Navigating the Emerging and Future Themes of the New Normal

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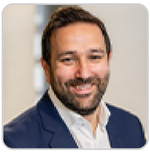
By Jeremy Cross



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With markets in uncharted waters, Jeremy Cross from Cadwalader and Jamie Mehmood and Ben James from the Fund Finance Advisory team at Deloitte have gathered together their collective experiences over the last few weeks to provide an overview of the main headwinds in the UK and European Fund Finance market during the current COVID-19 pandemic. Here they examine some of the key themes from both a manager and lender's perspective, as well as share some thoughts on the future direction of the market.

The Manager

Fundraising has slowed. Given the uncertainty in the market and knock-on to investor confidence, there has quite predictably and understandably been a slowdown in new fundraising activities. There are exceptions, particularly with funds raising capital to take advantage of investment opportunities being thrown up by the COVID-19 pandemic, and some managers have also been able to proceed with fundraising largely as normal depending upon their size or stage in the fundraising process. However, most have been forced to push fund closes back. The key question here will be around the timing of the return of investor confidence and, in the meantime, what sort of investments investors will prioritise.

Asset-level liquidity has been the driving consideration as existing portfolio assets have come under stress, with good portfolio businesses sometimes turning revenue zero overnight. Working capital revolvers at the underlying asset level were initially drawn to fund and prepare for liquidity shortfalls. This was also a feature for some subscription lines, before utilisation fell back to more normalised levels. Additionally, **refinances for many sponsor-held companies have become more challenging** as lenders come under liquidity pressure themselves. This has led lenders at the asset level to increase pricing in line with the widening of the high-yield bond market, making fund-level financing solutions all the more attractive for managers in search of liquidity.

Since mid-March there has been a notable **increase in demand for NAV/preferred equity solutions** provided at the fund level in order to downstream liquidity both to support stressed assets and to take advantage of forthcoming opportunistic M&A (as valuations decline), particularly in private equity. The breadth of NAV/pref structures has provided managers with a high degree of flexibility driven by the purpose, portfolio characteristics (LTV, concentrations) and any specific sensitivities they may have. These structures can provide an attractive financing solution to help address immediate manager concerns, albeit with a broad range of pricing depending upon the degree of flexibility required.

There has understandably been **increased scrutiny from Limited Partners for managers to maintain asset values.** This has resulted in **increased dialogue** between the manager and investors, with an expectation from investors for managers to be aware of and consider all financing options in order to provide liquidity to assets and maintain valuations as far as possible. Additionally, managers have sought more flexibility from investors to facilitate asset preservation, including by **increasing their ability to retain and recycle investment proceeds**.

The **decline in valuations** is likely to crystallise at the end of the second quarter as part of the June reporting cycle. Movements in valuations and the performance of underlying assets also have a **secondary knock-on impact on any existing fund leverage facilities** (*i.e.*, if the fund is following a levered strategy). The current emphasis, given the scale of the unknowns, is on an **open dialogue** with both investors and lenders.

There has been a **mixed picture on levels of capital calls.** There has been some information that there have been much higher levels of calls than usual in the current market (LACERS reported a doubling of its usual capital call level and ILPA have also reported an increase), but others such as the FFA see less of a change overall. Added to this, the **slowing of realisations and the reduced flow of realisation proceeds** is leading investors to also manage liquidity.

The **denominator effect** – private market allocation as a proportion of an investor's overall asset allocation – seems to be less of an issue for managers right now as public market valuations rebound from their historic lows, but continued volatility in those markets makes it too early to say that this issue has gone away.

The Lender

Liquidity pressures have been a consideration for some banks, with significant movements on both sides of the balance sheet (working capital revolvers drawn – including some subscription lines – plus an influx of "low value" deposits for banks). This has made large subscription lines, in particular, which historically have tended to be only partially drawn, more difficult to get away and forced some bank lenders to step back – an echo of the last financial crisis.

Bank processes have become more involved across the board, with local discretion often being diluted and additional committees being put in place to determine allocation of capital. Consequently, there has been a trend towards traditional banking players **prioritising existing clients** over new ones and focusing on transactions that were already in process prior to COVID-19. This is providing the opportunity for other players to increase market share.

The result has been a **widening of pricing** since March, with NAV and preferred equity pricing increasing by 100bps-200bps plus; subscription finance pricing has also widened but this has been less marked. In the main, a **pragmatic approach** continues to be adopted by lenders at both the underlying portfolio asset level and at the fund level, although the risk remains that this approach could change as time goes on.

Fund finance liquidity remains, albeit on an increasingly selective basis. The picture is mixed here, with there still being a robust level of capacity in the subscription finance market given the strong credit risk dynamics and influx of new lenders over the last couple of years. In the NAV space, however, capacity is more finite currently given the smaller pool of lenders, with the recent increase in demand having resulted in a **shift in the supply/demand dynamic** in favour of the lender. This has resulted in a **notable interest from non-bank lenders**, with a number of private debt funds considering providing liquidity to managers through NAV facilities given the strong demand and the credit enhancement that a portfolio-based lender provides (relative to a typical individual asset lender).

There are undoubtedly significant opportunities opening up in this space for funds, and it will be interesting to see how this is reflected going forward in lender appetite.

The Future

COVID-19 will reinforce the **longer-term shift in the influence of investors**. Frequent and open communication with investors is key in the current environment, and ILPA continues to play a leading role in driving communication and information sharing. Investors are also likely to be less accepting of delayed deployment of commitments. If funds accept government money for their underlying investments, it may also be the case that this brings increased regulatory scrutiny.

Pricing is likely to settle at a level slightly higher than has historically been the case. The delta in pricing and range of that pricing is likely to be **more marked for NAV and preferred equity than subscription lines**, reflecting a likely increased demand for the former.

Continued **innovation** is expected to be a strong theme from both managers and lenders in finding new solutions to the unprecedented challenges they are facing, as well as **increased flexibility** to take advantage of specific opportunities that present themselves in a more fragmented and difficult market (including secondaries). The experience and approach on COVID-19 may also help in heightening the focus on other globally impactful events like climate change through ESG. As with the 2008 financial crisis, the impact of COVID-19 may well be **increased activity from non-bank lenders**, particularly if those non-bank lenders can demonstrate proof of concept by coming through a full credit cycle.

Overall, despite the recent challenges, we believe the market to be robust and well-positioned for the recovery. The recent disruption has had the impact of accelerating some of the prior trends that were being seen in the market, and our expectation is that a number of these trends will form part of the new normal going forward.

‘Fund Finance Friday: Industry Conversations’ — Podcast with Scott Aleali and Dave Philipp (54 Minutes)

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Industry Conversations

 

Dave Philipp of Crestline Investors and Scott Aleali of First Republic Bank connect with Cadwalader’s Mike Mascia in this week’s podcast edition of *Fund Finance Friday: Industry Conversations*. In the podcast, Dave covers the breadth of the NAV-lending market, including detail about transaction structures and attachment points, addressing revised marks in an existing portfolio, the uptick in borrower inquiries post-COVID, and forecasts for how the NAV and pref equity markets may expand and evolve in the medium and longer-term. Scott gives a credit performance update on the capital call space, discusses the evolving uses of capital call lending in the new environment, and provides a host of insightful predictions for how both the fund finance market and the macro landscapes are likely to play through during the summer and into the future.

Subscribe on **Apple Podcasts**, **Google Podcasts** or **Spotify** to never miss an episode.

FUND FINANCE FRIDAY | INDUSTRY CONVERSATIONS

Fund Finance Market Analysis and Forecasts with Scott Aleali and Dave Philipp

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The Rise of Qualified Borrowers

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By **Trent Lindsay**
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Credit agreements often allow private equity funds to join their portfolio companies to fund finance facilities as "qualified borrowers." In the past, many sponsors did not take advantage of this option, but there has been a marked increase in qualified borrower joinders in recent months. The following is a general overview of the treatment of qualified borrowers in traditional subscription credit facilities (it does not, however, deal with NAV and hybrid facilities, which provide for the pledge of a fund's underlying assets).

A qualified borrower is generally a portfolio company of a borrower or a guarantor under the credit facility (a "Fund Party"). A portfolio holding company may also be a qualified borrower, but, in either case, qualified borrowers differ from other credit parties in that third-party limited partners do not hold direct equity interests in the qualified borrower. Instead, LPs make capital commitments to a Fund Party, which in turn holds a direct or indirect equity interest in the qualified borrower. The qualified borrower is joined to the facility by (i) a promissory note executed by the qualified borrower in favor of the lenders and (ii) a guarantee by a Fund Party of the loans and other obligations of the qualified borrower under the facility.

All loans to a qualified borrower are ultimately secured by the unfunded capital commitments of limited partners of the Fund Parties and collateral accounts into which capital is called. Such capital commitments are the primary source of repayment for lenders in traditional subscription facilities.

Subscription lenders are generally more concerned with unfunded capital commitments (which constrain the borrowing base as well as serve as collateral) than their secondary source of repayment – an unsecured claim against the borrowers that may be made if capital contributions are insufficient to repay outstanding obligations. It is worth noting, however, that there may be additional limitations on claims against the assets of qualified borrowers. Any Fund Parties that guarantee a qualified borrower's obligations are liable for all loans made to the qualified borrower. However, the reverse is not true – a qualified borrower may only be liable for loans made to the qualified borrower itself and not jointly and severally liable for loans made to Fund Parties or other qualified borrowers. Even if the qualified borrower is jointly and severally liable, an unsecured claim against a qualified borrower is likely to be of dubious value. In making loans to a qualified borrower under a subscription facility, lenders should be satisfied that the loan can be supported by the collateral (their unfunded capital commitments of the Fund Parties), given that the assets of portfolio companies are commonly used as collateral for leveraged loans. The security interest of the asset-level lender will have priority over an unsecured claim by the subscription lender with respect to portfolio company assets.

Since they are cross-collateralized by the same capital commitments, loans to qualified borrowers are typically made on the same terms as loans to Fund Parties (although it is possible to include additional covenants and sub-limits applicable only to qualified borrowers). Letters of credit are also commonly available to qualified borrowers to the same extent as to Fund Parties. Letters of credit are often more useful to portfolio companies than to funds, and have been one of the main drivers for joining qualified borrowers in the past.

To the extent that the cost of credit in the leveraged loan market increases, sponsors are more likely to find it attractive to obtain additional liquidity for their portfolio companies through the use of the qualified borrower provisions of fund finance facilities.

Quizzing Cadwalader: Samantha Hutchinson profiled in The Lawyer’s 'Hot 100 Career Quiz'

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Samantha Hutchinson features in *The Lawyer* this week, providing some interesting insights and tips for those looking to pursue a career in fund finance. She also takes a trip down memory lane, reflecting on her time as a junior lawyer and the resilience of the fund finance market throughout the global financial crisis. While the world has clearly undergone some fundamental shifts since Sam took part in the quiz late last year, her underlying message remains the same: fund finance products were key for managers surviving and thriving through the financial crisis, and the same is true today. The interview is available **here**.

Secondaries Investor Article on Fund Leverage

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Secondaries Investor this week published the first of a series of articles titled “Leverage in the time of Covid-19: Fund level facilities." The article examines how secondaries funds use subscription facilities and fund level leverage, discussing the positive credit performance of subscription facilities, the potential implications if there is a large drop in portfolio value, and the use of NAV lines for early distributions and dividend recaps. The subscription-required article is accessible **here**.

Private Funds CFO Article Shares Private Equity CFO Reactions to ILPA's Draft Recommendations

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In a *Private Funds CFO* article, private equity CFOs discuss the ILPA's draft recommendations for disclosure on funds' use of subscription facilities. Generally, the private equity CFOs are supportive of such recommendations; however, debate remains around the calculation of two IRRs – one that includes the impact of leverage and one without. A goal for ILPA in providing an IRR without the effect of a subscription facility is to more accurately compare manager performance. To read more, the article is available **here**.

Samir Kaji Article on Capital Call Lines

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Samir Kaji, Senior Managing Director and Innovation Sector Strategy Lead at First Republic Bank, this week published an article on LinkedIn titled “Use of capital call lines for emerging managers during economic downturns.” The article sets forth the typical uses for which an emerging VC manager might deploy a capital call line and what terms an emerging manager could expect in this environment. The article is available **here**.

Private Funds CFO Article on Subscription Facility Durations

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Private Funds CFO published an article this week titled “GPs look for longer sub line duration during fundraising.” The article focuses on how using a subscription facility for investments made between the initial investor closing and the final investor closing benefits both funds and investors by avoiding the need for true ups, but can often conflict with a fund’s clean down requirement. The subscription-required article is accessible **here**.

Recommended Reading

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- In *Buyouts*' April 30 article, "Private equity and the dry powder fallacy," author Chris Witkowsky addresses the misperception, furthered by politicians and the media, that the private equity industry can and should bail itself out by using its "$2 trillion of unspent capital." Witkowsky notes that current U.S. federal policy bars most private equity-backed companies from accessing U.S. government funds meant to preserve jobs, but that many private equity funds – especially older funds that have drawn all their capital – are limited in their abilities to further protect and re-invest into existing portfolio companies that need help. In turn, investments in retail, hospitality, and other sectors will continue to struggle, and more workers in those sectors will lose their jobs. The article is accessible **here**.
- In *Bloomberg*'s article this week titled "How Long-Feared 'Monetary Finance' Becomes Mainstream," journalist Ben Holland discusses the various forms of money-printing central banks are engaged in to pay for government fiscal policy stimulus to combat COVID-19 and its economic destruction. Where are the limits of Modern Monetary Theory? Available **here**.
- In *Dark Genius of Wall Street: The Misunderstood Life of Jay Gould, King of the Robber Barons*, author Edward J. Renehan Jr. makes the case that there is far more to Jay Gould than simply his enduring reputation as Wall Street's most-hated villain. Rather, Renehan suggests Gould was instead simply the most astute player of a game that at the time had very different rules than today and that he developed his negative reputation simply by outmaneuvering competitor after competitor by laying bear traps, cornering markets, manipulating the judiciary and aggressively pursuing hostile corporate activism. Reading the degree of deception and unapologetic conflicts of interest of the age, it is no wonder why the Securities and Exchange Commission came onto the scene in the 1930s. The book is available on barnesandnoble.com **here**.
- In its April 2020 House View, Prequin discusses key developments across alternative asset classes in Q1 2020 and looks at what is coming next. Commitments are expected to slow in 2020 due to the challenges posed by social distancing and portfolio revaluation, but LPs are not slowing down – they are looking beyond the short term and continue to trend towards higher allocations in alternatives. While GPs and LPs are expecting reduced returns on existing investments, they are not reducing targeted returns for new investments. On the private equity front, large funds from established managers are still securing considerable commitments, and capital raised was up in Q1 2020 compared to Q1 2019. Managers held off on completing deals in Q1 in anticipation that asset prices would fall. In the current situation, falling valuations may actually lead to 2018 and 2019 vintages outperforming prior expectations for buyout returns. Declining valuations, investors looking for opportunities across sectors, and nearly $1.5T in dry powder to put to work has the private equity industry well positioned to adapt to changes and generate returns. Read the article **here** for more on developments in private equity, opportunities in distressed debt, and snapshots of other alternative classes.