

FUND FINANCE FRIDAY

Navigating the Emerging and Future Themes of the New Normal

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With markets in uncharted waters, Jeremy Cross from Cadwalader and Jamie Mehmood and Ben James from the Fund Finance Advisory team at Deloitte have gathered together their collective experiences over the last few weeks to provide an overview of the main headwinds in the UK and European Fund Finance market during the current COVID-19 pandemic. Here they examine some of the key themes from both a manager and lender's perspective, as well as share some thoughts on the future direction of the market.

The Manager

Fundraising has slowed. Given the uncertainty in the market and knock-on to investor confidence, there has quite predictably and understandably been a slowdown in new fundraising activities. There are exceptions, particularly with funds raising capital to take advantage of investment opportunities being thrown up by the COVID-19 pandemic, and some managers have also been able to proceed with fundraising largely as normal depending upon their size or stage in the fundraising process. However, most have been forced to push fund closes back. The key question here will be around the timing of the return of investor confidence and, in the meantime, what sort of investments investors will prioritise.

Asset-level liquidity has been the driving consideration as existing portfolio assets have come under stress, with good portfolio businesses sometimes turning revenue zero overnight.

Working capital revolvers at the underlying asset level were initially drawn to fund and prepare for liquidity shortfalls. This was also a feature for some subscription lines, before utilisation fell back to more normalised levels. Additionally, **refinances for many sponsor-held companies have become more challenging** as lenders come under liquidity pressure themselves. This has led lenders at the asset level to increase pricing in line with the widening of the high-yield bond market, making fund-level financing solutions all the more attractive for managers in search of liquidity.

Since mid-March there has been a notable **increase in demand for NAV/preferred equity solutions** provided at the fund level in order to downstream liquidity both to support stressed assets and to take advantage of forthcoming opportunistic M&A (as valuations decline), particularly in private equity. The breadth of NAV/pref structures has provided managers with a high degree of flexibility driven by the purpose, portfolio characteristics (LTV, concentrations) and any specific sensitivities they may have. These structures can provide an attractive financing solution to help address immediate manager concerns, albeit with a broad range of pricing depending upon the degree of flexibility required.

There has understandably been **increased scrutiny from Limited Partners for managers to maintain asset values**. This has resulted in **increased dialogue** between the manager and investors, with an expectation from investors for managers to be aware of and consider all financing options in order to provide liquidity to assets and maintain valuations as far as possible. Additionally, managers have sought more flexibility from investors to facilitate asset preservation, including by **increasing their ability to retain and recycle investment proceeds**.

The **decline in valuations** is likely to crystallise at the end of the second quarter as part of the June reporting cycle. Movements in valuations and the performance of underlying assets also have a **secondary knock-on impact on any existing fund leverage facilities** (*i.e.*, if the fund is following a levered strategy). The current emphasis, given the scale of the unknowns, is on an **open dialogue** with both investors and lenders.

There has been a **mixed picture on levels of capital calls**. There has been some information that there have been much higher levels of calls than usual in the current market (LACERS reported a doubling of its usual capital call level and ILPA have also reported an increase), but others such as the FFA see less of a change overall. Added to this, the **slowing of realisations and the reduced flow of realisation proceeds** is leading investors to also manage liquidity.

The **denominator effect** – private market allocation as a proportion of an investor’s overall asset allocation – seems to be less of an issue for managers right now as public market valuations rebound from their historic lows, but continued volatility in those markets makes it too early to say that this issue has gone away.

The Lender

Liquidity pressures have been a consideration for some banks, with significant movements on both sides of the balance sheet (working capital revolvers drawn – including some subscription lines – plus an influx of “low value” deposits for banks). This has made large subscription lines,

in particular, which historically have tended to be only partially drawn, more difficult to get away and forced some bank lenders to step back – an echo of the last financial crisis.

Bank processes have become more involved across the board, with local discretion often being diluted and additional committees being put in place to determine allocation of capital. Consequently, there has been a trend towards traditional banking players **prioritising existing clients** over new ones and focusing on transactions that were already in process prior to COVID-19. This is providing the opportunity for other players to increase market share.

The result has been a **widening of pricing** since March, with NAV and preferred equity pricing increasing by 100bps-200bps plus; subscription finance pricing has also widened but this has been less marked. In the main, a **pragmatic approach** continues to be adopted by lenders at both the underlying portfolio asset level and at the fund level, although the risk remains that this approach could change as time goes on.

Fund finance liquidity remains, albeit on an increasingly selective basis. The picture is mixed here, with there still being a robust level of capacity in the subscription finance market given the strong credit risk dynamics and influx of new lenders over the last couple of years. In the NAV space, however, capacity is more finite currently given the smaller pool of lenders, with the recent increase in demand having resulted in a **shift in the supply/demand dynamic** in favour of the lender. This has resulted in a **notable interest from non-bank lenders**, with a number of private debt funds considering providing liquidity to managers through NAV facilities given the strong demand and the credit enhancement that a portfolio-based lender provides (relative to a typical individual asset lender).

There are undoubtedly significant opportunities opening up in this space for funds, and it will be interesting to see how this is reflected going forward in lender appetite.

The Future

COVID-19 will reinforce the **longer-term shift in the influence of investors**. Frequent and open communication with investors is key in the current environment, and ILPA continues to play a leading role in driving communication and information sharing. Investors are also likely to be less accepting of delayed deployment of commitments. If funds accept government money for their underlying investments, it may also be the case that this brings increased regulatory scrutiny.

Pricing is likely to settle at a level slightly higher than has historically been the case. The delta in pricing and range of that pricing is likely to be **more marked for NAV and preferred equity than subscription lines**, reflecting a likely increased demand for the former.

Continued **innovation** is expected to be a strong theme from both managers and lenders in finding new solutions to the unprecedented challenges they are facing, as well as **increased flexibility** to take advantage of specific opportunities that present themselves in a more fragmented and difficult market (including secondaries). The experience and approach on COVID-19 may also help in heightening the focus on other globally impactful events like climate change through ESG. As with the 2008 financial crisis, the impact of COVID-19 may well be **increased activity from non-bank lenders**, particularly if those non-bank lenders can demonstrate proof of concept by coming through a full credit cycle.

Overall, despite the recent challenges, we believe the market to be robust and well-positioned for the recovery. The recent disruption has had the impact of accelerating some of the prior trends that were being seen in the market, and our expectation is that a number of these trends will form part of the new normal going forward.