Mid-Year Market Update

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By **Wes Misson**
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As we near the close of the second quarter, eagerly look forward to next week's 6th Annual FFA European Fund Finance Symposium in London and keep a watchful eye on the macroeconomic environment, we thought it would be helpful to provide an update on 2022 market activity based on our observations.

Fundraising. Early indications are that YTD private market dollars raised are on track with last year's record pace while fund count may end the year meaningfully lower. Large platforms continue to attract a greater share of capital but, on the whole, capital raising totals in the vicinity of last year's record numbers means there are plenty of opportunities for lenders.

New matters. Mirroring the trend in fundraising, our overall deal count in the U.S. is slightly lower while dollar originations are in line with the record 2021 pace. Average deal size is up, which correlates to more large funds in the market. In fact, we have closed or are currently working on 11 multi-billion-dollar syndicated facilities. If this trend holds, this will set a record and smash 2021's mega-deal rebound following a COVID environment-slowed 2020. In the UK, our new deal activity is up 14%. Among lenders, it's been a multi-speed market as capital constraints, staffing capacity, and business mandates have evolved differently over the past two years.

Hours. While new matters correspond to new origination, our time accruals are a better measure of overall market activity since the stat captures deal events like amendments, joinders and investor closes. YTD our time accruals in the U.S. are running 19% ahead of last year and in the UK 30% ahead of the prior year, both pointing to significant overall market growth. To support this growth, we've increased our ranks by 19 attorneys and paralegals YTD to a total of 75 for our global fund finance practice. This growth also excludes attorneys and paralegals who will be starting this summer and a robust incoming class of 8 newly minted attorneys in the fall, our largest class ever for fund finance. The market growth continues to seed opportunities for many young professionals in our industry, a fact we should all be proud of as we continue our investment in the next generation's development.

Margins. As we previously forecasted, making clear observations on margins has become more complicated by the variations in credit spread adjustment approaches on SOFR loans. The simple takeaway on pricing, in our observation, is that lenders have retained pricing power in 2022. Average subscription facility margins are a few basis points wider than in 2021, but may be influenced by loans that incorporate what would have been a credit spread adjustment into the margin.

ESG. We have been watching the deal flow on the ESG side this year, and it remains strong with 6 deals worked YTD. This is on pace to exceed 2021's deal count by a slight margin despite the regulatory headwinds. As fundraising slows some, the ESG funds have not been immune, with this quarter bringing some of the first reported declines in ESG investor momentum during the last two years. That said, ESG-focused funds are not going anywhere, and we should expect this segment of the market to continue to evolve.

Outlook. The market environment has fundamentally changed in the past six months, but we don't expect to see a material impact to fund finance origination volume in the remainder of 2022 because of the existing momentum in fundraising and because subscription credit risk is not as directly tied to economic variables as many other commercial loan asset classes.

For the 2023 outlook, private capital market internals bear watching. Buyout fund deal value and exits appear to both have slowed meaningfully. Two observations on this: (1) A deceleration in capital velocity may present a headwind to 2023 fundraising as capital deployment and capital returned to LPs both slow, and (2) LPs are bound to be more selective in strategy and sponsor allocations given the more complex risk and return backdrop, which could also slow 2023 fundraising.

On the lender side, slower economic growth may lead to a more intense cost focus, especially at large lenders. As bank revenue growth becomes more difficult to generate in a slowing economy, expense control moves to the forefront as a tool for defending profitability. A positive perspective on this may be that the motivation to innovate in fund finance is moving higher. If slow-flation is the base case for the next 12 months, we expect lenders to spend more time on questions like: What is our all-in acquisition cost per million dollars of loan exposure, and what's the long-term target?

Where can customer interactions be migrated onto a self-service digital platform? Where can automation or process improvements be deployed to shift team member focus to relationship or advisory roles? Necessity, again, may prove to be the mother of invention as lenders and borrowers together solve for more efficient and streamlined approaches.

Best of luck with closing out the quarter, and enjoy your weekend. I look forward to seeing many of you in London. It will be so good to be back!

LSTA Publishes New Forms of Term SOFR Amendments

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By **Jeffrey Nagle**
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The LIBOR transition process continues to roll along. New transactions are (mostly) being closed without using LIBOR any more, and many legacy transactions are naturally transitioning when refinanced or renewed this year. However, a significant portion of the legacy loan market remains that will require active transition at or before LIBOR cessation on June 30, 2023. In order to help members think through the process, the LSTA has produced and distributed a series of **amendment forms** (LSTA membership required to access forms) that may be used by market participants as part of the LIBOR transition.

There are three basic ways to transition from a legacy LIBOR loan to a benchmark replacement rate. The first can be called a "Consensual Amendment." This is a standard, old-fashioned type of amendment – the parties to a transaction get together and all (typically this would require 100% lender vote) agree to modify an agreement to replace LIBOR with a replacement rate. The second is by operationalizing the ARRC-style "Amendment Approach." This would allow certain parties (typically the agent and the borrower) to select a new rate and, pursuant to an amendment, incorporate the new rate and mechanics necessary to implement it with a consent threshold that is typically lower than a Consensual Amendment (*e.g.*, as long as 50% of the lenders do not object after a certain period of time). The third is by using the "Hardwired Approach." This method provides for a transition to a pre-agreed rate on a certain date, as long as such rate is available and administratively feasible.

However, it is important to remember that, even under the ARRC Amendment Approach or Hardwired Approach, the fallback provisions are only part of what is necessary in order to fully transition loan documentation into alternative rates. While standard fallback language may tell you what rate to transition to, and when, it almost never provides the actual mechanics to transition. For example, fallback language may instruct the parties that, upon LIBOR cessation, the interest rate under a loan will change to Term SOFR plus an ARRC-recommended spread. However, as an additional step, the loan agreement will need to be modified to insert the definitions and mechanics of the Adjusted Term SOFR rate (*e.g.*, inserting definition of "Adjusted Term SOFR," deleting LIBOR references, modifying how "Interest Period" is used, changing the eurocurrency liabilities language, adding U.S. Government Securities Business Day definition, etc.). These technical, administrative or operational changes are referred to, in standard ARRC and LSTA drafting, as "Benchmark Replacement Conforming Changes" and often may be implemented on a unilateral basis by agents.

There are two basic ways to accomplish the mechanical portion of LIBOR transition developing in the market, with variations on the spectrum in between. One is a "standard" amendment. This is what it sounds like – it's a normal-looking amendment that we are all used to. Think of this as "delete Section 2.05(a) and insert the following Section 2.05(a) in lieu thereof." It is bespoke for a loan agreement, and describes (with specificity) which changes are necessary to implement a transition. It requires careful tailoring and drafting unique to each loan agreement.

Another option is a bit of a novelty that, as far as we know, was developed just for purposes of LIBOR transition. This we've nicknamed a "golden amendment." A golden amendment is designed to be a blunt tool that could modify documents en masse. Think of this as "if you have anything in your agreement that is a LIBOR definition or provisions that relate to LIBOR, they are deemed modified to refer to Adjusted Term SOFR instead." In order to be useful as a tool, it needs to be very generic and capture, to the extent possible, any variations or provisions that might be seen in the market for syndicated credit agreements.

There are pros and cons of using either approach (standard or golden amendments), or gradations in between, and some lenders are using each in different circumstances. Cadwalader is happy to talk through the options and considerations with any market participants (mandatory business development pitch quota satisfied!).

Below we will explain how the forms the LSTA has provided may be used in certain circumstances.

Term SOFR/Daily Simple SOFR Consensual Amendment: This is a form that would allow parties to implement a conformed, blacklined credit agreement (which would be attached as an exhibit) to transition the benchmark rate. This is a standard amendment, *i.e.*, it does not utilize fallback provisions. Many agents will have their own form of amendment that can be used for this purpose; the LSTA provided this form as an example. It will require a detailed modification exercise to have a correct conformed credit agreement, and is particularly helpful if other changes are being made at the same time.

Benchmark Replacement Amendment: This form is to be used in connection with ARRC-style Amendment Approach fallbacks. The faceplate of this amendment selects the replacement rate and replacement date, subject to necessary consents. An exhibit would be attached to include the “operative terms” that implement the details of the transition.

Benchmark Replacement Conforming Changes: This is the cover amendment used to implement Benchmark Replacement Conforming Changes. The Benchmark Replacement Conforming Changes are typically implemented unilaterally by the agent, and therefore neither the borrower nor any lenders are signing. An exhibit would also be attached to this form to include the “operative terms” that implement the details of the transition.

Operative Terms/Exhibit A: This is where the magic really happens. These are the operative terms for a “golden amendment” modification of a syndicated loan agreement. This exhibit can be attached to either a Benchmark Replacement Amendment or Benchmark Replacement Conforming Changes faceplate. These provisions, among other things:

- insert the applicable definitions for the new benchmark rate structure
- delete any unused LIBOR-related definitions
- set a date for LIBOR to be no longer available
- modify provisions in the documents to refer to Adjusted Term SOFR instead of LIBOR
- delete London Business Day and London interbank market references
- change notice periods to be a standard [three (3)] U.S. Government Securities Business Days
- update eurocurrency liabilities language

Note that this Operative Terms/Exhibit A makes it clear that you do not “break into” existing LIBOR tranches for purposes of transition, consistent with ARRC and LSTA drafting and most market participants’ expectations. That is if a 3-month LIBOR tranche was set on June 1, 2023, that loan would continue to bear interest at 3-month LIBOR until September 1, 2023 (even if LIBOR ceases on June 30, 2023).

The LSTA is preparing Daily Simple SOFR versions of these documents, where applicable, for later distribution.

Cadwalader was drafting counsel for the LSTA in the challenging and rewarding process of developing these documents, which worked their way through various working groups, the LSTA’s primary markets committee and, eventually, widespread distribution. We always remain happy to discuss these, or any matters, with our clients and friends.

Women in Fund Finance – ‘Infrastructure Fund Life Cycle Considerations’ Panel

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This week, Women in Fund Finance hosted a panel discussion, "Infrastructure Fund Life Cycle Considerations: A Bank and Funds’ Perspective." The esteemed panel included Adina Schwartz from Morgan Stanley, Micaela Mastrogiannis from KKR, Vicky Du from Standard Chartered, and Sarah Elliot from NAB. The panel was moderated by Carolyn Baker from Commonwealth Bank of Australia. This robust discussion focused on the unique challenges of using fund level credit facilities, including subscription, NAV, or hybrid, and providing liquidity management solutions throughout the lifecycle of an infrastructure fund.

We heard from both the financing side in terms of issues faced when structuring, underwriting and approving these facilities, as well as FX considerations. It was also interesting to hear the fund’s perspective in terms of liquidity management and considerations of using leverage vs. bridging. The panel also compared and contrasted these strategies with those we see in buy-out, real estate, and credit funds. The panel also touched on ESG.

CRT Webinar Replay and Register for June 29 Second Installment

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In case you missed this week's first installment of our Capital Relief Trades webinar series, titled “CRT Overview and Regulatory Capital Basics,” you can access a replay **here**.

The second installment is scheduled for June 29 from 1:00 p.m. to 2:00 p.m. Titled “Unpacking Regulation Q: CRT Structuring,” the webinar − led by partners Jed Miller, Daniel Meade and Ivan Loncar − will cover:

- What types of risk-weighted assets can benefit from a capital relief trade?
- What terms must a capital relief trade have in order to offer capital relief?
- What terms must a capital relief trade not have?
- How should a bank invest proceeds from the issuance of credit-linked notes?

Register **here**.

Moody's Report Highlights Cap Call Lending Growth

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Moody's Investors Service this week published a brief overview on capital call lending. Rather than ratings metrics, the write-up focuses on the role of capital call lending in the banking sector. Available behind a paywall **here**.

FFA – Rising Stars, 2022

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Do you know a Rising Star with an outstanding overall contribution to the Fund Finance industry? Nominate them **here** to be recognized at the 2022 annual "Rising Stars" award ceremony. The Fund Finance Association, in collaboration with NextGen, is eager to celebrate individuals with less than 10 years of fund finance experience who emphasize our industry's career pillars, such as professional contributions focused on excellence in client service, diversity and inclusion, training and mentoring, networking and community service. Nominees can be nominated by anyone, any number of times, by July 29. Click **here** to nominate someone.

WSJ Article on Limited Partner Fund Finance Solutions

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The Wall Street Journal this week published an article focused on how investors are addressing over-allocations to private equity using fund finance solutions like preferred equity and collateralized fund obligations as an alternative to reducing new commitments and sales in the secondary market. The subscription-required article is accessible **here**.

Muggsy Bogues Stars on Fund Fanatics

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Scott Aleali and Jeff Maier hosted former Wake Forest and Charlotte Hornets star Muggsy Bogues this week on Fund Fanatics for a wide-ranging conversation, including his NBA career, overcoming adversity, leadership and culture, and his philanthropic activities. Watch the episode **here**.