

CADWALDER

## Closing Remarks

December 21, 2018 | Issue No. 8



By Michael Mascia  
FFA Board Member

2018 has been another terrific and all-consuming year for the fund finance industry. A lot of hard work went into our industry's success this year, and I hope everyone is able to get some meaningful downtime over the holidays. As we wrap up the year, we provide some reflections on 2018, some observations from the year-end closing scramble and some forecasts on items we are working on for 2019. I am extremely appreciative of the support and trust our clients and friends have put in Cadwalader this year. A sincere thank you. I hope you have a restful holiday and a fun New Year's Eve.

- Virtually all of our lender clients are reporting great years with loan commitments up well into double digits year over year. When we update our size-of-the-market analysis in early 2019, we expect a number nearing the \$500 billion mark. All of the business metrics we track around our fund finance practice (number of discrete engagements, volume of hours worked, revenue, etc.) were up in 2018 over 2017. We plan to publish a comprehensive 2018 year-in-review update for our clients in the first quarter.
- The market continues to adjust to funds bringing their leveraged finance playbook to transactions and the resulting clash with lenders' relationship-based product orientation in fund finance. Among many impacts, this trend puts pressure on the number of transactions any one banker or lawyer can cover simultaneously.
- Sanctions was by far the most contested item in 2018, as banks dug in their heels at the behest of their compliance departments' efforts not to run afoul of legal and regulatory obligations. Interestingly, of all the waivers we worked on in 2018 (and we papered enough foot faults that we are thinking about forming a waiver practice group), not one had to do with an affiliated fund or portfolio company potentially being sideways with sanctions.
- As the market grows, so does the regulators' interest in fund finance. We consulted on multiple engagements this week revolving around responding to information requests from various regulators across the globe.
- We tried to draw a graphic showing the directional movement of personnel changes between banks and law firms in 2018. There were so many arrows that the slide looked awful and was trashed.
- Time to Make the Donuts. This week was heads down, all hands on deck, get the deals done week. On both sides of the pond. Multiple large, broadly syndicated deals closed. The volume of AIV and QB joinders timed to align with year-end investment closings was pronounced. Numerous mandates were awarded.
- Do you think God personally invented the Keurig coffee machine? How did we get through the 4<sup>th</sup> quarter prior to its invention?
- For lenders that use a securitization-style borrowing base with investor classifications and varying advance rates and concentration limits, it can prove helpful if the borrowing base spreadsheet at closing details the specifics of the investors' classifications. For example, is an "Included Investor" included based on its own rating, based on credit linkage to a rated affiliate (and if so, which one) or based on lender approval as an unrated Included Investor? If there is a subsequent shift in or elimination of a rating, having that detail reduces potential ambiguity around the implications.
- A lot of goodwill is created when a lead bank gives syndicate members reasonable timelines and thoughtfully reviews their comments. While the reality of meeting fund demands is a critical obligation for a lead, syndicate members greatly appreciate and remember bankers that help them get deals through their credit and KYC processes.
- Two events this week reminded me how lucky we all are to be in the fund finance industry. I attended a holiday party hosted by a prominent fund finance industry participant last weekend. As we were leaving, I told my wife that we will probably never attend another party so nice, with so many people we know, all of whom we are excited to see and (at least as far as they let on) are happy to see us. Just a great time. I suspect a good number of you attended a party last Thursday in New York as well that I had to miss that I am sure was a great time... Secondly, I had a long overdue dinner with Todd Cubbage to welcome him to Charlotte. You know you are in a great industry when you genuinely enjoy spending time with your competitors.

- Despite the pullback in the equity markets and this week's interest rate increase, I am very bullish on fund finance for the first quarter and reasonably optimistic for 2019. Our inventory (for lawyers, that means hours worked not yet billed and accounts receivable) is higher today than it was a year ago. And despite how many closings we had in December, we have put on more than we have taken off this month. A ton of term sheets were turned this week. The pipeline feels solid and the market feels very fluid, despite the noise on the macro level.
- *Fund Finance Friday* is nearing 1,000 subscribers. We are beta testing some significant improvements that we hope to roll out in the first quarter to make this newsletter a more valuable resource for market participants, including a corresponding website, a search function, industry participant profiles and more. Stay tuned. We would welcome direct industry submissions to add to the quality and diversity of the content.
- Absent something that moves the market, *Fund Finance Friday* will be taking off next week and will return in early January after the holidays.

## Concentration-Linked Overall Limitations

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By **Wes Misson**  
Partner | Fund Finance

We have seen multiple partnership agreements this week that include an embedded buffer in the concentration-linked overall limitations – a thoughtful evolution that provides a safety net to both the fund and its lender.

First, let's refresh. Most funds have a per investment diversification or concentration limit of around 15% of aggregate capital commitments (the "15% Cap"). Concentration-linked overall limitations, kryptonite to the fund finance banker, tie the permissible amount a fund is authorized to overcall as a result of investor defaults or excuses back to the 15% Cap. This is in contrast to the more standard overall limitation that limits the amount of the overcall to something like 35% or 50% of the original capital call. Many a deal has been shelved because the lender could not get comfortable with the limitations. The typical concentration-linked overall limitation is phrased something like:

In the event a limited partner defaults on a capital call, the general partner is authorized to make a subsequent capital call on the non-defaulting limited partners to make up the shortfall, *provided that such non-defaulting limited partner shall not be required to fund an amount with respect to any single investment in excess of the investment diversification limit for the fund set forth in section [x] of the partnership agreement if such limitation was applied on a partner-by-partner basis.*

Thus, with the above language, the fund is authorized to make a default overcall, but only up to the point where 15% of the investor's capital commitment is allocated to the applicable investment. This, of course, gives the investor some comfort that its interest in the fund will have some level of diversification in the underlying investments. But if a fund buys an investment already sized at the 15% Cap and any investor defaults, no other investor is obligated to fund any overcall to make up the shortfall at all, even for a *de minimis* amount. Ouch. That could suck.

Lenders, of course, underwrite transactions with an expectation that the fund can overcall on non-defaulting investors all the way up to their then unfunded capital commitments, so any limitation on that authority is a credit exception. Many funds are successful in getting an express carve-out to their overcall limitations that make them inapplicable for capital calls to repay debt. That is an optimal outcome for the fund and the lender, and results in the fund getting preferred terms in a credit facility. But what about funds without such a carve-out?

We have for years incorporated a solution into credit agreements to address this risk – the "Use of Proceeds Restriction." The Use of Proceeds Restriction only authorizes a fund borrower to use loan proceeds with respect to investments in which less than, say, 10% of aggregate capital commitments are expected to be called. This way, the fund always has the buffer between the 10% and the concentration-linked limit of 15% to overcall from the non-defaulting Investors. The fund is not prohibited from buying a maximum-size investment of, say, 14% or 15%; it just cannot use the credit facility to finance its acquisition. While this works in many cases, in certain funds it massively curtails the utility (and, in some cases, the viability) of a credit facility. This is especially true when the fund has had a first but not final investor close. The 15% Cap at an initial investor closing can sometimes prohibit even very small investments. Practitioner's note: During a fund's investor fundraising period, it may make far better sense for the 15% Cap to be based on anticipated fund size instead of actual fund size.

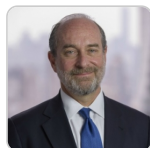
The embedded buffer we have been seeing assists the fund. It authorizes the fund, in the context of an overcall, to call up to 20% or 25% of an investor's commitment with respect to any investment, even when the per investment diversification limit for the fund is set at the 15% Cap. That way, the fund can always overcall into the buffer, and the fund will not find itself without an overcall option should it make a maximum-size investment. This makes perfect sense – how else could a fund effectively function if it bought a 15% investment and even a single investor defaulted? The buffer in turn takes some pressure off the threshold where a lender needs to set the Use of Proceeds Restriction, thereby increasing the size of investments that are able to be financed under the credit facility.

One interesting practitioner's note: A credit agreement's restriction on partnership agreement amendments would typically prohibit an LPA amendment that added an overcall limitation, as that amendment would fall within the prohibited scope of amendments to "Capital Commitments, Capital Calls, the Collateral, etc." But, if a lender relied on an embedded buffer like what is described above and the fund sought to amend the partnership agreement to increase the investment diversification limit itself (thereby reducing the protective buffer), would it be enough to trigger a

“Material Amendment”? While we think such an LPA amendment should fall within the catch-all standard for any lower case “material adverse effect” to lenders and thus trigger a “Material Amendment,” it would be prudent to explicitly capture any amendments with overcall implications within the definition.

## Fund Finance Risk Transfer Solutions Provided by Vanbridge

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By **Kenneth R. Pierce**  
Managing Principal | Vanbridge

Vanbridge is a unique advisory and intermediation firm that functions both as an insurance broker and a solutions provider, and brings together banks, insurance companies and asset managers to structure risk transfer and financing transactions, designed to meet the needs of each party.

- **Banks and Life Insurers.** Life insurers have a need to put cash to use over long time horizons and are seeking opportunities to generate yield in a regulatory capital-friendly format. Life insurers can enter into participation agreements with banks, allowing banks to continue to face the client but providing the bank an alternative path to syndication, funding and full risk transfer. A properly structured participation or similar agreement enables the life insurer to reduce the amount of risk-based capital it must hold while providing the life insurer a diversifying source of yield away from widely distributed corporate bonds. A good example of this type of transaction involves subscription facilities. Vanbridge is currently working on transactions in which life insurers would provide back-end funding and risk transfer for banks who may be over-exposed to certain LPs or asset managers, or who are seeking more capacity for their subscription facilities but do not wish to syndicate to competing banks.
- **Banks and Property & Casualty Insurers.** Property & casualty insurers are generally not a source of funding but are increasingly interested in assuming the risk of credit losses on loan portfolios. When structured properly, this type of insurance policy meets bank regulatory capital requirements for substantial risk transfer. As an example, given the historic low default rates on subscription facilities, there is substantial risk appetite for this type of default risk.
- **Funds & Insurers.** Since December 2016, Vanbridge has structured and intermediated over \$2 billion of transactions (and is currently at work on transactions that exceed \$2 billion in the aggregate) in which the firm has brought private equity, real estate and other funds, together with both life insurers and property & casualty insurers, to provide non-recourse leverage and financing, enhancing investment returns to equity investors in funds and tailored asset portfolios. In these transactions, property & casualty insurers provide wraps and credit enhancement, which enables the financing to be provided by life insurers at low capital charges to them.

There are many other ways in which banks, insurers and asset managers can work together to structure win-win transactions which make the best use of the attributes that each constituency brings to the table. Vanbridge operates at that intersection point, providing structuring, translation, brokerage and intermediation services. For more information, please contact: Ken Pierce, [kpierce@vanbridge.com](mailto:kpierce@vanbridge.com), 646-572-9386

## PitchBook Unveils its 2019 PE Outlook

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*PitchBook* unveiled its *2019 Private Equity Outlook* this week, detailing the trends it expects will drive the industry in the next year. We summarize a few of those trends here and provide a link to the full article below.

- **Evolution in GP stakes strategies.** GP stake funds will continue to move further into targeting emerging managers and smaller funds and in developing asset-class specializations. Liquidity strategies are likely to become a focus, with a possible exploration of public listing.
- **Secondaries' activity to reach a new all-time high.** Aggregate contributions and distributions from secondary funds reached a high water mark in 2017, as secondary market activity became more widely accepted. This momentum continued in 2018. Further gains, particularly in GP-led transactions, are likely in 2019.
- **Better PE performance relative to public markets.** Public and private market performance are generally positively correlated, but this correlation tends to breakdown during more volatile periods. PE funds have also historically outperformed public markets in years when public market performance is negative. Based on these factors, PE performance may outshine public markets in 2019.
- **Momentum in China-focused fundraising.** China-focused fundraising more than doubled in 2018, according to *PitchBook* data. GP survey data points to further growth ahead in China strategies.
- **A recovery in private debt fundraising.** After reaching a record \$124.0 billion across 121 vehicles in 2017, private debt fundraising has slumped in 2018 to only \$75.6 billion raised year-to-date through December 4. Interest in floating-rate debt and distressed strategies may spark renewed interest in private debt in 2019.

[The key trends that will shape PE in 2019](#)

## On the Move—Fund Finance Tidbits

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### On the Move

Well-known fund finance banker Charlie Owens joined Signature Bank this week as a Managing Director in its Fund Banking Division. He joins from Wells Fargo, where he was a Managing Director in the Subscription Finance group.

Owens brings over 20 years of experience to Signature Bank in the origination, structuring and execution of subscription facilities and other asset-oriented financings. The Fund Banking Division, led by Thomas Byrne, who joined Signature Bank in August, now constitutes a team of 10. In his new role, Owens will support Signature Bank's efforts financing top-tier private equity firms and alternative asset managers.

## Call Me By My Name—Volcker Rule Tweaks Proposed

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The FDIC, the Federal Reserve Board, the Office of the Comptroller of the Currency, the SEC and the CFTC proposed excluding certain community banks from the Volcker Rule. In addition, the proposal would permit a banking entity to share a name with a covered fund that it organizes and offers under certain circumstances. The proposal would amend the regulations implementing the Volcker Rule, consistent with the statutory amendments made pursuant to Sections 203 and 204 of the Economic Growth, Regulatory Relief and Consumer Protection Act. More available from the *Cadwalader Cabinet* [here](#).



## **Prior Editions of Fund Finance Friday**

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### **Debt Capital Commitments, Abraaj in the News and a LIBOR Transition Update**

Dec. 14, 2018

### **Joint and Several Liability**

Dec. 7, 2018

### **Random Fund Finance Observations**

Nov. 30, 2018

### **Winter and Sanctions are Coming**

Nov. 16, 2018

### **Another Capital Call Enforcement Proceeding???**

Nov. 9, 2018

### **Abraajfluena? Not in London...**

Nov. 2, 2018

### **The Inaugural Edition**

Oct. 26, 2018