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FUND FINANCE FRIDAY

Don’t Trip Over a SOFR Hole

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Letters of Credit – An Increasingly Popular Tool?

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By Katie McShane
Associate | Fund Finance, Corporate

Given the general economic uncertainty in today's world and the recent market turmoil, we have seen private equity funds jostling to preserve and ensure future liquidity, albeit at a higher price than before. Similarly, in this volatile economic environment, parties to business transactions increasingly want more certainty that they will be paid. Letters of Credit ("LCs"), which are often included in revolving subscription credit facilities, provide borrowers with the ability to guarantee contracts with third parties, providing certainty to the beneficiary that they will be made whole.

In light of the above, we thought it would be helpful to set out an introduction of LCs themselves, including what they are and how they fit into revolving subscription credit facilities.

What is an LC?

For anyone unfamiliar with LCs, an LC is essentially an irrevocable undertaking for the payment of money, issued by a bank at the request of the borrower in favor of a third-party beneficiary. There are many types of LCs; however, standby LCs are most commonly found in financing transactions and seen in revolving subscription credit facilities.

Standby LCs were developed to allow banks to provide the functional equivalent of guarantees without violating regulatory restrictions prohibiting banks from issuing guarantees. A standby LC is only drawn on by the beneficiary if the borrower defaults on its obligations to the beneficiary; in this sense, it is more like a cash guarantee of specified obligations of the borrower, rather than a means of payment of those obligations.

With a standby LC, the borrower can obtain LCs from its lender as a utilization of an existing LC sub-facility that is part of a larger revolving credit loan, therefore avoiding the need to acquire a "new" loan or a guaranty. By agreeing on LC terms at the date of origination of the larger loan, the borrower has established a negotiation instrument for future business with third parties.

How do LCs fit into a Revolving Subscription Credit Facility?

Request for LC

An LC is usually governed by the terms of the loan agreement. In terms of process, the borrower simply submits an LC request to the administrative agent (within the relevant timeframes required under the loan documents), who then notifies the lender(s) of such LC request. The LC request is usually in a previously agreed-upon form that comprises part of the loan documents.

In the LC request, the borrower attaches a completed Application and Agreement for an LC and requests that the LC issuer issue an LC substantially in the form attached to the request.

The borrower also typically brings down the representations and warranties set out in the related loan documents, confirms that no event of default has occurred, and confirms that upon issuance of the related LC, the LC liability won't exceed the lesser of (1) the available commitment minus all outstanding obligations at that date and (2) the letter of credit sublimit on such date. The LC sublimit is typically between 20% to 50% of the aggregate available commitment, which amount is negotiable. An updated borrowing base is also included in the LC request.

An LC's expiration date is usually 12 months after the date of issuance, which period can be renewed at the discretion of the LC issuer. LCs that expire beyond maturity will need to be cash collateralized in full (usually 30 days prior to maturity). Many subscription line lenders will require LCs to be cash collateralized with the proceeds of capital calls only to avoid bankruptcy preference risk. Issues relating to cash collateralizing LCs were recently discussed here.

Functionality

LCs that are outstanding and have not been drawn by their beneficiaries reduce the available commitment under the loan agreement because they must be funded by the lenders if they are drawn by their beneficiaries. This is the case regardless of whether the borrower could, at that time, satisfy the conditions precedent in the related loan agreement and borrow new loans under the related credit facility.

In the event of any drawing under an LC, the borrower is required to reimburse the LC issuer for the amount of such drawing together with interest, expenses and fees incurred by the LC issuer in connection with such payment. The borrower can make such reimbursement with either the proceeds of a loan from the underlying credit facility or with funds from other sources. When the underlying loan is syndicated, the lenders usually participate in the LC on a *pro rata* basis; however, sometimes only certain of the lenders agree at the outset to participate in any LCs.

Collateral and Liability

LCs share equally in the collateral and guarantees that support the loans made under the related credit facility. The LC issuer typically has no liability (absent fraud or gross negligence) for any action taken with respect to each LC. The borrower assumes all risk of the acts or omissions of any beneficiary with respect to its use of any LC.

Termination

If the obligations under the loan agreement become payable prior to the maturity date, the administrative agent can declare the obligation of the LC issuer to issue LCs under the loan agreement terminated or declare the LC liability to be due and payable, and demand that the borrowers cash collateralize, as security for the obligations, an amount equal to the LC liability plus any required reserves (for example, reserves for currency fluctuations) at the time such notice is given.

The cash collateral account is included in the collateral package granted by the borrowers to the administrative agent for the benefit of the secured parties. After all LCs have expired or been fully drawn upon, all LC liability has been satisfied and all other obligations have been paid in full, the balance, if any, of cash collateral held in a cash collateral account is required to be returned to the borrowers.

FFA Market Update Webinar

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The Fund Finance Association hosted a market update webinar on Wednesday with approximately 800 attendees. Led by Nick Mitra of Natixis and organized by Nick and Terry Hatton of MUFG, the webinar included a series of one-minute market updates from industry professionals across the globe and a fund formation **data presentation** from Dave Lowery at Preqin. Additionally, Jeff Johnston of Wells Fargo gave the closing remarks, which included the announcement of the FFA's 2020 London and Asia conferences converting to virtual and being scheduled for the week of November 16th (specifics forthcoming).

Below are key takeaways from the panelists.

- Transaction performance remains excellent. No investor funding defaults or transactions in credit distress were reported.
- Transaction volumes remain robust, despite the volatility in the market.
- While a number of banks pulled back from new originations at the start of COVID-19, that has thawed a good bit (but not completely).
- Lenders have tightened their credit parameters somewhat. Facility pricing has increased.
- Pre- and early-COVID transactions that now need to upsize can be very hard to syndicate into post-COVID pricing and structure. $1B+ transactions for very large funds can also be difficult to fully syndicate.
- A number of new banks have stepped in to fill syndication voids and have even taken lead positions.
- Despite 2020 fundraising projected to be materially down from 2019, participants still project a robust Q4 for fund finance.
- Secondaries transaction volume (*i.e.*, underlying trades) has been down a good bit 2020-to-date.
- There is a flurry of NAV lending activity in the European market. While preferred equity solutions are being evaluated extensively, they are at times a comparatively expensive form of financing.
- ESG-linked fund finance is forecasted to expand.
- There are a host of new entrant, non-bank lenders exploring entry into the NAV and leverage markets.
- Despite Hong Kong being on wave three of COVID, participants report a good year and have an optimistic forecast for Asia fund finance the rest of the year.

'Fund Finance Friday: Industry Conversations' — A Crash Course in SOFR

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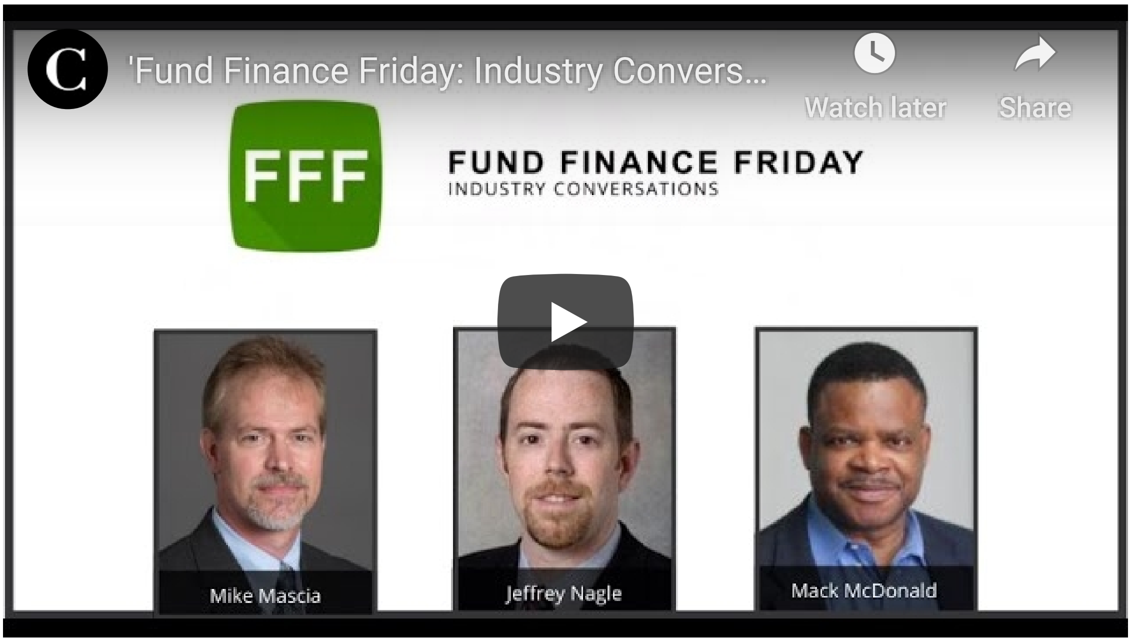
In this week's *FFF: Industry Conversations*, Jeff Nagle, a Cadwalader partner and member of our LIBOR Preparedness Team, teaches a SOFR 101 session. He covers all the high-level things you need to know, including how SOFR is actually calculated, how it differs from LIBOR, what its variations are and which are best, how margins will be impacted, what the expected market conventions are, and what comparable rates exist for non-dollar denominated loans. With the LIBOR phase-out date approaching, the session teaches the basics you need to know to be prepared for moving to SOFR benchmark rates. Additionally, Mack McDonald, CEO of Renaissance West Community Initiative, provides an update on the great work the non-profit is doing to tackle generational poverty with a holistic approach.

If you cannot access the video below, please **click here**.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INDUSTRY CONVERSATIONS
Mike Mascia
Jeffrey Nagle
Mack McDonald

Walkers Thought Leadership on Alternative Lenders

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Walkers this week published a thought leadership piece on Alternative Lenders in Fund Finance. The article focuses on the rise of non-bank lenders on the NAV side of the market and highlights their ability to create flexible, bespoke financing solutions, albeit at higher funding costs. The article is available **here**.

Fund Finance Hiring

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Fund Finance Hiring

State Street Bank is hiring for multiple Account Officer roles in its Global Credit Finance group, which includes its fund finance business. The senior roles are client-facing with flexibility as to location. Links to the job postings are available here and here.