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FUND FINANCE FRIDAY

# Alternative Lenders in Fund Finance

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Although commercial banks have long taken the lead in fund finance lending, alternative lenders have gradually taken on a larger role in the market. This trend appears to have accelerated over the last year, partly driven by a reduction in new lending by banks and the resulting search by borrowers for new sources of capital.

Increased demand from sponsors has been accompanied by changes on the supply side, including the extraordinary growth in the amount of capital committed to private credit and BDCs over the past decade. Prequin estimated that private debt funds had more than $800 billion in assets under management at the beginning of the year, and fundraising has continued at a rapid pace. With more capital to deploy, increasing yields have made fund finance a more attractive risk-return proposition for specialty finance firms, which may have a higher cost of capital but typically do not require returns as high as those of mezzanine funds. Recently, Fund Finance Partners has seen margins of LIBOR plus 600 to 750 basis points on NAV-based financings, real estate, private equity and control-buyout funds. These facilities typically come with one financial (LTV) covenant and have received investment grade credit ratings.

Alternative lenders participate in subscription facilities but are most active providing NAV and hybrid loans, preferred equity, and general partner lines of credit. Such transactions require the lender to underwrite the assets or equity of a fund or to estimate future cash flows from carried interest and management fees. A debt fund that has a close relationship with a private equity sponsor may be in a good position to estimate the value of its interests, GP commitment (to the extent invested) and carried interested payable (based upon the fund waterfall). Although some of these transactions may exceed the risk tolerance of depository institutions, alternative lenders funded by equity and creative back-leverage solutions may be able to shoulder the risk in exchange for higher yields and long-term relationships.

Insurance companies have also become more interested in fund finance and can be attractive to fund borrowers given their relatively low cost of capital. Insurers generally prefer to be participant lenders and to avoid serving as administrative agent, with the related operational and funding obligations. Solvency requirements and other laws applicable to insurance companies also considerably vary by jurisdiction and can affect the form that their investments take. For example, British and European insurance companies generally prefer that their investments be in the form of a security rather than a loan.

A subscription facility may also be useful for insurance companies and other institutional debt investors that find it difficult to lend on a revolving basis. If the investor is a limited partner of a credit fund, the fund may itself borrow under a subscription line to reduce the frequency and unpredictability in demands for funds.

For more information on alternative lenders in fund finance, plan to attend the related panel chaired by Cadwalader partner Nathan Parker at the **Fund Finance Association Symposium** on November 16.