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Article

Fund Finance Market Review

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Our outlook for the fund finance market for 2018 is positive, as we expect the market to build upon the successes experienced over the last calendar year. In 2017 strong credit performance, record-breaking fundraising and product expansion fueled significant market growth. In addition to a significant uptick in the number of traditional subscription credit facility (each, a "Subscription Facility") closings, Mayer Brown closed a record number of alternative fund financings. As expected with any mature market, however, we did see episodic defaults and borrowing base exclusion events in 2017. Such defaults were primarily technical in nature, and the exclusion events were isolated in respect of individual investors (each, an "Investor") and did not indicate broader systemic issues for the Subscription Facility market or the private equity fund (each, a "Fund") asset class. Below, we expand on our views on the state of the fund finance market as well as current trends likely to be relevant in 2018.

2017 Fundraising and 2018 Outlook

Fund fundraising experienced a banner year in 2017. Investor capital commitments ("Capital Commitments") raised in 2017 exceeded $453 billion, representing the largest amount of capital raised in any year, according to Preqin.[2] This continues the upward trend experienced in 2016 and is only the second year ever in which total fundraising has exceeded $400 billion.[3]

As we predicted in our last Market Review, Investors continued to flock to a smaller group of preferred sponsors in a flight to perceived quality, with fewer funds being closed but with a larger total Fund size.[4] This trend was evidenced by numerous Fund asset classes raising their largest single funds ever—including buyout, infrastructure and private debt Funds.[5] So too, consistent with prior years, we witnessed significant growth in the number of Facilities in favor of single managed accounts (also known as funds-of-one)—a trend we think will continue in 2018.

The rise of private credit and direct lending Funds (both in number and size) has been notable as they continue to fill the gap in the lending market left by traditional banks scaling back their lending operations in light of regulations imposed as a result of the last recession.[6] Notwithstanding recent indications that regulators may ease pressure on traditional banking institutions, many market participants expect that the leverage loan markets will continue to be popular with private credit arms of less-regulated Funds. Thus, the trend of sponsors forming credit funds has continued its upward trajectory through 2017 with many sponsors recruiting traditional bankers to Funds in order to increase their capacity and fine-tune their expertise. This optimism in the private credit and direct lending asset classes was evidenced by 136 vehicles closed and over $107 billion being raised for funds in this sector last year.[7] While we expect 2018 to continue this trend, many market participants expect fundraising

to ease as a result of the fact that dry powder is also at a record high as a result of successful fundraising.[8]

Consistent with prior years, most of the capital raised in 2017 originated in North America with North American-focused private equity Funds raising $272 billion and Europe-focused funds raising $108 billion.[9] Additionally, Preqin's data indicates that Investors continue to have a positive outlook on the industry, with 63 percent of Investors having a positive perception of private equity and a majority seeking to increase their allocation in the longer term.[10]

Product Diversification

Consistent with this data, our experience and anecdotal reports from a variety of market participants strongly suggest that the Subscription Facility market continues steady growth and is as robust as ever. 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. We have also seen more open-ended Funds interested in Subscription Facilities. Accordingly, many lenders have customized their loan programs to capitalize on this need. For more information on these alternative financings, including structural considerations, please visit our webpage at www.mayerbrown.com/experience/Fund-Finance.

Trends and Developments

TAX REFORM

The recent Tax Cuts and Jobs Act passed into law by the United States will significantly impact Funds and their portfolios. In addition to the much-publicized drop in US corporate income tax rates, changes in the tax rates for "pass-through" entities and the ability to repatriate overseas earnings, the legislation altered the tax treatment with respect to "carried interest."

Carried interest refers to equity interests that the general partner or sponsors of a Fund may receive as compensation. By characterizing this compensation as equity, the general partner or sponsor will benefit from a lower long-term capital gains tax rate (as opposed to ordinary income or short-term capital gains) on such compensation. The deduction for "carried interest" has largely survived the tax reform with certain tweaks to how and when it is calculated. One of the most significant is that in order to obtain long-term capital gain treatment, the required asset holding period has been changed from at least one year to at least three years. Additionally, amounts that fail to meet the three-year test are not treated as ordinary income but rather are treated as short-term capital gain. In addition to the carried interest, other changes to the tax code also affect Funds and Facilities, which among others, include:

Deductibility of interest expense - The limitation of deductibility of interest expense on debt negatively impacts the private equity industry as Funds often rely upon leverage to finance transaction purchases and sales. Previously, there was no limit on the amount of interest that could be deducted. Favoring the use of leverage by Funds, a company can now only deduct interest expense equal to 30 percent of its EBITDA (earnings before interest taxes, depreciation and amortization) (and, after 2022, 30 percent of EBIT (earnings before

interest and taxes)). This will likely result in a higher cost of capital and may affect valuations for assets making them relatively more expensive.

Long term Capital Gains - As noted above, the changes now require Funds to own companies for three years before getting lower capital gains tax treatment, although real estate Funds are exempt from this requirement.

Excise Tax on University Endowments - Certain private colleges and universities will be subject to a 1.4-percent excise tax on their net investment income. Given that these endowments are frequent Investors in Funds, this will likely impact their strategic planning and the investable assets available for private equity allocations.

Others - Other changes that may have an impact include limitations on the usage of net operating losses and limiting UBTI loss offsets to income to require such offsets from the same unrelated business (and not other businesses as was previously permitted). Additionally, the taxation of gains and losses on partnership interests owned by foreign investors have also changed and may also negatively affect their tax position when they choose to dispose of such investments in private equity funds. The totality of the impact of the tax overhaul on Investors in Funds and Funds themselves remains to be seen, and an experienced tax advisor is necessary to determine the impact on any particular set of Investors and Funds.

FLEXIBLE BORROWING BASE APPROACHES AND BRIDGE FACILITIES

Traditionally, lenders in the United States have employed one of three standard borrowing base approaches for Facilities: (1) a borrowing base of only highly rated "included" investors with a high advance rate; (2) a low advance rate across all investors for a larger fund; or (3) a two-tier approach, which provides for both highly rated included investors with a high advance rate and a designated investor class, where the latter has a lower advance rate. However, in the case where a Subscription Facility is being looked at during the early stages of fundraising, lenders have not always had the flexibility to optimize the borrowing base approach to best fit a Fund's needs, and Funds have had to make a decision as to the best approach for their borrowing base, guided by an estimate of what their final investor pool will be. More lenders have started to respond to this issue by offering flexible borrowing base approaches. One approach consists of single bank bridge facilities until a final investor closing. This can help in that the Fund can determine what borrowing base will ultimately work best. Other lenders have included an option in the loan documentation that permits the Fund to switch to an alternative borrowing base approach within a short window of time after the final investor closing. Another approach being used with more regularity is to increase advance rates once investors have funded a predetermined percentage of committed capital. Likewise, as we have noted in prior Market Reviews and above, more lenders are offering "hybrid" credit facilities—where the borrowing base is calculated off both the uncalled capital commitments and the assets of the Fund.

INCREASED SCRUTINY

Given the significant growth of the Subscription Facility market, many lenders have reported that they are being audited by internal risk officers and bank regulators with greater frequency. Among other things, these audits have focused on how lenders calculate and monitor the overall credit exposure to each Investor, the lender's portfolio management systems and whether the lender has an action plan for both market-wide disruptions and credit-specific defaults. In response, we are working with many lenders to

adopt a standardized approach to track investor-by-investor and fund-by-fund exposure, restructuring their compliance and portfolio management programs, and adopting a written policy on how best to address default and foreclosure scenarios (for more information on possible foreclosure remedies, see [Default Remedies under a Subscription Credit Facilities: A Guide to the Foreclosure Process](#).

LENDER RESPONSES TO TECHNICAL DEFAULTS

In response to the increased focus by regulators and auditors and in the rise in the number of technical defaults, lenders are starting to require more robust collateral monitoring provisions. For example, more lenders now require that the collateral accounts be held at the agent bank rather than a third-party depository. Generally, Funds establish their treasury management relationships ahead of entering into a Subscription Facility, resulting in lenders often agreeing to use the existing accounts held at a third-party institution as the collateral accounts. In such event, such accounts are subject to a lien permitting the agent to take control of the account during an event of default, including if a mandatory prepayment is not made. However, more lenders are now implementing the approach used in the broader loan markets, which provides a collateral sweep mechanic during the pendency of a mandatory prepayment from a collateral account, rather than simply using the control over the account as a default remedy. Given this approach is operationally difficult with an account that is not at the agent bank (due to the need to block and unblock an account multiple times), another route to achieving this result is requiring the accounts be held at the agent bank. This permits intermittent account blocks and sweeps to be achieved in a simpler and less costly manner.

ADDITIONAL EXCLUSION EVENTS

As reported in our last Market Review, market participants have been closely monitoring the impact of currency controls imposed on Investors by foreign regulators. As more Investors have defaulted under their capital commitment in light of these currency controls over the last quarter, many lenders are now contemplating adding a specific "exclusion event" to Subscription Facility loan documentation that would remove Investors subject to these restrictions from a Subscription Facility's borrowing base. We expect that this exclusion event and other exclusion events aimed at even larger geopolitical issues may develop over the next year to become common.

Industry Conferences

FUND FINANCE ASSOCIATION GLOBAL FUND FINANCE SYMPOSIUM IN NEW YORK

Once again, Mayer Brown will be a platinum sponsor at the Global Fund Finance Symposium. Held in New York City on March 21, 2018, this year marks the symposium's eighth anniversary. As the founding institution of the symposium, Mayer Brown is proud to support the Fund Finance Association and the significant growth of the conference—as well as the addition of the European Fund Finance and Asia-Pacific Fund Finance symposiums. Building on the prior success, we expect this year's symposium to bring together leading market participants to share their insights on the trends affecting the fund finance industry.

FUND FINANCE ASSOCIATION WOMEN'S EVENT

Mayer Brown is proud to host the next Women in Fund Finance event on March 20, 2018, in our New York office. The Women in Fund Finance Speed Networking Event is an opportunity to meet with some of the leading names in alternative investment for an evening of networking and conversation. To register for

this event or to learn more, please go to www.womeninfundfinance.com/events.

MAYER BROWN MID-YEAR MARKET REVIEWS

Mayer Brown will also host Mid-Year Market Reviews in New York City and Chicago this autumn. These Mid-Year Market Reviews traditionally address market developments in fund finance and focus on providing real-world advice on how such developments should be addressed by market participants. For more information on these events or to register, please email Dena Kotsores at dkotsores@mayerbrown.com.

Conclusion

After 2017 ended with steady growth in the fund finance market, and given the fund closings achieved through year end, we expect an uptick in the number of fund financings to occur in the near term—especially in favor of private credit funds and single managed accounts. While the impact on the recent tax reform remains to be seen, we envisage that overall health of the market for Subscription Facilities and other Fund Financings will continue through 2018.

Endnotes

[1] Kiel Bowen is a partner in Mayer Brown's Banking & Finance practice, where his practice centers on fund finance. Kiel Bowen is a partner in Mayer Brown's Banking & Finance practice, where his practice centers on fund finance.

[2] *Preqin Global Private Equity & Venture Capital Spotlight*, January 2018, p. 10.

[3] *Id.*

[4] *Preqin Q4 2017 Fundraising Update*, December 2017.

[5] *Id.*

[6] For more information on this trend, see m.mayerbrown.com/Files/Publication/0197402c-15f7-449e-87b7-f43e617b316f/Presentation/PublicationAttachment/1f741412-5427-4917-82f4-f7518ee59814/Leveraged-Loan-Regulatory-Spring-2016%20.pdf.

[7] Id.

[8] Fund Manager Says Red-Hot Private Debt Market May Cool Off, *Institutional Investor Online*, January 21, 2018, by Alicia McElhaney.

[9] *Preqin*, p. 10.

[10] *Id.*, p. 10

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