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FUND FINANCE FRIDAY

‘Fund Finance Friday: Industry Conversations’ — Ares Management's Eli Appelbaum and Richard Sehayek

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Fund Finance Friday was pleased to have the opportunity to speak with Richard Sehayek and Eli Appelbaum from Ares Management this week.

Eli is a Partner at Ares and Head of European Alternative Credit.

Richard is a Managing Director at Ares, with a focus on alternative credit investments. Prior to joining Ares earlier this year, Richard was a Managing Director and Global Head of Origination for Fund Financing at Credit Suisse.

Both Eli and Richard have a wealth of experience and are incredibly well placed to comment on the market. We are grateful to them for sharing their time for this piece.

FFF: There is a lot of discussion around the growth of the fund finance market, and it is fair to say that the market has grown significantly, particularly in the PE NAV space – both in terms of participants and structures. What do you see as the main drivers for this growth?

E&R: From our perspective there are multiple levers driving the organic growth of the fund finance market, and the example of PE NAV is helpful to illustrate this.

With the slowdown in M&A activity and the dislocation in capital markets extending portfolio realisation times, we are seeing an increasing acceptance of the advantages and usefulness of the product among both GPs and LPs as an instrument to drive value in the portfolio and manage distributions more efficiently.

There are also increasing challenges and costs associated with accessing subordinated or junior capital at the asset level, which, combined with the increased risk associated with accepting high-priced asset level financing in a high interest rate environment, make financing at a 'NAV' level more appealing. It is also worth mentioning that the growing concerns around possible recession and stagnation in certain sectors mean the advantages to having a portfolio-wide financing solution are more pronounced.

On the distributions side of the equation, GPs are facing a complex fundraising environment. Having access to a financing facility allows GPs to expedite distributions to LPs, which can be particularly helpful where those same LPs are being asked to commit to new vehicles.

On the portfolio side, the additional liquidity afforded by NAV facilities provides both offensive and defensive advantages. Access to an additional cash resource through the NAV line allows GPs to pursue compelling add-on acquisition opportunities at portfolio level that may otherwise be beyond the capacity of the fund where the assets are held.

Defensively, the facility provides the opportunity to de-lever and de-risk underlying assets with an efficient fund-level solution.

Outside of NAV, it is also worth mentioning that the increased requirements for co-invest to achieve successful fund growth is driving GP-level solutions for debt and equity to help finance growing demands for co-invest, to finance strategic acquisitions and to allow GPs to pursue new strategies.

FFF: With the product evolution we are seeing, it would be interesting to hear how you are viewing different structures at the moment and to get an understanding of what Ares is able to offer borrowers in terms of flexibility.

E&R: Traditionally, the market has seen, at one end of the spectrum, bank lenders tending to offer traditional fully secured and covenant-heavy NAV structures at a lower all-in cost. While at the other end of the spectrum, particularly over the last 18 months if we think again about the PE asset class, non-bank NAV lenders have tended towards lending into more flexible, covenant-light preferred equity NAV solutions, which come with a consequent higher ticket.

This has provided choice and solutions to GPs with varying needs, including regulatory and compliance needs that have driven a number of the preferred equity structures the market has seen. It could be said that the market has been efficient in this way, ensuring that both the bank and non-bank lenders have been busy and the borrowers have choice.

Within Ares' Alternative Credit strategy, we can offer solutions across the fund capital structure, and we can consider bespoke hybrid solutions pulling to meet the exact need of the GP. Notably, Ares had approximately $360 billion in assets under management and actively invested in over 1,750 portfolio companies, as of March 31, 2023.

FFF: And more generally, what are you seeing in the market at the moment? What is coming across your desk?

E&R: Demand for NAV financing facilities to these types of managers, particularly for the purposes of making acquisitions, has remained strong. We would caveat this slightly, though, as it is not uncommon for sellers of assets to offer vendor financing in an effort to expedite the transfer of assets from their balance sheet and increase the sale price. This competes with any NAV-based offering and acts as a release valve to some of the 'demand' pressure in the system.

We also see GP commitment facilities – financing facilities secured against fee streams – being popular again against the backdrop of a difficult fundraising environment. Increasingly, these facilities are being used to help fund GP commitments in new vehicles given both the increase in frequency of fund launches and increased fund sizes. This has resulted in larger GP commitments.

Separately, we are seeing an increase in NAV facilities being offered on more concentrated portfolios. We believe this is partly due to the reduced availability and higher cost of subscription lines, as well as GPs feeling less certain with respect to the annual renewal process for their subscription lines. The increase of more concentrated NAV facilities is also a symptom of managers turning to portfolio-level NAV facilities earlier in the life cycle of their funds.

We are also seeing momentum outside of the traditional private equity sectors. For example, there has been a noticeable increase in interest in NAV facilities coming from real estate funds.

Financing for continuation vehicles appears to have become much more prevalent, providing an important tool to create liquidity generally by handpicking one or two high-quality assets for the vehicle.

In terms of approach across the U.S. and European markets, generally speaking LTV on NAV trades tends to be tighter in the U.S. – both in terms of what borrowers are looking for and in terms of what lenders are willing to offer compared to their EU counterparts. That said, GPs have indicated that the European markets focus more on co-invest and management holdings, which may act as a fetter on enforcement, particularly around drag/tag rights and other minority shareholder issues. This can translate into specific covenants in the loan documentation. However, in the U.S. there appears to be more flexibility around these issues, and they are less likely to be specifically addressed in the financing documentation.

Finally, partnering with banks to help recycle risk, reduce RWA and balance sheet, reduce risk and manage internal limits is becoming a bigger part of what we see.

FFF: There is a trade-off to be had between pricing and structural flexibility. How are you seeing this play out at the moment?

As discussed earlier, in order to offer lower pricing bank lenders have historically needed to achieve optimal capital treatment on transactions. As such, they might be constrained by requiring LTVs to remain below certain levels and have greater security restrictions. Non-bank lenders can help fill a void on the financing product spectrum as they do not have similar

constraints, and so are able to be more flexible with key metrics such as LTV and security arrangements. Though this comes at higher cost to reflect the increased risk.

Increasingly, this is translating into a wider offering to GPs and managers, and with this additional flexibility – depending on what they are solving for – they should be able to find the right solution.

FFF: And finally, one of the main points of discussion in the market at the moment is lender capacity, which is presenting its own problems but also creates the potential for market development. How are you viewing it?

We agree. One of the biggest limiting factors at present is the availability of supply. The fund financing market is a constantly evolving ecosystem. With traditional financing routes under pressure given some lenders looking to reduce balances, de-leverage or even exit the space entirely, alternative methods of financing will have to fill in the gaps.

With this in mind, we have seen an increase in appetite coming from non-bank participants, including the insurance sector. For the most part – and subject to robust due diligence/underwriting – risk has not been at the forefront of minds, as the prevailing view has tended to be that these are low-risk, high-quality transactions. So, we don't see bank lenders reducing balances or exiting the market as a response or change of view with respect to risk but more so as a response to the availability of capital and upcoming regulatory changes.

This is what is leading to a re-pricing across the spectrum of transactions, particularly the lower-priced transactions, as supply and demand try to find an equilibrium once more.