Market Uncertainty and Fund Finance

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By Michael Mascia
FFA Board Member

The Fund Finance industry returned from the Miami conference to the most volatile two-week period since the financial crisis. With the coronavirus slowly spreading, the equities markets swinging wildly, Joe Biden surging in South Carolina and on Super Tuesday, Mike Bloomberg and Elizabeth Warren suspending their campaigns, and the Fed implementing an emergency 50 basis point rate cut (whew!), there has been a lot to keep up with. With this backdrop, I have closely reviewed our business metrics and connected with a number of industry leaders this week to try and identify any potential impacts for the fund finance markets. Below are my observations.

On the positive side, the fund finance markets have not felt any tangible business impact from the virus or the related market pullback and volatility; it's "business as usual." Every banker I talked with indicated that their opportunity flow has continued uninterrupted and that the number of prospective deals is accelerating, not slowing. No one I spoke with has observed any movement in transaction pricing, implemented a hiring pause or made a revenue adjustment to their 2020 budget. Positively, funds are not reporting any treasury challenges, including with respect to capital calls sent to investors in China. Similarly, our forward indicators at Cadwalader confirm this anecdotal feedback. Both our February hours accrued on prospective matters and number of partnership agreements reviewed project very favorably, with February exceeding January (which greatly exceeded December).

But on the negative side, it is early days. The equities pullback really only started in earnest on February 24, 2020, and there has not been much time for an impact on private markets to manifest. Time is needed to see how things will play out.

From a practical perspective, nearly every bank is reporting significant restrictions on international travel and moderate restrictions on domestic, non-essential travel. Some are requiring self-reporting of personal travel to affected locales. Many are conducting widespread work-from-home trials in preparation for a potential required work-from-home scenario. And a number are watching the impact of the rate cut and decline in the 10-year yield on net interest margins. Many conferences and events have been cancelled or postponed, and travel schedules are in flux. Many funds have reported to the banks a conversion of investor road shows to video conference presentations. We've also heard that funds have been asking banks to confirm their treasury capabilities in a work-from-home scenario.

Trying to forecast what is ahead, my expectation is that March will be extremely busy. There are a lot of deals in progress and a lot of funds that have had an initial investor closing but that have not yet selected a facility lender. We expect that clients will press hard to get these facilities closed promptly in light of the future uncertainty. We are all hands on deck to be ready. We have also beta-tested our own work-from-home capabilities to ensure we are prepared.

I remain optimistic for the remainder of the year. I do think, however, it would be naïve to think our market is pure Teflon and that these headwinds will not have some temporary impacts to our businesses. Travel restrictions, event cancellations and public market volatility will defer fundraising at least somewhat, and the equity market pullback will make bid-ask spreads more difficult to bridge, at least for a short period. I could see aggregate facility utilization across the industry declining a few percentage points in the second quarter as new investments and new facility borrowings pause for a bit. I also expect new investor capital commitments to drag a little in the second quarter, as investors take stock of their asset allocations and their inability to find yield in fixed income. Longer term, based on the incredibly solid performance of both private capital and fund finance during the crisis, we continue to hold our very positive outlook.

Chris Van Heerden, an Associate on our team at Cadwalader, is a former Managing Director on the CMBS research desk of a major investment bank. We are asking Chris to lean into analyzing the virus's impact on our market and to focus more of his time to researching, tracking and forecasting prospective implications for the industry. *FFF* will do its best to keep you informed and updated each week as the market evolves. But, for now, all traffic lights remain green.

Time to Stitch Up Those Legal Documents: Common Mistakes, Misunderstandings and Oversights that Every Fund Finance Lawyer Should be Aware of — Part I

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Legal documentation governing subscription credit facilities has certainly improved for both lenders and funds alike since the product first came to market. Funds have effectively negotiated for more flexibility where needed, and lenders have effectively negotiated for more protections where perceived risks may exist. However, as with many other corporate or financial transactions between two or more parties, and especially given the relationship-nature of subscription finance lending, provisions in legal documentation often get replicated from one transaction to the next, including errors and inconsistencies as a result of the fast-paced world in which practitioners find themselves or, in some cases, a failure to connect the dots. Thus, we are presenting a multi-part series on common mistakes, misunderstandings and oversights we have noticed throughout the legal documentation governing subscription credit facilities over the years.

1. <u>Whose obligations are intended to be secured by which assets</u>?

    With the introduction of borrowing groups and umbrella facilities that include separate fund families (which we have explained **here**) and even with regard to certain simpler structures that require certain fund entities to pledge assets to the administrative agent even though such fund entities do not have any borrowing capabilities (and thus will not incur any loan obligations), it is critical that attention be paid by lender and borrower's counsel to the lead-in in the granting clause of the security documentation. An example of a typical granting clause is the following:

    "*In order to secure the prompt payment and performance in full when due, whether by lapse of time, acceleration, mandatory prepayment or otherwise, **<u>of the Obligations</u>**, each Pledgor, to the extent of its respective interests, hereby grants to the Administrative Agent and pledges and creates a security interest in, all of its right, title and interest, in, to and under the following, whether now existing or hereafter acquired or arising and wherever located, for the benefit of the Secured Parties (the "Collateral"):*…"

    As you can see, in this granting clause the assets being pledged by the applicable entity secure all of the "Obligations." This is ideal for a lender but could be overly broad and problematic for a fund if your transaction includes borrowing groups where the intent is that assets pledged by an entity only secure obligations incurred by members of such entity's borrowing group. Likewise, you may have a granting clause drafted too narrowly. For example, if the entity who has pledged assets will not incur any obligations under the credit facility as discussed above, you would want to ensure that the granting clause does not provide that such entity's assets secure "its Obligations," as that particular entity will not have any obligations. Rather, the granting clause should provide that its assets secure "all Obligations" or such other appropriate subset thereof.

    As counsel for either the administrative agent or the borrower, you will want to work closely with your client to make sure you understand the business arrangement with respect to whose assets are securing whose obligations and document it properly. To the extent the security arrangement is explained across multiple documents, you will want to make sure this concept is treated the same way across all documents.

2. <u>Does your material adverse effect clause actually have teeth</u>?

    This next topic isn't necessarily specific to subscription credit facilities, but we felt it was worthy of being raised, given the number of instances where we've seen it come up as administrative agent's counsel. The issue is related to material adverse effect clauses often contained in loan documentation governing credit facilities. Such documentation may expressly provide that, as a condition to borrowing, no material adverse effect shall have occurred since a specified time. The documentation will then contain a likely-negotiated definition for what constitutes a "material adverse effect" but may include: some combination of a material adverse effect on assets, operations, properties, liabilities or the credit party's condition; a material adverse effect on the enforceability of the loan documents; or the credit party's obligations to fulfill their obligations, among other occurrences. In addition to or in lieu of a condition precedent to borrowing, some documentation will have a representation and warranty that since a specified time, no circumstances exist or changes have occurred which could result in a material adverse effect. And, finally, some loan documentation will have the occurrence of a material adverse effect as an automatic Event of Default.

    To the extent a material adverse effect appears as a condition to borrowing or as a representation and warranty, fund counsel often seeks to include language that reads "except as otherwise disclosed to the Agent." When presented with this comment, lender's counsel needs to analyze the effect of it not only with respect to the applicable provision where the comment is being made but holistically, and consider what other protections the lenders may have on this point. As an example, assume the representation and warranty contained in the credit documentation reads as follows:

“*Except as otherwise disclosed to the Administrative Agent*, since the Closing Date, no circumstances exist or changes have occurred which could reasonably be expected to result in a Material Adverse Effect.”

If the credit documentation does not contain an event of default that triggers upon the occurrence of a material adverse effect, then there are no repercussions for the credit parties if a material adverse effect occurs, so long as the credit parties disclose it to the Administrative Agent. In other words, if the credit parties disclose the material adverse effect to the Administrative Agent, they have not made a misrepresentation and no event of default will be implicated. On the other hand, if you have a material adverse effect as an automatic event of default, perhaps you do not mind accepting the comment because you have protection elsewhere and aren’t relying on a misrepresentation to ultimately trigger an event of default. Thus, be cautious when considering this comment or when coming across these provisions in older forms.

We hope that Part 1 of this series has been helpful for lawyers on both sides of a transaction. Additionally, our sincere hope is that it has the effect of getting older legal documents (and newer ones, in some cases) cleaned up and sanitized. More to come next time…

Fund Financing Trends in Offshore Jurisdictions: A Closer Look at Jersey

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This is the first in a series of articles that will look at fund financing trends and issues in key offshore jurisdictions. In this article, we speak with Julia Keppe and Simon Felton at Ogier (Jersey) about what they are seeing in the Channel Islands and, more specifically, Jersey.

Offshore jurisdictions are relevant to the majority of fund financing transactions and, through this series, we hope to highlight the trends and issues that you may encounter depending on which jurisdiction is relevant to your financing.

***FFF*: From your perspective, how has the fund financing market performed and developed in the Channel Islands over the last 12 months?**

Simon and Julia: We have seen a notable uplift in fund financing transactions structured in the Channel Islands or with a Jersey/Guernsey nexus during the past 12 months. In 2019, we advised in relation to upwards of 70 transactions across the two Channel Island jurisdictions, both lender and borrower side.

Our Channel Islands fund finance practice acts primarily on lender side mandates. Interestingly, during the last year we have advised over 20 different lenders, highlighting the increase in the number of market participants offering loans or other debt facilities to fund entities. Anecdotally, we understand that in the European market this in part reflects the popularity and growth of the product but also the degree of exposure concentration some of the leading market participants have, which has created the space for a diversification of the syndicate base.

***FFF*: What offshore trends are you seeing?**

Simon and Julia: The Jersey market is mainly led by the onshore market as loan origination is primarily based onshore (although some institutions do originate on island although this seems to be led by institutional needs following the UK retail bank ring fencing review). We have seen a continuing expansion of the market and a notable increase in the size and complexity of the facilities, as the product becomes a more mainstream feature of the European funds market and the sophistication of borrowers increase.

There has also been a rise in specialist (non-bank) lenders in this sphere, offering bespoke credit solutions outside of the traditional subscription line offering. While generally more expensive, such credit firms (usually funds themselves) are able to lend in situations where mainstream/traditional banks would be unwilling to lend.

There is also a greater range of products available, which has been well documented in the industry press. We have seen a diversification in funding lines and ancillary facilities, such as credit lines being made available to general partners or management, or financing aimed at funds in various stages of their investment cycle (with a continued rise in NAV and asset-backed lending to funds). While these are not necessarily trends that started over the last 12 months, they are part of the overall growth in the fund financing market and their more widespread use reflect the growing maturity of the European market.

One area where we have seen the Jersey market develop over the last 12 to 18 months is in respect of notification of security to investors. Unlike many other jurisdictions, following reforms to Jersey security law, it is not necessary to send a notice to a counterparty to perfect security. Despite this (and despite GP reluctance to deliver notices to investors), we have seen market practice evolve such that it is now relatively usual to send notices simultaneously with the grant of security (or very shortly thereafter). This is in part due to the increased focus on investor notices coming out of the Abraaj cases but also because the service of notice on investors is not just for the purposes of perfection but also puts an investor on notice of the financing and security, potentially reducing available defences should the security be enforced.

***FFF*: Have there been any recent changes in Jersey or Guernsey law of which borrowers and lenders should be aware?**

Simon and Julia: The most recent change of relevance is the introduction of economic substance rules for Jersey and Guernsey which apply to tax resident companies conducting, among other things, fund management business. They came into force in January 2019, requiring all relevant entities to include confirmations around compliance, with the rules to be included in their corporate tax return submitted from 2020. Discussing the detail and requirements of the substance rules is for another time, but it has led to both Jersey and Guernsey being placed on the EU’s "white list" of cooperative jurisdictions (having previously been on its "grey list").

Substance rules have had a limited impact on lenders to funds to date, as the compliance burden falls on the fund manager, and the general view in relation to documentation is that existing covenant packages cover borrower compliance. As the rules and guidance become more established, practice in relation to documentation may evolve – but the rules could also lead to changes in behaviour by managers of offshore funds as the funds they manage seek to demonstrate compliance with the rules, which documentation may need to reflect. Practice in this area is evolving and one which we are monitoring closely.

***FFF*: What do you see for the future?**

Simon and Julia: Growth. We think the overall expansion of the market onshore and offshore will continue, and there will be new entrants with a greater range of products available as borrowers and lenders alike seek more innovative and sophisticated credit solutions. Jersey and Guernsey legal structures are well suited to these developments, so we anticipate a continuation of the strong deal flow seen in 2019.

Mourant Shares Takeaways from Global Fund Finance Symposium

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Mourant has published an article articulating overarching takeaways from the Global Fund Finance Symposium held last month. The article summarizes developments and forecasts across the North American, European and Asian markets, including the overall growth of the global private equity market; suggested industry norms for the growing syndication market; and the rapid emergence of nontraditional markets, transactions and lenders in the fund finance space. To read the full article, click **here**.

McKinsey and Bain Publish Annual Reviews

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Two in-depth reports recently published expanded on the remarkable capital-raising environment while pointing to the challenges posed by high valuations, the growing stock of committed but uninvested capital and the potential for a more difficult investment environment. Here's what stood out to us from McKinsey's ***A New Decade for Private Markets: McKinsey Global Private Markets Review 2020*** and Bain & Co.'s ***Global Private Equity Report 2020.***

- Growth in the capital markets has been weighted heavily toward the private side. McKinsey reports that the private market AUM expanded 170% over the past decade while global public markets grew by 100%. U.S. sponsor-backed companies rose by 60% over the period while the number of publicly listed companies held flat.
- After a banner year in 2019, the outlook for fundraising remains robust, with announced targets by sponsors running above the year-end 2018 total, according to McKinsey. Roughly half of LPs report being below their targeted private equity allocation, according to Preqin data cited by Bain.
- Distributions again outpaced contributions in 2019. High fundraising volume, however, meant investors were only marginally cash flow positive, with the distribution-to-contribution ratio holding at 1.1x at mid-2019, according to Bain.
- Persistency in outperformance of public markets has declined, according to McKinsey, with the individual partner explaining a greater amount of investment performance than the firm.
- For the first time ever, private market performance for the past decade matched the broad public market, according to Bain. On the other hand, McKinsey cites Burgiss and Cambridge data to show that 2009-2016 vintage PE funds have outperformed public market equivalent (PME) benchmarks. We don't see these findings as incompatible given the potential impact of fund sample/vintage mix and the selection effect for PME comparisons. Suffice it to say, private market outperformance is not improving.
- U.S. buyout valuations reached a new all-time high of 11.9x on the back of rising leverage, according to McKinsey. Pro forma leverage for U.S. buyouts moved higher to 6.6x.
- Despite the increase in AUM, the McKinsey report indicates that deal volume held flat in 2019 at $1.47 trillion. Dry powder as a multiple of deal volume rose to nearly 2.0x, a significant increase from the 2016 low but in line with historical norms.
- In real estate, McKinsey notes, capital flows have favored open-end funds and core over value-add and opportunistic strategies.
- A downturn looms large in the GP mindset, according to McKinsey and Bain, but is not necessarily driving decisions at this point.

First Republic Bank Article on NAV Facilities

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Scott Aleali of First Republic Bank this week published the first of a two-part article on LinkedIn titled “NAV Facilities: A Portfolio Management Solution for a PE Fund’s Sunset Years.” The article draws input from Dave Philipp and Amit Mahajan of Crestline Investors’ Fund Liquidity Solution Group and sets out the potential size of the NAV lending market, the challenges for traditional banks entering the space, and the potential uses of loan proceeds by fund borrowers. The article is available **here**.

Fund Finance Hiring

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Fund Finance Hiring

Brickfield Consultants, the recruiting agency focused exclusively on fund finance, states that 2020 staffing demand is high and is set to continue.

Brickfield is currently seeking a director/VP fund finance originator/BD individual for an exclusive role in London.

They also have multiple opportunities for fund finance lawyers of all levels in London, Cayman, Jersey and the United States, especially individuals of PQE 2-5 and counsel/senior associates based in New York, Dallas or Charlotte.

Brickfield would also like to talk to VPs and associate bankers in NYC with portfolio management, origination and underwriting experience.

FFF is planning to catch up with Rory Smith, founder of Brickfield Consultants, later this month for a "deep dive" interview on the current fund finance staffing trends.

For more information, please contact **Rory** or visit the Brickfield **site**.

Recommended Reading

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- *PEI* **looks** at new sources of capital entering the fund finance market with a particular focus on insurance companies.
- Also in ***PEI***, Investec's Slade Spalding considers options available to management companies to raise or release equity against their management stakes.