Fund Finance Friday

Some Reflections on Supply and Demand in Capital Call Finance

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In a number of articles in *Fund Finance Friday*, we have reflected on the increasing size of the market for capital call facilities and on the increasing number of banks and alternative lenders now offering these facilities at increasing ticket sizes. An easy assumption to make (which does not necessarily mean that it is correct or incorrect) is that this increase means that supply in this market is plentiful and may well be outstripping demand. More on that below. If that is the case, then you would expect to see at least three things happening: first, a reduction in pricing as lenders compete for a share of the market; second, some loosening of terms (in particular but not only the extent and frequency of covenant compliance); and, third, some relaxation of leverage and related requirements.

So the question that a number of us in the industry often reflect on is whether, given the perceived supply/demand ratio, and assuming this is tilted in favour of oversupply, to what extent are any of these things actually happening? Some observations and thoughts are offered below, mostly subjective and – for, I hope, understandable reasons – dwelling on general trends rather than specific figures or ranges.

Starting with the assumption of oversupply, is this actually true? I would say to a certain extent, yes, but there are a number of reasons why this may not be quite as simple a picture as it looks. While it is certainly true that there is a great deal of “dry powder” available, this is not a product where “one size fits all,” and lenders will often adopt (or be required to adopt) quite different strategies and requirements as to what facilities they can make available and to whom. These requirements may include some limitations on acceptable geographies or types of fund, particular requirements as to minimum or maximum ticket sizes, and particular views around agency or participations in clubbed or syndicated facilities. In addition, given the fairly rapid growth in the market, some lenders may be running up against capital or credit constraints or limits within this particular sector or for particular funds. So maybe the extent of the supply is not necessarily as big as it may seem.

However, what certainly seems to be true is that most funds which have a reasonable investor profile will not be struggling to find lenders willing to lend and will have a far greater choice available to them than even in the recent past. So what benefits can those funds expect?

Well, there may be some pricing benefit, and it seems to be the case that average pricing in the industry has been reducing in recent years. That said, the market and credit rules have not ceased to exist. Any pricing benefit will be more easily realised by a well-established larger fund with a good track record and a good investor profile than for a smaller fund with less of a track record and/or a less obviously suitable investor profile. What may also contribute here is the flexibility that an increasing number of lenders now offer in these facilities, so that, for example, pricing may be brought down even where a fund’s investor profile is not quite so good for a capital call facility if lenders are prepared to look at other fund assets (including investments) as part of their credit.

Do the potential pricing benefits also extend to document terms? The answer here is (perhaps not what you would expect), not necessarily. While leverage multiples have maybe increased slightly over the past few years and the market is certainly seeing an increase in the frequency of borrower term sheets and draft facility documentation, as well as some variation in terms particularly between larger well-established funds and smaller or less well-established funds, the fundamentals have not shifted as much as one might expect. There is at least, as far as we have seen, no similar shift to that seen in the leverage finance market to “cov lite” and/or incurrence covenants. There may be a number of reasons for this. From our perspective, these would include the increasing scrutiny that a fund’s investors will bring to bear on any facilities taken out by a fund, ably reinforced by institutions such as ILPA, as well as perhaps the slight oddity of a market in which actual defaults (and, therefore, a lender’s ability to become more comfortable with and familiar with the consequences of looser or different terms) are rare (and indeed until recently were almost non-existent). This state of (more or less) equilibrium may not last forever, particularly if competition heats up further and as

we see funds and their counsel take more aggressive negotiating stances on current terms, but it is likely to continue to provide a brake on any significant loosening of terms.

I have already touched on leverage requirements in the paragraphs above. Again, these have not shifted as much as one might expect given the size of the market. Investors will continue to play an important (and restrictive) role in this, which is one factor, but perhaps another is that there is not really a lot to play with here. In a capital call financing, the only "asset" is the investor commitment, and that, by its nature, is the same (or very similar) in whichever fund it is held. It also has a very easily determined (and certain) value, which generally will not change.

As I said at the beginning of this article, consider these thoughts as observations only. No doubt there are many other points that could be discussed, but these thoughts are offered in the hope that they might chime with others and maybe provide food for additional thought.