Private Capital Fundraising: Outlook Constructive Despite Uncertainties

February 28, 2020 | Issue No. 66

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Global private capital fundraising reached an all-time record $888.0 billion in 2019, according to PitchBook data summarized in its *2019 Annual Private Fund Strategies Report* published last week. Record flows into private investment vehicles came in the context of high public equity valuations, a growing supply of negative-yielding debt around the world and signs of coordinated global deceleration in economic growth.

The Outlook: Constructive

On the whole, market conditions in 2020 look set to support sustained momentum in fundraising. Public equity valuations are even loftier now than a year ago, U.S. interest rate benchmarks are testing all-time lows, the global stock of negative-yielding debt is on the rise and potential sources of volatility have become more prominent. We see each of these factors as favoring ongoing asset allocation into private vehicles as investors solve for investment return and mark-to-market volatility challenges.

At the same time, issues that have been simmering on the back burner may command more attention this year. High asset prices that are driving capital flows into the private market pose a challenge within the market as sponsors are forced to choose between idling capital or making potential performance tradeoffs by investing. In a historic first, private equity returned less than the S&P 500 over the 10-year period to June 2019, according to recent **research** by Bain & Co. As public and private market performance converge, sponsors will likely face intensifying pressure to adjust the traditional economic model. The trend toward consolidation among sponsors may, in part, reflect a growing understanding that platform scale may be part of the answer to achieving cost efficiencies and economic flexibility in the long run.

Rising market volatility can become counterproductive at a point. According to Bain & Co. data, roughly a quarter of buyout firms stopped raising capital after the last recession, with the impact disproportionally felt by smaller firms. Potential sources of disruptive volatility abound in 2020, not the least of which is the potential for a private market-unfriendly election outcome.

Without assigning a probability weighting to each of the risks in the outlook, we believe clearly distinguishing between long-term and short-term variables is essential to a complete fundraising outlook. Looking beyond the immediate concerns, we see expanding individual participation in the private markets potentially providing meaningful lift to fundraising for years to come. Earlier this month, Vanguard announced a strategic partnership with HarbourVest, through which the partnership expects to deliver private equity access to individual investors in the future.

The reality is that more investment activity, especially growth investment, is taking place in the private market. Illustrating this point, in 1996 there were more than 8,000 publicly listed companies in the United States. Today that number sits around 4,400, based on data from the World Bank. We expect asset managers to increasingly develop products to offer individual investors more representative market access by adding private market offerings. Regulators have signaled a willingness to support the shift. In December, the SEC **proposed amendments** to the Accredited Investor definition, which, if implemented, would expand the classifications of individuals that qualify to participate in private markets.

2019 Fundraising in Review

As noted earlier, global private capital fundraising reached an all-time record $888.0 billion in 2019 as institutional investors upped private capital allocations, in part by rotating out of hedge funds and public equity, according to Pitchbook data. While dollars raised increased, fund count extended a multi-year decline to 1,064, reflecting the trend toward greater fund sizes. Total private capital AUM increased by 7% to reach $6.53 trillion.

Private equity powered much of the overall gain in fundraising. Dollars raised for the strategy totaled $474.1 billion, up 6.3% over the prior year, while the number of funds closed increased by 1%. Average fund size increased, and the top-10 funds raised posted significant step-ups in fund size versus the prior vintage. The decline in sub-$1 billion funds that has been evident in recent years paused. Funds sized below $1 billion made up 16% of private equity fund raising, in line with the 2018 share, and down from a 32% yearly average over the preceding decade. By count, 256 sub-$1 billion funds closed in 2019, roughly in line with 2018, and down about 21% from the trailing 10-year average. Fundraising by first-time funds declined significantly from the past three years to total $9.0 billion across 30 funds, down 46% and 29%, respectively.

Private debt fundraising accelerated during the year to $131.1 billion, up 21% over 2018. Here again, the trend was toward larger funds. Sub-$1 billion funds accounted for 15% of 2019 private debt fundraising, down from 35% yearly over the preceding decade. By strategy, infrastructure, general debt, special situations, and direct lending funds posted significant gains in fundraising, while real estate debt raised declined 56% from the prior year.

In other strategies, venture capital fundraising declined 15% year-over-year to total $75.5 billion, real asset dollars raised declined 9% to total $170.2 billion, fund of funds activity was also lower by 18% at $15.6 billion and secondaries moderated by 23.3% to total $21.6 billion.

Capital deployment continues to challenge both investors and sponsors. CalPERS highlighted this trend when it reported total distributions of $7.4 billion and contributions of $4.6 billion for its fiscal year ending June 30, 2019. The notional value of dry powder continues to press higher, reaching $2.41 trillion for private capital overall and $1.25 trillion for private equity specifically, according to mid-year 2019 PitchBook data.

What's often lost in the discussion on dry powder, however, is the context of total AUM. Dry powder made up 37% of total private capital AUM in the recent PitchBook estimate, exactly in line with the market average dating back to 2006. As the private capital market grows, it's natural that the notional amount of dry powder grows with it.

Conclusion

If anything, drivers for private market fundraising have been amplified in 2020. Liability-matched investors that were yield-deprived in 2019 are now contending with a fixed income matrix wherein the long end of the Treasury curve is testing never-before-seen lows. At the same time, accommodative central bank policies have supported financial asset values and investors have meaningful gains to re-allocate. With this backdrop, we expect institutional investors to continue to rotate into private funds to solve for investment return challenges and thereby support 2020 fundraising momentum.

We expect to see further consolidation among asset managers. The Brookfield-Oaktree tie-up in 2019 pointed to a trend among managers to combine multiple strategies on a single platform that benefits from scale. Last week, Franklin Resources Inc. announced an agreement to acquire Legg Mason Inc. Investors are increasingly opting for passive investment vehicles when investing in public markets, and when paying for active management, increasingly prefer to do so in the private market – both trends that are likely to continue to re-shape the asset management landscape.

Finally, we expect to see private fund sponsors contending with intensifying investor pressure to adjust the economic model. The existing paradigm for management fee and performance economics looks increasingly anachronistic as private and public fund performance converge and may drive investors to demand more economic concessions in exchange for the give-up in liquidity to make private fund commitments.

An Introduction to Secondaries

February 28, 2020 | Issue No. 66

By **Katie McShane**
Special Counsel | Fund Finance

It is not unusual to hear the term "secondaries" in the fund finance world. It is thrown around conversationally and references arise frequently in market updates and panel discussions. For anyone not familiar with the term "secondaries," we thought it would be useful to provide a concise introduction, including what secondaries are, why they are popular and how a secondary transaction is documented.

What are Secondaries?

The private equity secondary market (commonly referred to as the "secondaries" market) refers to the buying and selling of investments in private equity funds. An acquirer of an investment in a private equity fund also assumes any remaining unfunded capital commitment to the fund.

Why Sell Secondaries?

Investments in private equity funds are illiquid. Investors do not have rights of redemption and generally must wait for a fund to liquidate investments through a public offering or sale of the underlying portfolio companies in order to realize their investment in the fund. A secondaries sale allows an investor to realize that investment early. A seller is often motivated by a desire to lock in attractive underlying fund valuations or to generate liquidity to reinvest into other opportunities.

And Why Buy Them?

A buyer of secondaries is able to evaluate the holdings and performance of a fund before committing to the purchase of an interest in the fund. Secondaries therefore have a different risk profile when compared to primary investments in private equity funds, where the investor is committing to an investment in an entity that has no track record and holds no assets. A buyer in the secondaries market is also drawn to attractive valuations and shorter time horizons for realization of a return on their investment.

What Fund Documents Are Typically Required in Secondary Transactions?

1. Purchase and Sale Agreement

The main document in a secondary transaction is the Purchase and Sale Agreement ("PSA"). The PSA sets out the terms and conditions of sale between the buyer and seller, including the various rights and remedies of the parties, the closing conditions and, of course, the purchase price.

The purchase price is synced to a specific date, typically the most recent valuation date of the fund, which is commonly referred to as the cut-off date. Any distributions or contributions occurring prior to the closing date are accounted for from the cut-off date, and the purchase price is adjusted accordingly.

The PSA also details expenses or losses that are excluded from the sale. Examples include tax liabilities and losses arising from breaches of representations and warranties under the related subscription agreements or side letters of the seller, in each case arising prior to the closing date, since it would arguably be unfair for the buyer to bear such risk.

The PSA also includes an indemnity, making the buyer whole for any obligations arising prior to the sale and indemnifying the seller for certain liabilities other than the excluded obligations set out above.

The PSA also includes representations, warranties and covenants that are provided by both the buyer and the seller. The seller usually represents that it has title of the assets it is transferring and that it is not subject to any material litigation that could impact the secondary transaction. The buyer relies heavily on the seller's representations in a secondary transaction.

Provisions allowing the buyer to terminate the transaction are also commonly included.

2. Transfer Agreement

The transfer of the fund interest between the buyer and seller is typically documented in a tripartite Transfer Agreement, which is provided by the fund and entered into by the buyer, the seller and the fund. The Transfer Agreement contains the consent of the private equity fund or its general partner to the transfer of the secondary interests from the seller to the buyer and specifies the documentation that the buyer must deliver to the fund, including a subscription agreement and additional know-your-customer/anti-money laundering documentation.

3. Additional Deliverables

It is necessary for both the buyer and seller to carry out due diligence on the underlying fund documents, which typically include a limited partnership agreement, a subscription agreement, and, to the extent applicable, a side letter.

- The Limited Partnership Agreement

  The most important provisions to review are the transfer provisions, which explain the process required to transfer the fund interest from the seller to the buyer. The transfer provisions will specify if there is a right of first refusal, the length of the notice period for the transfer, who must consent to the transfer, additional conditions precedent required to effect the transfer (such as the delivery of legal opinions or the payment of fees), and whether the buyer will be admitted as a substitute partner such that no residual liabilities remain for the seller.

- The Subscription Agreement and Side Letter

  The subscription agreement of the seller is helpful in confirming ownership of the secondary interest. Further, a review of the seller's subscription agreement and side letter (if any) will disclose elections, rights and waivers that are relevant to the seller's investment. The buyer may wish to discuss with the fund's general partner the extent to which such elections, rights and waivers will apply to the buyer's investment after completion of the secondary sale.

If a subscription credit facility is already in place for the fund, this will also need to be considered. Specifically, if the existing investor is included in a borrowing base, the parties will need to determine if the applicable transfer reduces the borrowing base such that a pre-payment will be required. The transfer provisions of the subscription credit facility will also need to be reviewed to make sure the transfer complies with the terms thereof.

Secondary Fund Finance

Buyers can finance an acquisition of secondaries interests. Such financing may be provided by the seller of the secondaries, in the form of a secured or unsecured deferral of the buyer's purchase price obligation under the PSA, or by a financing provider that accepts the secondaries interests as collateral. Typically, the secondaries are owned by a special purpose vehicle ("SPV") and the seller or financing provider (as applicable) will take security over the shares of the SPV, in addition to the accounts of the SPV into which distributions from the underlying investments are paid. In the event of enforcement, the lender will be entitled to sell the pledged interests in the SPV or to take control of the SPV and the SPV's bank accounts so that it will be the sole beneficiary of any distributions paid to the SPV.

Lenders and borrowers have become more and more sophisticated in secondary financing transactions over time. Our team continues to see more complex credit facilities being negotiated due to the unique nature of each transaction. We expect to see a continued growth of secondaries in the fund finance world in 2020.

Women in Fund Finance Meeting Recaps Past Year of ‘Wit & Wisdom’ and Looks Ahead

February 28, 2020 | Issue No. 66

By Kristin Castellanos
Managing Director | MUFG Investor Services

In 2019, Women in Fund Finance (WFF) launched the Wit and Wisdom Program, a series of events designed to connect rising young stars in the fund finance industry with senior women for discussions on issues affecting the next generation of female fund finance professionals.

Last year, WFF hosted five events focusing on a range of issues, including networking in male-dominated fields, working through female stigmas and stereotypes, career negotiations, diversity and inclusion and personal advocacy.

On February 20, Wells Fargo graciously donated space for an interactive panel dialogue to recap the key lessons and takeaways from the 2019 series and to discuss what individuals and companies can do to continue to promote equality and inclusivity in our industry. The evening kicked off with Dee Dee Sklar welcoming the attendees and then a lively discussion on the key themes that were covered in the events. The level of audience participation was not only a testament to how well the topics resonated with the audience but the high caliber of the rising women and men in our industry.

WFF will continue this initiative into 2020 and encourages all of our industry participants to consider what we can do to attract and promote a more diverse talent pool across our industry. Want to get involved? Click **here** to contact WFF.

Some Reflections on Supply and Demand in Capital Call Finance

February 28, 2020 | Issue No. 66

In a number of articles in *Fund Finance Friday*, we have reflected on the increasing size of the market for capital call facilities and on the increasing number of banks and alternative lenders now offering these facilities at increasing ticket sizes. An easy assumption to make (which does not necessarily mean that it is correct or incorrect) is that this increase means that supply in this market is plentiful and may well be outstripping demand. More on that below. If that is the case, then you would expect to see at least three things happening: first, a reduction in pricing as lenders compete for a share of the market; second, some loosening of terms (in particular but not only the extent and frequency of covenant compliance); and, third, some relaxation of leverage and related requirements.

So the question that a number of us in the industry often reflect on is whether, given the perceived supply/demand ratio, and assuming this is tilted in favour of oversupply, to what extent are any of these things actually happening? Some observations and thoughts are offered below, mostly subjective and – for, I hope, understandable reasons – dwelling on general trends rather than specific figures or ranges.

Starting with the assumption of oversupply, is this actually true? I would say to a certain extent, yes, but there are a number of reasons why this may not be quite as simple a picture as it looks. While it is certainly true that there is a great deal of “dry powder” available, this is not a product where “one size fits all,” and lenders will often adopt (or be required to adopt) quite different strategies and requirements as to what facilities they can make available and to whom. These requirements may include some limitations on acceptable geographies or types of fund, particular requirements as to minimum or maximum ticket sizes, and particular views around agency or participations in clubbed or syndicated facilities. In addition, given the fairly rapid growth in the market, some lenders may be running up against capital or credit constraints or limits within this particular sector or for particular funds. So maybe the extent of the supply is not necessarily as big as it may seem.

However, what certainly seems to be true is that most funds which have a reasonable investor profile will not be struggling to find lenders willing to lend and will have a far greater choice available to them than even in the recent past. So what benefits can those funds expect?

Well, there may be some pricing benefit, and it seems to be the case that average pricing in the industry has been reducing in recent years. That said, the market and credit rules have not ceased to exist. Any pricing benefit will be more easily realised by a well-established larger fund with a good track record and a good investor profile than for a smaller fund with less of a track record and/or a less obviously suitable investor profile. What may also contribute here is the flexibility that an increasing number of lenders now offer in these facilities, so that, for example, pricing may be brought down even where a fund’s investor profile is not quite so good for a capital call facility if lenders are prepared to look at other fund assets (including investments) as part of their credit.

Do the potential pricing benefits also extend to document terms? The answer here is (perhaps not what you would expect), not necessarily. While leverage multiples have maybe increased slightly over the past few years and the market is certainly seeing an increase in the frequency of borrower term sheets and draft facility documentation, as well as some variation in terms particularly between larger well-established funds and smaller or less well-established funds, the fundamentals have not shifted as much as one might expect. There is at least, as far as we have seen, no similar shift to that seen in the leverage finance market to “cov lite” and/or incurrence covenants. There may be a number of reasons for this. From our perspective, these would include the increasing scrutiny that a fund’s investors will bring to bear on any facilities taken out by a fund, ably reinforced by institutions such as ILPA, as well as perhaps the slight oddity of a market in which actual defaults (and, therefore, a lender’s ability to become more comfortable with and familiar with the consequences of looser or different terms) are rare (and indeed until recently were almost non-existent). This state of (more or less) equilibrium may not last forever, particularly if competition heats up further and as we see funds and their counsel take more aggressive negotiating stances on current terms, but it is likely to continue to provide a brake on any significant loosening of terms.

I have already touched on leverage requirements in the paragraphs above. Again, these have not shifted as much as one might expect given the size of the market. Investors will continue to play an important (and restrictive) role in this, which is one factor, but perhaps another is that there is not really a lot to play with here. In a capital call financing, the only “asset” is the investor commitment, and that, by its nature, is the same (or very similar) in whichever fund it is held. It also has a very easily determined (and certain) value, which generally will not change.

As I said at the beginning of this article, consider these thoughts as observations only. No doubt there are many other points that could be discussed, but these thoughts are offered in the hope that they might chime with others and maybe provide food for additional thought.

FFA Next Gen '2020 Vision' Initiative — March 13 LIBOR Event in New York

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The Next Gen New York team is pleased to announce its "2020 Vision" initiative. 2020 Vision will be a series of educational seminars focused on developing events in the market that will touch all aspects of our shared business: lending, fund management, and the law practices that bind us. 2020 Vision seminars will bring together seasoned fund finance veterans and future industry leaders to share collective experiences and insights in a collaborative, insightful atmosphere.

Join the team on the morning of March 13 for the inaugural seminar to discuss a topic we are all currently grappling with: LIBOR transition. Next Gen has assembled a panel of professionals actively engaged in addressing:

- LIBOR's current status as the go-to benchmark rate for $350 trillion in products and derivatives;
- LIBOR's history and manipulation in scandals within the last decade;
- Public and private measures being taken globally towards the transition of a new benchmark; and
- Lenders' and fund managers' approach towards LIBOR's phasing out in loan agreements today.

Featured speakers will include:

Jeffrey Nagle – Partner at Cadwalader, Wickersham & Taft LLP

Jeff is a Partner in Cadwalader's Charlotte office with a focus on leveraged finance, distressed debt trading, asset-based lending, commodities financings, energy project financings and rescue financing, workouts, debtor-in-possession financings and exit financings. He is part of the firm's team selected by the Federal Reserve's Alternative Reference Rates Committee (ARRC) to assist in guiding the post-LIBOR financial world in developing best practices for fallback language across all cash products.

Scott Diamond – Deputy General Counsel at Sumitomo Mitsui Banking Corporation

Scott is Managing Director and Deputy General Counsel of Sumitomo Mitsui Banking Corporation in New York. He manages the investment banking legal group with a focus on securities, derivatives and similar financial products. For LIBOR discontinuance, Scott is a member of the firm's overall steering committee and lead counsel for the project.

Moderator: Jorge Grafal – Vice President at Mizuho Group

Breakfast and coffee will be served. For any questions on the event, please reach out to **info@fundfinanceassociation.com**.

Date of event:

Friday, March 13

Venue:

Wells Fargo Connections Center
150 East 42nd Street (Concourse Level)
New York

Time:

Registration: 8:30-9:00 a.m.

Program: 9:00-10:30 a.m.

On the Move — Fund Finance Tidbits

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On the Move

Michael Mbayi has joined Luxembourg-based law firm Wildgen as a director, where he will head the firm's Fund Finance practice.

Michael advises leading banks and financial institutions on a wide range of fund finance transactions (including, namely, capital call subscription credit facilities, net asset value credit facilities and hybrid credit facilities).

He started his legal career in 2006 with Wildgen, joined a Luxembourg magic circle law firm for more than six years and has now returned to Wildgen.