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Fund Finance Market Update

By Kiel Bowen and Ann Richardson Knox[1]

The first half of 2019 continues a long growth rally for the fund finance market, with fund finance deal volume at Mayer Brown significantly up from last year. This growth occurred despite a three-year decline in the number of final fund closings.[2] This apparent contradiction can be explained both by the penetration of traditional subscription credit facilities into a broader range of fund types and the diversification of fund finance product offerings in the market (including a notable uptick in the number of hybrid facility and net asset value credit facility closings).

This perspective has been reinforced by our own experience: in the first half of this year, Mayer Brown has advised clients on numerous subscription credit facilities for both new and established sponsors that have previously not utilized fund-level leverage. Mayer Brown has also served as lead counsel for an increasing number of alternative fund finance transactions as compared to the same time period last year. In addition to a significant increase in deal volume, it is clear to us that the market is embracing fund finance products outside of hybrid facilities and net asset value facilities, including co-invest and partner loan programs, management fee facilities, unencumbered asset facilities and registered fund credit facilities. These facilities, which were historically viewed by lenders as accommodations to larger fund sponsors, are now being marketed alongside traditional subscription credit facilities by many lenders. Additionally, as we note below, collateralized fund obligations ("CFOs") have also reemerged in a meaningful way from levels not seen since the 2008 recession.

In this article, we explore a number of new and developing trends that we expect to shape the fund finance market moving forward, including recent fundraising activity, the effects of broader economic and political factors impacting fund finance deal terms, certain drivers behind product diversification, investor structuring needs and certain other legal developments impacting the fund finance industry.

Fundraising

Since our *Spring 2019 Fund Finance Market Review*, fundraising activity continues to reflect a trend towards fewer fund final closings with larger funds.[3] With investor demand strong through Q2 2019, the largest funds and sponsors continue to capture an outsized amount of investors' attention and equity commitments, even though the number of funds entering the fundraising market continues to rise.[4]

The most active fundraising markets continue to be North America and Asia, with fewer funds focused on Europe. Preqin's investor polling indicates that while investors remain bullish on the North American and Asian markets, the percentage of investors polled that are looking to invest in European-focused funds in the next 12 months has dropped to 49 percent of all investors (as compared to 61 percent of investors in the market in Q2 2018), demonstrating lesser willingness to invest in

Europe. We expect Europe's lag is likely a result of the uncertainty around Brexit and signs of a slowing European economy.

In addition to the jurisdictional focus discussed above, fundraising has likely been slowed by the sheer amount of dry powder remaining to be deployed for private equity and private debt. Dry powder has continued to climb the first half of this year, with Preqin reporting September levels relatively high with overall dry powder at just over $2,400 bn versus $2,300 bn in December 2018; and with overall dry powder at high levels as compared to prior years.[5]

Geo-Political and Economic Forces

The current geo-political and economic environment is murky with the ongoing US-China trade war, political unrest in Hong Kong, and broader signs pointing to a slowing global economy. While these factors will likely continue to impact the global economy, we believe that interest rate cuts and Brexit may have a disproportional impact on the fund finance market.

INTEREST RATE CUTS

While the recent Federal Reserve interest rate cut was widely expected and already priced into the broader market, many believe that more cuts will follow this year, especially if the trade wars continue. If cuts succeed in accelerating economic growth and stimulating the broader economy, investors will likely continue their search for higher yields and allocate more capital into alternative assets, including private equity. Accordingly, the fundraising environment (and resulting subscription credit facility market, which largely tracks the fundraising market) is anticipated to remain robust.

On the other hand, while a market disruption would likely slow fundraising, it would also provide a ripe opportunity for funds to capitalize on a down economy and put their stockpile of dry powder to work. As funds convert uncalled capital to invested capital, we expect even greater demand for fund financings keyed off the investments and asset value (as opposed to uncalled capital), including net asset value and hybrid financings. Thus, while it is difficult to predict whether economic unrest will occur in the short-term, we think the fund finance market as a whole is well-positioned to capitalize on both market stability and market disruption.

BREXIT

As Boris Johnson settles into his new role as prime minister and the rhetoric surrounding a "No-Deal" Brexit becomes more plausible in light of the UK government's recent move to prorogue parliament, it is likely that the UK and European markets will react accordingly. While it is entirely possible that Brexit will lead to increased investment opportunities for some funds (dependent on their jurisdictional scope and asset focus), the disruption and uncertainties surrounding the eventual outcome of any Brexit process will make fund sponsors naturally cautious about investing in the current environment (and thereby potentially suppressing deal activity in the short term). Moreover, if a "No-Deal" Brexit occurs, it could be a catalyst for a wider recession in the fund finance market, especially in Europe, and could affect European-based lenders operating in markets outside of Europe (such as the United States and Asia). The Loan Market Association has also recently noted the publication of UK legislation in order to incorporate EU law in the event of such a "No-Deal" situation (where the United Kingdom leaves without a transition period), and has noted that it is not yet planning on making changes to English law documents prior to proposed changes in English law. As a result, the global legal market is not currently anticipating that there will be a significant move away from the use

of English law documentation post-Brexit (in circumstances where it would have been a choice of the parties pre-Brexit).

Fund Finance Outlook

No matter whether geo-political and economic forces ultimately serve to quiet the market or expand opportunities in fund finance, we think it is clear that any significant market disruptions will result in tightened deal terms. With that said, we expect two opposing trends to continue so long as a significant market disruption does not occur. The first is more flexible and borrower-friendly business terms as a result of the increased competition in the US and European markets by lenders (as established lenders are increasing allocations to the fund finance industry and new lenders are entering the space). The second is tighter legal structures as lenders both prepare for the possibility of a recession and also adjust their programs to account for the alleged facts and circumstances surrounding the Abraaj Group.[6]

FLEXIBLE AND BORROWER-FRIENDLY BUSINESS TERMS

Subscription credit facility deal terms have started to diversify away from the status quo. Thus far, the diversification has centered on borrowing base availability (and less on pricing or other structural elements). Many lenders that were traditionally tied to a single method of underwriting a borrowing base are offering a wider variety of credit facility structures to better suit a particular fund's borrowing needs and/or investor pool. For instance, certain lenders are offering a variety of subscription facility structures (flat advance rate, coverage ratio, designated investor structures), and/or simply being able to increase the overall effective advance rate within their traditional model (often accomplished by stretching advance rates, including hurdle investors, relaxing borrowing base designations, or adjusting concentration limits).

(For more on such borrowing base structures, see our Legal Update Comparison of Borrowing Base Structures.)

Additionally, although other key deal terms have remained relatively constant, the uniformity on pricing and tenor are starting to wane. This year, some European market participants have emerged with lower pricing, resulting in enhanced competition in that market. We have not yet seen this trend spread to the US market and expect the US market to resist aggressive downward pressure on pricing (particularly for longer tenor transactions). While every fund will approach this issue differently, if market uncertainty grows, we expect more funds may request facilities with longer committed tenors which will likely stabilize short-term pricing.

TIGHTER LEGAL STRUCTURES

While the insolvency proceedings relating to Abraaj continue to progress, lenders have not had any knee-jerk reactions but are taking a closer look at their documentation and legal structures. Despite aggressively competing on business terms, some lenders have sought to tighten certain aspects of their facilities in light of the Abraaj fact pattern, including the following:

- Increasing scrutiny on investor notice delivery in jurisdictions where notices are commonly delivered in connection with security arrangements (e.g., Cayman, England, Luxembourg, etc.). While borrowers often negotiated the delivery of such notices post-closing or in the course of the next regular communication with investors, most lenders have now instituted portfolio-wide requirements with little-to-no flexibility regarding timing of such notices;
- Enhancing and expanding covenants and events of default that have traditionally

applied to the fund's investment manager to the actual sponsor and any other investment manager controlled by the sponsor. These aim to address the fact that sponsors often now have "fund specific" investment managers, and though legally separate, investor confidence in the sponsor is tied to the platform and not a specific legal entity;

- Including termination events and events of default to the extent investors allege fraud, embezzlement or misappropriation of funds, or if sponsors, managers or related entities are convicted of such acts or subject to investigation by governmental officials;
- Including borrowing base exclusion events for investors alleging fraud, embezzlement or misappropriation of funds, including if such investor makes such allegations with respect to another fund managed by the same sponsor;
- Increasing scrutiny of requests to delay the required delivery of financial statements or to deliver non-GAAP or non-audited financials;
- Shortening grace periods on events of default relating to involuntary insolvency; and
- Enhancing emphasis on affiliate transaction covenants, including prohibitions on non-arm's-length transactions, even where otherwise permitted pursuant to a fund's organizational documents.

Additionally, as more lenders form dedicated fund finance teams that are better educated on the nuances of the risks associated with these products, we have seen a greater emphasis on legal structure and investor pool diligence in general.

Additional Considerations and Legal Updates

In addition to the above trends, we think the following developments will help shape the fund finance market outlook in the coming year.

INSTITUTIONAL LIMITED PARTNER ASSOCIATION ("ILPA") – PRINCIPLES 3.0

The recent publication of "Principles 3.0" has continued ILPA's focus on general requirements for disclosure and transparency to investors of fund-level debt usage, unlevered internal rates of return and cost associated with leverage, rather than requiring hard-and-fast rules applicable to all funds. While investors have requested more standardized reporting and performance calculations from sponsors and ILPA has recommended disclosure of levered and unlevered internal rates of returns, they

have not yet recommended standardized disclosure and reporting formats. While the

Principles 3.0 do mention certain thresholds for use of subscription credit facilities, such as clean down requirements and general guidelines regarding debt in excess of 20 percent of uncalled capital, it appears that the guidance also recognizes that appropriate use of debt can vary based on the strategic focus of a fund, investor appetite and geography (and therefore a "one-size-fits-all" strategy is not necessarily appropriate).

As facilities may differ in tenor and scope based on the strategy of the fund, ILPA also recognized the need for investor disclosure and engagement and potential limited partner advisory committee approvals in connection with more levered strategies. Principles 3.0 included a recommendation to permit

investors to opt out of leverage, which could in the future lead to increased bifurcation of investors through use of parallel funds.

(For more information on this trend and issues related thereto, see the article, Investor Pre-Funding Rights in Subscription Credit Facilities.)

INSURANCE INVESTOR STRUCTURES

Insurance company investors are driving significant innovation in the fund finance market. Among other things, the market for CFOs is returning to levels not seen since pre-crisis. Such CFOs borrow securitization techniques popularized in the context of collateralized debt obligations and apply them to portfolios of hedge fund and private equity fund investments. Because regulators currently treat CFOs similar to bonds, rather than equity investments, insurance company investors can take advantage of such technology by exchanging their equity stakes in private equity fund portfolios for such obligations, which permit them to maintain similar exposure to such investments with the benefit of not having to hold as much capital against the investments.

In addition to the use of CFOs to reduce capital requirements in connection with existing portfolios, insurance company investors are increasingly exploring using alternative structures for new investments in private equity in order to reduce their capital requirements. In addition to the creation of particular investment products geared towards insurance company investors (including use of products that mimic the structures of secondary facilities), we have also seen a notable uptick in the use of leveraged feeders to minimize risk-based capital charges. Under this structure, the feeder can fund its capital calls to the main fund in whole or in part through a draw on a facility provided by the feeder's investors (who act as lenders). While the feeder investors still have an equity commitment obligation to the feeder, if the feeder receives proceeds from a draw under the facility, it will satisfy such investor's obligation to otherwise make an equity contribution to the feeder. Lenders have had mixed reactions to including such investors in subscription facility borrowing bases in light of complexity and potential interaction of such feeder leverage with a subscription credit facility, as well as concerns with competing lender claims at the feeder level. We also understand that risk-based capital requirements are also currently under review by insurance regulators.

OTHER LEGAL AND REGULATORY UPDATES

Since our spring market review, certain legal and regulatory developments have rippled through the market—namely the QFC Stay Rules (with respect to facilities that secure derivatives), widespread adoption of the beneficial ownership provisions, a change in the Delaware law which permits limited partnerships to divide (mimicking the earlier change to the Delaware limited liability company framework which also permitted divisions, which was explored in our *Spring 2019 Legal Update*[7]), and the Alternative Reference Rate Committee publication of suggested guidance on LIBOR replacement, which has already been adopted by some market participants.[8] While none of these changes have disrupted the market, they have resulted in some new negotiations and longer amend-and-extend amendment documents than what most market participants are accustomed to reviewing.

Conclusion

For more information about the topics raised in this article, please contact any of the following lawyers and subscribe to our fund finance mailing list by contacting Dena Kotsores at dkotsores@mayerbrown.com.

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[2] *Preqin Quarterly Update: Private Equity & Venture Capital Q2 2019* ("Preqin"), p. 5.

[3] *Preqin*, p. 5.

[4] *Preqin*, p. 6.

[5] *Preqin Dry Powder Report*, Sept. 2019.

[6] Abraaj was a large investment manager based in the Middle East that has been accused of fraud and misappropriation of funds. The holding company is currently in insolvency proceedings in the Cayman Islands.

[7] https://www.mayerbrown.com/en/perspectives-events/publications/2019/03/divisive-mergers-and-impact-on-fund-financings.

[8] For more on LIBOR Replacement, please see https://www.mayerbrown.com/en/perspectives-events/publications/2019/06/the-arrcs-final-fallback-language-recommendations-for-new-libor-syndicated-loans.

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