CADWALADER

Learning to Live with Lower for Longer

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The low yield environment is backing long-term investors into a corner. “Pension World Reels from ‘Financial Vandalism’ of Falling Yields,” a *Bloomberg* headline aptly summarized in late August. While stock indices are up nicely year-to-date, the rally in bonds presents profound challenges to liability-matching investors in 2019. Nearly a third of government and corporate debt globally trades at negative yields, according to a recent *Financial Times* estimate.

Negative yielding debt holds important implications for fund lenders. We expect to see more fund-level asset leverage deployed to counter declining investment returns. Large investors may also turn towards portfolio leverage to aid returns and free up buying power ahead of a dislocation. Finally, as low rates persist, pressure to move farther out the risk spectrum will continue for funds, investors and lenders.

Declining government bond yields necessarily filter into expected returns for all asset classes. But you don’t have to be an adherent of modern portfolio theory to be a believer: 2019 has seen a parade of down-round IPOs – initial public listings at valuations below the implied value at the last round of private fundraising – and of private-to-public listings that settle into trading ranges below the IPO price. Public markets, in these cases, have been more willing to be critical of valuation than private investors and so call into question exit assumptions.

Dry powder, sitting at a record $2.44 trillion at mid-2019, according to Preqin data, may also weigh on future returns because it signals steep competition for assets. Funds face pressure to deploy capital in an environment of high valuations, slowing growth and low returns. At the same time, private funds manage to an 8% preferred return component under a structure that dates back to the decade of "Cheers," Drexel Burnham Lambert, big hair bands and 10-year Treasury yields between 9% and 11%. The preferred return, initially intended as proxy for the risk-free rate, is now five times higher than the 10-year Treasury yield.

Given this backdrop, we expect that more sponsors will turn to fund-level asset leverage. Fund-level leverage allows sponsors to prioritize asset quality while at the same time defending returns. While generalizations in this area are of limited value, over the past two years or so, we’ve seen low attachment point NAV facilities price at an average margin of around 280 bps over LIBOR and hybrid facilities at roughly 240 bps. While these margins are comparable to what’s available in the corporate loan market, fund-level facilities can (1) finance a variety of asset types, (2) look to a dynamic pool of assets as collateral, including future acquired assets, and (3) offer one-stop shopping logistical and cost advantages compared to financing individual assets.

These benefits may become more appealing to U.S. funds over time as low yields persist. Based on internal data, a full 60% of the fund financing originations in Europe our team has worked on in 2019 consists of NAV or hybrid facilities. The ECB’s euro area 10-year government bond yield index has held below 1% over the past four years. If Europe is a forerunner in the low yield paradigm, the European fund finance experience may well be instructive to U.S. lenders.

Pressure on returns is not unique to funds. Pension plans posted median returns of 6.47% for the year ending June 28, 2019, according to data from Wilshire Trust Universe Comparison Service. Since then, the challenge has only intensified. In August, high yield bonds of 14 European issuers crossed below 0% on a yield-to-call basis. Defined-benefit pension funds are particularly exposed to the shift lower in returns.

Not surprisingly, portfolio leverage at pension funds seems to be gaining interest. CalPERS CIO Yu Ben Meng is reportedly considering leveraging the fund’s portfolio. This is not a new discussion at CalPERS, but one that may be gaining traction. (A **June presentation** summarized how the use of fund leverage could play a role in bridging a market dislocation without forced asset sales). Canadian pension funds have led the way in using fund level leverage, often employing an array of borrowing tools under tight overall constraints on leverage.

Where does this leave fund lenders? We think lenders should consider defining their mission broadly. Fund lending, from our vantage, will increasingly encompass more than subscription lines. Lenders that thrive may be those that solve today’s challenges facing funds and their clients. While today’s risk-and-return environment is demanding, we see continued opportunities for growth and innovation in the fund finance market.

Subscription Finance Loan Agreement Series, Part 9: Features and Limits of Accordion/Extension Options

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Accordion and Extension Options are a common feature of a number of financing documents in a number of sectors other than Funds Finance, not least in Leverage Finance and Real Estate Finance transactions. This week we focus specifically on why and how these are used in Capital Call/Subscription Finance transactions and on some of the common issues that arise when they are used.

So, first the why. This is relatively straightforward. Capital call/subscription facilities are, almost without exception, put in place at an early stage in the life of a fund, usually on or after first close and before the fund finally closes its doors to additional Investors. At that point, the fund will have targets as to the pace of spend on investments but no certainty around that, so it may well need some flexibility around the period during which facility utilisations are available. The fund may also have constraints under its LPA or other constitutional documents on the term of any facilities that it may take out. Additionally, and particularly if the fund puts a facility in place prior to final close, the fund will anticipate that it may require an increase in the amount of its facilities should its fundraising go to plan and the investor profile allows it. At the same time, while the fund will want the option of an increase, it will not want to pay commitment fees for the potential increased amount until it is reasonably certain it will actually need it.

If a fund does require an extension option, then the documentation and implementation process for this is usually pretty straightforward. The Facility/Credit Agreement will set out (i) the possible term or terms of such extension (usually this will be by way of allowing one or more extensions of 12 months), (ii) the notice period required for the extension to be implemented (commonly between 30 and 60 days or a similar period before the facility is due to terminate), and (iii) the conditions to any extension being granted (which will usually include a condition that no default or event of default has occurred, often a requirement for a payment of an extension fee, and sometimes a provision stating that the extension is at lenders' discretion). Although this is much more common in implementing an accordion, there may be a provision allowing lenders to opt in or out of any proposed extension, with a proviso (in the case of an extension) that if a lender does opt out then the facility will continue, but only at the reduced level at which the remaining lender or lenders are committed.

For a lender, its only concern with an extension in a funds facility (which they or their counsel should check before the extension is granted) is that the period for which the extension is or could be granted does not affect the fund's ability to draw down on the facility or the obligations of the investors to repay out of their commitments. In reality, this means ensuring that the extension period does not go past any trigger (such as the end of an investment period) in the fund documentation which may change the fund's and investors' obligations in this respect. Where the facility is secured, lenders should also check that the extension remains covered by such security and, if not, implement any necessary confirmations or further security to ensure that it is.

If a fund requires an accordion option, then again the documentation and implementation of this is relatively straightforward, although it can look somewhat less so. As with an extension option, the documentation will specify a notice period required before the accordion option is exercised, as well as the number of times and the period during which the option can be exercised. It will also specify the minimum and multiples of any amounts that can be requested as part of the accordion. The accordion may be "committed" (which means that the lenders are required to make it available absent a failure to satisfy any specific conditions of the accordion, such as the non-occurrence of a default or event of default) or "uncommitted" (which means that the viability of the accordion is at lender discretion). Or it may be a combination of the two. More often than not, an accordion will be uncommitted (or mostly uncommitted), and this is where the documentation can start to look complex. From the fund's perspective, it wants to know that it can make its best shot at obtaining the accordion at the level it requires (whether from the existing lenders or even new lenders) and from the existing lender's perspective, it will want at least first shot at providing that accordion. In documentation, this can lead to a number of frankly repetitious clauses in the accordion section that both allow existing lenders to retain options to provide the accordion (even if other existing lenders have rejected that option) over one, two or more "go rounds." This will be allied with a provision (once the existing lender option has been exhausted) allowing the fund to bring on board a new lender or lenders to form part of the syndicate.

For lenders, there are probably three issues to focus on with an accordion, leaving aside the question of whether or not they are committed or not to provide it. The first is to ensure (as with an extension option) that the fund documentation continues to permit the accordion to be taken out and does not affect either the fund's ability to utilise the accordion or the fund's and investors' obligations to repay. The second is to ensure that, in all jurisdictions where security might have been given for the facility, that security will continue to cover the accordion (and, if not, that new or further security or confirmations are put in place to ensure that it does).The third is to ensure that, to the extent that an accordion is not taken up equally by all the existing lenders, any existing commitments are adjusted between lenders so as to ensure that once the accordion is put in place, each lender is sharing equally both in existing utilisations and in ongoing (unutilised) commitments. The latter may require some adjustment mechanics to be included to allow this to occur relatively seamlessly.

A final word on accordions. Accordion wording is not part of the standard LMA documentation, but there is a similar clause (in the Leveraged LMA document), which commonly also appears in Fund Finance facilities, which allows for increases in existing lenders' commitments and/or for new lenders to be brought on board where there is a "defaulting" lender. This wording deals with a different situation and is usually far more straightforward than the terms used for the accordion, but the base assumptions and drafting are very similar.

Fund Finance Partners is Launched

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FFF this week got hold of Zac Barnett and Richard Wheelahan, who last week announced the founding of Fund Finance Partners. Here is our conversation.

FFF: Congrats on launching Fund Finance Partners! Tell us about the business and the services it will be providing.

Zac Barnett: Thanks for reaching out and great to speak with you. As far as we know, Fund Finance Partners (FFP) is the first debt advisor here in the U.S. that is dedicated to optimizing fund sponsors' fund and management company-level debt arrangements. We intend to focus on the placement of subscription-backed, hybrid, NAV, secondaries, management company and general partner financings, but we have experience with many other capital markets solutions as well.

Our model is fairly simple, but our knowledge and capability are unique. We start by guiding sponsors as they formulate the fund or company-level capital structure. We then go to market on their behalf, and obtain the best possible range of potential debt capital solutions to choose from. After a lender is chosen, we oversee the execution process. I think what sets us apart is our ability to drive the transaction from inception through closing, making sure all parties remain attentive, on time and on budget. There's not much Richard and I haven't seen, so we're certainly able to spot all of the commercial, legal and operational issues with a particular credit arrangement. We make sure our sponsor clients are aware of problematic fund and loan structures, non-starters and off-market terms.

FFF: We saw your website, fundfinancepartners.com, is up and running. How far along in the start-up process are you? Are you open for business?

Zac: We closed our first deal last week, so we are officially open. Frankly, it has taken us a little longer than we would have hoped, but developing our identity, our message and our processes (down to forms, communications and templates) was time-consuming but certainly needed to be crisp. The rollout was actually delayed due to our time and attention being focused on advising fund sponsors while executing our first two deals. Finally, we did not want to open our doors until we had the proper personnel in place to flawlessly execute these transactions. The team we've put together is a solid one, and the "insider" perspective that Richard brings has proved invaluable, giving us the ability to immediately relate to our sponsor clients. We've all put in a lot of work to get here and are excited for the future.

FFF: What type of clients are you ideally situated to assist? Is there a particular segment of the market you intend to focus on?

Zac: I'd say we're ideally situated to assist any fund sponsor that uses debt capital, whatsoever, in the financing of its and its funds' business, and is committed to obtaining optimal terms and the best pricing for its investors. Much like our colleagues in the broader fund finance markets, we are sector-agnostic, having worked on hundreds of fund financings for sponsors with just about every asset strategy you can imagine. I will say that our team, particularly Richard, has a great deal of familiarity with private credit. I've been representing private equity real estate and buyout funds for nearly 20 years, so we're strong there as well.

As far as size of manager, we initially thought our target market would be small to mid-size sponsors, but our first couple of engagements have come from larger firms, so I suppose time will tell. If I had to guess, the larger firms will be using us for the more esoteric transactions and market checks whereas the smaller sponsors may benefit from our relationships, market knowledge and execution capability.

FFF: Richard, you are the General Counsel and Chief Compliance Officer of Capitala. What's your role in FFP and how do you plan to split your time?

Richard Wheelahan: That's a great question. I'm as plugged-in as ever at Capitala. It's been a remarkable 18 months, and I'm proudly working on strategic initiatives that will make the firm more responsive to our constituents' needs than ever. One thing that Joe Alala, our founder, has always emphasized to the team is Capitala's place in the asset management ecosystem. Capitala has always emphasized relationships over transactions. For years, I've whiteboarded or brainstormed debt capital markets, structured finance and other credit solutions with dozens of our fund sponsor brethren, whether in their offices, at conferences or on the backs of napkins at happy hour.

When I approached Joe about FFP, he agreed that my and Zac's expertise and dedication is needed, and he has been supportive of not just my co-founding role but also FFP's mission. They say that if you're doing what you love, it never feels like work. I'm certainly working harder, and more, but I'm thrilled to be able to build a new firm with Zac, my long-time friend and colleague. It is a privilege to build a culture at FFP that reminds me of some of Capitala's best attributes: intellectual freedom, uncompromising dedication to our clients and making a positive impact on the industry as a whole, whether big or small, competitor or colleague.

FFF: Starting your own firm must be exciting. Why do you feel the timing is right?

Zac: My wife and I just welcomed a new baby, so why not add another challenge? In all seriousness, we've been discussing the idea with numerous industry leaders over the last two to three years. Witnessing the success that some of the fund finance advisory shops have had over in Europe probably pushed us a little closer. We still can't believe we're first to market here in the U.S. Finally, we unofficially polled over 50 sponsors, the vast majority of which were positive, noting their desire to focus on their core businesses rather than devoting valuable internal resources to the loan process. That, more than anything, pushed us over the edge. Every other lending market of equal or greater size has utilized advisors to inject much-needed efficiency and transparency to the loan process. Fund finance should be no different. Given the immense growth that fund finance has experienced, coupled with the proliferation of products, we certainly think such a resource is overdue.

FFF: What about FFP's process or approach might stand out to the fund sponsor that mandates you for a financing process?

Richard: In a normal, full-scope engagement, the first thing that happens is Zac and I pore over the fund's marketing materials, governing documents and model. We then invite the sponsor's principals tasked with the financing to discuss the range of debt capital structures we would suggest. For example, we might identify nuances about the collateral or strategy that might be optimally financed with a combination of products or alternatives to what the sponsor anticipates. Next, the sponsor will review and approve the material that FFP would go to market with, on their behalf (rather than spending time and utilizing investment professionals to create these materials internally). Sponsors would then receive a matrix comparing and contrasting the financing options that we obtained for them, and after discussing, we would negotiate the chosen term sheet, either with sponsor's counsel or autonomously. Another aspect that we think sponsors will appreciate is that in addition to Zac and I knowing how to execute and how to effect optimal outcomes, we're no stranger to working with (or as) outside counsel. We are confident that sponsors will appreciate our ability to hone in on issues that would previously have gotten jammed between law firms, and resolve them directly with the lender, saving time and money. Finally, as a fund sponsor, I always appreciate working with advisors who make me look good! Sponsors will appreciate the post-closing materials and guidance we provide to make the operation of the credit facility streamlined and less burdensome.

FFF: We are forecasting significant growth in NAV-oriented lending over the next five years. Does that play into your strategy?

Zac: Definitely. The proliferation of the number and type of fund financing products is of great interest to our sponsor clients. Unfortunately, many of them are skeptical of a lender's ability to execute on these structures, and that's where FFP comes in. We've worked with various lender credit committees for years helping them get these products approved. As you at CWT well know, hybrid and particularly NAV transactions are the future. From our research, the market has increased by 50% year over year each of the last 3 years.

The relative inability of sponsors to find solutions to post-commitment period financing for their funds has consistently resulted in lower returns for their investors. This is changing, and we will show sponsors and lenders that these facilities can and are being executed in a manner that preserves creditworthiness for the lender while setting the record straight on the perceived (and misguided) cross-default risk to the borrower.

FFF: Do you promise not to drive all of our lender clients crazy???

Zac: Only those that don't take us to lunch. Look, these are our friends and folks Richard and I have worked with for a combined 35+ years. I have represented more than half of the major lenders in the space and value those relationships as much as any. We're here to grow the market and increase transaction volume. I can't tell you how many times over the years that we've seen deals die because the sponsor's docs weren't in order, they hadn't left enough time for lender selection and document negotiation or they went too far down the road with the wrong lender. FFP solves those issues before they crater the deal. I would think that over the years Richard and I have gained the respect of those in the market through our work ethic, intellectual honesty and sense of fairness. We certainly plan on bringing those attributes to the table when working with lenders. In the end, we think lenders will see the value in negotiating with folks that have lived in the space for years and understand precisely what is market rather than someone who jumps in once or twice a year and references market terms they overheard at a cocktail party.

FFF: Thanks for taking time out to visit with us. Best of luck on your new venture.

Zac: We appreciate your time.

Richard: I always appreciate the effort that your team puts into *FFF*. I'm looking forward to working with you and your clients, and it's really cool to be a part of this issue of *FFF*.

ACG Article on Minority Interests and GP Financings

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Middle Market Growth, published by the Association for Corporate Growth, earlier this month published an article titled "The Future's at Stake: New GP Financing Strategies Can Be a Lifeline for Middle-Market PE Firms." The article covers the state of the market around GP stakes, including covering GP financing facilities. Doug Cruikshank, head of Fund Financing for Hark Capital, is quoted. The article is available **here**.

Private Funds CFO Article on Subscription Facilities

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Private Funds CFO published an article titled “Investors Reluctant to Curb Credit Line Use – Lawyer.” The subscription-required article quotes Patricia Lynch from Ropes & Gray extensively and is available **here**.

Walkers Article on Fund Finance Trends Across the Atlantic

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Zoë Hallam of Walkers Guernsey wrote an article for *Asset Servicing Times* titled “Beyond Subscription Lines: Fund Financing Trends Spreading Across the Atlantic.”

The article highlights data that suggests 90% or more of closed-ended funds in Europe intend to use a capital call facility. Yet even with growth of these traditional facilities expected to continue, NAV and hybrid products are also being offered by an increasingly diverse lender base. Trends in subscription lines for GPs, management fees and even employee co-investment opportunities appear to be on the upswing, as do the emergence of debt advisers in the European fund finance space. The article details factors that are leading to our industry’s growth and what it could mean for growing competition in our sector. The article is available **here**.

FFP Article on Fund Finance

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Zac Barnett, Managing Partner at newly formed Fund Finance Partners, authored an article this week titled, "Subscription Facilities – No Apology Necessary," in response to recent criticisms of fund sponsors' use of subscription-backed credit facilities. In addition to more well-known advantages, Zac highlights such facilities' lesser-known strategic value, including their use as a balance sheet builder for ramping up a fund's investment portfolio, providing access to letters of credit and alternative currencies at a low cost, and enhancing a fund's ability to pay distributions to investors and honor redemptions on their behalf. The article can be found **here**.

Recommended Reading

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“Why you should be selling a piece of your firm”: *Private Funds CFO* reflects on the emergence of GP-stake deals over the past couple of years, the incentives behind these transactions, challenges with valuations and whether there is a typical structure for these deals. [**Private Funds CFO**]

“TA seeks up to $1bn to double down on its strong performers”: *PE Hub* reports that TA is in the market to raise up to $1bn to allow it to retain an interest in its strong-performing portfolio companies that have compelling future growth potential rather than selling those investments to third parties. Another example of GPs getting creative to hold investments longer and realise better returns.
[**PE Hub**]

“Shares in private equity group EQT surge 25% after IPO”: EQT takes the rare step of listing with its stock soaring by more than 25% on its first day of trading. This isn’t the first time a PE fund has taken this step; however, the fact the fund was ten times oversubscribed and the leap in share price on the first trading day indicates there may be greater demand in the public markets for buyout funds. [**Financial Times**]

Fund Finance Hiring

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Fund Finance Hiring

Standard Chartered is seeking a Director of Fund Finance for its Financial & Strategic Investors Group in New York. For more information or to apply, please click **here**.

The Charlotte office of Cadwalader is seeking an associate for its Fund Finance practice. Qualified candidates will have 3-7 years of experience in syndicated lending, commercial lending, leverage finance, fund formation, CLOs or other relevant experience. Candidates must possess excellent academic credentials and solid law firm or in-house legal experience as well. For more information, reach out to **Wes Misson**.