Credit Facility Market Review, we identified four key trends that were impacting the facility market:

(1) the general maturation of the facility product and market;

(2) the continuing expansion of facilities from their real estate fund roots into other fund asset classes, and particularly, private equity;

(3) fund structural evolution, largely responsive to the challenging fundraising environment and investor demands; and

(4) an entrepreneurial approach among funds to identify new investor bases and new sources of capital commitments.[1] We think these trends hold. They bear repeating here because they will continue to have a material impact on the facility market in 2014 and beyond.

But there are a number of additional trends that either presented or accelerated in the second half of 2013 that we believe will become increasingly relevant in the facility market in the year ahead, including the following:

(1) an improving global fund formation market, which will drive facility growth in 2014, especially in international submarkets;

(2) an influx of new market participants in particular facility submarkets, bringing different structuring standards and mixing up existing competitive balances;

(3) an expansion of investor interest in facilities, including the exercise of influence into facility terms and structure;

(4) lender recognition of the positive historical credit performance of facilities and a resulting comfort in expanding traditional frameworks and going further down the credit spectrum;

(5) a constantly evolving regulatory environment for lenders coupled with real difficulty applying promulgated regulation to facilities; and

(6) continuing stress on some of the largest investors — municipal pension funds — and accelerating interest in procuring defined contribution plan monies for funds. We analyze each below.

An Improving Global Fund Formation Market

We are seeing increased fund formation activity globally, including in Europe and Asia which have been somewhat slower to emerge from the crisis. Based on fourth quarter 2013 experiences and certain recent macroeconomic data, we are optimistic this positive trend will continue into 2014.

According to Preqin data, non-North American based and focused funds raised approximately $144.4 billion in capital in 2013, up slightly from 2012. Additionally, according to Preqin surveys, 34 percent of all expected fund launches in the market are targeted with a geographic focus in Asia. Thus, our expectation is that a moderate to healthy increase in consummated funds will lead to additional expansion of the facility market in 2014, perhaps with the biggest growth occurring outside of the United States.

New Market Participants

The facility market has for some time noted the efforts of new entrants (lenders, law firms, etc.) trying to establish themselves in the space, each with different strategies and often with varying levels of success. In 2013 however, certain new entrant movements occurred or accelerated that have the potential to be disruptive to the historical competitive dynamics, at least at the margins.

For example, multiple European lenders are investing in and building their capabilities in the United States. Unlike some of their new-entrant predecessors, these lenders have real, demonstrable execution capabilities, if primarily in a different submarket.

Similarly, and in reverse, many of the dominant U.S. lenders are increasingly attentive to Europe and Asia, recognizing the positive opportunities those submarkets may hold. Several U.S.-based lenders had demonstrable success in 2013, at least in Europe.

As lenders emigrate in both directions, they bring their historical facility structures and underwriting guidelines to the new submarket. As a result, funds are increasingly finding themselves with term sheets for facilities that are no longer distinguishable only by lender name and pricing. Funds are now weighing significant structural variation (a traditional borrowing base vs. a coverage ratio, as a simple example) in their facility proposals.

Along a parallel path, multiple regional U.S. lenders are expanding beyond their historical geographies and middle-market fund roots, often in efforts to keep up with the growth of their fund clients. Many of such regional lenders have increased their facility maximum-hold positions to levels comparable to that offered by the money center lenders, at least for certain preferred funds.

In fact, several of the regional lenders made substantial progress increasing their relevance in the greater facility market in 2013. As their facility structures and underwriting parameters often differ from a traditional facility, they are also altering the competitive landscape. Correspondingly, variances in

facility structure dictate the syndication strategy and prospects for a particular facility, adding additional complexity to a transaction.

Expansion of Investor Influence Into Facilities

Investor recognition and consideration of facilities is increasing, and investors are taking a more active look at how facilities are structured and what their delivery obligations are in connection with a facility. Investor side letters now routinely incorporate provisions addressing the facility, often displaying investor efforts to carve back their delivery obligations to lenders.

We often see entire side letter sets with a limitation that investors only need deliver financial statements made publicly available. Further, a few tax-exempt investors have inserted themselves into facility structuring, insisting that the parallel fund they invest through be only severally liable for borrowings under the facility so as to preserve a more favorable tax structuring analysis with respect to the separation between the multiple parallel funds.

Whether facilitated through the work of the Institutional Limited Partners Association or just via greater investing experience, investors appear increasingly aware of the facilities their funds are entering.

Extension of Credit Guidelines

No doubt partly in response to both the excellent historical credit performance of facilities and the competitive landscape, lenders are increasingly willing to go further down the risk continuum than they have in the recent past. While this has been true for some time now with respect to the historical requirements for delivery from investors of acknowledgment letters ("investor letters") and legal opinions, we are now seeing a greater acceptance of less than ideal fund partnership agreements.

Many lenders are no longer requiring a near-verbatim recital of a historical form investor letter in the partnership agreement, but instead are accepting less explicit authorization and acknowledgment language. Similarly, lenders are increasingly finding ways to get comfortable, including municipalities with sovereign immunity issues, certain sovereign wealth funds and fund of funds in a borrowing base that have historically been excluded.

We have also seen some shifting in view on investor withdraw/cease funding rights in relation to a fund's breach of its representations regarding placement agents and political contributions, with some lenders now willing to partially accept this risk, at least in limited concentration scenarios.

Further, we have seen a relatively significant expansion in the underwriting consideration of fund assets, both in terms of supporting more aggressive borrowing bases and for mitigating other perceived credit weaknesses in a particular facility, such as a tight overcall limitation. Notably, many lenders are now actively considering NAV-based facilities or hybrid variations (especially for funds later in the life cycle), and we expect these trends to continue as lenders look for higher yielding opportunities.

Importantly, in our view, we think the data supports these trends. We see this as a rational expansion based on the greater availability of positive historical investor funding and facility performance data; we have not yet seen many facilities consummated, which we deemed unduly risky or reaching.

The Regulatory Environment

Lenders are, and have been since the crisis, facing a regulatory environment as challenging as we have seen in a generation. Many of the regulations emanating from the crisis are now moving to the finalization and implementation stages, and lenders are having to adapt.

Moreover, additional regulations continue to be proposed. Virtually every post-crisis law and regulation that has been proposed or implemented is not express as to facilities, and judgment must be applied to determine the appropriate impact.

For example, the Volcker Rule's application to facilities, whether a facility constitutes a "securitization" under the European securitization risk retention regulation CRD 122a and what outflow rate is appropriate under the recently proposed U.S. Liquidity Coverage Ratio requirements are all occupying significant time at present.[2]

We think it is quite possible some of these regulations will lead lenders to offer structural variations to their facilities, such as uncommitted facilities or uncommitted tranches within facilities, as a means of counteracting some of the regulatory capital burdens accompanying changing regulation. We expect the regulatory environment will be increasingly relevant in 2014, as lenders adapt to the shifting landscape.

Municipal Pensions

Municipal pension funds in the United States, often the flagship investors in facilities, are under ever-increasing economic pressures. Despite the relatively robust performance of the equity markets in the United States and the significant rebound in many real estate markets in 2013, the outlook for municipal pensions to meet their prospective funding obligations seemed to get bleaker on a real-time basis last year.

Many states are actively making efforts to enact reform, but such reforms are severely limited by constitutional protections for earned and accrued benefits, let alone political gridlock. The initial holding by the U.S. Bankruptcy Court for the Eastern District of Michigan that Detroit has the ability to alter its pension obligations under Chapter 9 of the U.S. Bankruptcy Code, combined with Illinois' massive funding deficiencies and reform struggles, have furthered the uncertainty.[3]

We expect municipal pensions to occupy the headlines throughout 2014 and for a considerable period of time to come. We think these funding deficiency challenges are ultimately (although not promptly or easily) solvable, and we expect a major part of any solution will include a greater emphasis on defined contribution plans (DC plans) for employees going forward.

As a result, our expectation is that the credit profile of many municipal pensions will continue to trend negatively in 2014 and that sponsors will be increasing their speed of pursuit of a fund product for DC plans. We forecast breakthroughs in this regard in 2014 and think facility market participants should all be thinking about how the connection between DC plans and funds could best be structured to positively impact the facility market.

Additional Trends

In the coming years, we also expect to see healthy growth in the volume and frequency of commitments to funds by sovereign wealth funds and in the use of separate accounts by investors.[4] Preqin estimates show that in 2013, sovereign wealth funds surpassed the $5 trillion mark for total assets under management, a number which is up more than $750 billion from 2012 and nearly $2.5 trillion since

2008.

Meanwhile, 19 percent of investors surveyed by Preqin currently invest through separate accounts, as opposed to only 7 percent a year ago. Sixty-four percent of those surveyed indicated that separate account commitments will become a permanent part of their investing strategy going forward. Thus, including sovereign wealth funds in facility borrowing bases and single investor exposure when lending to separate accounts will become increasingly relevant for lenders going forward.

Conclusion

We project a robust facility market in 2014, building on the growth and positive momentum experienced in 2013, but with challenges at the margins. We expect the number of facilities consummated will continue to grow at a solid clip as fundraising improves, the product further penetrates the private equity asset class and a greater number of existing facilities get refinanced. But we expect that fund structural evolution, investor demands and competitive dynamics will continue to challenge facility structures and ultimately drive facilities somewhat further down the credit continuum.

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[1] For a copy of our Summer 2013 Subscription Credit Facility Market Review, please go to http://www.mayerbrown.com/Summer-2013-Subscription-Credit-Facility-Market¬Review-07-29-2013/.

[2] For an in-depth review of applying the Liquidity Coverage Ratio to Facilities, please see Mayer Brown’s Legal Update, Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio, available at http://www.mayerbrown.com/Capital-Commitment-Subscription-Facilities-and-the-Proposed-Liquidity-Coverage-Ratio-12-20-2013/.

[3] For more information about the initial holdings in the Detroit bankruptcy proceeding, see Mayer Brown’s Legal Update, Detroit, Michigan, Eligible to File Chapter 9 Bankruptcy, available at http://www.mayerbrown.com/
Detroit-Michigan-Eligible-to-File-Chapter-9- Bankruptcy-12-13-2013/.

[4] For more information regarding separate accounts, please see Mayer Brown’s article, Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities, available at http://www.mayerbrown.com/Separate-Accounts-vs-Commingled-Funds-Similarities-and-Differences-in-the-Context-of-Credit-Facilities-07-29-2013/.

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