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Article

Fund Finance Market Review

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

The strong credit performance and significant growth of subscription credit facilities (each, a "Subscription Facility") and the broader Fund Finance market continued into the first half of 2017. In fact, Mayer Brown remains unaware of any Subscription Facility lender (each, a "Lender") experiencing a loss in connection with any Subscription Facility. Likewise, while we are aware of a handful of exclusion events occurring in 2017, these events were isolated and were largely based on factual issues related to the specific investor (each, an "Investor") and not the private equity fund (each, a "Fund"). Below we set forth our views on the state of the Fund Finance market as well as current trends likely to be relevant as 2017 comes to a close.

Fundraising in 2017

Investor capital commitments ("Capital Commitments") raised in Q2 exceeded $100 billion, continuing what Preqin has described as an "unprecedented sustained period of strong fundraising."[2] In fact, Q2 saw traditional buyout Funds have their best Q2 in five years, raising approximately $88 billion – accounting for 73 percent of total capital raised in the quarter.[3] Notably, the five largest Funds raised in Q2 were buyout funds, and they accounted for 71 percent of all buyout capital raised and 52 percent of total Q2 fundraising.[4]

While buyout Funds comprised the vast majority of capital raised, the trend of larger sponsors attracting the lion's share of Capital Commitments was consistent across all Fund types, as evidenced by the fact that nearly 63 percent of Capital Commitments were committed to the ten largest Funds closed in Q2.[5] Likewise, the average Fund size grew over the first half of 2017 with $543 million as the average size in Q1 and $637 million in Q2.[6] As more Investors look to limit their investments to a smaller group of preferred sponsors, sponsors are also diversifying their product offerings. For example we have seen a number of sponsors leverage their existing Investor relationships by creating Funds focused on sectors in which they have not traditionally participated (i.e., buyout shops creating direct-lending Funds). Mayer Brown's fund formation team confirms this trend, indicating that a large portion of their work this year has been devoted to assisting sponsors in developing new platforms in the private credit and debt sectors.

Consistent with prior quarters, most of the capital raised in Q2 originated in North America.[7] Europe was again the second-largest fundraising market, and notably, the largest Fund that closed in Q2 was a €16 billion Europe-focused buyout Fund.[8] Asia continued its steady climb into private equity in Q2, including the closing of a $9 billion Asia-focused Fund.[9] As further explored below, many Investors have indicated increasing interest in Asia making that the second-most-targeted region for future investment after North America and supplanting Europe. This shift is evidenced by the fact that four out of the five largest Funds in the fundraising market are Asia focused, and three specifically target investments in China.[10] Capitalizing on this trend, Asia-focused Funds that are in their fundraising periods are seeking $94 billion more in Capital Commitments than Europe-focused Funds.[11]

Fund Finance Growth and Product Diversification

Although the Fund Finance market lacks league tables or centralized reporting, our experience and anecdotal reports from a variety of market participants strongly suggest that the Subscription Facility market continues it steady and persistent growth and, as of Q2, is more robust than ever. In fact, both the number and size of Subscription Facilities Mayer Brown has documented this year have outpaced last year. Based on anecdotal reports, again from a variety of market participants, most of those polled expect growth and performance of Fund Finance to continue into at least mid-2018.

We also continue to see diversification in Fund Finance product offerings (including hybrid, umbrella and unsecured or "second lien" facilities). In particular, "Alternative Fund Financings" such as fund of hedge fund financings, management fee lines, 1940 Act lines (i.e., credit facilities to Funds that are required to register under the Investment Company Act), and net asset value credit facilities have garnered more interest by Funds and Lenders alike. In the first half of 2017 alone, Mayer Brown had already documented more and larger "Alternative Fund Financings" (i.e., net asset value facilities, secondary facilities, hybrid facilities and second lien facilities) than all of last year. Our mid year update will be held in New York this year, focused on such types of Alternative Fund Financings. Please join us on September 13th for our Hybrid Facilities and Other Alternative Lending Products Seminar focused on Alternative Fund Financings.[12]

Trends and Developments

TECHNICAL DEFAULTS

As expected with growth, we have seen an uptick in technical defaults over the course of 2017. A handful of such technical defaults were caused by Funds making capital calls without notifying the Lender as required in the Subscription Facility documentation. We note that Subscription Facility covenants providing for monitoring of collateral (including prompt delivery of capital call notices, notices of transfers, Investor downgrades and similar requirements) have continued to tighten, and more Lenders are preparing monitoring guidelines in order to provide a document compliance roadmap for Funds. Additionally, a number of Lenders have refined their back office processes with the goal of detecting any compliance problems more quickly and getting ahead of any potential issues.

As more Funds enter into Subscription Facilities prior to their final Investor closings, market participants have seen an increased number of defaults resulting from Funds entering into side letters without prior Lender review and consent, contrary to the requirements of the Subscription Facility loan documentation. Working through these issues and unwinding the problematic side letter provisions (including provisions that had spread through the "most favored nation" clauses) prove to be difficult and costly for Funds. Such situations highlight the importance of Funds working with both the Lender and their counsel to confirm the reporting requirements and to devote adequate resources in connection with loan document compliance prior to entering into side letters.

EVOLVING EXCLUSION EVENTS

While the market has traditionally been cognizant of jurisdictional risks such as sovereign immunity concerns, the globalization of the product and investor base have also presented new concerns in light of cross-border economic policies such as - currency controls. It was widely discussed at the Asia-Pacific Symposium (discussed in further detail below) that in some instances, Chinese Investors have been prohibited from moving cash outside of the country, in light of currency controls recently implemented by the Chinese government. To mitigate the risk that this leads to their inability to fulfill their contractual obligation to fund a capital commitment, Lenders should consider whether their current exclusion events cover off such a risk, and if not, could consider add an exclusion events tailored to currency controls and similar legal impediments to funding.

ILPA RECOMMENDATIONS

Since our last market review, there has been much discussion in the press regarding the ways Funds and sponsors can utilize Subscription Facilities, and the disclosure provided to Investors regarding Fund performance in light of the use of leverage – specifically how using Subscription Facilities can distort a Fund's internal rate of return ("IRR"), one of the key financial metrics used in the Funds industry to judge overall performance.

The resulting discussion has been robust, with a number of interested parties expressing their views as to the use of such leverage. Perhaps most importantly, the Institutional Limited Partners Association ("ILPA"), which is the industry organization for institutional Investors in private equity, issued "Subscription Lines of Credit and Alignment of Interests – Considerations and Best Practices for Limited and General Partners" in June.[13]

The ILPA guidelines focused mostly on Funds properly disclosing the key terms and conditions of any Subscription Facility to Investors. To that end, ILPA included a sample due diligence questionnaire Investors might consider having a Fund answer prior to investing.[14] The guidelines also recommended that Funds also report IRR net of any Subscription Facility indebtedness and suggested that quarterly Investor reports include outstanding Subscription Facility usage, the amount of time that Subscription Facility draws are outstanding and fees and costs relating to Subscription Facilities. While these guidelines remain a work in progress and Fund Finance market participants are currently working with ILPA to refine them, we do think a standardized approach to disclosure would be a positive development for Funds, Investors and Lenders.

Industry Conferences

MAYER BROWN CHICAGO MID-YEAR REVIEW

We hope you can join us at September's Mayer Brown Mid-Year Review to be held in Chicago on September 20th.[15]

In last year's Mid-Year Review in Chicago one of the more interesting discussions revolved around a "race to the bottom" arising from Lenders and counsel new to the market, which often unknowingly take underwriting and loan documentation risks. One Lender cited an example where they were asked to join a syndicated deal for a top-tier fund where agent's counsel failed to flag unfavorable side letter provisions (including cease-funding rights) and the loan documentation did not contain numerous market-standard exclusion events. The topic garnered so much interest that we plan to address the topic again at our September review in Chicago.

FUND FINANCE ASSOCIATION ASIA-PACIFIC SYMPOSIUM

The 1st Asia-Pacific Fund Finance Symposium (the "Asia-Pacific Symposium") was held in Hong Kong in mid-June. The Symposium brought together over 350 bankers, lawyers, Lenders and Fund sponsors for the first time to discuss the Asian private equity market generally as well as the market for Subscription Facilities and Alternative Fund Finance products. A number of themes were raised during the Asia-Pacific Symposium and a brief summary is set forth below.

INCREASED APPETITE

One of the themes of the Asia-Pacific Symposium was the increased interest and appetite of Asia-sponsored Funds for Subscription Facilities. In particular, while the market in America and Europe is viewed as mature and a number of Asia-focused Funds with U.S. or European sponsors have Subscription Facilities, most Funds with Asian sponsors do not yet take advantage of such leverage at the Fund level. Additionally, many facilities with Asian sponsors tend to be fairly bespoke given the newness of the product in the market and the complexities regarding investor bases for such Funds

Preqin provided an interesting presentation at the Asia-Pacific Symposium which expanded on this theme, noting a strong start to fundraising in the Asian market, with 95 percent of Investors in private equity seeking to maintain or increase allocations to Asia and 86 percent wishing to invest equal or greater Capital Commitments in Asia in 2017 versus 2016.[16] Additionally, preliminary data show the IRRs for Asia-focused Funds exceeding those of European Funds for vintage years since 2010.[17] As the market for Subscription Facilities generally follows fundraising, it is not a leap to suggest that Asia is a burgeoning market.

It was also noted at the Asia-Pacific Symposium that the recent press relating to Subscription Facilities has not led to a negative impact on lending activity, but rather led to discussions and interest from sponsors and Investors in better understanding the product and perhaps using such leverage.

SEPARATE MARKETS

Another point that was emphasized by Preqin was the diversity of various markets within Asia. Asia-focused Funds continued to delve mainly in private equity buyout and infrastructure, with smaller concentrations of Capital Commitments being raised for venture capital, private debt, real estate and natural resources.[18] However, it was also noted that allocations among these areas varied widely depending upon country focus as the areas of focus for China-focused Funds varied from that of Australia-Asia Funds and Japanese markets.

INVESTOR MATTERS

The impact of special purpose Investor vehicles, which are often used by Asian Investors, was debated. Such vehicles, often used to make a single investment, can muddy Lenders' assessment that a credit link exists whereby parent entities with otherwise demonstrable creditworthiness are in fact backstopping the vehicle's obligations to Fund Capital Commitments. With respect to such Investors, the availability of financial information and Investor privacy were also raised as barriers to Lenders' ability to properly assess credit risk and create a diverse borrowing base. On the other hand, it was noted that the ability to assess creditworthiness of Investors in the Asian market may be a particular advantage for Asian banks that have established deep relationships with such Investors and can assess such risks more readily.

Additionally, the Asian Investor profile is changing as private wealth increases. The proliferation of high net worth Investors and family offices can be challenging to Lenders to the extent they make up a significant proportion of the borrowing base for a Subscription Facility. While this challenge is not a new one for Lenders, and is often mitigated by the use of concentration limits, this also seems to be increasingly impactful for Funds with Asian sponsors in particular (as opposed to Funds investing in Asia with U.S. or European managers, as the mix of Investors in such Funds tends to be different).

Another overarching theme was that larger economic forces may be brought to bear on Funds and Investors in the Asian market. The flight of capital from China in 2015 and 2016 drove foreign exchange reserves down by 25 percent, and China responded by slowing capital outflows and tightening controls on moving cash out of China since late 2016.[19] Recent news reports indicate that such controls have already impacted some of China's most prolific overseas Investors in making overseas Investments.

Additionally, the segregation of separate feeder or parallel Funds for Investors who could be impacted could be a solution for Lenders with respect to Subscription Facilities, such that those Investors' Capital Commitments would not be financed by a Subscription Facility. Additionally, it was noted that Chinese banks' increased role in the market for Subscription Facilities could make them uniquely suited to finance such Investor risk, in that structures to permit payment in local currency in China might be arranged, to the extent such controls would otherwise prevent funding to a Lender outside of China to repay a Subscription Facility.

Conclusion

2017 continues the generally steady growth in the Fund Finance market. Large sponsors diversifying their platforms into debt funds and credit funds will likely give rise to an uptick in the number of fund financings during the near term. The germination taking place in Asia should eventually lead to significant cultivation over the long term. So long as market participants remain vigilant with respect to underwriting, diligence and structure we project that that overall health of the market for Subscription Facilities and Alternative Fund Financings will be well sustained for several years to come.

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 Quarterly Update Private Equity and Venture Capital*, Q2 2017, p.2.

3 *Preqin* at p.3.

4 *Preqin* at p.3.

5 *Preqin* at p.2.

6 Please note that the fundraising related to the Soft Bank Vision Fund, which is targeting a $100 billion close, and has raised $93 billion year to date, skews these averages.

7 *Preqin* at p.4.

8 *Preqin* at p.4.

9 *Preqin* at p.4.

10 *Preqin* at p.5.

11 *Preqin* at p.5.

12 Please register for this year's Mayer Brown Hybrid Facilities and Other Alternative Lending Products Seminar at https://connect.mayerbrown.com/133/630/compose-email/internal-invitation-event-170913-nyc-seminar-fundfin-hybrid.asp?sid=blankform

13 https://ilpa.org/wp-content/uploads/2017/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf.

14 For more proposed sample answers to these due diligence questions, see *Model Responses to ILPA's Subscription Credit Facility Due Diligence Questionnaire*.

15 Please register for this year's Mayer Brown Mid-Year Review at https://connect.mayerbrown.com/email_handler.aspx?sid=blankform&redirect=https%3a%2f%2fconnect.mayerbrown.com%2f56%2f316%2flanding-pages%2fblank-rsvp-business_draft.asp.

16 *Preqin Private Capital in Asia Pacific, Insight into this Diverse Market,* Ling Yan Teo, Manager, Asian Fund Managers,

http://www.fundfinanceassociation.com/wp-content/uploads/2017/06/Asia-Pacific-Preqin-Slides.pdf.

[17] *Preqin Private Capital* at p.3.

[18] *Preqin Private Capital* at p.5.

[19] *China Gives up its Global Role for a Stronger Yuan,* Nathaniel Taplin, Wall Street Journal, Aug. 7, 2017 https://www.wsj.com/articles/china-gives-up-global-role-for-a-stronger-yuan-1502106508.