Fundraising and Subscription Facility Growth

Ann Richardson Knox, Kiel A. Bowen and Kristin Rylko [1]

Fundraising in 2016 and view to 2017

In our last Market Update, published in the Fall of 2016, we predicted a positive fundraising trend for private equity funds through 2016 (each, a "Fund"). Despite the volatility and uncertainty seen in each of the US and UK political spheres, our optimism proved to be correct for the balance of 2016. Globally, Funds raised over $347 billion in investor (each, an "Investor") capital commitments ("Capital Commitments"), which surpassed 2015 when $329 billion of commitments were raised.[2] Flight to quality (or at least familiarity) continued in that larger sponsors continued to attract a more-concentrated share of commitments. Notably, the 10 largest Funds accounted for 26% of all fundraising and 12% fewer Funds closed in 2016 than in 2015, resulting in an average fund size of $471mm—an all-time high.[3]

As the low interest rate environment persists, the interest in Funds appears to be high, and it seems that such activity will continue into 2017. Returns for Funds in 2016 continue to average in the mid-teen range[4] for all asset classes—which makes such investments popular for institutional investors. In particular, public pension funds generally experienced lackluster returns in 2016 (a gross 1.7% on assets)[5] as did endowments (as described below). With options for higher returns limited, we believe that Investors seeking higher yields will continue the trend of increasing their exposure and allocations to private equity asset class.

Secondary Funds

A significant area of growth in the Fund Finance area continues to be the financing of Secondary Funds (Funds that primarily purchase private equity LP interests on the secondary market). These Secondary Funds provide liquidity and other benefits for both Investors and sponsors, especially at the end of a Fund's life cycle. Sponsors find the use of Secondary Funds attractive as it can allow them to restructure or recapitalize their Funds. Secondary Funds can also be attractive to Investors looking to realize investments at a price certain or rebalance or reallocate their asset class exposure and investment priorities.

In 2016, there was continued and significant demand for assets to be purchased by Secondary Funds, given large fundraises by such Funds closing last year.[6] The competition resulting from such demand has also resulted in higher than expected asset value.[7] One private equity secondary advisor, Greenhill, has estimated that pricing increased for such transactions as a result, with pricing at 89% of net asset value on average.[8] Notwithstanding the robust demand, secondary purchases were reportedly down in 2016 by about 10% (as measured by net asset value).[9]

The financing of Secondary Funds follows both fundraising in respect of traditional

Facilities as well as Alternative Financings focused on both the acquisition of a portfolio of investments and potentially dividend recapitalizations for the end stage of fund life. Given the significant amount of dry powder that remains, we are optimistic with respect to additional volume and performance for both acquisition activity and Alternative Financings in 2017.

Subscription Facility Growth

Although the Fund Finance market lacks league tables or an overall data reporting and tracking service, our experience is that, in 2016 and so far in 2017, the Subscription Facility market is continuing its steady upward trajectory as Funds seek to take advantage of the numerous benefits Subscription Facilities provide.[10] Following this trend, Mayer Brown saw an increase in both the number of fund finance transactions and the aggregate new-money lender commitments in 2016, with new-money commitments across the Firm's Fund Finance platform exceeding $36 billion – a new record for the Firm. Moreover, diversification with respect to such financings continue, in both product offerings (such as hybrid, umbrella and unsecured or "second lien" facilities) as well as geographic scope. We have also seen that the Subscription Facility market is rapidly gaining traction outside of the US and the UK with Asian, Canadian and Latin American lenders heavily investing in strengthening their own Fund Finance platforms.

Additionally, Alternative Fund Financings, such as fund of hedge fund financings, management fee lines and facilities based on the net asset value of a Fund's underlying assets, have garnered more interest, with Mayer Brown representing Lenders and Funds in approximately $8 billion of such transactions that closed in 2016.

These Alternative Fund Financings have been a driver of growth in the Fund Finance market and are emerging as a permanent fixture of the market with such additional opportunities for leverage being increasingly appealing to general partners. One recent poll of general partners in Funds found that Alternative Financings of interest include general partner facilities, hybrid facilities and asset recourse facilities with 45%, 29% and 26% respectively, of general partners polled saying they would consider using them in the future.[11]

Trends and Developments

MONITORING AND TECHNICAL DEFAULTS

We are not aware of any technical defaults over the course of 2016, which seems to follow more rigorous monitoring of collateral by lending institutions (including prompt delivery of capital call notices, notices of transfers, Investor downgrades and similar requirements). As reported in our prior issue, a number of lenders have provided their customers with monitoring guidelines or templates to assist with their back-office processes, which have likely contributed to this result.

COMPLEXITY OF FUND STRUCTURES

We have seen Funds be more willing to adjust their Fund structures to admit Investors with specific needs, including those related to tax, jurisdictional and similar concerns. This has resulted in a proliferation of parallel funds, funds-of-one, sidecar vehicles, and rather complex Fund structures over the last year. For example, while so-called "cascading pledge" structures have been somewhat common for years in Subscription Financings, we are now seeing structures where capital contributions must "cascade" through five or six layers of fund entities before hitting the borrower's collateral account. Lenders have adjusted accordingly and are actively developing solutions to streamline documentation and

overcome a multitude of new obstacles presented by these structures.

PENSION FUND UPDATE

Much has been made with respect to the funded status of public pensions, due to recent reports regarding investment losses and underfunding of various plans. In particular, recent reports relating to both the State of Connecticut and the Dallas Police and Fire Pension Fund have highlighted funding level declines. In the case of Dallas Police and Fire, this decline has occurred due to mounting real estate and other investment losses over the past few years, leaving the fund with only 45% of the assets necessary to meet future benefits, requiring substantial additional contributions to be requested from the city of Dallas[12] and additional withdrawals as retirees opted to accelerate retirement. With respect to the Connecticut State Employee Retirement System, recent valuations coupled with state budget proposals would provide that it has only enough assets to cover 35% of its long-term liabilities,[13] and new proposals for taxation have been raised to close state budget shortfalls associated with payment of pension costs.[14]

However, for the most part, good news prevailed in 2016, which marked the third year where the average funded status of public pensions made gains, with the average status of public pension funds being 76.2% at the end of 2016.[15] Additionally, such gains were made while 40% of the funds lowered their assumed rate of return and many reduced their investment return assumptions[16] to be more realistic in light of the overall investment environment. Regardless, in a typical Subscription Facility, public pensions are only included in the borrowing base to the extent that they have an investment grade rating and/or 90%+ funding status, so a significant drop in a pension's funding status versus its liabilities would likely cause a mandatory prepayment of a Subscription Facility (to the extent such an investor were to be necessary to support outstanding borrowings).

Additionally, continued lender attention has been seen with respect to the issues of pay-to-play and other common side letter provisions which often have withdrawal or other consequences for Investors in Funds, and ultimately with respect to Facilities as well. In particular, federal prosecutors have recently targeted a former pension executive of the New York Common Retirement Fund in a probe of possible misconduct.[17] The allegations stem from possible bribery including trips and other possible compensation by contacts at an outside brokerage providing services to the pension fund. While such allegations remain unproven, they continue to show the importance of obtaining assurances to the extent possible in side letters containing cease funding or other requirements, in order to require funding by a pension fund to a lender who has relied on commitments.

ENDOWMENT UPDATES

Another traditional investor in Funds, endowments, struggled in 2016. The largest US endowments, in particular, have seen below-average and in some cases negative investment results in 2016, with the worst average annual return (-2.6%) since the financial crisis.[18] Most of these returns have followed the capital markets and, therefore, reflect asset allocations for such endowments that were more heavily weighted on exposure to such markets rather than private equity.[19]

In fact, disappointing overall returns have caused many endowments to shift strategy. In a public move, the largest US endowment, Harvard University, with $34.5 billion of assets under management, has recently announced that it is revisiting its traditional approach of relying on a large internal team.[20] Instead, it

seeks to eliminate a large number of its in-house investment staff, and the remaining investment staff would become more "generalist" covering multiple aspects of the portfolio rather than specialists on a particular asset class or strategy. [21]

We think that such shifts in strategy may also lead to growth of endowment interest in Funds managed by outside managers and perhaps increase allocations by endowments in private equity in 2017.

Hague Convention and Impact on Alternative Financings

One development of particular note for Alternative Financings is the upcoming effectiveness of the *Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary*, commonly known as the "HSC," which was promulgated by the Hague Convention on International Private Law. This conflicts of laws regime is important in respect of multi-jurisdictional transactions and applies to securities held through an "intermediary" and generally relates to perfection and priority of a security interest in a security entitlement of securities accounts.

Given securities accounts can often serve as the primary collateral account for Financings, and in respect of Alternative Financings such as hedge fund of fund financings, the primary collateral is a securities entitlement with respect to a hedge fund of fund's accounts; the HCS and its applicability to indirect holdings systems can cause issues of concern for Lenders relating to perfection of security interests.[22] Such issues should be carefully navigated by Lenders using experienced counsel with respect to both the intersection of the HSC, the Uniform Commercial Code and Alternative Financings.

2017 Outlook

As noted above, 2017 continues the generally steady growth in the Subscription Facility market. We, like Investors that are currently in the market, remain optimistic that such trends will continue through the remainder of 2017 and that the recent market changes in the United States, United Kingdom and Europe will continue to provide opportunities for Investors as well as Funds seeking financing and institutions providing such 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. Kristin Rylko is a partner in Mayer Brown's Banking & Finance practice.

2 *Preqin Private Equity & Venture Capital Spotlight*, January 2017, p.11.

3 *Id.*

4 *Preqin* at p.10.

5 *Public Pension Funds Lower Fees, Improve Funding Ratios in 2016,* Meghan Kilroy, Pensions and Investments Online, January 17, 2017.

6 *Greenhill Secondary Market Trends & Outlook,* January 2017.

7 *Id.*

8 *Id.*

9 *Id.*

10 For more information on the benefits of Subscription Facilities, please see our article in this 2017 Spring edition titled: *The Advantages of Subscription Credit Facilities.*

[11] *Investec Fund Finance GP Trends 2016.*

[12] *Dallas Mayor Sues to Stop Police, Fire Pension Exits*, Heather Gillers, November 21, 2016, Wall Street Journal.

[13] *Future Payment Scheme Takes a Heavy Present Toll on State Pension Fund*, Keith M. Phaneuf, January 5, 2017, Connecticut Mirror.

[14] *Connecticut Governor Seeks to Shift Teacher Pension Costs to Towns, Cities,* Joseph De Avila, February 3, 2017, Wall Street Journal.

[15] *Kilroy* at p.1.

[16] *Kilroy* at p.1.

[17] *New York Pension Scandal Prompts Firing of Second Employee*, Justin Baer, February 1, 2017, Wall Street Journal.

[18] *Large Endowments Struggled with Returns in Fiscal 2016*, Christine Williamson, February 6, 2017, Pension and Investments Online.

[19] *Id.*

[20] *Harvard Decides to go Different Way on Investing,* James Comtois, February 6, 2017, Pension and Investments Online.

[21] *Id.*

[22] For more information on this topic and assistance navigating these changes, please see the recent article by Mayer Brown partner Barbara M. Goodstein, *Hague Securities Convention Comes Into Effect*, New York Law Journal, February 1, 2017. http://www.newyorklawjournal.com/id=1202778150394/Hague-Securities-Convention-Comes-Into-Effect?mcode=1202614952687&curindex=0&curpage=1

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