

Fund Finance Friday



The Practical Also Forecasts Growth in NAV-Based Lending

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Last week, my colleague Chris van Heerden wrote a compelling note forecasting the increased use of fund-level leverage in the United States. He based his conclusion on two primary demand side principles. First, Chris points out that the low yield environment will negatively impact fund returns and, to help counteract this, funds will increase their use of leverage. As evidence, he notes that Europe has been the forerunner of the low yield paradigm the past several years and that this year, a full 60% of the fund finance transactions Cadwalader has worked on in Europe consist of NAV or hybrid borrowing bases. Second, Chris notes that dry powder is at an all-time high, creating significant competition for assets and high purchase valuations. Pointing to the recent down round IPOs and the material post-IPO price declines of multiple PE-backed listings, he offers evidence of elevated entry points for private equity – which again suggests increased leverage may be employed to offset the downward pressure on returns. This is exactly the kind of next-level depth I find missing in most legal writing but that I hope for from our team. A copy of the note, if you missed it, is available [here](#).

While I think Chris's macro analysis is well founded, there are also some practical considerations supporting his growth conclusions. First, on the supply side, the two primary factors that have driven the growth of the subscription market (the growth in fund formation and the expansion of subscription finance from real estate funds into all asset classes) are both slowing. Fund formation for 2019 projects another down year (although the game is not over). And increasing market penetration is nearly complete – subscription finance is basically ubiquitous across the fund market. At the same time, bank leadership has become accustomed to their subscription desks delivering the growth. While drifting down the risk continuum into the assets is easy to resist when the subscription book is growing 30%+ per year, views may change in 2020 if growth slows to mid-single digits. The banks have built huge portfolios of subscription facilities that are all a capital call away from getting cleaned down. Banks are unlikely to watch loans to later stage funds simply roll off the books when they already have familiarity and history with such funds and there is a built-in need for ongoing financing based on the funds' assets.

Secondly, fund finance is now widely deployed in the buyout space. The CFOs and Treasurers at buyout funds are some of the most sophisticated financial engineers on the Street, many now with decades of experience creating value for the equity via financing at the portfolio company level. Transitioning some of that playbook to the fund level would seem a natural progression. Funds have separate, non-consolidated balance sheets from their portfolio companies; it seems unlikely that both balance sheets will not ultimately be optimized from a capital stack perspective. We think this makes it almost inevitable that preferred equity-like and true leverage solutions at the fund level are going to increase.

We do think growth in the area will be somewhat incremental, not explosive. Many existing funds are bound by partnership agreements that did not fully contemplate financing innovations such as preferred equity when they were originally formed. Additionally, the negative press around subscription facilities has created some consternation in the investor community around fund-level borrowings. And, depending on factors including the strategy of the fund, the concentration of assets and the size of the loan, it can be hard at times to find a lender willing to do a deal. But these issues are going to get worked out. A very high percentage of investors are now involved in the private debt asset class and the vast majority of them understand and consent to the levered sleeve of debt funds. Some are even in talks about leveraging their own portfolios. This understanding is going to ultimately lead to investor comfort around and support for modest levels of leverage in other asset classes. We are already seeing this manifest in partnership agreements for new funds as well as the increasing use of debt by continuation vehicles in connection with GP-led

restructurings. Banks, in turn, are also at work on white papers and are pressing for internal approvals for NAV-lending authority. And we see new entrants on the banking side in search of a niche of the market to enter. With their blank slate credit boxes, they are going to ultimately craft initial credit policies that focus on, or at least permit, some limited exposure to the assets. And where the banks cannot get it done, debt funds are emerging to both fill the gap and provide higher attachment points. The funds and banks that are able to figure these things out in the near future are poised to extend their runways.

With this in mind, we intend to do what we can this fall to be helpful. At the Finance Forum in Charlotte next week, our session on fund finance statistics will include structural guidance on hybrid and NAV facilities. In addition, we will include some upcoming writings in *FFF* on the key items that bankers need to know but seem to get left out of the legal writing to date: typical attachment points, concentration limits, eligible investment definitions, valuation challenges and third-party appraisal rights, etc. As always, if we can be helpful in this regard, please let us know.