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Country Question and Answer Chapters:

Chapter 11

The Global Subscription Credit Facility and Fund Finance Markets – Key Trends and Forecasts

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Introduction

The Subscription Credit Facility (each, a "Facility") and related Fund Finance markets continued their expansion in 2016, extending the long-standing industry trend. Mirroring our recent experience both during and after the financial crisis, Facility credit performance remained pristine, with no monetary defaults having become public last year. This chapter summarizes the key trends in the Facility and Fund Finance markets in 2016 and forecasts developments for the coming year.

Credit Performance

To our knowledge, there were again no payment events of default in the Facility or related Fund Finance markets in 2016. Similar to the past three years, we were not consulted on any funding delinquencies by limited partners ("Investors") on their capital calls ("Capital Calls"), other than a few by high-net-worth Investors ("HNW Investors"). This positive credit performance again extended to our hybrid and asset-level facilities, which have ticked upward (slightly) as a percentage of our overall deal portfolio. Interestingly, we have for the first time been consulted on a pre-default analysis for a Facility facing uncertainty as a result of real credit and liquidity deterioration of the key Investor. While the details of this Facility are of course confidential, we are comfortable that the underlying factual circumstances are highly unique and isolated and not reflective of any systemic issue or risk.

Resilient Growth

Despite the Brexit vote and the unexpected result in the United States presidential election, 2016 was another healthy year for private equity generally and the Facility markets specifically. According to Preqin research, private capital raised in 2016 hovered around the $600 billion mark for the fourth straight year and private equity dry powder climbed to an all-time high.[1] Coupled with increased interest and acceptance of the Facility product in the buyout and venture capital asset classes, many of the major lending institutions in the market (each, a "Lender") again report portfolio growth in excess of 20% last year, exceeding our forecasts. While there are certain Lenders that have reached their institutional lending limits for particular Fund sponsors (each, a "Sponsor") and even for the Facility product itself (and even a small handful of Lenders that exited the market in 2016), this self-imposed constraint has done little to slow industry-wide growth.

Structural Evolution

Last year was very muted in terms of structural evolution in the Facility market. Frankly, very little changed. At the 7th Annual Global Fund Finance Symposium on March 14, 2017 in New York (the "2017 Global Conference") hosted by the Fund Finance Association (the "FFA"), panelists had to stretch a bit to come up with concrete examples of how Facility structures evolved in the last year. For sure, from a Lender's viewpoint, private equity fund (each, a "Fund") limited partnership agreements ("Partnership Agreements") continued to improve, which has led to a reduction in asset-level mitigants such as periodic clean downs or net asset value ("NAV") floors. Facility borrowing bases ("Borrowing Bases"), while holding remarkably stubborn to the traditional Included Investor/Designated Investor structure (particularly in the United States), have inched upward incrementally. Advance Rates moved slightly higher in the last year and concentration limits were relaxed moderately, at least for high credit quality Investors. But these changes were really at the fringe; Facility structures remain quite consistent with where they have been in recent years.

Industry Developments and Press Coverage

The Facility and Fund Finance markets and industry continue to mature and 2016 was very active in this regard. Over 700 people registered for the 2017 Global Conference, with 55 different market participants formally sponsoring. Despite a major snow storm, over 400 people actually attended. The FFA also formed a Women in Fund Finance subgroup, which had a very successful inaugural event in March in New York that was followed by a companion event in London the following week. The events included a screening of the movie Equity and a discussion panel with several of the producers and actresses in the film. Global Legal Group Ltd., the publisher of this Legal Guide, published the inaugural edition of *Global Legal Insights – Fund Finance 2017*, a comprehensive legal guide on the Fund Finance markets. The guide includes 14 product-oriented chapters and 17 jurisdictional updates contributed by many of the world's preeminent Fund Finance law firms.[2] Fund Finance has clearly matured from a product category into an industry in its own right.

The Facility market was also covered more extensively in both mainstream and private equity press in 2016, sometimes fairly and sometimes frankly in an alarmist and inflammatory way. On October 20, 2016, the *Financial Times* published an article about the Facility market titled "Financing 'trick' boosts lucrative private equity fees".[3] While the article begins by quoting a professor that characterizes Facilities as a "trick" to enhance Sponsor fees, it does go on to provide

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some balanced reporting, explaining that Facilities offer utility to both Funds and Investors and in actuality are unlikely to materially impact Sponsor fees over the entirety of most Fund lifecycles. The article also goes somewhat astray paraphrasing another purported expert who indicated that Facilities could be adding "inappropriate leverage" into buyout transactions and that as a result, in the event of a financial crisis, it could "force fund managers to sell their liquid equity and bond holdings first, exacerbating market instability". Of course, Facilities are not leverage at all in the traditional sense, in that they do not allow a Fund to invest a single dollar more than the Fund's committed equity capital from Investors. Further, with Facilities' expected source of repayment being Investor Capital Calls, suggesting Facilities are likely to lead to forced liquidations of Investments also seems somewhat off the mark. Private Equity International also published two articles on Facilities early this Spring, both casting a somewhat negative light on Facilities from the vantage point of the Investor. Both articles, however, did note many of the benefits of Facilities as well and pointed out that many Investors are benefitted by, and are supportive of, Facilities.[4] Investment advisor TorreyCove Capital Partners also recently published a thoughtful academic analysis of the Facility product, which provided mathematical examples of the interplay between Facility usage, IRR and Sponsor fees. This press attention, while new to the Fund Finance market, is further evidence of the industry's maturation.

2017 Market Forecast

From a Facility structural perspective, we expect evolution to continue to be limited to the margins in 2017. Credit performance of Facilities during the financial crisis validated current structures and Lenders have expended significant institutional resources the past several years developing their Facility product programs and policies. We believe wholesale revisions and exceptions to these programs and policies are quite unlikely and thus, structural change will be incremental. Outside of the Facility space, we do note discussions in the market about Funds structuring NAV-based facilities in the form of preferred equity. While non-tenured leverage certainly has an inherent appeal to Funds seeking to optimize their financing options, we think this new product offering will only expand slowly in 2017. Sponsors are highly focused (rightfully) on thorough Investor disclosure at present, and many older vintage Partnership Agreements were of course unable to foresee this financing innovation. So while in many cases Sponsors may be comfortable going to Investors for amendments to Partnership Agreements to permit the innovations, our expectation is that growth in this product segment has a longer term horizon. One area where we do think NAV-based and hybrid structures are likely to grow significantly in the coming year is with private debt Funds. Over the last few years, the number and size of private debt Funds has grown significantly. And Investors are widely forecasted as likely to increase their allocations to debt Funds in 2017.[5] This asset class is in many cases seen by Investors as entirely appropriate for traditional leverage, and the Fund's strategy may simply require leverage to meet the expected return targets. Further, levering at the Fund level makes complete sense for a debt Fund, as Investment-level financing is unlikely to be attractively available in most cases. Further, debt, of all asset classes, is where Lenders are going to be the most comfortable (and most competent) adding NAV to a Borrowing Base. Hence, we have seen, and expect to continue to see, growth in this area.

While we do expect the rate of Facility growth to slow in 2017 as compared to the 20+ percent of the past few years, we forecast 2017 growth in Lender portfolios in the 10%–15% range year-over-year. The historical factors supporting expansion remain sufficiently pronounced. The number of Funds in the market is at an all-time high at 2,965.[6] Cash distributions made to Investors in 2015 and 2016 again meaningfully exceeded Capital Calls, requiring Investors to re-up with Funds at current or greater levels to maintain their asset allocations. As a result, we forecast a healthy 2016 for Fund formation. Dry powder (i.e., Borrowing Base availability) again increased meaningfully in 2016. And interest rates have remained low and pricing margins have trended downward. We also think there is additional market growth from new Sponsors; we continue to work on transactions for a Sponsor's first Facility despite having multiple prior Funds. Thus, market growth, while perhaps somewhat more modest than that sustained in recent years, is likely to exceed double digits once again in 2017.

Hot Button Issues

Two issues we see drawing increased attention in 2017 involve anti-terrorism provisions in Facility credit agreements and "Know Your Customer" documentation and information requests. While Lenders are optimistic that the new presidential administration in the United States will be helpful at reducing or at least improving the regulatory environment generally, there is near universal agreement amongst Lenders that terrorism is one area where regulation is likely to intensify. As a result, virtually every Lender is closely examining their sanctions, anti-money laundering, anti-corruption and KYC policies and provisions. Updates are coming. And the combination of greater use by Funds of alternative investment vehicles with heightened KYC deliverables is likely to lengthen the new borrower onboarding process.

Upcoming Events

On June 19, 2017, the FFA is hosting the inaugural Asia-Pacific Fund Finance Symposium at the Four Seasons Hotel in Hong Kong. This will be the first industry-wide event held in Asia and it will be exciting to see the level of interest and attendance. The 3rd Annual European Fund Finance Symposium is scheduled for October 11, 2017, this year moving to a new venue, the Landmark Hotel in London. And the 8th Annual Global Fund Finance Symposium has been scheduled for March 21, 2018, again at the Grand Hyatt Hotel in New York City.[7]

Conclusion

The Facility market appears poised for another solid year in terms of portfolio growth in 2017. While Facility structures have been trending ever so modestly in favor of Fund borrowers, we continue to believe that the credit profile of market-structured Facility transactions forecasts well for Facility performance in the coming year.

Endnotes

1. See *Private Capital in 2017, Key Findings from the 2017 Preqin Global Alternatives Reports*, Preqin, Christopher Elvin, Head of Private Equity Products, presentation at the 7th Annual Global Fund Finance Symposium on March 14, 2017 in New York, New York ("Preqin FFA Presentation"), pages 6 and 8.
2. An electronic copy of *Global Legal Insights – Fund Finance 2017* can be accessed at https://www.globallegalinsights.com/practice-areas/fund-finance/global-legal-insights---fund-finance-2017-1st-ed.

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3. A copy of the article is available at https://www.ft.com/content/c5c24c58-953c-11e6-a80e-bcd69f323a8b.
4. Copies of the two Private Equity International articles can be accessed at http://link.privateequityinternational.com/view/582073023f92a457f5e281815c7yb.7k5/a7760b76 and https://www.privateequityinternational.com/news/europe/2017-03-09/walking-the-line/.
5. *Preqin* research shows that 57% of surveyed Investors report planning to invest more money into private debt in 2017 and that 62% report expecting to increase their asset allocation to private debt going forward. See *Preqin FFA Presentation*, pages 22–23.
6. See *Preqin FFA Presentation,* p. 21.
7. Information on these events is available at the FFA's website, http://www.fundfinanceassociation.com/.

Acknowledgment

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Mike Mascia is a partner in Cadwalader, Wickersham & Taft's Capital Markets Group. He has extensive experience representing a variety of lenders across a range of secured lending transactions, with particular emphasis on the financing of investment funds and financial institutions. He has a globally recognized practice in the subscription Credit Facility space, having represented both balance sheet and commercial paper conduit lenders in facilities to real estate and private equity funds sponsored by many of the world's preeminent fund sponsors.

Mike has represented the lead arrangers in many of the largest subscription credit facilities ever consummated. He has been lead counsel on numerous hybrid facilities, and is one of the few attorneys in the United States with experience in both subscription credit facilities and CLOs. Mike represents lenders on leverage facilities to secondary funds and other credits looking primarily to fund assets for repayment. Many of his transactions are cross-border in nature, and he is well-versed in the nuances of multi-jurisdictional transactions.

Mike is the founder of the annual Subscription Credit Facility and Fund Finance Symposium and is a founding member and the Secretary of the Fund Finance Association. Mike is recognized as a Leading Lawyer in the area of Banking and Finance in the International Financial Law Review's *IFLR1000 Legal Directory* in 2015.

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Wes has served as lead counsel on many of the largest and most sophisticated fund financings ever consummated, notably having assisted more than 35 banks as lead or syndicate lender during the past two years with transaction values totaling in excess of $25 billion. Many of the transactions he advises on are precedent setting, carrying unique structures and complex international components – whether that be foreign limited partners or funds, multi-currency advances or foreign asset investment.

Wes has been recognized as a "Rising Star" in the US in the area of Banking and Finance in the International Financial Law Review's *IFLR1000 Legal Directory*, and is also a frequent speaker and an accomplished author in the area of fund finance. He has worked extensively with financial institutions to develop form agreements for fund finance transactions, many of which are the dominant forms used in the market today, and to educate bankers, internal legal counsel and credit officers on hot issues and trends affecting the fund finance market.

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