



# FUND FINANCE FRIDAY

## **Turkeys Better Take Cover**

**November 20, 2020 | Issue No. 104**

### **Table of Contents:**

- **Fund Finance Growth Analysis and the Case for NAV Lending**
- **Accelerating the Evolution of Fund Finance: 'Necessity Is the Mother of Invention'**
- **Fund Finance Symposium 2020: European Key Themes**
- **To Be a Non-Fund Arrangement or Not to Be – That Is the Question**
- **New Fund Fanatics Episode**
- **Perfect Match: Finding the Ideal Fund Finance Solution**

# Fund Finance Growth Analysis and the Case for NAV Lending

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**By Michael Mascia**  
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I was able to watch a good number of the sessions at the Fund Finance Association's Virtual Conference this week and enjoyed the event. Congrats and thanks to Michelle Bolingbroke, the event planning team at Sequence, and the regional chairs and committees on a job well done. I especially enjoyed the session with Ronald Cohen; his thoughts on quantifying and measuring the societal impact of private enterprise were enlightening and worth a watch for anyone who was not able to see the session live. One of the clear themes coming out of the conference is the heavy interest and support for ESG initiatives in both the private equity and fund finance communities. While that is massively positive in its own right, I actually think this industry-wide focus will ultimately be a meaningful growth driver of NAV-oriented lending and related fund-level leverage. Hear me out on this.

From the Business Roundtable's shift from shareholder to stakeholder primacy all the way to Elizabeth Warren's proposed "Stop Wall Street Looting Act," it is clear that private equity is going to (and needs to) lean further into ESG. Sponsors do not really even have a choice: their investors are going to demand it, their employees are going to demand it, the communities where their portfolio companies are based are going to demand it, and, potentially even at some point, regulation is going to require it. This is, in my view and I am sure in most everyone's, an important and productive directional shift in private industry. Addressing diversity and inclusion, environmental impact and climate change, the gender wage gap, safe working conditions, and economic inequality are essential corporate and societal priorities.

I also buy into the "doing well by doing good" narrative and that many of the firms that contribute meaningfully to these ESG priorities will ultimately be rewarded with higher financial returns for their equity holders compared to their lower contributing peers. But, as we all embrace and encourage stakeholder primacy, I think we need to be realistic that a sizeable portion of the forecasted financial return improvements will not be realized until the long run. And if ESG is to be real and not just lip service, improved economic performance driven by these initiatives will in many cases require not insignificant short-term investment. Thus, furthering these priorities in a committed and holistic way is going to require PE funds at times to spend and allocate resources at the expense of portfolio company short-term profitability. How long is the "long run" and how expensive is the short term will depend on the specific circumstances of each specific portfolio company. But many prospective portfolio companies, particularly in the middle market, will need to make substantial improvements to get in line with a top-tier sponsor's ESG values and priorities. For example, a sponsor that wants a portfolio company to provide all employees with a livable wage and eliminate a gender pay gap may need to make substantial increases to payroll. A sponsor that wants a portfolio company to reduce the likelihood of widespread employee layoffs may need to operate at a lower than historical leverage level. Reducing pollution, enhanced employee safety, etc. all require upfront

capital allocation. I mean, a polluter polluted in the first place because polluting was cheaper and faster in the moment than responsible disposal.

There are, of course, great impact investors at certain sponsors that will make terrific decisions and still deliver outsized returns. But on an industry-wide basis, it is hard not to think that the increased upfront investment and time period it takes to get new portfolio companies ESG-acceptable and ready for sale will in many cases stretch the traditional PE hold periods. The industry average “J” in the J curve will get a little lower and a little longer. Portfolio companies are going to need to run at somewhat lower leverage multiples than historical averages. And increasing employee compensation will test margins, and in turn, multiples. And all of these things are likely to put near-term downward pressure on fund investment returns, at least in the aggregate (which we are all saying we are OK with; that is sort of the whole point of moving away from shareholder primacy).

Yet, across the world, we still have a huge problem with underfunded pensions. This matters; it is an important “S” in ESG, too. Society needs to keep our collective promises to retired workers. To have any chance at doing so, pension investors are still going to need meaningful returns on their private equity investments. This is all the more heightened by COVID-19: governments are fiscally stressed and wholly unable to increase their pension contributions while, at the same time, pensions are earning borderline nothing on their fixed income portfolios (current monetary policy is awesome until you want to buy a treasury bond).

So how can PE funds still deliver handsome returns when they need to increase their capital outlays to, decrease the leverage at, and expand the hold period of many of their portfolio companies? There is no simple answer, but part of the solution involves replacing some of the reduced leverage at the portfolio company level with leverage at the fund level. On an industry wide-basis, especially in the buyout sector, the aggregate fund balance sheet has a leverage ratio that is virtually zero. Very few optimized balance sheets in any business sphere operate with zero debt like this. Modest amounts of leverage can be added without materially impacting the risk analysis while improving the return profiles. Fund level leverage in most cases costs less than portfolio company leverage as well, reducing gross spend. And Fund level leverage has both a greater degree of repayment diversification and is a step removed from large payrolls, thus being far less likely to cause corporate bankruptcies and create painful human costs like widespread layoffs.

We think these things are largely obvious, not insightful. And sponsors have been employing leveraged strategies in their debt and secondaries product offerings for years; adding a levered sleeve option to their equity strategies to enhance prospective return profiles is deploying a known tool, not innovation. It’s not hard. We also understand that certain investors have a reflexive negative reaction to the word “leverage.” But that is solvable as well. We forecast that more funds will be offering levered optionality to their investors – separate levered and unlevered parallel fund options – allowing the investor to select the fund balance sheet structure and the risk/return profile best aligned with its investing preference.

Considering this in totality, NAV-lending products are frankly well-aligned with and support both a sponsor's and an investor's overall ESG commitment and priorities, while offering investors a return profile that will help enable the meeting of future beneficiary obligations. Thus, we think the NAV-lending sphere is poised for long-term incremental growth in the go forward.

*FFF* is taking off next week for the Thanksgiving holiday in the U.S. We in fund finance all have a lot to be thankful for this year. Have a great weekend.

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

November 20, 2020 | Issue No. 104



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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.

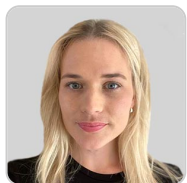
### **Conclusion**

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.

# Fund Finance Symposium 2020: European Key Themes

November 20, 2020 | Issue No. 104



**By Carla Pilcher**  
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This year's Fund Finance Symposium may have felt a little different from previous years, mainly because there were far less post-networking drinks headaches, but the content was just as insightful and challenging as previous years. As always, the panel discussions were wide-ranging and incredibly enlightening, especially given current circumstances. It's however safe to say that a few predominate themes surfaced throughout the discussions.

- **ESG.** It's clear that the market participants are driving change in how they are interacting with the world and, as a result, financing solutions have adapted to cater for this new consciousness. Discussions confirmed that lenders are up for the challenge and have implemented policies and products that can be utilised to this end. It was also made evident, though, that for real change to permeate the market we will need to see a top-down approach, with regulators possibly creating capital requirement incentives.
- **Market resilience.** With panels titled "The Evolving Lender," "Traditional or Something More Exotic," and "Beyond the Sub. Line," it's evident that another key theme raised in various discussions addressed the impact of COVID-19 and the adaptability of the market through the use of products from subscription lines, NAV facilities to preferred equity solutions. The message that was repeated during the panels was that, while the crisis initially resulted in cautionary slowdown, the market has pivoted and adapted to the "new normal" in creative ways, showing again that the industry is up to the challenge as its continues to expand and evolve.



# To Be a Non-Fund Arrangement or Not to Be – That Is the Question

November 20, 2020 | Issue No. 104



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The Cayman Islands Monetary Authority this week issued its long-awaited Statement of Guidance on Non-Fund Arrangements (the "SOG"). The SOG provides guidance on what vehicles can be considered to fall within the categories of non-fund arrangements set out in the Schedule to the Cayman Islands Private Funds Law. Any vehicle that falls within one of these categories is not required to register with CIMA. A more detailed consideration of the effects, if any, that the SOG may have on the Private Funds Law analysis of commonly seen vehicles within Cayman Islands fund structures and any resulting considerations for finance transactions will follow in the coming weeks.

## **New Fund Fanatics Episode**

November 20, 2020 | Issue No. 104

Scott Aleali and Jeff Maier of First Republic Bank put out another episode of “Fund Fanatics” on LinkedIn this week, this time with guest Abilash Jaikumar, Co-Founder of TresVista. To watch the clip, click [here](#).

## Perfect Match: Finding the Ideal Fund Finance Solution

November 20, 2020 | Issue No. 104

Join Alice Murray from *The Drawdown* on December 16 for a webinar featuring Mohit Sondhi (OakNorth) and Emilio Di Spiezio Sardo (Bluegem Capital Partners) as they discuss securing the "perfect" lending partner to weather our turbulent market conditions. The speakers will provide insight into both lender and fund perspectives, delve into a recent subscription line deal, and forecast the trends in fund financing for 2021.

Register [here](#).