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Fund Finance Friday

The Macro in the Spotlight

July 26, 2019 | Issue No. 38

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Back in 2008, you had to make a choice. You could either get your work done or you could stay current on market developments. With multiple daily bank failures, mergers, CEO changes and TARP investments, it was hard to do both well. The last few weeks sort of reminded me of that conflict, albeit on less distressing substance. So many interesting macro events are occurring right now that warrant attention and have the potential to impact fund finance. In other *FFF* postings this week, Jeremy Cross has covered the new Prime Minister in the UK and Chris van Heerden has covered the CFA Institute's updated GIPS standards. Below are some thoughts on the other key issues I have been following.

Fund Formation Data. Both *Private Equity International* and Preqin published their 1st half fund formation data in July and the results underwhelmed as forecasted. *PEI* reports $177 billion raised across 240-something funds, down 7 percent from the same period last year and down a full 40% from 2017. Yet, as I mentioned previously, we believe fund finance is up in the 10^{+} percent range from 2018 based on a good number of anecdotal sources as well as our own data. Part of that dichotomy is likely attributable to dry powder, which has been going up in 2019 even as fund formation has gone down. Preqin shows dry powder at a new high of $1.54 trillion as of the end of June. While fund formation drives new deals, dry powder provides collateral, and there is a lot of it in the market right now (query to what extent fund finance contributes to the growth in dry powder by delaying deployment). Both Preqin and *PEI* are forecasting more robust formation stats in the second half and so are we; we are working on a number of facilities for very large funds that we expect to reach final close in the latter half of the year. But this trend does bear watching. If capital does not start getting deployed more quickly, it is going to push back subsequent fundraises for existing managers. My view is that it will be challenging for private equity AUM to grow over the next 5 years consistent with Preqin's bold predictions if we do not start seeing some meaningful deployment of existing dry powder in the near term.

Stop the Looting? Merriam-Webster defines looting as "to engage in robbing or plundering especially in war." And so Elizabeth Warren last week decided to name her proposed private equity regulatory legislation the "Stop Wall Street Looting Act of 2019." The inflammatory language is unfortunate. In addition to entirely gutting the principle of limited liability and eliminating most fundamental tenets of equity ownership, private equity professionals will now no longer be able to feed elementary school children to their pet chupacabras. (Not really, but it is clear that the Bill's proponents have an awfully sinister view of private equity.) The substance of the Bill was succinctly covered in *Buyouts* **here** and Elliot Ganz of the LSTA nicely summarized how the Bill would impact loans and CLOs **here**.

While the Bill is political posturing and not wellâ€‘considered legislation, income inequality is tearing at our social fabric and needs to be better understood and thoughtfully addressed. And the effects of a corporate shutdown on a community, particularly in rural areas, can be devastating. I highly recommend the book "**Glass House: The 1% Economy and the Shattering of the Allâ€‘American Town**" by Brian Alexander. It is sort of a combination of "Barbarians at the Gate" and "Hillbilly Elegy." While I have no idea if it is factually accurate, the book is a fascinating read about the corporate history and drama at Anchor Hocking Glass Company, once the world's largest maker of glass tableware. It also colorfully details the impact layoffs had on Lancaster, Ohio, from the fundraising falloff at local charities to the increase in opioid abuse by the recently unemployed. These are, of course, real societal issues that need to be addressed, but laying it all on the doormat of private equity is misdirected. But Wall Street is and always will be a popular scapegoat for politicians.

Based on the language of the Bill, I suspect fund finance is going to eventually find itself entering the discord of the 2020 U.S. presidential election. I expect that we will be lumped into the “excessive and risky leverage” bucket and be demonized as a weapon the funds use to wreak havoc. We should all be prepared for our products and businesses to be criticized by name during the election process. The FFA is going to need a public relations firm.

United States Debt Limit. On Monday, President Trump and U.S. Congressional leaders announced a deal for a twoâ€‘year extension of the federal debt limit and increases in the federal spending caps. Both the President and the Democrats in Congress seemed pleased with the agreement. The only people not happy about it are the fiscal disciplinarians. But there are only about seven of us left in the United States.   The debt limit agreement is good for our markets, though. It is one less thing to worry about, and the last government shutdown did cause us a fair amount of nuisance when we could not get tax ID numbers for AIVs to satisfy banks' KYC requirements.

Interest Rates. The Federal Open Markets Committee meets next week, and the market is widely forecasting a 25 basis point reduction. I did not agree with the December hike and, coming off the June job numbers, I am in the sit still, wait and see camp for next week. (I spend about 20 minutes a month thinking about interest rate policy, so I’m entirely qualified to criticize Jerome Powell.) While I think the Fed should save their dry powder for a real rainy day, a rate reduction would probably be positive for fund finance transaction volume and facility utilization but negatively impactful for net interest margin at many of the banks. We will see where we end up next week.

Cadwalader fund finance enjoyed a solid first half, and we are grateful to our clients and counterparties. Enjoy your weekend.