ROPES & GRAY

ALERT

February 17, 2023

Takeaways from the 12th Annual Global Fund Finance Symposium

Attorneys
Daniel J. Coyne
Patricia C. Lynch
Patricia Teixeira

On February 8-10, 2023, the Fund Finance Association hosted its 12th Annual Global Fund Finance Symposium in Miami. Market participants gathered to discuss the latest developments in fund finance and to consider the outlook for the industry in 2023. Below is a summary of our key takeaways from the conference.

- NAV Facilities — The increase in the use of NAV facilities was a key topic in this year's conference. At this time last year, we noted that NAV facilities, which traditionally had been used by secondary funds and credit funds, had been discovered by private equity buyout funds during the pandemic as a way to provide liquidity to struggling portfolio companies in legacy funds, to fund add-on acquisitions and to fund 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. As predicted, this market has experienced tremendous growth in the past year. With higher yields than traditional subscription facilities, NAV credit facilities are attractive to several alternative credit providers, including insurance companies, pension funds and asset managers who have all been entering the fund finance space in large numbers. Alternative credit providers also tend to have more flexibility in the way they structure their collateral packages (or lack thereof), tenor and repayment mechanics.

  The expectation is that with increased liquidity demands generally, funds will utilize these financing options more to make follow-on investments in their portfolio companies, as well as to make distributions to investors. With sponsors eager to maintain flexibility to enter into NAV facilities, fund documentation at least at the top of the market has started to catch up, with fund managers looking to include provisions in their partnership agreements that allow NAV facilities to be part of the GP's toolkit, much like what we have seen with respect to subscription facilities borrowings over the last decade. Responses from limited partners have been mixed with some LPs not willing to give GPs carte blanche upfront to additional leverage and pushing for consent rights over these products, whereas other LPs see NAV facilities as an important source of liquidity for funds at an advanced stage of their life cycle.

- 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. It can also be an attractive option for funds subject to restrictions on longer term debt in their partnership agreements.

- Rated Note Feeders — Insurance companies participate in the fund finance market in many ways, one of which is as an investor in a feeder fund that issues rated notes instead of, or in addition to, traditional equity interests, as discussed here. Rated note feeder structures have become increasingly popular with insurance companies in recent years since they can obtain more favorable regulatory capital treatment for holding rated notes than for holding equity interests.

  Fund managers should be aware of certain complexities surrounding the use of rated feeders, however. These structures may carry some risk for lenders providing subscription facilities to the fund, given the uncertainty in certain jurisdictions around the enforceability of the note commitments in the event of a bankruptcy of the fund. The market has come up with several solutions to mitigate lenders' concerns, including trigger events following

which the note commitment may convert into equity, waivers of defenses by noteholders/investors and/or structures in which the rated note feeder is set up as a bankruptcy remote entity.

Another development affecting rated feeder fund structures has been a recent proposal by the National Association of Insurance Commissioners (NAIC) that, rather than automatically be treated as bonds for regulatory capital purposes, the regulatory capital treatment of rated feeder fund notes should be determined by the NAIC's Securities Valuation Office on a case-by-case basis. While this proposal is just one step in the lengthy development of a regulatory framework applicable to these structures, and the final regime that is adopted by the NAIC may well be different, the evolving regulatory landscape is one that fund managers and insurance companies are monitoring closely.

- Collateralized Fund Obligations — While collateralized fund obligations (CFOs) maintain their presence as a rather niche corner of the fund financing market, all signs point to a moderate increase in the number of publicly rated, ramped portfolio CFOs in 2023. Like rated feeder notes, the notes issued by CFOs are popular with insurance company investors, and the recent NAIC proposals described above have raised certain questions about the regulatory capital treatment of CFO notes in the future. This uncertainty is not expected to chill the CFO market, however, as it is expected that different types of investors, including investors that have traditionally invested in other types of structured credit, will step into the arena. In addition, market participants are strategizing to ensure that CFOs are structured in such a way as to continue to be able to receive favorable treatment under the NAIC guidelines as they evolve.

- New Sources of Capital — In 2022, demand for fund-level credit facilities largely outpaced supply. While fundraising has slowed relative to recent years, total AUM growth across alternative asset classes has generally continued. At the same time, due to increased funding costs, the tightening of regulatory capital requirements applicable to banks and the exit of certain large bank lenders from the fund finance space, capacity among the traditional players on the lender side has been curtailed. The reduced supply of credit has in certain cases led to a tightening of terms in fund facilities, but it has also created opportunities for new sources of capital. While traditional banks brainstorm possible solutions to free up liquidity, including potential capital markets transactions, non-bank lenders, including pension funds, other asset managers and, most notably, insurance companies, are beginning to step into the gap created by the decrease in bank lending, whether as syndicate partners in bank-led facilities (particularly subscription facilities) or by providing financing on their own.

  The impact of non-bank lenders on fund finance terms has been mixed. Non-bank lenders may pose challenges for fund borrowers in certain cases, in that they are generally unable to provide the full range of bank products traditionally found in subscription facilities, such as letters of credit and same-day or multi-currency borrowings. On the other hand, certain non-bank lenders, particularly alternative asset managers, are able to provide borrowers with more flexible commercial terms than may be available under a traditional bank facility, including higher advance rates, fewer diversification requirements in the case of a NAV facility, and longer maturities to better match the lifecycle of a fund.

If you would like to discuss in more detail any of the topics mentioned above, please contact one of the Ropes & Gray attorneys below. Thank you to associates Justin Gaudenzi, Douglas Hollins and Patrick MacDonald for their help in preparing this Alert.

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2022 Ropes & Gray LLP

ATTORNEY ADVERTISING