C A D W A L A D E R

Cadwalader Partners Review Fund Finance Trends

November 1, 2019 | Issue No. 52

Cadwalader partners Samantha Hutchinson, Wes Misson and Tim Hicks shined a light on the firm's Fund Finance practice at the recent Cadwalader Finance Forum hosted in Charlotte. Drawing from the firm's representations in Q1-Q3 on both sides of the Atlantic, the three presented a data-driven analysis on fund lending trends. Key observations included the following:

- Representations by deal count in the U.S. increased 15% in Q1-Q3 on an annualized basis compared to 2018. Much of the growth has been powered by specialist mid-size banks engaging mid-tier funds. In London, the firm's representations are on pace to exceed the prior year by more than 80%.
- Fewer $1 billion-plus facilities closed in the U.S. in the first three quarters, playing into average facility size. However, the visible pipeline shows a number of large loans on the horizon.
- The lender community continues to broaden. Nearly 60 lenders participated as leads or participants.
- In the U.S., 85% of deals were subscription-backed, compared with only 30% in London. Secondaries funds are increasingly users of fund finance in Europe, accounting for 27% of 2019 deals.
- Scale matters. The top five sponsors accounted for nearly 50% of U.S. commitments in Q1-Q3.
- As a corollary, lending continues to be relatively concentrated: the top two U.S. lenders accounted for 63% of commitments in Q3. Specialist platforms at mid-size banks, however, are making meaningful gains – three such firms rank among the top 10 lenders.
- Continued saturation and competition in the U.S. subscription finance market, coupled with a low return environment, may make conditions ripe for material growth in U.S. hybrid and NAV lending activity for 2020 and beyond.

We anticipate providing a full summary of 2019 after we close out Q4. Thank you to all who attended the Finance Forum.

ILPA's Model LPA on Fund Finance

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ILPA this week published a model limited partnership agreement that lives up to its stated mission of providing a starting point for an Investor-friendly fundraise. The model LPA is available on ILPA's website **here**. Below are our observations on the very light provisions in the model LPA covering fund finance.

Overcall Limitations. There is a percentage of prior call overcall limitation for both defaults and excuses set at "[50]%" of the original call. No overcalls for management fees are permitted. § 6.6.6; § 6.7.3.5.

Debt Section. The debt section is insufficiently robust to be bankable by many lending institutions in the United States. All debt is prohibited other than on "a short-term basis for periods of less than six months to finance investments pending receipt by the Fund of Drawdowns." There is no clarification on letters of credit, although there is a footnote at the end to the effect of "[t]o be tailored on a fund-by-fund basis." Debt is limited to [15]% of Commitments with no consideration of the prospective increase in fund size between the first and final investor close. The pledge language is incomplete, neglecting authorization to pledge the Commitments and the collateral account. The language is ambiguous as to derivatives and other financial structures and could be more clear as to the authorization to call capital to repay debt after the investment period. § 7.2.

No Setoff, Counterclaim or Defense. It is missing.

Third- Party Beneficiaries. Subscription lenders are completely neglected in the third-party beneficiary section. § 20.11.

Third-Party Contributors. ILPA published a list of the participating attorneys and firms on its LPA task force. None of the preeminent law firms we see on the fund formation side in the United States appear to have been involved. Nor were any of the primary fund finance law firms involved. To our knowledge, ILPA did not request any feedback from the Fund Finance Association prior to publishing its model LPA.

Player Profile — Charles Newcomb

November 1, 2019 | Issue No. 52

Player Profile

This week we bring you an interview with Signature Bank's Charles Newcomb. Charles is a Managing Director in the Fund Banking Division at Signature Bank. He is responsible for the origination and structuring of debt products for private equity-style funds across all asset sectors. These include subscription, hybrid, NAV and management company credit facilities. He has held various origination roles in the fund finance industry for 13 years. Prior to joining Signature Bank, he was a Managing Director at Comerica Bank in the Equity Fund Services Group in New York as well as a Vice President in the Subscription Finance Group at Wells Fargo Securities.

***FFF:* Charlie, tell us a bit about how you ended up in fund finance.**

Oh, there's a humdinger of a story: In 2006, I met a woman by the name of Dee Dee Sklar on a beach in the West End of Anguilla in the British West Indies. At the time, I had graduated from Colgate University and was working at a law firm in New York (Skadden, Arps), figuring out what to do with the rest of my life.

A few months after that fateful meeting on Shoal Bay, Dee Dee hired me as an Analyst at WestLB in the Financial Institutions Group. When FIG was purchased in 2012, I moved with Dee Dee (and Michele Simons) to Wells Fargo's Subscription Finance Group, and the rest is history.

***FFF:* It's been exciting to watch the Signature platform continue to grow in 2019 on the fund finance side, but also in cash and treasury management and in expanding the West Coast presence. What matters most to funds when choosing a lender?**

I think the most fundamental and important piece to think about is: can my banker and the institution execute for me when I most need them to; and, do I have faith in that execution?

It's very easy to preach transparency, flexibility and ease during the origination phase – but what about when there is material upsize that needs to be approved and drawn on in 24 hours for an acquisition? Can you count on your lender to get that done? If your back is against the wall and you need your lender's help, you want to be confident that they will go to the mat to get it done.

Here at Signature we have had $400mm facilities approved by our Board of Directors in a matter of hours and have closed materially sized permanent increases in less than 24 hours. Because we have a flat organizational structure, we are able to be nimble without sacrificing our combined expertise.

***FFF:* By our count the number of active fund finance lenders in 2019 (leads and participants) stands just shy of 60. How important is it for a lender to carve out a clearly defined target market or a niche, if you will?**

Extremely important – especially if you're a new entrant with a strategic mandate to originate bilateral facilities. If you don't differentiate yourself from other players in the space, or add value in ways that they can't – either structurally or economically – it becomes challenging to compete very quickly.

***FFF:* We have a thesis that funds over time will need to consider fund-level asset leverage to support returns and that lenders may need to broaden their product offerings to include NAV and hybrid products if they're interested in maintaining loan growth. This hasn't really started playing out in the origination data yet. What's your take?**

Absolutely agree with the thesis. We've done a number of sizable hybrid facilities here since August 2018, and they are an important part of our mandate. At the moment, the nature of the collateral and the advance rates make these challenging to syndicate to more than a few lenders; however, I think we'll see that change in 2020.

***FFF:* Where is the fund lending market most ripe for innovation?**

I think it's what we touched on earlier – hybrid and NAV facilities – but I would also add facilities for single managed accounts ("SMAs"). The market is frothy for all three of these products, and the question will be: what lender can come up with viable offerings that can be applied to funds across all asset classes.

***FFF:* What do you see as the ingredients for success as a fund banker that differ from other general lending and capital markets disciplines?**

In order to be successful in fund finance, your skill set needs to be broader and more finely-tuned. Someone I used to work with used to emphasize being a “five-tool player” (using the baseball analogy of being able to hit for power and average, steal bases and have fielding prowess and arm strength). In other words, you can’t just be good with clients and focus on the origination component – you need to know how to look at both fund and facility structures through the lens of a credit officer and understand the nuances of the legal and security documentation.

***FFF:* Tell us a bit about how you keep busy outside of work.**

Spending time with my family is very important. My parents, sister and niece live in Nashville, so I spend a good amount of time down there. My wife Diana and I love to travel (Cayman Islands and St. Barths are our favorite spots). We also just got a 4-month old Cavachon puppy named Leo (short for Leonardo/Leo-nardog/Leo de Janeiro) who keeps us on our toes.

***FFF:* Any bold fund finance predictions for 2020?**

The first large, broadly syndicated, hybrid or NAV facility will clear the market ... and it will be led by a non-traditional lender (*i.e.,* not by a money center bank).

Subscription Finance Loan Agreement Series, Part 12: The Use of Hedging through Borrowing Base/Security

November 1, 2019 | Issue No. 52

An increasingly common trend in subscription/capital call financing, reflecting the increasing appetite of funds in this area, is the utilisation of what is a fairly typical leverage or borrowing base in a subscription/capital call line to facilitate the provision of hedging (either for interest rates or for fx) on top of the standard subscription/capital call line.

In some respects, the terms on which this is done follow, as you would perhaps expect, similar principles to those adopted in the LMA documentation (in particular, the leveraged LMA facility and intercreditor). It is probably worth summarising these principles (although a detailed discussion of these often quite complex provisions is beyond the scope of this article):

- Under the LMA documentation (specifically, the LMA intercreditor documentation), hedging liabilities rank alongside and equal to any "senior" debt (and benefit from security, which is held for the benefit of both the other senior creditors and the hedge counterparties in common and on an equal basis).
- There are restrictions imposed on hedge counterparties on what payments can be made to them by the borrower/counterparty (usually by reference to those payments not being made after or triggering Events of Default under the senior credit facilities).
- There are also restrictions on the hedge counterparty taking enforcement action (in the sense of terminating or closing out a hedging transaction). While hedging liabilities generally rank alongside other "senior" debt (as per the above), security enforcement is left to the security agent and subject to the terms of the senior facilities, so the hedging counterparties usually have no separate and independent right to insist on security enforcement.

In applying these principles (and hedging generally) to a subscription/capital call finance, there are some additional issues that have to be considered (and a variety of approaches can be taken to documenting and solving these issues).

The first issue is that subscription/capital call lenders are working within specific leverage constraints in terms of the investors in the fund borrower. If any hedge provider is to be included equally alongside the other "senior" lenders, then the potential liabilities to that hedge counterparty need to be taken into account in assessing the leverage (or borrowing base) required to make both the other senior lenders and the hedge counterparty whole.

The hedging liabilities are usually defined by reference to the mark-to-market liabilities applicable to a hedge arrangement on any particular day and by reference to the liabilities on a termination or close-out of the hedging. In any case, anticipating the liability level is difficult to do since hedging liabilities (however they are assessed) can fluctuate significantly.

One way this is often addressed is to have a limit or cap on the amount of the overall leverage or borrowing base that can be allocated to hedging and to allocate that based on a reasonable assumption as to what the maximum liabilities could be. If the hedging liability goes above that pre-allocated amount, then it is effectively regarded as being outside the leverage and/or borrowing base coverage and also as being, in effect, unsecured.

The second (and potentially more difficult) issue arises where the fund's LPA contains a specific leverage limitation at subscription finance level. Because of the way hedging liabilities can fluctuate (and assuming that hedging is included in the LPA as "debt" which contributes to the leverage calculation), it's possible that a fluctuation in the hedging liabilities would cause an excess over the permitted leverage. That can "infect" not only the hedging but also the remainder of the subscription/capital call piece. The most common way to deal with this is simply to ensure that the hedging (alongside the capital call/subscription facility) includes a very significant "headroom," which, in most foreseeable circumstances, should be sufficient to ensure that the leverage restrictions are not breached.

Finally, including hedging arrangements and hedge counterparties (whether just within an allocation of a proportion of the available leverage or borrowing base or as part of the security) needs to be addressed carefully in documentation. If, as is sometimes the case, the (bank-side) hedge counterparty is the same entity as the lender under the subscription/capital call facilities, then the primary concern will be properly dealing with how the hedge liabilities are allocated and defined. In many cases, however, the hedge counterparty and lenders will not be the same. Particularly in a "multi-bank" subscription/capital call facility, they will almost certainly not be the same.

At that point, the documentation can go one of two ways. If the hedge counterparty is also a lender (but not the only lender) in the subscription/capital call line, then a number of the "intercreditor" and related provisions that need to be included where a hedge counterparty is a party can be included in the facility agreement itself, and it is possible to do without a separate intercreditor document. Even in such cases, however, and certainly in any case where the hedge counterparty is not part of any subscription/capital call facility, having a separate intercreditor agreement between the relevant parties should be considered.

As with any intercreditor arrangement (whether included within a subscription or capital call facility or outside it in a separate intercreditor), the senior lenders and the hedge counterparties will need to consider carefully which matters within the subscription facility and/or the hedging arrangements may concern them and, if so, to what extent they should have a say in those matters being resolved. It is worth noting that hedge counterparties in a subscription/capital call facility arrangement may actually look for more “general” protections here than is standard in the related leveraged LMA documentation.

The inclusion of hedging in capital call/subscription facilities is a relatively complex and developing area. We are watching these developments with interest, and as with some other aspects of current subscription/capital call finance, this may well be an area that we revisit as these developments take hold.

American Banker Article on Subscription Finance

November 1, 2019 | Issue No. 52

American Banker earlier this week published an article titled, “Banks extending more credit to PE. Will they regret it?” The article covers the growth of fund finance as well as discussions of subscription finance on recent bank analysts calls. The article cites some data that we provided to demonstrate the growth of the global market for subscription lines of credit to PE firms.

The subscriptionâ€‘required article is available **here**.

On the Move — Fund Finance Tidbits

November 1, 2019 | Issue No. 52

On the Move

David Arthurson has joined Standard Chartered Bank as Executive Director in its Financial Strategic & Investors Group. Based in New York, David joins from Westpac and will be working to further develop Standard Chartered's client coverage of North American strategic investors and alternative asset managers, both at the Fund and Portfolio Company level. Standard Chartered has been active in fund financing for approximately 20 years and is able to provide solutions from fund formation to after-care facilities.

FFA Call for Award Nominations

November 1, 2019 | Issue No. 52

The FFA earlier this week requested nominations for the Julian Black Contribution to the Industry Award, the Dee Dee Sklar Women in Fund Finance Award, and, new for 2020, the Next Gen Member of the Year Award. The awards will be presented at the FFA's Global Fund Finance Symposium in Miami on February 12-14, 2020. Nominations are due by January 3, and nomination forms are available on the FFA's website **here**.