Summer 2014 Subscription Credit Facility Market Review

On July 22nd and 23rd, we held our annual Fund Finance Mid-Year Market Update Panels, this year in Los Angeles and San Francisco (the "Market Updates").[1] Based on our experiences and the views expressed by the panelists at the Market Updates, capital call subscription credit facilities (each, a "Facility") have continued their positive credit performance and growth momentum in the first half of 2014. Below we set forth our views of the current market trends and developments likely to be relevant for the remainder of 2014.

Credit Performance

2014 Year-to-Date Credit Performance

Mirroring all of 2013, Mayer Brown LLP has not been consulted on a Facility payment event of default or an institutional investor exclusion event in 1H 2014 and we are not aware of any existing Facilities under credit duress. All five of the bank panelists speaking at the Market Updates reported consistent credit performance across their portfolios so far this year.

Short Term Credit Forecast

Fund Investment Performance. There is an abundance of data that forecasts continuing positive Facility credit performance on the macro level for the foreseeable future. Private equity funds of virtually all asset classes and vintages (each, a "Fund") have achieved positive investment return performance in the recent past. The Cambridge Associates LLC US Private Equity Index® (the "C-A Index") shows one-year and three-year returns as of December 31, 2013 of 20.6% and 14.9%, respectively, and Preqin reports promising current aggregate cumulative returns for Funds of virtually all vintages and geographies. This positive performance has continued into 2014, with Preqin reporting as one example a 6.3% average increase in net asset value ("NAV") for real estate Funds in 1H 2014.[2] While positive Fund investment performance enhances Facility repayment prospects in its own right, Fund limited partners (each, an "Investor") with demonstrable NAV in a Fund are highly incentivized to fund future capital calls ("Capital Calls") and avoid the severe default remedies typical in a Fund partnership agreement (each, a "Partnership Agreement"). Setting aside the well-established, enforceable contractual obligations of the Investors, it is difficult to foresee widespread Investor funding defaults in the near term when the vast majority of existing Funds have generated positive returns.[3]

Harvest Events and Investor Distributions. Additionally, there is generally positive liquidity data at virtually every level of the Fund structure relevant for Facility lenders ("Lenders"). Private equity-backed investment exits in 2014 have continued and built upon the robust harvest activity in 2013, with 394 transactions valued at $137 billion in Q2 2014 alone.[4] Exit events of course lead to Investor distributions, and distributions are at record levels. In 2013, Fund distributions to Investors greatly exceeded capital contributions called and funded, with Funds in the C-A Index calling $56.3 billion, while distributing $134.6 billion (the largest yearly amount since the C-A Index's inception). On a global basis, $568 billion was distributed back to Investors in 2013 (up 49% from 2012).[5] Investors receiving significant distributions forecasts well for their ability to fund future Capital Calls.

Secondary Funds. The fundraising success of secondary Funds, Facility borrowers in their own right, has created an unprecedented volume of dry powder available to offer exit opportunities to any Investor that experiences liquidity challenges and needs to exit a Fund position. In fact, the single-largest Fund closed in Q2 2014, and the single largest secondary Fund to close in history was the Ardian Secondary Fund VI, closing on $9 billion in April. There has reportedly been $15 billion raised by secondary Funds in 1H 2014 and there are multiple premier Sponsors in the midst of fundraising with significant interim traction. This significant growth in secondary Fund dry powder creates a readily available market for any Investor wishing to transfer, whether for diversification purposes or because of financial distress, and the current secondary market is very active. The first half of 2014 saw more than $16 billion of secondary transactions (an annualized pace that would exceed 2013 by over 10%) and it has been reported that the Montana Board of Investments received more than 40 offers for eight Fund positions that it recently put out for bid.[6] If the Facility market performed extremely well during the financial crisis when the secondary Fund market was a fraction of what it is today, today's secondary Funds market with some $50 billion in dry powder certainly provides Lenders a far greater buffer to any initial collateral deterioration.

Long-Term Credit Forecast Concerns

Despite the nearly uniform positive trending in the data above supporting Facility credit performance, none of it goes to the heart of the fundamental credit underwriting premise of a Facility. That is, that the Investors' uncalled capital commitments are unconditionally due, payable and enforceable when called, regardless of Fund investment performance, NAV, receipt of distributions, market liquidity or Investor transfers. And from this vantage point, the 2014 year-to-date trending has been far less beneficial for Lenders. We have for some time been noting that Facility structures have been drifting in favor of the Funds and that Lenders have become increasingly comfortable going incrementally down the risk continuum, at least for their favored Fund sponsors ("Sponsors"). In fact, at the end of 2013, we gave the view that much of the trending (as an example, the including of certain historically excluded Investors in borrowing bases at limited concentrations) seemed perfectly rational and completely supportable by the available Investor funding data. But as 2014 has progressed and the downward trending has continued, we are seeing the emergence of structural issues in prospective Facilities that we believe further conflict with Lenders' general expectations as to the appropriate allocation of risk between the Lenders, Funds and Investors. While the Facility market is far from uniform and every particular Facility needs to be evaluated in its own context, there are a number of emerging credit concerns we think Lenders should rightfully put heavy emphasis on. Examples include Partnership Agreements that fail to appropriately contemplate or authorize a Facility, overcall limitations structured so tightly that the degree of overcolleralization buffering Investor defaults is insufficiently adequate to cover the Facility obligations in a period of distress, lack of express Investor obligations to fund without setoff, counterclaim or defense, and Fund vehicles being formed in non-US partnership structures that require the Fund to issue some form of equity shares or certificates each time a Capital Call is funded. And there are others. Our view has been, and remains, that the most likely way a Lender will suffer losses in this space is not via widespread Investor credit deterioration, but rather via a Sponsor or Fund failing to meet its contractual obligations to Investors, ultimately resulting in a dispute and an Investor enforcement scenario. Thus, Lenders should thoughtfully contemplate documentation and structural risks that undermine their expected enforcement rights. If this downward trending on the risk continuum continues at its current pace, we ultimately see an inflection point where particular Lenders determine that certain proposed structures simply drift too far from the fundamental tenets of a Facility and no longer meet the investment grade credit profile expected in a Facility.

Facility Market Expansion

Fundraising

Fund formation in the first half of 2014 has remained positive and generally consistent with levels seen in 2013. 417 Funds had their final closing, raising $236 billion in capital commitments in 1H 2014. The "flight to quality" trend has continued, with fewer Funds being formed but raising more capital, with the average Fund size in Q2 2014 being the largest to date.[7] We continue to think this trend towards consolidation slightly favors incumbent and larger Lenders at the expense of new entrants and smaller institutions. Experienced Sponsors are more likely to have existing relationships with incumbent Lenders in multiple contexts and larger Funds need larger Lender commitment sizes in Facilities. We note, however, that several smaller Lenders have greatly increased their maximum hold positions and have created syndicate partnerships to effectively compete.

Deal Volume and Pipeline

Facility deal volume remains robust and likely above 2013's pace, although we hesitate to confirm the double-digit growth we forecasted in January based on the available anecdotal evidence alone. The pipeline of both large syndicated transactions and bilateral deals forecasts well for the remainder of the year. We expect 2014 deal volume to ultimately finish ahead of 2013, albeit perhaps by only single digits.

Growth Prospects

The Facility market, in our view, still projects substantial opportunity for future growth. With global dry powder now at an all-time high of $1.16 trillion as of the end of Q2 2014, up a full 8% from the end of 2013, there is simply a greater and increasing pool of collateral available to support Facilities.[8] And if you take a ratio of Facility size to Fund uncalled capital across a large portfolio of Facilities (admittedly not a statistic clustered close to the mean) and determine an average percentage, say 30%, you could project out a potential Facility market size of well over $300 billion. As most market participants estimate the current Facility market to be less than $200 billion, it does appear that plenty of existing Funds have yet to benefit from Facilities. When you combine this room for further penetration into Funds new to Facilities with the greater volume of Funds presently fundraising (estimated currently around 2,000), the increasing use of returned capital mechanics to refresh dry powder and the greater use of Facilities throughout the entire Fund life cycle, it seems evident that the opportunity for outpaced growth remains.[9]

Facility Market Trends

There are a number of interesting trends in the Facility Market itself that are impacting both transaction structures and terms. We highlight below a few that are most impactful.

Extensive Refinancing Activity

Many Facilities of 2011 or so vintage have been coming up for renewal and the vast majority have been extending instead of terminating. Lenders are increasingly comfortable extending Facilities beyond Fund investment periods (subject to appropriately supportive language in Partnership Agreements) and Funds appear to be valuing the liquidity and other utility of a Facility well into their harvest periods. Virtually all Facilities coming up for renewal have been pricing flat to down, further encouraging their extension. We expect the volume of amend and extend activity to increase slightly towards year-end, mirroring an uptick we experienced in 2H 2011.

Transaction Structures

Structural Evolution. The evolution of Fund structures continues to complicate Facility structures, as the incorporation of multiple Fund vehicles, in an effort to optimize investment structure for Investors, is continuing and perhaps accelerating. Separately managed accounts, co-investment vehicles, joint ventures and parallel funds of one are all increasingly common, each of which stress the traditional commingled Fund collateral package for a Facility. As the various vehicles often have challenges being jointly and severally liable for Facility obligations, Lenders are increasingly finding themselves with Facility requests involving single-Investor exposures. Interestingly, in certain instances, these single-Investor exposure structures are leading back to the delivery of Investor acknowledgment letters (which have been in certain cases trending out of the commingled Fund market), as Lenders seek credit enhancements to offset the lack of multiple Investor overcollateralization.

Umbrella Facilities. We are seeing increased appetite for umbrella Facilities (multiple Facilities for unrelated Funds advised by the same Sponsor but documented on the same terms in a single set of loan documents). In fact, Mayer Brown LLP has closed more umbrella Facilities in 1H 2014 than in all of 2013.

Hedging Mechanics. Embedding hedging and swap collateralization mechanics into Facilities has also accelerated in 1H 2014. While extending Facility collateral to cover collateralization requirements under ISDAs entered between the Fund and the Lender has existed in the bilateral Facility market for some time, including clear structural borrowing base allocation, tracking and measurement mechanics in syndicated Facilities is relatively new.

Regulatory Impact

The regulatory landscape continues to occupy a substantial amount of Lender and Sponsor time. Analyzing Facilities for compliance with the final Volcker Rule, for appropriate risk weighting under Basel III and other regulatory capital regimes and the appropriate outflow analysis under the minimum liquidity coverage ratio promulgated by the US regulatory agencies all require thoughtful care in application to Facilities, especially in light of the speed of Facility structural evolution. We expect the regulatory environment will be increasingly relevant throughout 2014 and that Lenders may ultimately need to structure around, or price, for their increasing regulatory requirements, particularly around Facility unfunded revolving commitments.[10]

Legal Developments

Cayman Islands Legal Developments

Two new statutory enactments have occurred in the Cayman Islands in 1H 2014, both of which are in small part helpful to Lenders. The first, the Contracts (Rights of Third Parties) Law, 2014, was enacted on May 21, 2014. Although not explicit as to Facilities, the new law allows third parties not party to a contract (such as a Partnership Agreement) to rely on and enforce provisions that are intended by the contracting parties to benefit the third parties, even though the third parties are not signatories. This brings Cayman Islands' third-party beneficiary law closer in line with other jurisdictions and can ultimately accrue to the reliance and enforcement benefit of Lenders if Partnership Agreements are expressly drafted to do so. The second key change is the enactment of the revised Exempted Limited Partnership Law, 2014, which took effect on July 2, 2014 and is a comprehensive revision of previous Cayman Islands exempted limited partnership law. While few of the changes are relevant for Facilities, the new law does expressly confirm that any right to make Capital Calls and to receive the proceeds thereof vested in a general partner or the Fund shall be held by the general partner as an asset of the Fund, thus providing greater certainty of a Fund's right to grant security in the right to issue and enforce Capital Calls.[11]

Case Law Development: Wibbert v. New Silk

A case of interest to Lenders, *Wibbert Investment Co. v. New Silk Route PE Asia Fund LP, et al.*, is pending in the New York state courts. While no mention of a Facility is evident in the pleadings, the case is illustrative of the type of fact pattern and dispute that could potentially find a Lender in an enforcement scenario. In this case, the Investor, Wibbert Investment Co. ("Wibbert"), alleges, among other things, that the Fund failed to disclose the occurrence of a key person event after a principal of the Sponsor was charged and convicted of insider trading and that the Fund's general partner committed gross negligence and/or willful malfeasance. The Fund fully contests the claims and the facts are in dispute. Wibbert has declined to fund a Capital Call and alleges that the Fund has threatened to implement default remedies as a result. On June 17, 2014, at Wibbert's request, the New York Supreme Court, Appellate Division, granted a preliminary injunction in favor of Wibbert barring the Fund from declaring Wibbert in default and from exercising default remedies while the case proceeds. The ruling is currently on appeal. While the facts of this case are highly unique and have involved extensive publicity in connection with the trials and convictions of certain of the principals, the case does stand as evidence of why Lenders may want to consider the importance of a contractual obligation on Investors to fund Capital Calls to Lenders without setoff, counterclaim or defense. The case merits further attention and monitoring as it proceeds.[12]

Case Law Development: TL Ventures, Inc.

In June 2014, the US Securities and Exchange Commission (the "SEC") brought a pay-to-play case against a Sponsor pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (the "Advisers Act"), to our knowledge the first such case brought by the SEC. The SEC alleged that an associate of TL Ventures, Inc. made a $2,500 campaign contribution to the Mayor of Philadelphia and a $2,000 campaign contribution to the Governor of Pennsylvania at a time when the Pennsylvania State Employees' Retirement System was an Investor in Funds sponsored by TL Ventures, Inc. Both the Mayor and the Governor have vested authority to appoint certain people with influence as to investment selection. The SEC alleged that this action violated Section 206(4) and Rule 206(4)-5 of the Advisers Act, noting that it need not allege or demonstrate a showing of *quid pro quo* or actual intent to influence an elected official by the Sponsor. The Sponsor, without admitting or denying the relevant subject matter, consented to an order with the SEC to resolve the matter. As Lenders are increasingly reviewing side letters between governmental Investors and Funds that contain withdrawal and/or cease-funding rights if prohibited political contributions are made or improperly disclosed, Lenders must bear in mind that such a circumstance may not be purely hypothetical and that even the most innocent and well-intentioned political contributions may trigger the withdrawal rights.[13]

LSTA Model Credit Agreement Provisions

On June 25, 2014, the Loan Syndications and Trading Association® published an exposure draft of its Model Credit Agreement Provisions. The proposed revisions include a host of technical revisions, but the two most relevant revisions relating to Facilities include an extensive set of mechanics governing facility extensions and changes to the lender assignment and participation provisions, including certain prohibitions of assignments or participations by lenders to competitors of the borrower or institutions the borrower has requested in advance be disqualified for assignments or participations. August 8, 2014 is the current target date the LSTA plans to publish the revisions. A copy of the exposure draft is available to LSTA members on the LSTA's website at http://www.lsta.org/legal-and-documentation/primary-market.[14]

Conclusion

We project a robust Facility market to continue in 2H 2014 building on the growth and positive momentum to date, but with competitive, structural and underwriting challenges at the margins. We expect the number of Facilities consummated will continue to grow at an outpaced but measured rate, reflective of the time-consuming nature of educating new Sponsors of the utility and benefits of a Facility. We continue to anticipate excellent credit performance throughout the remainder of 2014, but recommend caution to Lenders as certain emerging Facility structures reallocate the traditional Facility risk allocations among Lenders, Funds and Investors and stress some of the most fundamental tenets of a Facility. ◆

Endnotes

1 Mayer Brown LLP would like to thank the panelists at the Market Updates. In Los Angeles: Kristin Rylko, Partner, Mayer Brown LLP (Moderator), John Gilb, Senior Managing Director, CBRE Global Investors, Ann Richardson Knox, Partner, Mayer Brown LLP, Nick Mitra, Executive Director, Natixis, Matt Posthuma, Partner, Mayer Brown LLP, Tom Soto, Managing Director, TCW, Emily Stephens, Managing Director, Oaktree Capital Management, LLP, David Wasserman, Executive Director, Sumitomo Mitsui Banking Corporation, and Tom Wuchenich, Partner, Simpson Thacher & Bartlett LLP. In San Francisco: Scott Case, Global Head of Private Equity Services, Silicon Valley Bank, Kevin Dunwoodie, Principal, Pantheon, Jeff Johnston, Managing Director and Head of Subscription Finance Origination, Wells Fargo Bank, N.A., Mary Touchstone, Counsel, Simpson Thacher & Bartlett LLP, Matt McCormick, Vice President, Stockbridge, Wes Misson, Attorney, Mayer Brown LLP, and Robert Wood, Director, Bank of America, N.A.

2 See *US PE/VC Benchmark Commentary*, Quarter and Year Ending December 31, 2013 (the "C-A Benchmark"), Table 1, page 2, Cambridge Associates, July 2014, available at http://40926u2govf9kuqen1ndit018su.wpengine.netdna-cdn.com/wp-content/uploads/2014/07/US-PE-VC-Benchmark-Commentary-4Q13.pdf; *Preqin Quarterly Update: Private Equity*, Q2 2014 ("Preqin PE Q2"), Figure 3, page 8; *Preqin Quarterly Update: Real Estate*, Q2 2014, page 7.

3 For an in-depth review of the enforceability of Investor capital commitments, please see Mayer Brown's Legal Update, "Enforceability of Capital Commitments in a Subscription Credit Facility," available at http://www.mayerbrown.com/publications/Enforceability-of-Capital-Commitments-in-a-Subscription-Credit-Facility-07-07-2011.

4 *Preqin PE Q2*, page 8.

5 See *C-A Benchmark*, Figure 1, page 6; *Preqin PE* Q2, page 2.

6 See, *Secondaries Investor*, news compendium, page 3; available for download at http://www.secondariesinvestor.com/newscompendium/; *Secondary Market Trends & Outlook*, Cogent Partners, July 2014, p. 1.

7 See *Preqin PE Q2*, Figure 1, page 5.

8 Id., page 2.

9 Id., page 3.

10 For an in-depth review of applying the Volcker Rule to Facilities, please see Mayer Brown's Legal Update, "Subscription Credit Facilities and the Volcker Rule"; 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/.

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12 The case is *Wibbert Investment Co. v. New Silk Route PE Asia Fund LP, et al.*, case number 650437/2013, in the Supreme Court of the State of New York, County of New York.

13 The case is *In the Matter of TL Ventures Inc.*, case number 3-15940, before the SEC.

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