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Article

Winter 2015 Subscription Credit Facility Market Review

Capital call subscription credit facilities (each, a "Facility") continued their post-crisis growth and positive credit performance in 2014, again achieving an excellent year as an asset class. Anecdotal reports from many of the key Facility lenders (each, a "Lender") indicate substantial portfolio growth last year, and the Mayer Brown Facility practice closed more than 100 new transactions for the year, a first for our practice. Investor capital call (each, a "Capital Call") funding performance continued its near-zero delinquency percentage, and, correspondingly, we were not consulted on any Facility payment events of default in 2014. Below we set forth our views on the state of the Facility market and current trends likely to be relevant in 2015.

Fund and Facility Growth

FUNDRAISING IN 2014

Overall, 2014 was a very positive year for private equity funds (each, a "Fund"). Fundraising, although down slightly from the marks set in 2013, was relatively robust. Globally, 994 Funds held their final close last year, raising $495 billion in investor (each, an "Investor") capital commitments ("Capital Commitments"). This surpassed the fundraising levels seen in 2008-2012 but was down slightly from the 1,203 Funds raising $528 billion in 2013. The "flight to quality" trend we noted in our Summer 2014 Fund Finance Market Review (the "Summer Review") has continued, with fewer Funds being formed but on average raising more capital. In fact, the average Fund size in 2014 was $544 million, the largest average ever recorded.[1]

FACILITY GROWTH

While the Facility market still lacks an industry-accepted data reporting and tracking service to pinpoint exact numbers, the market undoubtedly expanded by double digits in 2014. Multiple Lenders grew their portfolios extensively, with several reporting a growth rate in revolving commitments in the neighborhood of 50%. Mayer Brown represented Lenders and Funds in new money transactions reflecting in excess of $25 billion of Lender commitments, without counting accordion upsizes or increase amendments. We believe this growth rate is at a minimum consistent with, if not in excess of, that in 2013.

Interestingly, one of the theories behind the 2014 fundraising decline involves the growth of separate accounts (each, a "Separate Account"). As Separate Accounts are often structured to obtain their own Facilities, that may explain in part how we are seeing Facility growth despite a nominal decline in fundraising. While perhaps a factor, we continue to believe that Facility growth over the past several years is most attributable to increased market penetration; that is, Fund families that in the past rarely used Facilities are awakening to their benefits. In 2014, we saw several top 30 Fund sponsors (each, a "Sponsor") obtain their first Facility for a Fund and then look to procure additional Facilities across their platforms. Many additional Sponsors also explored and consummated their first Facility. This market penetration has clearly seeded

Facilities growth over the past few years and in our view has been the primary growth driver.

Looking forward, we continue to forecast outpaced growth for Facilities in 2015, although we do expect the growth rate to slow somewhat from the double-digit and perhaps unsustainable growth rate of the recent past (especially in the United States). Absent a Facility default or a major macro-economic event, there are too many positive data trends not to be cautiously bullish. For example, at the beginning of 2015, a record 2,235 Funds were on the road fundraising, an all-time high. Dry powder increased by $128 billion in 2014 to a record $1.2 trillion. Even if one were to assume that the Facility market has hit $200 billion in global Lender commitments, we are still looking at a global advance rate of less than 17% on available dry powder. Many Lender portfolios have an average funded advance rate of 25% to 30% of uncalled Capital Commitments ("Uncalled Capital"), suggesting there is still a fair amount of growth opportunity remaining. Furthermore, with the record levels of distributions to Investors in 2013 and 2014 (nearly $200 billion ahead of Capital Calls for each year) and the continued positive investment performance of Funds as an asset class, it is hard not to forecast extensive fundraising success in 2015. These trends are all likely to combine and result in additional Facility growth in 2015.[2]

Facility Market Trends

Not surprisingly, many of the trends we noted in the Summer Review continued and in some cases accelerated in the latter half of 2014. We highlight these below along with a few other trends likely to be impactful in 2015.

CONTINUING TRENDS

Extensive Refinancing Activity. As predicted, we saw significant amend-and-extend volume over the course of 2H 2014 and that trend has continued its momentum thus far in 2015. Facilities of the 2011-12 vintages are increasingly coming up for renewal. In some cases, Funds are even renewing early to take advantage of the lower pricing that is generally available. While we are seeing Facilities reduce in commitment size, very few are being repaid and terminated. Facilities extending long into the Fund's harvest period are increasingly common.

Fund Structural Evolution. Separate Accounts and parallel funds of one Investor have continued to permeate the Facility market as Investors (frequently sovereign funds and large institutional Investors) seek investment flexibility, lower fees, greater control and structuring alternatives for regulatory and tax relief. Many Lenders have gotten comfortable with these single Investor exposures and the Separate Account Facility market is flourishing. Investor credit linkage, transparency and a continuous education on the evolving structures will be key as Lenders pivot to serve this growing sub-market in 2015.

Umbrella Facilities. Facilities encompassing multiple sub-facilities for unrelated Funds advised by the same Sponsor continue to gain increased traction in the market. Mayer Brown has advised on nearly as many umbrella facilities to date in early 2015 as in all of 2014. We expect the efficiencies created by these structures to support their continued expansion.

Hedging Mechanics. Lenders and Funds increasingly want to secure trading activities with Facility collateral and several Lenders have been successful in accommodating this construct in syndicated Facilities. We expect that these secured hedging mechanics, embedded within the Facility documentation, will continue to be a popular request in 2015.

NEWER TRENDS

Credit Continuum

Throughout 2013, Facility structures and covenant packages were clearly drifting in favor of Funds as Lenders were becoming increasingly comfortable going further down the risk

continuum. In early 2014, that trend seemed to accelerate. For example, Facilities were being consummated that included advances for Investors that would never have previously been included in a borrowing base. Lenders were far more lenient with respect to Fund partnership agreement language, Investor credit linkage and sovereign risks, as additional examples. That downward trending, however, seemed to level out somewhat toward year-end. Other than a few instances of extended tenors, Facility structures seemed to largely stabilize. Facility structure and credit trending will be interesting to watch in 2015.

HNW and Family Office Facilities. During 2H 2014 and thus far into 2015, we have seen a notable uptick in the establishment of Facilities for Funds comprised mostly or exclusively of high net worth and family office Investors ("HNW Investors"). This trend has emerged not only for middle-market Sponsors but also for some of the largest Sponsors in the market. For Funds where the HNW Investors invest directly, the transparency of the Investor, the number of Investors and the granularity of the pool have in some cases actually been credit positives for certain Lenders. For Funds where the HNW Investors invest indirectly through managed platforms of wealth management institutions, comfort with the managed institution and some level of negotiated look-through rights or bespoke exclusion events related to the platform have been present. Many of these Facilities have been bilateral and generally smaller in overall Lender commitment size, but we do expect this market to develop going forward.

Hybrid Facilities. Funds that are approaching or have passed their investment period often have ongoing liquidity needs. Lenders have historically offered "after-care" Facilities for seasoned Funds with appropriately drafted partnership agreements. The after-care Facility approach, however, offers little utility if a Fund has nearly exhausted its Uncalled Capital. Hybrid Facilities are structured on a case-by-case basis but typically include a pledge of whatever Uncalled Capital remains, as well as some form of a pledge of the Fund's investments. The hybrid borrowing bases are typically comprised of the standard 90%/65% advance rates on the tiered credit quality of the Investors and a much lower advance rate on the NAV of the investments after a reduction for concentration limit excesses. Each hybrid Facility is structured differently and a pledge of the assets and evaluation of the collateral package will require enhanced diligence and differing underwriting criteria. Interest in hybrid Facilities, and NAV-based lending generally is clearly on the upswing.

Open-End Fund Facilities. Facilities for open-end Funds, which permit Investors to redeem their equity interests at their election (typically following a "lock-up" period and sufficient notice to the Fund), are on our list as a product to watch in 2015 and beyond. While Facilities for open-end Funds have been somewhat slower to catch steam than we originally forecast, Mayer Brown advised on a number of opportunities for open-end Fund financings in 2H 2014.

LIBOR Floors of Zero. Recent activity by central banks has resulted in periodic negative LIBOR rates for certain currencies. In order to prevent unintended consequences of a negative index rate, many Lenders are now including LIBOR floors of zero in their loan agreements. The floor will specify that if LIBOR is below zero, it shall be deemed to be zero for purposes of calculating the rate under the loan agreement.

Energy Sector Watch. While 2014 represented a strong year in terms of Fund performance generally, falling crude oil and related commodity prices are stressing certain investments in energy Funds. The press has reported Investor Fund losses of greater than $12 billion in value in 2H 2014 alone.[3] We think we are still in the early innings of volatility in the energy markets. While it is quite likely that the sharp downward

movements to date have and will create some meaningful losses on investments for certain Funds, it may also create more realistic pricing and attractive investment opportunities for the very same Funds incurring the recent losses. The energy sector certainly warrants considerable attention in 2015.

Legal and Regulatory Developments

LSTA MODEL CREDIT AGREEMENT PROVISIONS

On August 8, 2014, the Loan Syndications and Trading Association (the "LSTA") published a revised version of its Model Credit Agreement Provisions ("MCAPs") that addresses, among other topics, prohibitions on lender assignments to so-called "disqualified institutions" (commonly also referred to as "ineligible institutions" or "disqualified lenders") which specifically contemplate limitations on assignments to the borrower's competitors. The revised MCAPs allow the borrower to establish a list of entities that cannot own its debt, which may include both competitors and entities that the borrower desires to "blacklist" (such as an entity with which the borrower has previously had a bad experience). For a complete summary of the revised MCAPs, please see the Mayer Brown article, *Limitations on Lender Assignments to Competitors in Subscription Credit Facilities and Other Fund Financings*, at page 13 hereto.

LIQUIDITY COVERAGE RATIO: FINAL RULE

On September 3, 2014, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (collectively, the "Agencies") each adopted a final rule (the "Final LCR Rule") to impose a quantitative liquidity coverage ratio ("LCR") requirement on US banking organizations with total consolidated assets of $250 billion or more and certain other institutions (collectively, "Covered Companies"). The Final LCR Rule went into effect for Covered Companies as of January 1, 2015.

Last year, at the time the Agencies circulated the proposed regulations to address this LCR requirement (the "Proposed Rule"), Mayer Brown released the Legal Update *"Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio"* in which we expressed our view that Facilities are most appropriately classified as "credit facilities" rather than "liquidity facilities" and addressed other aspects of the regulations that could affect traditional fund finance products. The Final LCR Rule as adopted by the Agencies did not change the Proposed Rule in a manner that we believe changes this analysis for Facilities. For more information, please see the Legal Update available at http://www.mayerbrown.com/Capital-Commitment-Subscription-Facilities-and-the-Proposed-Liquidity-Coverage-Ratio-12-20-2013/.

EXTENSION OF VOLCKER RULE CONFORMANCE PERIOD FOR LEGACY FUNDS

Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule, remains an area of focus for many Lenders. On December 18, 2014, the Federal Reserve Board (the "FRB") responded to industry concerns regarding conformance with the Volcker Rule by extending the conformance period for investments in and relationships with "covered funds" and "foreign funds" that were in place prior to December 31, 2013 ("legacy covered funds") through July 21, 2016. The FRB announced that next year it intends to further extend the conformance period for investments in and relationships with these legacy covered funds to July 21, 2017.

In our related Legal Update from August 2014, we described our belief that traditionally structured Facilities should not cause Lenders to run afoul of the Volcker Rule's prohibition on acquiring ownership interests in a "covered fund."[4] Lenders must be aware of certain terms or structures which could give rise to an "ownership interest" under the regulation's broad definition, but the traditional Facility structure, including the collateral and remedies associated therewith,

should not rise to this level. The extension granted for conformance of legacy covered fund relationships should help mitigate risks in certain existing Facilities to covered funds where the Fund Sponsor itself is a Covered Company subject to the Volcker Rule.[5]

Conclusion

We forecast continued growth of the Facility market in 2015, riding a projected positive wave of fundraising for Funds, further penetration into new Fund families and expanded use of Facilities by Funds throughout their harvest periods. Facility structures are likely to continue to evolve commensurate with the growth of Separate Accounts, Open-end Funds and similar alternative investing structures. We also anticipate growth in hybrid Facilities and NAV-based lending as Lenders search for yield and utilization and Funds seek leverage and liquidity later in their lifecycles. Of course, there are a fair number of material uncertainties in the greater financial markets currently, especially in the energy sector, the Middle East and Eastern Europe, all of which could potentially spook Investors and change the fundraising landscape rather abruptly. But while these risks are real and should be monitored closely in 2015, we expect that the 2015 Facility market will trend favorably and comparably to the uptick in 2014.

Endnotes

1 *See 2015 Preqin Global Private Equity and Venture Capital Report ("Preqin PE 2015"),* p. 4; for a copy of our Summer Review, please go to http://www.mayerbrown.com/Summer-2014-Subscription-Credit-Facility-Market-Review-08-06-2014/.

2 *See,* Preqin PE 2015, p.4.

3 Dezember, Ryan, "Buyout Shops Caught in Crude Exposure," *The Wall Street Journal,* December 4, 2014

4 For more information, please see Mayer Brown's Legal Update, *Federal Reserve Board Issues Volcker Rule Conformance Period Extension*, available at http://www.mayerbrown.com/Federal-Reserve-Board-Issues-Volcker-Rule-Conformance-Period-Extension-12-19-2014/.

5 For more information about the Volcker Rule's impact on Lenders, please see Mayer Brown's Legal Update, *Subscription Credit Facilities and the Volcker Rule,* available at http://www.mayerbrown.com/Subscription-Credit-Facilities-and-the-Volcker-Rule-08-06-2014/. For an in-depth analysis of the Volcker Rule's final regulation, please see Mayer Brown's White Paper, *Final Regulation Implementing the Volcker Rule,* available at http://www.mayerbrown.com/Final-Regulation-Implementing-the-Volcker-Rule-12-18-2013/.

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