

FUND FINANCE FRIDAY

Accelerating the Evolution of Fund Finance: 'Necessity Is the Mother of Invention'

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In *Fund Finance Friday's* 8th May edition, we took a look at the challenges facing the UK and European fund finance market and made some predictions for the future. Now, six months on, we thought it was time for a look at what's happened in the market since then in terms particularly of pricing and liquidity and to use this opportunity to revisit and, where appropriate, to recast some of those predictions in light of what has actually developed.

The world has had to reconsider how it goes about its business in 2020, with the challenges shaping a radical rethink on how to overcome a number of unprecedented obstacles – be it the rapid development of vaccines to halt or reverse the onward march of COVID-19 or the thousands of businesses that have had to reinvent themselves in order to survive. Whilst the alternative funds and fund finance sectors have to date weathered this storm admirably, they have not been immune to this same driver for accelerated evolution, in order to adapt to the changing needs of the market.

So here we will explore some of the key trends that we have observed in recent months around liquidity, pricing and terms and how these are accelerating the evolution of the fund finance market.

Liquidity

It has become apparent as the pandemic has progressed that the majority of traditional bank lenders have been experiencing broader balance sheet pressures as well as pressures on returns. Over time, these pressures have filtered down to their fund finance teams, which has not been unexpected given the scale of, in particular, subscription line facilities out in the sector. As a result, lenders have become more selective around deployment, creating a more challenging financing environment for newly formed funds and new-to-lender relationships and also, in many cases, looked to expand their offerings outside the traditional subscription finance sector. Whilst balance sheet pressures seemingly eased for most bank lenders as the summer progressed, the environment for new relationships undoubtedly remains somewhat more challenging than prior to COVID-19.

In parallel to and maybe in part driven by the above, the widening in pricing dynamics early through the pandemic as well as the need for more flexible offerings have led to heightened interest from institutional liquidity, notably debt funds looking to deploy capital through NAV and preferred equity, in particular for private equity. These institutional lenders have demonstrated that they are able to provide flexibility, tailored to borrowers' specific needs and sensitivities. This has included scope to support more concentrated portfolios or provide flexibility around financial covenants, such as the ability to address manager concerns around underperforming portfolios or even forced realisations, with that support also being flexed (depending on a specific institution's appetite) to cover not only traditional NAV-based lending but also preferred equity solutions to Funds, their GPs and Managers.

This influx of institutional capital is a longer-term trend that we have witnessed, with insurance companies and pension plans increasingly active. We anticipate a continued move towards more direct engagement in the provision of liquidity from these institutional lenders, a theme that was mirrored in the leveraged finance market over the last decade and will continue to be fuelled by the low interest rate environment.

We've also seen that, positively for the sector, and despite some concern in the early days of the pandemic, credit and liquidity for the fund finance market has proven to be robust. The pool of lenders serving the subscription finance market has grown, with now in excess of 50 active, and the pool of those lenders with appetite to service NAV, including preferred equity and other solutions, while smaller, is also growing rapidly. There has also been a corresponding ability to provide a greater degree of flexibility, with COVID-19 acting as the catalyst for this evolution.

Pricing and Terms

As has been widely reported, pricing has increased through the pandemic on all fund finance structures to reflect the increase in underlying risk, with a more marked increase on structured financing solutions. More recently, pricing has tightened, having reached an inflexion point over the summer, albeit settling at a higher level than pre-COVID across all structures of +20-30bps on subscription lines and +50-150bps on asset-backed fund financing.

Of particular note, however, in recent months is the increased variability in pricing between lenders that has been evident. This is even the case on more vanilla structures such as subscription lines, where we have seen a range in pricing of up to 40–50bps replacing the 10bps spread we would have expected prior to COVID-19, reflecting different lenders' positioning relative to that inflexion point. Similarly, the variability in pricing for more structured solutions remains wide, reflecting the broader range of risk profiles that this encompasses.

One other key observation on terms has been the pressure on facility tenors to shorten, in part driven by the wider balance sheet pressures experienced by banks. That said, our experience has been that liquidity remains robust, and if borrowers are willing to test the market, they can continue to achieve their preference for longer-term financing: three-year tenors on subscription lines and four-year plus on asset-backed fund financings.

Stepping back, the unprecedented period of stress resulting from the pandemic has tested many fund finance structures and financial covenants; however, these have in the main proven robust, with negligible noise in the market around stressed situations. The pragmatism displayed by both lenders and funds and their managers and GPs at both the underlying portfolio level and fund level has continued to date, which is undoubtedly linked to the strong long-term performance of the fund finance sector and deep-rooted relationships upon which it is built. Whilst a number of uncertainties remain, these trends bode well for the fund finance sector as a whole going forward.

Accelerated Change in the Market

The influx of liquidity, coupled with changing financing requirements of borrowers brought about by the stress of the pandemic, has acted as a catalyst for the evolution of the fund finance market. This has been no more evident than in NAV financings for private equity, where there have been a number of transactions closed in recent months.

As the purpose of these NAV financings has evolved through the pandemic – from upstreaming capital to investors (DPI enhancement) prior to COVID-19, to a defensive downstreaming of capital to stressed assets and then opportunistic positioning in anticipation of the recovery phase – the relevance and use case of NAV as a fund-level financing solution has only grown. Going forward, our expectation is that this will continue to evolve, increasingly accommodating a combination of upstreaming capital to investors as exits are delayed and downstreaming both to support stressed assets and to take advantage of opportunities as they arise as the pandemic continues, and perhaps even more as the effects of the pandemic ease.

Managers have undoubtedly become more open to and active in exploring and executing more structured solutions in fund finance as a result of COVID-19. We have also seen that investor appetite towards fund finance structures has evolved through the pandemic, with an increased awareness and tolerance for more structured solutions as a means to maintain value within the portfolio.

Conclusion

Overall, the fund finance market has demonstrated its resilience in the face of the challenges of COVID-19. Existing financing lines have withstood the stresses they have faced and new structures have evolved, enhancing the relevance of fund-level financing solutions to meet managers' needs.

Whilst we are far from out of the woods, the fund finance market has, like so many other parts of our economy and society, shown an ability to adapt at pace in order to face these challenges head on, and we fully expect that to continue.