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Takeaways from the 11th Annual Global Fund Finance Symposium

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On February 16-18, 2022, the Fund Finance Association reconvened for its 11th Annual Global Fund Finance Symposium in Miami where market participants gathered to discuss the latest developments in global fund finance and to consider the outlook for the industry in 2022 and beyond. Below is a summary of our key takeaways from the conference.

- **Market Update** — The year 2021 saw a record level of fund financing activity. The pace of fundraising on the sponsor side accelerated in 2021 and, with it, interest in fund financing solutions. Subscription facilities have become essential working capital products used by an ever-increasing number of private funds from their initial formation through and sometimes beyond their investment periods. Conference participants expect deal volume to continue to increase in 2022, particularly in subscription lines and NAV facilities. Fund structures are become increasingly complex, including from greater use of alternative investment vehicles, co-investment funds, "side pockets" for certain categories of investments (e.g., distressed), warehouse vehicles and series limited partnerships.In light of this complexity, sponsors and their legal counsel should seek to ensure that the fund's organizational documents provide sufficient flexibility to obtain appropriate financing for these structures at the outset to avoid having to go back to investors for amendments.

- **Effect of COVID-19** — The global pandemic gave the fund finance industry a chance to prove its resilience and flexibility. Conference participants agreed that, while some borrowers had difficulty obtaining funding at the start of the pandemic in early 2020, most lenders were able to deliver flexible and creative solutions to their borrowers' liquidity needs, including temporary upsizes to existing facilities, the addition of qualified borrowers and NAV and hybrid facilities. By the end of 2021, the fund finance market exceeded its pre-pandemic level and continues to grow with new entrants and more complex financing structures. On the lender side, competition has increased since the start of the pandemic, resulting in lower margins, higher advance rates and riskier structures, forcing lenders to consider what products they should focus on to set themselves apart.

- **Alternative Lenders** — Alternative financing sources, such as private credit funds and insurance companies, have demonstrated enormous interest in acting as lenders in fund financing transactions. Since they generally require a higher return than banks and have more flexible risk appetites, alternative credit providers will likely find their niche in more bespoke structures, including NAV and preferred equity facilities, rather than subscription lines. For sponsors, the entry of alternative lenders into the fund finance space brings both opportunities and risks.Sponsors should bear in mind the implications of sharing confidential information (such as the identities of LPs) with alternative lenders and should ensure that the loan documents provide sufficient notice and consent rights with respect to potential assignments and participations by lenders.

- **"Fund Finance 2.0"** — Conference participants discussed the evolution of the fund finance market from its origin in simple "bridge" subscription facilities to today's variety of dynamic, solution-focused products. Several factors have driven the growth of non-traditional fund finance products, including the financing challenges created by the pandemic, increasing familiarity and comfort with fund financing on the part of sponsors and investors, greater complexity of fund investment structures and the entry of alternative financing sources. While many traditional lenders have been slow in offering these products, one panelist expects that, once these lenders gain confidence in their long-term durability, the growth will be exponential rather than linear. Some of these structure include:
    - Rated note feeders — This structure was designed to enable sponsors to raise capital from insurance companies in the form of rated notes (typically pay-in-kind) that are treated more favorably, as compared to

equity investments, under capital requirement regulations applicable to insurance companies. A fund's subscription facility must allow inclusion of the insurance companies' commitments to purchase the rated notes in the borrowing base similarly to equity capital commitments. For lenders, these structures may carry some risk since the enforceability of the insurance companies' note commitments in the event of a bankruptcy of the fund may be unclear or untested in the relevant jurisdiction. These risks may be mitigated by incorporating an investor's note commitment into the fund's partnership agreement or other organizational documents. As a result, it is crucial for fund managers to engage with subscription facility lenders early on in the process to ensure that an investor's note commitments will be included in the borrowing base, including in circumstances in which the note commitment may convert into equity.

  - Hybrid facilities — Under hybrid facilities, borrowing capacity is based on both investor's uncalled commitments and the fund's net asset value (NAV), theoretically extending the term of the facility from "cradle to grave." Despite their attractiveness to sponsors, many lenders struggle to provide these facilities given the bifurcated collateral packages, which are typically covered by separate credit review processes and underwriting teams. However, lenders that can successfully coordinate these teams internally are able to provide a flexible financing product that is well suited to every stage of a fund's life cycle.
  - NAV facilities — The use of NAV facilities, which were traditionally utilized primarily by secondary funds, took off during the pandemic. New to the product, private equity buyout funds began to use NAV facilities to provide liquidity to struggling portfolio companies in legacy funds, as well as to fund add-on acquisitions and even distributions. With a limited number of assets, these "concentrated NAVs" are often too risky for commercial banks and thus have been provided primarily by alternative lenders. In the secondaries market, the use of NAV facilities also skyrocketed in 2021, with these facilities still provided primarily by commercial banks and requiring a minimum level of diversification in the portfolio. With the growth of secondary funds sizes, lenders are being asked to write bigger checks, requiring banks to rely more heavily on syndication, including to insurance companies that have been entering the space in increasing numbers. Secondaries' NAV facilities are also seeing greater interest from LPs and family offices that started to look into these facilities as a way to leverage their own portfolios.
  - Preferred equity — Typically used as an alternative to a NAV facility, preferred equity may be issued at the fund or aggregator level. While preferred equity (unlike debt) does not have a fixed maturity or require regular cash interest, investors may obtain a preferred dividend "ratchet" and/or the right to force a sale if the preferred equity is not redeemed within a certain period. Preferred holders are entitled to receive a percentage of future distributions (e.g., when the fund sells an underlying portfolio investment) in accordance with a waterfall set out in the preferred equity documentation. Although more expensive, preferred equity may be preferable to debt given the longer horizon, PIK dividends and fewer restrictive covenants as compared to debt.
  - GP financing — GP financing, i.e., financing secured by the GP's capital and carried interests in the underlying funds, is used by GPs to get liquidity without selling their GP stake. Although panelists agreed that this type of financing is still very much in its early stages, at least one panelist made the bold prediction that the volume of GP financing transactions will surpass the volume of GP stakes deals in the near future.

- **Single/Separate Managed Accounts (SMA) Funds** — SMA funds (also known as "funds of one") are becoming increasingly common as GPs seek to build relationships with large institutional investors, who are attracted to SMAs for their greater input into investment decision-making and tax or regulatory advantages (as compared to commingled vehicles). To mitigate the risk associated with relying on a single investor's commitment, subscription lenders conduct greater due diligence and require enhanced documentation from investors, such as investor letters that give the lender contractual privity with the investor. Lenders also run lien searches to ensure that the investor's limited partnership interest is not back-levered and tighten events of default

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and investor transfer restrictions in the loan documentation. Having been pressure-tested during the pandemic, the SMA and "fund of one" sub-line seem to be here to stay.

- **Effect of Fraud Cases** — As Ropes & Gray has previously discussed, the potential for fraud in fund finance transaction brought to light by the *Abraaj* and *JES Global* cases has ultimately had limited impact on the subscription finance segment. One lender-side participant at the conference mentioned attempting to run a more intensive due diligence process on an existing sponsor client after *JES*, only to be emphatically rebuffed by the sponsor. On the other hand, lenders *are* conducting more intensive diligence on new fund sponsors than they had historically, including verification of the identities of LPs and obtaining confirmation from LPs of their specific fund commitments. Notably, lenders report that LPs have been constructive in cooperating with this process, presumably because they have a shared interest in minimizing LP default risk. Ultimately, while panelists noted that while fraud will always remain a risk, actual instances have been exceedingly rare and the risk remains highly remote, particularly for established sponsors.

- **ESG** — Both sustainability-linked and "green" use of proceeds facilities have accelerated in Europe in the past two years though, even there, there is not yet a wholesale shift in incorporating these into fund financings. In the U.S., while these products are far less common, investors are certainly focused on ESG considerations. Nevertheless, as one panelist remarked, ESG-related finance is still in its "first inning" and investors and LPs remain focused on a fund's ESG strategy and mission broadly rather than how that strategy plays into fund-level financing specifically. The risk of "greenwashing" remains a concern, especially as there is still no market standard for setting or measuring KPIs. However, panelists were optimistic that achieving such standardization is only a matter of time and that, as more comps come to market and participants as a whole become smarter on this topic, investors will embrace the advantage of potential savings in funds' costs of capital. (For additional information on Ropes & Gray's ESG practice generally, and sustainability-linked debt specifically, please refer to our ESG practice homepage and our podcast on ESG-linked debt.)

- **LIBOR Transition** — In the fourth quarter of 2021 and continuing into early 2022, lenders have been accelerating the process of transitioning their portfolios from LIBOR to alternative rates. While most lenders have adopted CME Term SOFR as the fallback, some lenders continue to explore various "credit-sensitive" rates or, in some cases, simply the "prime rate".With the widespread transition to Term SOFR, the main point of contention has been whether to add a credit spread adjustment (CSA) on top of the margin. While the syndicated market has been increasingly adopting a no-CSA approach, lenders under bilateral and privately placed facilities have sought to maintain a CSA, whether tiered (as contemplated by the original ARRC "hardwired" fallback provisions) or flat.One panelist noted that, without a CSA, lenders may seek to limit borrowings to a one-month interest period while, if there is a CSA, they are more likely to be comfortable with one-, three-, or six-month periods. The lack of market consensus on spread adjustments creates complexities for asset-liability matching, particularly for credit funds whose assets and liabilities may use different benchmarks, or use the same benchmark but with spread adjustments. While the market is expected to move toward a consensus during 2022, the current lack of consistency is causing enormous frustration on the part of sponsors.

If you would like to discuss in more detail any of the topics mentioned above, please contact one of the Ropes & Gray attorneys above.

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