Fund Finance Market Review

Ann Richardson Knox and Kiel A. Bowen

Looking forward in 2019, we are optimistic that the market for fund financing remains robust. In 2018, Mayer Brown noted a significant uptick in the number of traditional subscription credit facility (each, a "Subscription Facility") closings and a record number of alternative fund financings such as net asset value facilities, hybrid facilities, secondaries transactions, management fee facilities and partner loans (together with Subscription Facilities, "Facilities"). Counterintuitively, this occurred even though fundraising in 2018 did not exceed the prior year's numbers and in light of the recently publicized events relating to the insolvency proceedings of a Cayman Island domiciled fund that was sponsored by a Middle Eastern sponsor. In general, given investor ("Investor") expectations for continued investment and the reaction of both private equity and other investment funds (each, a "Fund") and lenders, we continue our optimism for 2019 with respect to both the Facility market and that of the Fund asset class. Below, we expand our views on the state of the fund finance market as well as current trends likely to be relevant in 2019.

2018 Fundraising and Effect on Fund Finance Market

While final reports on fundraising for private capital in 2018 are still coming in, it appears that fundraising in 2018 did not match the banner year experienced by the market in 2017. As compared to 2017, a year in which the largest amount of investor capital commitments ("Capital Commitments") were raised in recent memory (exceeding more than $925 billion) preliminary data suggests that just over $757 billion of Capital Commitments were raised in 2018.[1] This drop suggests a slowing of Fund closings from 2017, but likely better than 2016 fundraising numbers and, if so, would make 2018 the second best year ever for new capital commitments.

The trend of Investors flocking to a smaller group of preferred sponsors continues with familiar US and European sponsors on the list of the largest Funds closing in 2018.[2] Moreover, increased interest in Asia was a clear trend throughout 2018, and, according to Preqin, for the first time Asia saw more funds closed than Europe.[3] We expect this trend to continue into 2019 given Investor appetite seems to be focused on Asia more than any other emerging market (including Central and Eastern Europe).[4]

Because both the appetite and the need for Facilities often follows fundraising activity, it would be natural to think that fund financing activity would have dropped in 2018 given the most recently released Preqin data. However, anecdotal evidence and Mayer Brown's own experience in this area suggest that the Facility market as a whole was as robust as ever in 2018. We think a number of factors may account for this including the following:

The often-cited Preqin data on fundraising activity used for year over year comparisons captures only Funds that had a final close in a given year. So, while the data provides for Funds that had a final close in 2018, Subscription Facilities are often put into place in connection with or shortly after an initial close but prior to a final close. Therefore, we would expect that in addition to Funds that had a final close in 2018, the market is seeing robust activity from Funds that are currently still fundraising. Other information supplied by Preqin supports this argument as it provides for a substantial uptick in the number of Funds in the market as of January 2019 (5,147) compared to January 2018 (3,484). There is a much larger amount of capital being raised compared to the comparative periods as well ($1.634B vs. $1.263B).[5]

Penetration of the market with respect to Facilities has also grown. Long gone are the days where only real estate and buyout Funds used Facilities. Recently we have witnessed an uptick in debt and private credit Funds wanting Facilities, as well as infrastructure Funds, that have become larger consumers of Facilities than in years past.

Finally, 2018 continued to prove that fund finance is much larger than just Subscription Facilities. The continued diversification in fund finance product offerings tilts towards Funds that are further along in their life cycle, including net asset value, hybrid and unsecured or "second lien" facilities. Unlike the typical Subscription Facility, such Facilities would have a lower correlation to fundraising in the same year because such Facilities are premised upon the investments and investment activity of a Fund. As a result, one would expect that these types of Facilities would depend upon Funds having their final closing in or prior to the banner years of fundraising in 2016 and 2017 (rather than 2018). We believe that these factors explain, at least in part, the solid 2018 for Facilities.

Onward to 2019

Based on the number of term sheets and proposed transactions coming our way, 2019 is off to a strong start, with robust activity both in the Subscription Facility market and the market for other Fund Financings. As noted above, while fundraising does not perfectly correlate to the volume of new Fund Financings, it does appear that with a 40-percent increase to Funds in the market fundraising in January 2019 versus the prior year, we expect 2019 to see a similar number of Fund Financing originations.

With respect to the Investor perspective, while sponsor performance track record is key to Investors, we also note that some changes in sentiment among Investors may mean that the flight to a smaller number of larger sponsors of Funds that has been recently experienced may be diminishing. A majority of Investors in private equity seems to be interested in looking to increase its fund manager relationships rather than maintain or reduce them.[6] Moreover, the vast majority of Investors in private debt, real estate and infrastructure are seeking to either maintain or increase the number of sponsors they work with.[7]

Recent Trends and Developments

SPONSOR-LED RESTRUCTURINGS AND SPONSOR SECONDARIES

Another development in the market is that general partners are increasingly restructuring old Funds to move assets into new vehicles. This generally will occur where a general partner seeks to liquidate investments in an appropriate manner and for the right price. Multiple techniques have been implemented to achieve such results, including Fund recapitalizations permitting a cash-out or a roll into a new Fund with new terms. Additionally "strip" transactions that involve

Funds or third-party investors have also developed.

In general, it would appear that while Investors involved with such restructurings have generally felt that adequate opportunities had been given to them to decide whether to cash out or roll into the new entity, they were not necessarily of the view that costs were fairly divided between the general partner and the Fund.[8] This is despite the fact that many such transactions will seek a fairness opinion as to the consideration paid by new investors.

We think this will continue to be a trend as Funds age and investments for one reason or another are not yet realized. We also note that Mayer Brown has seen an increasing number of Funds specializing at providing financing either to permit continued time to realize investments, to assist with custom solutions relating to a general partner restructuring or to offer additional management support to enhance asset values.

Another interesting topic of discussion we've heard is whether Funds may look to the secondaries market in order to sell interests in management companies. Whether this materializes in 2019 remains to be seen.

HURDLE BORROWING BASES

In response to Funds requesting greater borrowing base capacity in the later stages of their lifecycle, many Subscription Facility lenders are now more regularly using the "hurdle" concept. Traditionally, hurdles were used sparingly to include Investors that would have otherwise been excluded from the borrowing base due to cease funding rights, sovereign immunity or other issues. Under a hurdle approach, these previously excluded Investors would be eligible for borrowing base credit after certain financial hurdles were satisfied (e.g., a percentage of capital commitments funded and a minimum net asset value of the Fund). Lenders grew comfortable with this approach based on the theory that the Investor's "skin in the game" would outweigh any negative economic incentive to exercise their cease funding right or immunity. Until recently, the concept was usually reserved for limited circumstances where an excluded Investor had a large commitment to the Fund and such Investor's exclusion would severely impact the usefulness of the Subscription Facility. Recently, however, hurdle conditions have become part of many borrowing bases and are a key feature of the overall borrowing base structure. In addition to including previously excluded Investors, hurdle conditions are now used to also increase concentration limits and advance rates applicable to a subset of Investors already included in the borrowing base. We expect this trend to continue to grow over 2019.

DIVERSITY IS ON THE AGENDA

The Institutional Limited Partners Association ("ILPA") recently released a new form of due diligence questionnaire ("DDQ"), which includes questions relating to diversity and inclusion. Given many of ILPA's members are themselves being held to best practices in this area, it is a natural progression for ILPA's members to encourage best practices among the sponsors in which they choose to invest. In fact, a recent survey revealed that almost half of Investors include pay disparity at the sponsors as part of their due diligence efforts.[9]

ILPA's proactive approach to diversity and inclusion includes queries in their DDQ, as well as including a template for sponsors to measure and report the diversity of their teams. Such information is fairly granular, requiring reporting of whether individuals are on the investment team or in operations and highlighting what seniority they hold in their role.[10] Moreover, ILPA has included particular forms for certain jurisdictions (United States, United Kingdom, Canada or Australia) so as to more appropriately capture the breadth of underrepresented groups in each country.

The DDQ also includes questions designed to respond to issues that many firms are already choosing to address given the current "Me Too" movement. This includes requests regarding sexual harassment and discrimination claims and codes of conduct. It also seeks to elicit information regarding hiring and promotion policies and data at the sponsor level, in addition to the board composition of portfolio companies. Such information can provide Investors with more transparency in choosing a sponsor and emphasizes that diversity is good business.

OTHER TRENDS AND DEVELOPMENTS

As you would expect, this market review also covers in more detail very timely issues that we are seeing, including updates on Delaware LLC technology regarding divisive mergers, financing of single managed accounts in Europe and, in light of recent events, cancellation of Capital Commitments.

Industry Conferences

MAYER BROWN EUROPEAN MARKET UPDATE

As a global service provider within the Fund Finance market, we will be hosting a European Market Update in London on March 6. This event will feature panelists from the lender, sponsor and investor communities and will address developments in the European Fund Finance market and trends taking shape for 2019 and beyond.

FUND FINANCE ASSOCIATION GLOBAL FUND FINANCE SYMPOSIUM IN MIAMI

Once again, Mayer Brown will be a platinum sponsor at the Global Fund Finance Symposium. To avoid the snowstorms that plagued the New York City conferences the past two years, the symposium's ninth annual conference will be held this year in Miami, Florida. As the founding institution of the symposium that spurred the Fund Finance Association ("FFA"), Mayer Brown is proud to support the symposium. We expect this year's symposium to again bring together leading market participants to share their insights on the trends affecting the Fund Finance industry.

WOMEN IN FUND FINANCE

Mayer Brown is also a proud sponsor of Women in Fund Finance, which will be holding a networking boat trip in connection with the Miami conference. To register for the Miami event and learn about other planned events in the United States, London and Asia, please go to www.womeninfundfinance.com/events.

MAYER BROWN MID-YEAR MARKET REVIEWS

As we have done in prior years, Mayer Brown will again host Mid-Year Market Reviews during the late summer. 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.

Endnotes

[1] Preqin Private Capital Fundraising Update Q4 2018, January 2019.

[2] Id.

[3] Id.

[4] The Complete LP View: Perspectives 2019, Private Equity International, January 2019.

[5] Prequin.

[6] PEI.

[7] Id.

[8] PEI

[9] Id.

[10] The DDQ and templates can be found at: https://ilpa.org/due-diligence-questionnaire/.