

## FUND FINANCE FRIDAY

### Some See Reduction. I See Opportunity.

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Given recent market volatility, we are seeing some funds in the hardest hit sectors start to pivot and employ capital reduction measures or a change in investment strategy to weather the crisis. We are seeing this firsthand in the form of LPA amendments and requested consents as subscription facility lenders are required to review and approve material LPA amendments. This, of course, includes any change that has the effect of reducing or delaying the calling of investor uncalled capital.

It seems that fund managers are becoming increasingly creative with strategy to pivot toward better opportunities for investors. In some cases, newer funds with longer terms remaining on investment periods are tweaking investment guidelines or concentration limits at the fringes to permit deployment of capital into more sought-after asset classes with attractive valuations unforeseen at the time of the fund's inception. Investors have been receptive – promptly approving such amendments to investment strategy.

At the other end of the spectrum, we are seeing some late-stage funds that have reached or will soon reach the end of their respective investment periods institute capital commitment reductions on a pro rata basis. Obviously, this reduces collateral and may have a material impact on borrowing base availability, and so lenders are playing close attention. But is it cause for concern?

The handful of reductions we are seeing are centering around a threshold of 10% of total remaining capital commitments. For those who argue that such reductions are in light of a perceived liquidity strain on investors and are intended to appease them by reducing capital call exposure, I'd like to proffer a different rationale: fund managers are finding ways to allocate this capital to more opportunistic strategies. Many investors have been starving for more opportunity. Lenders will be the beneficiary of the new fund financings.

Yes, things have been unforeseen and shaky – look no further than oil going negative and nearly 30 million workers filing for unemployment in the U.S. over the past few weeks as a guide. This explains why many of the older funds employing such reductions are in the energy

or real estate/hospitality sectors. There is less need and opportunity for new investment but still a need to maintain the existing portfolio. These reductions, however, are less indicative of a cash crunch and more the consequence of a strategic initiative – put the money where there is money to be made. The denominator effect is waning – the stock market has recovered more than half of its losses since the early days of the pandemic. Distributions, meanwhile, while declining in frequency, have not completely disappeared. Many fund managers are holding for cash reserves or reinvesting in near-term funding needs without the need to call down mass amounts of capital from investors' pockets. Reductions are also nothing new. We saw them in '08-'09, too. These were more dire and typically in the range of 20-25% of uncalled capital (and sometimes even up to a third of total capital).

Here, I think this is capital being reallocated into distressed, special situations and other more near-term investment opportunities. And while these "reductions" remain quite rare and represent only a tiny fraction of the overall percentage of the whole facility market, new funds brought to market and fundraising trends in the coming months will tell a story. I fully expect overall fundraising will be down at least through the end of the year, but proven and savvy managers will still find opportunities to raise (or reallocate) capital. It looked almost certain that 2020 was going to continue the recent challenging environment of low returns as dry powder piled up to an all-time high. Now, it will be interesting to see the pivot and results produced by funds raised this year. Like a good wine vintage, the 2020 funds may benefit from their unique climate conditions. Only time will tell.

At Cadwalader, we are still seeing a healthy dose of new funds and new facility origination. In fact, six new deals have kicked off in the last week. I am reminded of a colleague who told me four weeks ago that, by summer, we will have changed our business slogan to "Amendments 'R Us." The giraffes have not taken over yet, my friend. We are still serving a full menu from home, and that includes an expanded offering of "Extensions and Increases To Go."