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FUND FINANCE FRIDAY

September Reflections

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This past weekend officially marked the end of summer in the U.S. as vacations and Labor Day gatherings have come and gone, and the kids are now back in school. And while I anticipate that everyone's in-office attendance will be positively impacted by this development, it's also a good marker as we approach the end of the third quarter to assess how the year has gone.

Different is one way to describe it – particularly the impacts of the events of March. In our recent **Fund Finance Friday Industry Conservations**, my good friend Mike Mascia gave the analogy of sitting in a kayak on the lake on the Fourth of July. We have all been paddling along in the calm waters for years with each stroke better than the last, and then out of nowhere we are being rocked about in the wake of multiple speed boats.

I feel like we can all relate. The last two years especially were filled with non-stop high fives as the fund finance industry soared to new heights – gravity nowhere to be found. In fact, at Cadwalader we found ourselves in what I call the 500 Club – representing U.S. lenders in more than $516 billion of transaction volume by commitments across from more than 500 fund sponsors during this two-year period alone. Our practice grew. We hired more than two dozen practitioners and in terms of total lawyer count exceeded 80 globally for fund finance.

Then came the headwinds, which ultimately culminated in the events of March. The regional bank mini-crisis took down a few of the fastest-growing lenders in fund finance. Fortunately, the six months that have passed since that market distress feels more like six years. Everyone, and by no surprise in our industry, has been incredibly resilient. At least seven new bank entrants have become active in the U.S. this year. Product evolution has accelerated. It's an exciting time to be in fund finance. As was the case 15 years ago, many of the transactions we do today have the potential to be precedent-setting.

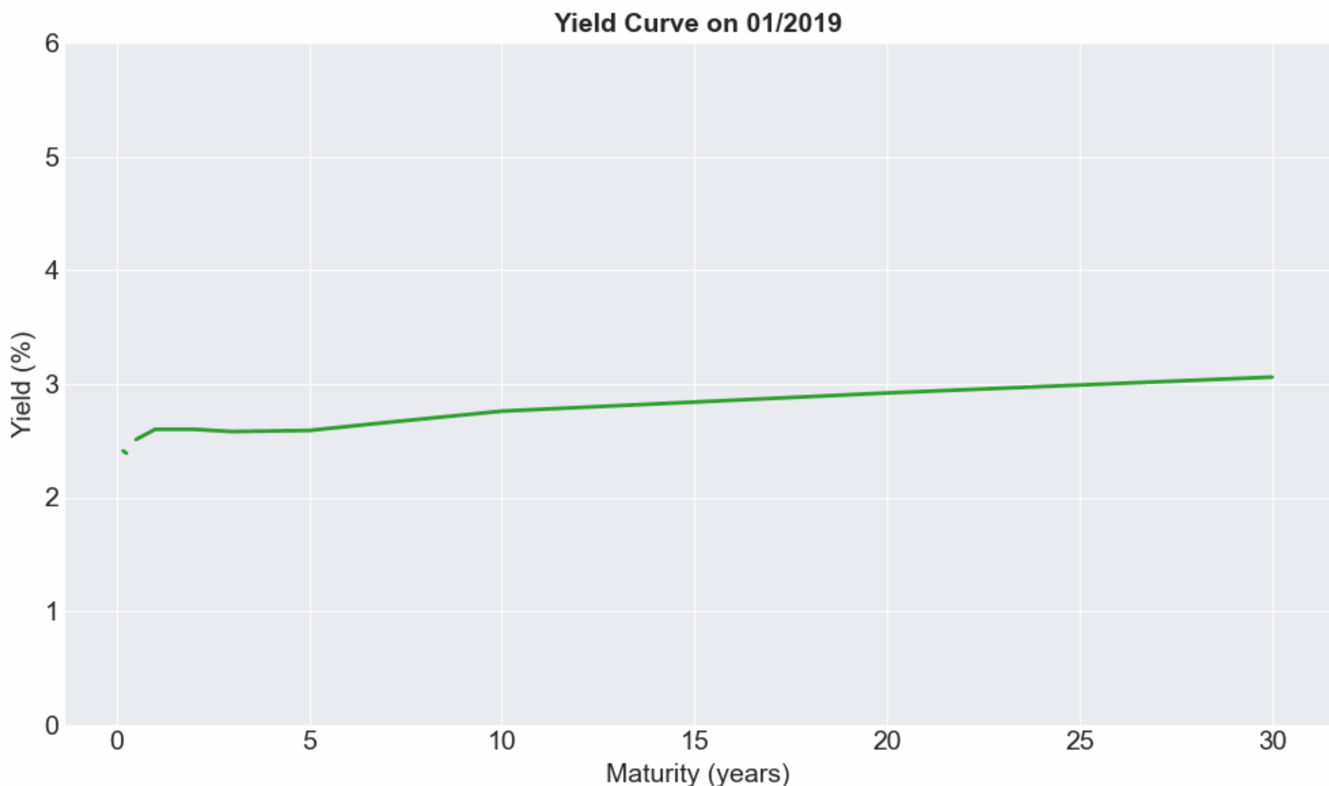
Some of the themes of 2023:

- While we often talk about "the fund finance market," we're seeing fundamentally different trends in Europe compared to the U.S. The European market experienced less of an

interruption in the spring, and deal velocity has only added momentum since.

- Overall, servicing portfolio volume has accounted for the lion's share of work allocation over new money origination.
- We have served 76 lender clients globally this year. This number has expanded despite bank market volatility. It will be interesting in the coming months to see if further bank consolidation reduces this number or if it continues to increase with the addition of more non-bank lenders to the space.
- On the same note, a number of new bank players are putting oars in the water and will begin contributing to origination volume in Q3 and Q4. A few established fund finance lenders could also see expanded mandates. Fund finance will continue to be a career-advancing market.
- YTD fundraising totals $832.5 billion according to the latest from Preqin, suggesting a significant full-year shortfall from the $1.5 trillion raised last year. Average fund size is up 51% to $510 million.
- As fundraising gravitates to the larger platforms, the middle market feels under-banked. Pitchbook data showed about 120 sub-$1 billion funds closed in the first half, and we suspect a number of these sponsors found it more difficult to line up financing.
- More established lenders (and larger banks) have been beneficiaries of subscription borrowers moving deposits away from their historical lending bank.
- Despite concerns in the credit markets, overall loan growth for the year across U.S. banks has totaled just over 2%—still a very healthy mark. Loan growth is higher at banks below the top-25 in assets. And if you dig in further you will find that loans to non-depository financial institutions, often the category for fund finance loans, have grown at a rate of nearly 5%.
- The addition of term loan tranches into traditional revolving subscription structures have provided an avenue for new institutional non-bank lender liquidity in a market starved for a capital injection.
- The rise of credit risk and liquidity management transactions and other alternative capital market-oriented structures continue to grow. Basel End Game planning supports further momentum.
- The ratings process for sublines has meaningfully entered the conversation.
- Median subline margins are up by more than 100 bps over market lows, with some facilities pricing at a multiple.
- Lender unused fee toggles are back *en vogue* with wide variation of structure.
- MFN provisions on lender fees and market flex language are entering the fray in a very active syndications market.
- U.S. dollar deals have been almost entirely SOFR indexed post-LIBOR transition and due in part to disruption in the prime rate lender segment of the market.
- NAV lending volume in our practice tracked about 15% ahead of 2022 pace for the first half of this year in terms of overall lender commitments. We have seen nearly 30 active lenders (bank and non-bank) in the space this year.

- We are seeing more LPAs and deals for continuation funds. It makes sense given the current environment because it enables the fund to hold onto the asset longer and dispose of it at the opportune time.
- Continuation funds have generally had NAV financings but as of late we are seeing a number of hybrid deals come in and are aware of others that are in the works or being considered by our lender clients.
- There is greater deal complexity in the space as lenders and funds think creatively about how to create liquidity solutions for fund borrowers. We have a number of bespoke hybrid and other highly structured facilities underway.
- In the hybrid space, the collateral package seems to be shifting. Previously most deals had a security interest in the proceeds of investments and the related collection accounts, or alternatively, just the collection accounts with a negative pledge on the investments. We are now seeing hybrid deals where the NAV segment of the transaction has greater complexity and lenders are more often taking security over the assets.
- Fund finance still benefits from what it's not. The product continues to offer bank lenders an opportunity to recycle balance sheet into higher-yielding assets while avoiding potential credit issues that are emerging in other asset classes.
- It's a great time to originate at the front-end of the curve.



Source: U.S. Department of the Treasury and Cadwalader, Wickersham & Taft LLP.

The currents have clearly shifted. What will the next four months hold? We are seeing innovation and structural evolution in fund finance at a rate never seen before. If we can be helpful on the solutions side for driving your business or planning forward, please reach out.