CADWALADER

FUND FINANCE FRIDAY

FFA European Fund Finance Symposium Review – Key Themes

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Last week saw almost 1,140 registrants attend the FFA's annual symposium at the Queen Elizabeth II Conference Centre in London. As ever, the event brought together a wide range of market participants from across the industry, providing a unique opportunity to network and learn more about the many exciting developments taking place in fund finance.

The panels at this year's event covered a diverse range of topics including (but not limited to) NAV, securitisation, ratings, CRTs, secondaries as well as the growth of credit funds in the market. The variety of speakers at this year's event reflect how much the fund finance market has grown and matured in recent years. We heard from bankers, sponsors and lawyers but also ratings agencies, insurers, credit funds, administrators and advisors (including our very own Head of European GP Solutions, Mike Hubbard!)

The Cadwalader London team has set out below some of the key themes arising from the panel discussions . . .

Challenges

Attendees at this year's conference will know that it has been a challenging period for the industry. Macroeconomic events have had a big impact on fundraising, with the war in Ukraine exacerbating pre-existing inflationary pressures across European and US economies, and central banks raising interest rates in an effort to tame inflation. Against these economic headwinds, GPs face a slowdown in fundraising, a sub-optimal exit environment for investments and increased LP demand for liquidity. Adding fuel to the fire, and at a time when

GPs need liquidity more than ever, fund finance products are under the microscope, facing increased scrutiny from regulators, the press and investors alike.

Despite the challenges, the mood in the conference remained upbeat, with panellists generally taking the view that our collaborative and innovative industry will continue to grow and provide solutions.

Regulation

The implementation of Basel 3.1 (commonly referred to as Basel IV or, more ominously, Basel 3 Endgame) next year will have a significant impact on the amount of capital banks are required to hold, predominantly as a result of certain lenders being required to adopt standardised methodologies for the purpose of calculating risk-weighted assets (RWAs) as opposed to using an internal rating based approach. For many lenders, finding solutions to improve their capital treatment will play an essential part of adjusting to the new regulatory landscape and ensuring they have sufficient capacity to meet client funding needs. What those solutions might look like is still very much up for debate; with securitisation structures, rated facilities and capital relief trades (CRTs) all being mooted as possible ways forward (something discussed in detail on the Securitisation, Risk Transfer and Ratings panel). A lack of consistency across institutions in terms of focus on this area and how the rules are interpreted was also noted as a possible roadblock in what is a highly syndicated market. Panellists were also clear on the need for greater dialogue between lenders and the regulators, particularly in response to the letter recently issued by the Prudential Regulation Authority outlining its findings following its ‘thematic review of private equity related financing activities’.

Consolidation, relationships and liquidity concerns

Anxieties around liquidity constraints were echoed across panels, with many noting that balance sheets were at risk of drying up quickly in a brave new world of “mega funds” – particularly if fundraising starts to pick up again. Indeed, some were quick to point out that subdued fundraising in 2023/2024 may have even protected some GPs and Lenders from more substantive liquidity issues last year.

Liquidity concerns have forced GPs to focus on developing good relationships with a wider pool of lenders (both bank and non-bank) and to work with lenders on structures that look to unlock institutional capital. GPs are increasingly having to help lenders manage their own liquidity by tailoring their financing demands to what they actually need: speakers noted that this has resulted in smaller commitments being made available under facilities from day-1, with a more significant role for accordions as funds increase commitments through subsequent investor closings. Handling a fund’s financing arrangements is no longer a part-time job, with many sponsors bringing in dedicated specialist teams to undertake the role.

The slower fundraising environment has also necessitated greater focus by GPs on high net worth individuals, open-ended structures (with liquidity windows) as well as the need to offer LPs co-investment and SMA opportunities. These structures are more challenging from a traditional fund finance perspective, but in light of their growing importance to GPs there was a significant emphasis on the need for Lenders and their counsel to find innovative solutions to financing these structures.

NAV Facilities

NAV facilities were a hot topic at this year's symposium. The increased use of these products across a range of asset classes illustrates what a versatile and useful source of liquidity they have become for GPs. Panellists were aligned in their view that NAV facilities are now widely considered an established financing tool for funds (much like subscription facilities) and that the use of these products will continue to grow.

Despite the cautious optimism, the use NAV facilities is not for everyone: as has been widely reported in the press, some LPs have raised concerns about the use of these facilities and, in particular, whether such loans might be used fund distributions in a way that erodes value for LPs. Whether panellists agreed with those concerns or not, consensus was reached around the importance of ILPA's impending guidance on the use of NAV loans. Participants expect the guidance to set out a shared set of expectations and recommendations for LPs and GPs around the use of NAV products and to place increased emphasis on education for LPs and transparency. Ultimately, speakers agreed that getting buy-in from LPs should be a prerequisite to putting in place a NAV line and that the ILPA guidance may go some way to alleviating investor concerns in this regard. It was also noted that concerns have been raised around the robustness of valuations and, for this reason, credit analysis of the underlying investments, alongside the negotiation of any eligibility criteria and concentration limits, remains a key area of focus and negotiation for lenders.

The increased presence of non-bank lenders in the fund finance market was widely discussed throughout the conference, particularly in the NAV space where term loan structures are more common (and can therefore attract institutional capital). Indeed, it was hard to find a panel that did not acknowlede the growth of credit funds and their growing influence of fund finance. Credit funds operate not only as lenders of NAV lines but also as borrowers, a topic explored further in the NAV lending to Credit Funds panel. The panel highlighted some of the unique aspects of these transactions (when compared to NAV loans to PE funds for example); in particular, that such transactions necessarily involve greater regulatory analysis on the basis they are invariably treated as securitisations. Panellists expect these kinds of financings to face increased regulatory scrutiny in the years ahead.

Secondaries

Discussions on secondaries transactions were – perhaps rather predictably – optimistic in outlook. In what has been a tough year for fundraising across almost all asset classes, secondaries funds have defied market trends and continued to raise investor capital at pace (albeit with much of that capital being raised by top sponsors via so called "mega funds"). GP-led secondaries have increased in volume as a result of a lack of exit opportunities in a high interest rate environment and this has resulted in the increased use of continuation vehicles ("CVs") by GPs.

Panellists reflected that the growth of CVs has created additional financing opportunities for lenders; with loans being provided to these vehicles via a range of financing products, from sublines, to hybrids, to NAV facilities. In light of possible concerns around concentrated LP bases and/or underlying asset portfolios of the newly formed funds, such financing are often structured so as to include some kind of hybrid security/covenant package.

Panellists discussed that perceptions of the use-case for CVs have shifted. What were once regarded as vehicles established for the purpose of housing the tail end of a fund's portfolio (or, so called, "zombie assets") are now seen in a much more favourable light: these are vehicles established to ensure that GPs can hold onto what are often their most prized assets. Assets which present great opportunity for future upside given current exit conditions.

It was also noted that there are various attractive aspects of these kinds of financings for lenders, not least the absence of any blind pool risk. Regardless of whether any security over the underlying assets is provided as part of the financing, lenders will be focused on the quality of the assets and the importance of ensuring they are properly and independently valued – particularly in light of the potential conflicts of interest that can arise in a GP led secondary. Whilst GPs are not necessarily incentivised to sell the asset for the highest price possible (on the basis it will want the value of the asset to continue to rise once acquired by the CV), they will need to ensure that the transaction is appropriately and properly managed so that interests of one group of investors (e.g. the selling investors) is not prioritised over those of another (e.g. the rolling investors). For this reason, secondary investors subscribing to a CV will often be happy to rely on latest NAV reported by the fund, knowing that the tyres have been kicked.

In their conclusions, speakers were generally upbeat about the future growth of the secondaries market and the related financing opportunities, particularly as assets are sold over the next 1-3 years and facilities are repaid.

Final Thoughts

A lot has changed in the world of fund finance in recent years and it feels like the industry is at point of inflection. Yes, there are challenges, but this year's conference also emphasised the wealth of opportunities for growth and innovation in the sector. In our view, it could not be a more exciting time to be part of the conversation.