Subscription Credit Facility Market Review

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The past year was an active year for Fund Financings, with positive growth and strong credit performance through 2015 as an asset class. Capital call subscription credit facilities (each, a "Facility") continued steady growth and followed the uptick of closed funds and capital raised through Q3 and Q4 2015. Additionally, anecdotal reports from many of the major Facility lenders (each, a "Lender") and Mayer Brown's practitioners noted a substantial increase in alternative fund financings, including unsecured Facilities looking to the assets of private equity funds, such as hybrid and NAV Facilities, a trend that seems to be continuing through 2016 ("Alternative Fund Financings"). Additionally, Investor capital call (each, a "Capital Call") funding performance continued its near-zero delinquency status, and we were not aware of any Facility events of default in 2015 that resulted in losses. Below we set forth our views on the state of the Facility market and current trends likely to be relevant in 2016.

Fundraising and Facility Growth

FUNDRAISING IN 2015

Overall, 2015 was a positive year for private equity funds (each, a "Fund"). Fundraising was up slightly from 2014 levels, which were the highest levels seen prior to 2008. Globally, through Q3 2015, Funds raised over $391 billion in investor (each, an "Investor") capital commitments ("Capital Commitments"), higher than the same period in 2014 with $389 billion of commitments raised.[2] Continuing the prior year's trend of flight to quality, Investor capital was attracted to larger sponsors. During the same periods, fewer Funds were formed, with 760 Funds in 2015 as contrasted to 889 in 2014, resulting in a larger average Fund size. We note that the focus of such fundraising appears to be in the more mature North American and European markets as well as in the buyout, real estate and infrastructure sectors.[3] Additionally, anecdotal reports from Mayer Brown practitioners point to Europe in particular having a good early 2016 in terms of Funds and amount of capital raised.

Moreover, Investors have expressed continued interest in private equity, and the majority of Investors in 2015 expressed that they were below their target allocation to private equity, which is encouraging for the prospects of new commitments in 2016.[4] Given that Facility growth typically follows fundraising activity, this appears to bode well for the coming year.

FACILITY GROWTH

Although the Fund Finance market lacks league tables or an overall data and reporting and tracking service, it is clear that the market continued to expand in 2015. In respect of Fund Financings, Mayer Brown represented Lenders and Funds in new money transactions reflecting in excess of $30 billion of Lender commitments, a significant increase from $25 billion in 2014. We believe this growth to be steady, and initial indications are that this will be sustained into 2016. Notably, we are seeing growth not only from the continued penetration of Facilities with Funds and

sponsors who have traditionally not utilized them but also from the continued diversification in product offerings in the Facility market (including hybrid, umbrella and unsecured or "second lien" Facilities). We note that the active European market has also been focused on product diversification (perhaps even more so than in the United States), and we have seen growth in respect of unsecured Facilities in that market as well. Such diversification makes Facilities more attractive to a broader spectrum of Funds and increases the utility and lifespan of the product for Funds. Separately, throughout 2015, we have also seen a proliferation of interest in Alternative Fund Financings such as fund-of-hedge-fund financings, management fee lines and facilities based on net asset value ("NAV") of a Fund's underlying assets with our representing Lenders and Funds in approximately $5 billion of transactions closed during 2015. We believe that Alternative Fund Financings will be a key driver of growth in the Fund Finance market in 2016 and beyond.

Trends and Developments

MONITORING AND TECHNICAL DEFAULTS

We are aware of a handful of technical defaults over the course of 2015, arising primarily out of reporting failures in respect of borrowing base calculations and components thereof (including failures to timely report the issuance of Capital Calls). While none of these defaults resulted in losses, some resulted in temporary borrowing base deficiencies requiring cure through prepayments. Facility covenants providing for monitoring of collateral (including prompt delivery of Capital Call notices, notices of transfers, Investor downgrades and similar requirements) could have properly identified such issues. As a result we may, and probably should, see renewed focus by Lenders on Capital Call monitoring procedures and borrower reporting.

NAV AND SECONDARY FUND FACILITIES

The private equity secondary market continues to grow as Investors review their portfolio allocations and seek to tailor their investments, either to diversify their exposure to particular asset classes or to free up capital for investment in newer Funds. Additionally, various financial institutions have sought to respond to regulatory capital pressures through the sale or adjustment of investment portfolios, which has led to a robust secondary market in the recent past.[5]

As a result, we have seen continued interest from both Investors and lenders in finding ways to provide either for financing of the acquisition of such assets on the secondary market or financing of Investors' current portfolios. In a number of cases, the desire for leverage has also been undertaken in order to provide for capital relief. These financings are generally NAV financings, as the borrowing base is comprised of the reported NAV of such private equity investment portfolios as may be adjusted for certain factors. Such financings tend to be bespoke in nature and based upon the particular basket of investments the borrower seeks to finance, requiring significant due diligence by the lending institution and the incorporation of concentration and other limitations in respect of the assets being financed. We believe this type of Facility will continue to grow in popularity as the secondary market remains strong and those acquiring or holding such investment portfolios desire leverage to enhance returns or obtain capital relief.

HEDGING MECHANICS

The inclusion of hedging and swap collateralization mechanics ("Hedging Mechanics") in Facilities was a significant trend in 2015. Hedging Mechanics offer a means for borrowers to secure hedging and swap

obligations under existing Facilities, rather than posting cash or other collateral. Typical Hedging Mechanics allow borrowers to request that hedging or swap agreements entered into with Lenders ("Hedging Agreements") be allocated a portion of the borrowing base (a "Trade Allocation") for purposes of collateralizing such Hedging Agreements. The borrower's obligations under an applicable Hedging Agreement are then deemed a part of the borrower's obligations under a Facility, reducing the borrowing base and the borrower's availability by the amount of the Trade Allocation. In the event the termination value of an applicable Hedging Agreement moves against the borrower, the borrower may be permitted to request that an additional Trade Allocation be made for such Hedging Agreement.

A number of other Hedging Mechanic components may require consideration on both a business and a legal level. For example, while Hedging Agreements secured by a Trade Allocation are typically pari passu with the Facility obligations (in each case up to the full amount of the Trade Allocation), Lenders will need to determine where amounts owing pursuant to obligations exceeding a Trade Allocation will fall in the payment waterfall. Additionally, Lenders and borrowers should also consider the impact that existing Trade Allocations should have on a Lender's ability to assign its interest under the Facility. From a legal perspective, counsel must consider the impact of certain regulatory requirements applicable to Hedging Agreements (e.g., the Commodity Exchange Act). The foregoing provides only a brief overview of some of the key components of Hedging Mechanics, and other aspects should be considered on a deal-by-deal basis. Given the increase in the popularity of Hedging Mechanics in Facilities, we expect to see continued development and innovation in this area during the 2016 year.

BAIL-IN PROVISIONS

In 2015, the European Union adopted the EU Bank Recovery and Resolution Directive ("BRRD") with the aim to curtail future taxpayer-funded bail-outs of banks. The BRRD provides that, among other things, unsecured liabilities of a failing EU bank or other covered market participants governed by certain EU member states (a "Covered Institution") may be written down or canceled in order to recapitalize the Covered Institution. According to the Loan Market Association ("LMA"),[6] the powers to write down and cancel liabilities extend to commitments the Covered Institution has to fund loans under a credit facility and could result in the cancellation of a Covered Institution's ongoing commitment in a Facility and excuse from making its pro rata share of a loan).[7] The BRRD also provides that any contract that a Covered Institution enters into, including those that are governed by the law of non-European jurisdictions (such as New York law), must include a provision providing notice of the bail-in requirements and an acknowledgement by the other contract participants that the Covered Institution's obligations can be written down or cancelled via the BRRD (the "Contractual Recognition Provision"). These new rules take effect as early as January 1, 2016 for some European jurisdictions; and the LMA has further taken the position that transactions pre-dating such date should add the Contractual Recognition Provision if (a) a Covered Institution joins the facility (including as an increasing or assignee Lender), (b) the document is materially amended, or (c) new liabilities arise under the facility document.[8] In response to these new requirements, the main US loan trading organization, the Loan Syndications and Trading Association ("LSTA") has adopted form bail-in provisions including a suggested Contractual Recognition Provision and amendments to the LSTA standard "Defaulting Lender" provisions to pick up the possibility of the application of

such write-down and cancellation powers. While these provisions are not technically needed unless a Covered Institution is a party to the Facility, in an effort to freely and quickly syndicate (both before and after a default), we have seen Lenders request these provisions in deals going forward and believe they will become standard in all syndicated credit facilities in 2016.

MANAGEMENT FEES AND OVERCALLS

Last year we saw the proliferation of provisions in Fund partnership agreements that prohibited making overcalls[9] to pay management fees. From an Investor's perspective, the rationale of not paying another Investor's management fee seems reasonable. However, this creates issues for Facility Lenders as the use of proceeds section of most Facilities permits borrowings to pay management fees. By creating such an overcall limitation, if the Fund uses the Facility to front management fees, a Lender could theoretically face a situation where any Capital Contribution default (including a default made by Investors not included in the borrowing base) would result in a dollar-for-dollar loss. Lenders have largely responded to the rise of this provision by either prohibiting the use of Facility proceeds to front management fees or creating other limits in respect of such borrowings to limit exposure to such risks such as periodic cleandown or other requirements.

CONFIDENTIAL INVESTORS

In 2015, we saw more Funds agree to confidentiality provisions with Investors that prevented them from disclosing the identity of such Investor to Lender. The presence of a confidential Investor creates a number of issues for a Facility, even if such Investor is not included in the borrowing base. Lenders may face challenges with respect to confidential Investors given the often-required "know your customer" and "anti-money laundering" checks, particularly where such Investors make up a significant portion of a borrower's commitments. However, such issues relate not only to Investor due diligence, but also Capital Call mechanics. In particular, the need to make pro rata Capital Calls on all Investors as required under the Fund partnership agreement would not be possible if such Investor's identity was unknown. This would pose issues in respect of an exercise of remedies by a Lender. While Lenders vary on the solutions they may find acceptable with respect to Investor due diligence issues, there are a number of methods that are being used to address the issue of making pro rata Capital Calls including the insertion of various provisions in side letters permitting such a call or the potential structuring of such Investor's commitments through a feeder fund so that a call upon the actual Investors of the Fund would only require a call upon the feeder fund through which such confidential Investors invest, in order to satisfy the pro rata Capital Call requirement.

SOVEREIGN WEALTH FUNDS AND THE ENERGY SECTOR

It is estimated that sovereign wealth funds ("SWFs")[10] currently hold investments exceeding $7 trillion (more than all of the world's hedge funds and private equity funds combined) and have significant uncalled commitments to private equity funds.[11] Most SWFs are energy dependent (the Institute of International Finance suggests that almost 60% of their assets are within the energy sector), and thus, the recent market volatility and drop in oil prices has strained their liquidity. In 2015, many SWFs liquidated assets to counteract the poor portfolio performance. From a subscription finance perspective, SWFs have traditionally been difficult to underwrite as very few publicly disclose financials or issue any annual report. With that said, in the last few years we have seen Lenders become increasingly comfortable lending against SWFs

at reduced advance rates or subject to certain concentration limits. While this approach logically makes sense given the historical performance of the subscription facility space, in light of the energy crisis, we suspect Lenders will take a harder look at advancing against SWFs in 2016.

As the commodities market values continue to slide, we have also seen a number of market participants seek additional collateral to secure new and existing asset-level facilities in the energy sector, including traditional Facility collateral. While such efforts have differed in their scope and structure, including whether such collateral was provided on a secured or unsecured basis, this trend may continue to the extent commodities markets remain volatile.

Conclusion

As noted above, 2015 was a year of steady growth in the Facility market accented by both penetration into new Funds as well as product diversification of both Facilities and Alternative Fund Financings. We are cautiously optimistic that such trends will continue in the near future through 2016, and while the recent volatility in the greater financial markets provides a number of uncertainties, especially in the energy sector and with respect to Investors who are focused on such returns, we believe that such uncertainties also provide opportunities for savvy Investors and Lenders in providing necessary financing.

Endnotes

1 Ann Richardson Knox is a partner in the Banking & Finance practice at Mayer Brown and oversees the Fund Finance team in the New York office. Kiel Bowen is a partner in Mayer Brown's Banking & Finance practice, where his practice centers on fund finance.

2 Prequin Quarterly Update Private Equity Q3, 2015, p. 6.

3 Prequin at p. 6.

4 Prequin at p. 8.

5 Prequin. Private Equity Spotlight November 2015, p. 3.

6 The LMA is the leading industry organization for loan trading in Europe.

7 In addition to writing down or canceling lender commitments, other liabilities of a Covered Institution can be compromised by the BRRD, including (a) indemnities typically given by the Covered Institution to the administrative agent; (b) requirements of the Covered Institution to share or turn over recoveries made from the borrower; (c) confidentiality duties; (d) requirement of the Covered Institution to obtain borrower or administrative agent consent prior to transferring its interest; (e) restrictions on a creditor's actions typically found in intercreditor documentation; (f) administrative obligations, such as notifications of tax status or requirements to make other notifications or to supply or forward information; and (g) potential noncontractual liability under loan market documentation such as potential claims in negligence or misrepresentation. See The LMA Recommended Form of Bail-in Clause and Users Guide, Dec. 22, 2015, http://www.lma.eu.com/documents.aspx?c=170.

8 See Id.

9 "Overcalls" are capital calls on non-defaulting Investors to resolve a shortfall caused by an Investor that defaults on its obligation.

10 Sovereign wealth funds are special purpose investment funds sponsored by governments and/or sovereigns that typically hold, manage, or administer assets of their sponsor.

11 See Simon Clark, Mia Lamar & Bradley Hope, "The Trouble With Sovereign-Wealth Funds," Wall Street Journal, December 22, 2015.

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