

Fund Finance Friday



Mid-Year Market Update

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By **Wes Misson**
Partner | Fund Finance

As we near the close of the second quarter, eagerly look forward to next week's 6th Annual FFA European Fund Finance Symposium in London and keep a watchful eye on the macroeconomic environment, we thought it would be helpful to provide an update on 2022 market activity based on our observations.

Fundraising. Early indications are that YTD private market dollars raised are on track with last year's record pace while fund count may end the year meaningfully lower. Large platforms continue to attract a greater share of capital but, on the whole, capital raising totals in the vicinity of last year's record numbers means there are plenty of opportunities for lenders.

New matters. Mirroring the trend in fundraising, our overall deal count in the U.S. is slightly lower while dollar originations are in line with the record 2021 pace. Average deal size is up, which correlates to more large funds in the market. In fact, we have closed or are currently working on 11 multi-billion-dollar syndicated facilities. If this trend holds, this will set a record and smash 2021's mega-deal rebound following a COVID environment-slowed 2020. In the UK, our new deal activity is up 14%. Among lenders, it's been a multi-speed market as capital constraints, staffing capacity, and business mandates have evolved differently over the past two years.

Hours. While new matters correspond to new origination, our time accruals are a better measure of overall market activity since the stat captures deal events like amendments, joinders and investor closes. YTD our time accruals in the U.S. are running 19% ahead of last year and in the UK 30% ahead of the prior year, both pointing to significant overall market growth. To support this growth, we've increased our ranks by 19 attorneys and paralegals YTD to a total of 75 for our global fund finance practice. This growth also excludes attorneys and paralegals who will be starting this summer and a robust incoming class of 8 newly minted attorneys in the fall, our largest class ever for fund finance. The market growth continues to seed opportunities for many young professionals in our industry, a fact we should all be proud of as we continue our investment in the next generation's development.

Margins. As we previously forecasted, making clear observations on margins has become more complicated by the variations in credit spread adjustment approaches on SOFR loans. The simple takeaway on pricing, in our observation, is that lenders have retained pricing power in 2022. Average subscription facility margins are a few basis points wider than in 2021, but may be influenced by loans that incorporate what would have been a credit spread adjustment into the margin.

ESG. We have been watching the deal flow on the ESG side this year, and it remains strong with 6 deals worked YTD. This is on pace to exceed 2021's deal count by a slight margin despite the regulatory headwinds. As fundraising slows some, the ESG funds have not been immune, with this quarter bringing some of the first reported declines in ESG investor momentum during the last two years. That said, ESG-focused funds are not going anywhere, and we should expect this segment of the market to continue to evolve.

Outlook. The market environment has fundamentally changed in the past six months, but we don't expect to see a material impact to fund finance origination volume in the remainder of 2022 because of the existing momentum in fundraising and because subscription credit risk is not as directly tied to economic variables as many other commercial loan asset classes.

For the 2023 outlook, private capital market internals bear watching. Buyout fund deal value and exits appear to both have slowed meaningfully. Two observations on this: (1) A deceleration in capital velocity may present a headwind to 2023 fundraising as capital deployment and capital returned to LPs both slow, and (2) LPs are bound to be more selective in strategy and sponsor allocations given the more complex risk and return backdrop, which could also slow 2023 fundraising.

On the lender side, slower economic growth may lead to a more intense cost focus, especially at large lenders. As bank revenue growth becomes more difficult to generate in a slowing economy, expense control moves to the forefront as a tool for defending profitability. A positive perspective on this may be that the motivation to innovate in fund finance is moving higher. If slow-flation is the base case for the next 12 months, we expect lenders to spend more time on questions like: What is our all-in acquisition cost per million dollars of loan exposure, and what's the long-term target? Where can customer interactions be migrated onto a self-service digital platform? Where can automation or process improvements be deployed to shift team member focus to relationship or advisory roles? Necessity, again, may prove to be the mother of invention as lenders and borrowers together solve for more efficient and streamlined approaches.

Best of luck with closing out the quarter, and enjoy your weekend. I look forward to seeing many of you in London. It will be so good to be back!