Recent Fund Finance Observations

December 6, 2019 | Issue No. 56

By Michael Mascia
FFA Board Member

By Jeremy Cross

We have had a couple of very active weeks since the last edition of *FFF*. With that in mind, Jeremy and I coordinated this week to provide our combined observations as we head into the home stretch.

- Activity Levels. All of the activity-level data metrics we follow continue to project quite favorably. Our November hours accrued, adjusted by number of business days, exceeded any prior month. And we opened 33 discrete new matters on the U.S. side – our most ever in a single month. London activity was equally strong, with 28 new matters getting underway. The visible pipeline also signals momentum: Our hours accrued on prospective matters in November exceeded all prior months other than a high-water mark in October.
- Next Gen. One of the main signals of a growing and active sector is the number of bright and motivated people coming into it and bringing different ideas and perspectives to the table. As an old hand in the sector and having seen it through various cycles, it is great to see the way this has mushroomed over the past year or more. A particular standout from my perspective has been seeing the FFA "Next Gen" initiative led by Billal Malik at Citi in the UK kick on with a number of events that have been notable both for the excellent content and the number and quality of those attending. But I'd also extend this generally to encompass the many people in the Fund Finance-focused teams at many of our friends and clients who we have had the pleasure of getting to know. Long may it continue.
- Innovation. We continue to participate in calls and meetings on product innovations and entrepreneurial ideas. Risk transfer solutions, capital markets financing, capital commitments structured as rated notes, regulatory capital relief and preferred equity are all areas where we forecast continued development in 2020.
- Umbrella Facilities. I thought Fund Finance Partners' Richard Wheelahan's piece on Umbrella Facilities this week was timely; if you missed it, it is available **here**. We are also seeing a lot of current enthusiasm around Umbrella Facilities. Wes gave our update on them a while back **here**. One practical thing we struggle with on Umbrella Facilities is getting our statements with respect to the general documentation work to look the way the funds want to properly allocate expenses between the various funds. Any upfront guidance on that can be helpful.
- FFA Miami Conference Content Committee. The Content Committee for the FFA's 10th Annual Global Fund Finance Symposium has a kickoff call scheduled for next Wednesday. If your firm is a speaking-level sponsor and you are interested in being involved with content, reach out to Nick Mitra or Dee Dee Sklar, who will be leading the committee.
- Ray Dalio's *Principles*. I finished reading and then re-reading Ray Dalio's book, *Principles: Life and Work,* over Thanksgiving. There is a tremendous amount of excellent, immediately actionable guidance packed into the book. There is also some crazy: printing and distributing baseball cards for our employees listing their strengths and weaknesses would be a lead balloon at our shop. But much of his substance, particularly around data-driven decisioning, is superb. I found it pretty fun trying to decide which ideas are brilliant and which are crazy. It is definitely worth the read. The book is available on Amazon **here**.
- Daniel Kahneman's *Thinking Fast and Slow*. Continuing with the theme of books which are worth reading and then re-reading (even for those of us in countries where the last Thursday in November is just the last Thursday in November), this is a fantastic guide (backed up by a significant body of scientific and empirical research) as to how to think properly and carefully about the decisions you make (both in business and in the rest of one's life) and how to make the right decisions. It achieves this in large part by explaining very clearly how much the way we process what we see, hear and read influences us, often unconsciously, to jump to the wrong conclusions and to make the wrong decisions.
- Ron Rivera. I hated to see Ron Rivera move on from the Carolina Panthers this week. He is a great man. He was such a terrific supporter of the Humane Society of Charlotte while I was on their board. And he was incredibly

patient with me one night over dinner as I peppered him with questions about leadership, Norv Turner's play calling and being prepared for having the unforeseeable dropped on your plate in the middle of the night. Another team is going to be lucky to pick him up.

Preferred Equity — The Best of Both Worlds?

December 6, 2019 | Issue No. 56

By Ian Wiese
Investec Bank, Head of Secondaries

Preferred equity is a tool employed by dedicated funds and traditional secondary investors to provide liquidity and funding solutions to managers with portfolios of assets looking for a solution which allows them to retain the majority of the upside and avoid giving up control of the portfolio in a down-side scenario, either where the manager is looking to accelerate liquidity or invest more capital.

Whilst preferred equity has some down-side protection, it provides significantly more flexibility to managers than traditional debt, which typically comes at a lower LTV, with a repayment profile, a set maturity date, and collateral over all or part of the portfolio and covenants. Preferred equity lacks these features, making it more akin to equity but ranks senior to the equity in terms of cash-flow until the preferred return is achieved. After this, all of the upside accrues to the equity holders.

Preferred equity bridges the gap between traditional debt and equity, and it is easy to see why dedicated vehicles to this strategy have been so successful in the last 15 years or so. Before the emergence of preferred equity in or around 2006, managers with liquidity or capital requirements had the choice of either selling assets, thereby removing any potential upside, or adding leverage to their portfolios, and the closest investors came to a preferred equity product was via single-asset or holdco financings. Dedicated vehicles have now taken this model and transformed the way it is used in private equity. Investors can now gain exposure to private equity through this hybrid tool, which carries the upside potential of private equity returns over a shorter investment period with volatility reduced as a result of the downside protections. Sound like the beginnings of the secondaries market? This is still a relatively small segment of the secondaries market (albeit it is acknowledged that not all pref deals are necessarily counted in the global secondary figures and, if they were, the number would be significantly higher) but one which is growing rapidly, accounting for an estimated 5% of global secondary deal activity last year and with the number of secondary funds exploring this as an alternative investment increasing day by day.

Where and when is preferred equity relevant?

Although the secondaries market has evolved as an efficient and effective trading ground for the sale of private equity portfolios, a traditional sale isn't necessarily the right solution for all managers. Where a manager still sees value and upside in the underlying portfolio, it may be that holding onto those assets to allow them to mature and generate further returns – rather than embarking on a traditional sale – is in the best interests of the investors. Preferred equity is also a powerful source of capital to release liquidity in the portfolio or provide additional investment capacity without leveraging the portfolio directly. We are also seeing an increasing number of acquisitions supported by a preferred equity solution.

How is debt finance used to support these transactions?

Private markets managers are on the whole very familiar with how to use subscription lines and who to approach as a provider. Finding a debt provider to lend on a non-recourse basis purely against a fund portfolio, particularly in the primary private equity space, is much more difficult and requires a financial institution to have end-to-end capabilities to diligence and analyse the credit of the underlying portfolio of investments, the underlying leverage and the impact on the potential financing. Finding a debt provider able to lever a preferred equity interest is almost impossible. We were privileged to have worked on a ground-breaking transaction in 2019 with Investec, Palamon Capital Partners and Pomona Capital on a back-levered preferred equity financing which allowed for the creation of significant liquidity for investors whilst avoiding the creation of additional leverage in the portfolio. The use of leverage as part of the structure was a key component in significantly driving down the blended cost of the preferred equity instrument, thus making the returns attractive from both Palamon's and Pomona's perspectives.

Summary

As the secondary market is continuing to evolve and innovate, so too are the financing solutions following it. Secondary funds and primary funds are using the tools available in the secondary market and more often relying on finance providers to partner with them to provide fire-power in competitive acquisition processes and to unlock liquidity and value in their assets. The menu of solutions have increased significantly, and we suspect this time next year we will be discussing even more innovative and bespoke structures and processes.

Subscription Finance Loan Agreement Series, Part 15: Information Undertakings

December 6, 2019 | Issue No. 56

In common with many other LMA facilities, subscription/capital call facilities include standard information covenants relating to provision of general financial information (in particular, annual and quarterly accounts), provision of compliance certificates and other specific "information" covenants covering other matters. However, they also differ from other LMA-based facilities in a number of respects. This article in our series seeks to summarise the main areas of difference and the considerations which apply in particular to this part of the subscription/capital call facility.

Before noting the differences, let's start with something that is pretty similar. This is the requirement to produce audited or unaudited accounts of the various obligors on a periodic basis, and here the subscription/capital call facility is very similar to other LMA facilities in that annual audited accounts (sometimes consolidated) will be required to be produced within a period of usually somewhere between 120 and 180 days after the financial year-end, with quarterly (unaudited) accounts being required to be produced within a period of somewhere between 30 and 45 days after the end of the financial quarter to which they relate. Compliance certificates will also be required to be produced alongside the production of the annual or quarterly accounts.

After that, the terms of a subscription/capital call facility start to diverge. Because the issue of what investor commitments remain available for repaying the facility is so fundamental to these facilities (and because of the number of situations in which a change in the level of that availability can occur), it is quite normal for lenders to request certification particularly in respect of investor commitments at much more frequent intervals than, say, the requirements for financial information to be updated in a leveraged finance facility. So, in addition to the production of compliance certificates with the annual and quarterly financial statements, lenders will very often ask for additional certificates to be produced on every occasion on which there is a utilisation or a change in the level of availability. That can mean that the borrower has to produce certificates whenever an investor is excused, withdraws, defaults on its commitment or pays in any part of its commitment, because all of those events will change the level of the available commitments of investors. Where the subscription/capital call facility is based on the concept of an investor borrowing base, then the compliance certificate will often be combined with (or even replaced by) the production of a borrowing base certificate. The "borrowing base" model may also create additional circumstances in which a fresh certificate is required – for example, on a change in the ratings treatment (or equivalent) of any particular investor. All of this creates an obvious strain on the resources of any borrower, so we would expect some negotiation of these requirements, particularly around the frequency with which certificates are required and/or the level of materiality needed to trigger the requirements.

Moving on to the more "general" (*i.e.*, non-financial) information covenants, again, a number of these are very specific to these types of facilities and are aimed squarely at ensuring that the lenders have as much current information as they need to assess the level of the investors' commitments, the likelihood that they will honour those commitments if called and the ability to enforce their security over the investor commitments if things turn out that way. So, the covenants will almost always include general requirements that information provided to investors generally also be provided to the lenders under the facility (although this is often negotiated so as to impose some sort of "materiality" on such requirement). They will also often include a requirement that the lenders are informed of (and even receive copies of) all drawdown notices served on investors, as well as notice of any changes or amendments made to any underlying fund documentation (although this is also often the subject of a negotiation as to what is or is not a "material" amendment). The covenants will also cover any factors directly affecting the investor base, including transfer, withdrawal and/or addition of investors, as well as information on any excused or defaulting investors and information on any investors exercising or claiming rights of set off or counterclaiming in respect of their commitment obligations. Finally, covenants will be included to ensure that, if it comes to it, the lenders can properly and quickly enforce their security. These covenants will consist of (a) requirements for updates when they occur to any investor's contact details; and (b) where the investors have included additional conditions (for example, in side letters) as to the information a drawdown notice must contain or as to the format of any drawdown notice covenants covering the provision of the information required to enable the lenders to comply with any such conditions if they need to issue drawdown notices under the security.

All of the above will be in addition to other more "standard" information covenants that one would expect to see and which are common to a number of other LMA-based facilities – for example, requirements on the borrower to provide information on legal proceedings or other claims or judgments against the fund borrower and other fund parties such as the general partner or manager (as applicable) and general requirements for the fund borrower to provide any information relating to any potential default.

In reviewing and negotiating information covenants, lenders should consider all of the factors referenced in this article but also should be aware that there is a balance to be struck in negotiation between what is necessary and the extent to which the imposition of such covenants imposes additional administrative demands on the borrower.

How Will PE Inflows Impact Facility Utilization?

December 6, 2019 | Issue No. 56

By **Chris van Heerden**
Director | Fund Finance

At the cusp of a new decade, the flood of capital into private funds risks becoming too much of a good thing. None of this is news to astute *FFF* readers: Equity strategies in many cases face a “buy high” proposition given rich buyout target valuations while debt strategies operate in a flat forward curve matrix with uninspiring credit fundamentals. Bloomberg journalists again traversed this familiar terrain in an **article** earlier this week titled "‘Peak’ Private-Equity Fears Are Spreading Across Pension World." The consensus: An ever-growing pile of money chasing a finite number of deals means lower future returns.

For fund lenders, downward pressure on facility utilization rates may be the first-order effect moving into the "roaring ’20s." High asset valuations are giving sponsors pause and, as a result, dry powder is piling up. Unspent capital targeting North American buyouts sits at a record $771.5 billion as year-to-date buyout transactions have dropped to lows last seen in 2014, according to Preqin data **cited by** *The Wall Street Journal*.

Of course, private capital doesn’t operate in a vacuum – robust inflows can continue even as returns move lower. This, in fact, appears to be the status quo for now. Public equity funds continue to experience significant outflows ($46.7 billion globally year-to-date through October, according to ICI data), while a number of investors are moving to up their private market allocations. So, while expectations for private vehicle returns may be moving lower, confidence in the outlook for public markets is not exactly running high.

Loyens & Loeff Primer on Fund Finance in Luxembourg

December 6, 2019 | Issue No. 56

Luxembourg-domiciled funds manage assets totaling €4.5 trillion as of August 2019, underscoring the Grand Duchy’s significance in the fund finance market. Loyens & Loeff partners Vassiliyan Zanev and Antoine Fortier-Grethen summarize fund financing in Luxembourg in a recent primer available **here**.

On the Move — Fund Finance Tidbits

December 6, 2019 | Issue No. 56

On the Move

Veteran fund finance banker Jonathan Peiper joined Mizuho Americas last month as a Managing Director to lead its subscription finance business. Jonathan brings 20-plus years of industry experience, having most recently served as Managing Director of the Subscription Secured Finance Department at Sumitomo Mitsui Banking Corporation. There, he oversaw the origination, structuring, execution and monitoring of subscription facilities.

Westin Brake joined Bridge Bank as a portfolio manager in its Equity Fund Resources Group, where he will focus on growing and managing the group’s subscription book and capital call lines to SBICs, private equity and venture capital funds. Westin arrives with experience in the funds industry from positions at Citi Private Bank and Comerica.