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Fundraising and the Fund Finance Outlook: It’s Complicated

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By **Chris van Heerden**
Director | Fund Finance

The fundraising outlook has become more complicated in recent months. No question, year-to-date data looks good. PitchBook, for example, reports that 191 U.S. PE funds raised $176 billion in the first half, annualizing ahead of last year’s full-year fund value raised of approximately $340 billion. More broadly, global private capital raised in the first half totaled $645 billion, according to Preqin data, which, while lower than in 2021, sets the industry up for another trillion-dollar-plus year.

Those numbers, however, are in the rearview mirror at this point, and a host of factors are clouding the forward outlook:

- The record pace of fundraising over the past 18 months is reportedly exhausting LP bandwidth. PitchBook highlighted the theme in its recent ***Q2 PE Breakdown,*** noting, “This is perhaps the most crowded fundraising market in history.” Some LPs reportedly already exhausted their full-year 2022 allocations in the first half. PitchBook points out, however, that the top platforms are successfully plowing through the turmoil to get flagship fundraises closed.
- The velocity of capital, particularly in the buyout market, is slowing. The downshift in deployment and deceleration in exits means a slower return of capital to investors to recycle proceeds into new commitments. The overall business cycle suggests that deployments and exits are likely to stay lower.
- A challenging IPO market is contributing to the decline in exits. The 10 U.S. IPOs raising $339 million in July marked the slowest month since January 2016, according to Bloomberg data.
- A valuation disconnect between public and private markets partially explains the drought in IPOs and may have a lingering effect. This valuation disconnect is apparent in the fact that only one out of the more than 70 U.S. IPOs completed to date in 2022 priced above the marketed range, making for the fewest above-range pricings in two decades, according to Bloomberg. Buyout exits via IPOs are likely to stay muted until private and public views on valuations converge. Reuters touched on the same theme this week in “***Dreaded ‘down rounds’ shave billions off startup valuations**.”*
- Declines in public markets can mean that LP portfolios can become more heavily weighted towards private strategies. As the theory goes, LPs that become unintentionally overweight private investments may scale back new private capital allocations in what is known as the denominator effect. Broad market private fund performance data is reported on a significant lag, but we suspect that the relative public versus private performance differences are not significant enough to materially impact fundraising at this point. Year-to-date, the S&P 500 is down 10.9% and the Bloomberg U.S. Aggregate Bond Index has posted a total return of -8.8%. We don’t see these returns as wholly out of step with the private fund return numbers that were mentioned in Q2 earnings calls.

In assessing the significance of these factors to the fund finance market, we think there are a few important points to keep in mind. First, buyout funds don’t define the entire industry. The broader private equity category accounts for 58% of the dollars raised in the private markets year-to-date, according to Preqin data, whereas 15 to 20 years ago private equity funds often made up 65-70% of the private capital raised in a given year. We see the broadening trend accelerating going forward. KKR & Co. Inc., a pioneer in the buyout industry, for example, reported that 40% of the firm’s new capital raised in Q2 went to infrastructure and real estate strategies. In the same vein, Rede Partners recently reported, in its inaugural **Private Credit Report**, that 82% of surveyed LPs expect to increase allocations to private credit in the year ahead. Challenges in capital raising for buyout funds shouldn't be automatically imputed to other strategies.

Second, the link between fundraising and fund finance origination volume operates at a lag. For new facilities that we closed in 2021, the date between the LPA execution and credit facility closing averaged about 220 days. This suggests to us that the robust fundraising activity in the first half has already laid the groundwork for continued growth in fund finance origination in the second half.

This is not to say that the developments in capital raisings are immaterial. Fundraising timelines are likely to stretch longer, more fund closings are likely to push into 2023, and the 2023 calendar could also stack up to compete for finite LP attention and allocations. These points, however, are more material to the fund finance outlook for next year than for 2022.

Separate from fundraising, bank balance sheet availability will be a key determinant of fund finance origination volume for the remainder of the year. The specific concern is that deposit outflows could drive a greater sensitivity to adding risk-weighted assets. (On this point, we **previously covered** capital relief trades as a balance sheet management tool.) In Q2, total bank assets declined by 1.1% ($255.9 billion) as deposits dropped by 1.9% ($369.9 billion), according call report data compiled by BankRegData. The decline in assets was the largest since Q1 2009, and the deposit drawdown set a new historic record.

But, here again, nuances matter. The overall decline in assets was largely driven by reductions in cash balances and securities holdings. Loans and leases, in fact, posted the largest-ever dollar increase in the quarter, rising by 3.7% ($410.6 billion). C&I lending is leading the growth. Bank C&I loan exposure rose by $48.0 billion in July, while Treasury and mortgage-backed securities declined by $35.3 billion (real estate loans exposure also increased), according to the Fed's latest H.8 data.

The big-picture trends driving balance sheet allocation are intuitive. The 2022 operating environment for fee businesses has been challenging, with investment banking, asset management, and mortgage origination revenues coming under pressure. The regime change in interest rates and uncertainty on QT has made fixed income securities investments more challenging. On the other hand, higher rates are allowing banks to shift into higher yielding assets through loan growth, driving gains to net interest margin and net interest income.

While the pace of deposit outflows and sensitivity to risk-weighted assets will be important to watch going forward, we don't see any adverse impact on lending trends to date in the data. Of course, specifics vary between institutions. But we expect to see loan growth continue to be a key driver of bank earnings.

Headlines have turned more cautious in recent weeks. We think fund finance participants should expect a multi-speed market. Certain sponsor platforms and strategies will continue to show greater traction in fundraising than others. On the lender side, origination capacity trends will also vary between institutions. While this is less uniformly positive than the past two years, we expect the overall demand for fund finance credit and the supply of available capital from lenders to support sustained growth through the rest of the year.