CADWALADER

An Interview with NAB's Alex Bolton; Prepayments under LMA Documents and More

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Player Profile — Alex Bolton

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Player Profile

This week we connect with Alex Bolton for a sweeping discussion that covers competing in a crowded lending market and the outlook for fund-level asset-backed lending, as well as his observations on deal pricing. Alex is a senior banker in the New York fund finance team of National Australia Bank. NAB's practice spans private equity funds, listed funds and real money managers. NAB has been especially active in supporting private equity infrastructure funds, with subscription finance, NAV facilities and hedging solutions. This includes regular lead arranger roles for some of the largest infrastructure managers in the world.

FFF: **Alex, tell us a bit about how you became involved in fund finance**.

Like so many of our industry colleagues, I was fortunate enough to be given an opportunity to join a growing fund finance practice. The first 10 years of my career were in corporate restructuring, both in a consulting and banking capacity in Australia and the U.S. This experience gave me deep structuring experience across a wide range of products and industries and provided a great platform to start my fund finance career. It has been incredibly busy and rewarding so far, and I am excited for what the future holds as our business goes from strength to strength and the industry continues to evolve.

FFF: **Give us the background on NAB's involvement in fund finance and the major milestones along the way.**

NAB has had a fund finance business for over 20 years and globally has over 50 people dedicated to the segment. I would say the build-out of our global business was a key milestone. Since around 2011, we have gradually built teams in each of our key geographies – Australia, U.S., Europe and Asia. We have fantastic teams in each jurisdiction, and we work well together, whether it is the sharing of knowledge or mobilizing for transactions. Some of our greatest successes in recent years have been when more than one office has collaborated to solve a problem for a customer. Another key milestone was the establishment of our infrastructure business in New York in 2015. NAB has a very strong global franchise in this asset class, and the business is highly complementary to our funds business. As a testament to this, some of our most prominent lead arranger roles in recent years have been for a number of the largest infrastructure managers in the world, both here in the U.S. and globally.

FFF: **By our count, the number of active lenders (leads and participants) stands just shy of 60 to date in 2019. How important is it for a lender to carve out a clearly defined target market or a niche, if you will?**

For a sustainable business in the long term, I think it is of upmost importance that lenders build a clearly defined strategy that corresponds with the bank's core capabilities. This is not to say there is not a great deal of business available for a bank to take participations in transactions across a broad cross-section of the market, but from a business perspective, it can just make it a challenge to present a coherent value proposition and build long-term customer relationships.

Following the 2008 financial crisis, NAB made a conscious decision to narrow the set of financial sponsors we bank with and focus on those where we can be a meaningful part of the entire value chain, whether it is supporting fundraising through our capital markets business, fund finance, hedging, or asset-level finance. It would be unusual for us to join a fund facility where we did not have anything else to offer either the fund or the sponsor's broader platform.

***FFF*: We have a thesis that funds over time will need to consider fund-level asset leverage to support returns and that lenders may need to broaden their product offerings to include NAV and hybrid products if they're interested in maintaining loan growth. This hasn't really started playing out in the origination data yet. What's your take?**

I think there are plenty of sponsors who would consider this right now if the structures were available, permitted by LPAs, and not cost-prohibitive. In most cases, at this stage, better pricing is obtained with separate fund and asset-level facilities. As to whether this will be a necessity in the long term, I think we are just as likely to see a downturn in the cycle, which could create buying opportunities and/or normalize the yield environment.

Rather than for leverage and with the exception of a few asset classes, my view is that we are more likely to see hybrid and NAV facilities to provide access to bridging and temporary credit later in a fund's life when uncalled capital balances have been reduced. At NAB, we approach these solutions through the lens of a broad fund finance business versus a product-led business (*e.g.*, subscription finance), which has allowed our global business to structure a range of NAV and hybrid facilities. As to the proliferation of these facilities for leverage, there are comparable "HoldCo" transactions in other industries, so I think it is only a matter of time before more banks crack the code on this form of lending. The difficulties most banks seem to encounter is that fund-level indebtedness tends to be subordinated, equity/asset pledges can be difficult to obtain, and the fund finance teams underwriting the transaction are not always sufficiently well-versed to take a view on providing leverage over the given asset pool. For that reason, I can see a time in the not-too-distant future where we are looking to embed sector specialists, such as infrastructure or real estate professionals, into our fund finance teams.

***FFF*: Fund finance pricing has arguably been somewhat inefficient historically. Margin so often shakes out at a generic level without any discernible regard to the fund, the investors, or the leverage in a particular deal. More recently, however, we've seen six deals close below the conventional floor level in Q1-Q3 2019. Do you think this is a sign that margins are heading tighter?**

Pricing has definitely tightened for some sponsors and specific transactions, although you cannot look at margins in a vacuum. I would argue that, for most banks, the shift in recent years to committed extension options on three-year deals – meaning they need to be treated for regulatory capital and funding purposes as a four-year deal – has been more consequential. I think the decoupling from the typical peg is more a reflection of pricing starting to more closely

align with banks' capital, risk and pricing models, in addition to lenders differentiating for the given risks in transactions. Sponsors are also becoming savvy with regard to the way they can get better price execution, such as maintaining higher facility utilization or exercising temporary increase tranches. I expect we will continue to see some tightening, although there are a lot of funds in the market and some really big tickets to fill, which gives me confidence that the margin compression will be moderate.

***FFF*: The fund finance market is a bit of a paradox considering the high growth rate in recent years and, at the same time, the reliance on a traditional bank loan template. Where is the fund lending market most ripe for innovation?**

I think anything that involves permanently drawn debt, most likely leverage facilities, is going to attract the attention of capital markets participants. On a relative value basis, fund finance spreads are going to be attractive to these investors. We have seen a number of private transactions where institutional investors have participated in leverage tranches, and there is momentum behind middle-market CLOs. However, in most cases, traditional subscription finance facilities are likely to stay in the bank market because banks tend to be better equipped to offer revolving lines, administrative agent services, and letters of credit backed by high credit ratings.

***FFF*: The IMF just downgraded its forecast for global growth in 2019 to 3% and characterized global growth as in a state of “synchronized slowdown.” We don’t hold ourselves out as economists, so no predictions here. But thinking through the cycle, how would an eventual economic slowdown affect fund lending generally and NAB’s approach particularly?**

As a former restructuring banker, building a sustainable business that can support customers through the cycle is near and dear to my heart. At NAB, our strategy is deeply relationship-focused, and I expect this will allow us to continue to support our customers when it matters most. With respect to the broader market, it is much bigger in terms of both AUM, accepted asset classes, and the pool of lenders than it was in the last downturn. As a result, you will see more opportunities for funds running counter-cyclical strategies, and even those managers running traditional strategies will likely see multiples as welcome relief.

***FFF*: What do you see as the ingredients for success as a fund banker that differ from other general lending and capital markets disciplines?**

Our sponsor customers can have incredibly diverse businesses, and they are always looking for ways to improve from both a capital structure and operational perspective. Similarly, fund structures are increasingly becoming complex and multi-jurisdictional. To be successful as a funds banker, you really need to immerse yourself in both the sponsor’s broader business and the strategy and structures of each fund. This means a high capacity to solve problems, be willing to delve deep into the detail, and, in the current market, work really hard to keep up.

***FFF*: What do you like to do when you’re not closing credit facilities?**

I have a young son, so I try to spend as much of my weekends with him and my wife. I recently returned from 12 weeks of parental leave – a policy our New York office adopted from our home office in Australia. This was a life-changing experience for a range of reasons, and during this

time, I realized how little time we had been spending as a family while trying to juggle busy work and social schedules. So it has definitely been a focus since returning to work.

I am also an avid golfer, and if there's any time left over, I really enjoy cooking and would say I am very much a convert to American BBQ.

***FFF*: Any bold fund finance predictions for 2020?**

I am not sure how bold it is, but I think we will see some real momentum behind NAV and hybrid facilities. It will be some time before these structures become truly commonplace or rival subscription finance in terms of market share, but based on the conversations we are having with customers, there is clearly interest and appetite. For many closed-end fund managers, this will require amendments to the indebtedness provisions in their LPA, so it could take a while to work through the system. There are just too many smart people in the industry for this demand not to be met.

Subscription Finance Loan Agreement Series, Part 11: Mandatory/Voluntary Prepayments and Cancellations

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A regime for a mix of events which require mandatory prepayment and options for borrowers to make voluntary prepayments, as well as mandatory or voluntary cancellations, are a common feature of all LMA-based loan documents, and a subscription/capital call facility is no exception. Considerations around the circumstances in which (and how much and subject to what periods of notice) a voluntary prepayment or cancellation can be made are similar in a subscription/capital call facility context to any other loan document. However, those around mandatory prepayments and cancellations have certain characteristics and nuances that are more specific to subscription/capital call financing. In this article, we will cover this as well as provide a brief summary of the more common features of voluntary prepayment and cancellation provisions.

As background, here is a brief reminder of why these provisions are included in the first place. Mandatory prepayment/cancellation events are generally aimed at dealing with circumstances in which events have occurred in respect of the fund borrower that significantly change the lender's view of the credit but which are, in effect, "no default" type events. In other words, they are not events which the fund borrower itself has caused or allowed to happen. In some types of facilities (although not generally in subscription/capital call facilities), they may also be there to effect cash sweeps. Voluntary prepayment or cancellation options are, in contrast, there primarily to assist the fund borrower in adapting the outstanding debt or commitments available under the facility to changes in the fund borrower's ability to pay down the facility or its need for the facility commitments.

So in a subscription/capital call facility, one often sees typical "mandatory prepayment" provisions common to a number of facility types. There will always be a requirement for a mandatory prepayment on illegality (and this will be almost identical to the triggers for mandatory prepayment in any other facility). "Change of Control" mandatory prepayment events are also pretty much universal. In subscription/capital call facilities, these tend to be triggered by a mix of (a) changes in the ownership of the general partner or manager and (b) more directly, the general partner or manager ceasing to be the general partner or manager of the relevant fund borrower.

After that, the options in terms of mandatory prepayment will vary depending on the particular credit criteria and the constitution of the fund. It was (and sometimes still is) the case that the occurrence of a "key person" event (*i.e.,* departure of one or more of the "key" individuals in a fund as defined in its LPA), or a failure to resolve that event within a certain time, would trigger a mandatory prepayment. Other mandatory prepayment events may include the end of an investment period (if that is likely to impact on the financing or security) and, in the case of an amortising facility, a requirement to repay down to the revised facility limits as the amortisation kicks in. With a nod to the circumstances reportedly surrounding the Abraaj case, lenders may also consider whether to include other events in the mandatory prepayment provisions.

It will often be a matter left to negotiation whether some (or all of the above) additional options as to mandatory prepayment triggers (if they are included) are left as “mandatory prepayment” events or are moved into events of default. In making decisions on this, it is always worth bearing in mind that the underlying rationale for most “mandatory prepayment” events is that they do not themselves involve “default” by the fund or other obligors.

Turning now to voluntary prepayments and cancellation, the provisions in subscription/capital call facilities on these are similar in most respects to those in any other LMA-based facilities. There will be provisions allowing voluntary prepayment (and usually cancellation) in whole or in part on notice (and in minimum amounts and multiples) pro rata for all the lenders. In addition, there will be an ability to prepay or cancel facilities or commitments of an individual lender if there are tax gross-ups or tax indemnity payments required by that lender, or if the fund is required to pay increased costs to that lender. Where the facilities are revolving facilities (as they often are in the subscription/capital call world), a specific prepayment or cancellation option may also be included for “defaulting” lenders.

A few final comments. In subscription/capital call facilities, the line between what should be a “mandatory prepayment/cancellation” event and what should be an “event of default” can be blurred, in particular in relation to the various additional mandatory prepayment/cancellation options. For voluntary prepayments/cancellations, it is worth considering how often these options are likely to be exercised and in what circumstances. Subscription/capital call facilities are generally made available before investments are realised, so the opportunities for prepayment may be limited. Also, whereas the facilities are revolving facilities, funds will generally want to ensure that a voluntary prepayment can be reborrowed (so it does not permanently cancel that part of the facility repaid). And, finally, as some subscription/capital call facilities are offered in the market on an uncommitted basis, in these cases the option to “pre-cancel” may not be one that the fund has any particular incentive to exercise, and it is always good to retain the option.

Accounting Changes Could Signal Larger Allocations to Private Assets from Insurers

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By Chris van Heerden
Finance Practice Group Director

An IASB accounting standard set to take effect in 2021 may lead non-U.S. insurance companies to increase allocations to private funds to diversify existing holdings and to enhance returns. IFRS 17, which was initially published in 2017, requires insurance liabilities to be measured on a risk-adjusted present value basis when it takes effect. The standard represents "the most significant change to insurance accounting requirements in over 20 years," according to Ernst & Young. Under the new standard, low prevailing interest rates may lead to higher reported long-term obligations, thereby leading some insurers to add long duration, higher return assets.

How does this compare to U.S. standards? FASB rolled out Accounting Standard Update 2018-12 last year, which will similarly require liabilities to be re-forecasted using the yield on an "upper-medium grade" (*i.e.*, single-A rated) fixed income instrument as the discount rate. The discount rate assumption is to be updated at each reporting date. Not surprisingly, the U.S. change has also earned high marks from accounting firms, with PwC labeling it the "the biggest change in U.S. GAAP reporting for life insurers in the last 40 years." The standard takes effect in 2021 for public entities.

Private Debt International **recently highlighted** a discussion among Asian insurance companies regarding their planned response to the revised IASB standard. For fund lenders, the changes may, in time, lead to greater insurance company representation in investor pools.

Cross-Referenced Debt Limits

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By Michael Mascia
Partner | Fund Finance

In the United States, while there are certainly exceptions, it has become a common market custom for the debt limitations in a subscription facility to simply incorporate the debt limitation(s) in the fund's partnership agreement (the "LPA"). We reviewed a facility recently where that construct had the potential for a syndicate member to get sideways with the terms of their initial credit approval, so we wanted to highlight the issue.

A large percentage of funds have debt limitations in their LPA, often limiting a subscription facility to 25% or 30% of aggregate capital commitments and true leverage as a percentage of NAV at the time of incurrence. While virtually all lenders need some level of maximum indebtedness in a facility, they are often comfortable with the threshold agreed to between the fund and the investors. The provision that caught our attention had a debt limitation in the LPA that was qualified by "unless otherwise approved by the Advisory Committee." The credit agreement simply required compliance with the LPA, which could in all likelihood be complied with even at a higher debt threshold if approved by the Advisory Committee. The bank's credit approval was not explicit with this potential increase nuance, leaving the possibility of a disconnect. We have seen several funds in the past that have, in fact, obtained approvals from advisory committees for temporary increases, so the risk may be a bit more than theoretical.

When facility debt limits are defined by cross-reference, lenders have typically incorporated changes to the applicable provision of the LPA as a "Material Amendment," requiring lender consent to the changes. But the voting threshold to approve an LPA amendment may at times be set at less than all lenders. Thus, lenders should be clear in their credit approvals when relying on a debt limitation like this that its change may not be an all-lender "sacred right" from a voting perspective.

Fitch Primer on Private Equity Collateralized Fund Obligations

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Fitch Ratings recently published a primer on the securitization of private equity fund interests or "LP interests" (typically called "collateralized fund obligations" or "CFOs"). In a CFO, LP interests are transferred into a special purpose entity (the "SPV"). The SPV issues tranches of both debt and equity to finance the purchase of the LP interests. The sponsor enters the transaction to generate liquidity, add leverage to its portfolio and/or obtain regulatory capital relief, among other motivations. A copy of the primer is available **here**.

London Fund Finance Function

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Our London team hosted a special private function for their clients and families on 12 October with performances from entertainers, including a private performance from leading comedian and “8 out of 10 Cats star” Sean Lock and a few other famous faces!

The little ones were treated to an indoor arcade, bubbleologist, magician, bouncy castles and a bucking bronco, amongst others (which the older guests took full advantage of after-hours!). The adults enjoyed live music acts as well as Sean Lock and upcoming comedian Paul McCaffrey. We were also privileged to have one of the founders of a local charity, Sadie’s Rescue Dogs (**https://www.sadiesstraydogrescue.com**), join us to talk about the tremendous work they do in rescuing and rehoming street dogs in Romania. The event was a huge success, and the London team thanks all of their clients and families that attended to make this such a special night. A few photos of the event below for those who missed it. On to the 2020 planning!

Ogier Article on Cayman and Lux Powers of Attorney

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Offshore law firm Ogier earlier this week published an article about Powers of Attorney as a component of a subscription line lender’s security package. The article analyzes this issue under both Cayman Islands and Luxembourg law. The article is available **here**.

Corporate Bond Ratings Called into Question in WSJ Analysis

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The Wall Street Journal published an important analytical article on bond ratings earlier this week that may have been overlooked because of its Sunday publication.

Here's the upshot: Corporate bond ratings have not stayed in step with the increasing debt loads and, in some cases, the debt-to-EBITDA calculations that underlie ratings have been miscalculated. Low interest rates are aiding interest coverage ratios, but the article leaves an impression of rating agencies that are reluctant to revise.

Earlier in the year, **we observed** that one of the most helpful factors favoring fund finance in the competition for bank capital may be the things it's not. Fund lending continues to offer banks an avenue to deploy balance sheet away from corporates and from the consumer and commercial real estate categories where lending standards continue to tighten.

The *WSJ* article is available **here**.

RBS International Article on IRR

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RBS International published an article last week titled “Internal rate of return: a trusted metric?” The article focuses on the use of IRR as the most widely accepted measurement of performance in the private equity industry and raises questions about the potential issues that may arise when funds rely solely on a single metric to measure fund performance.

A copy of the article is available **here**.

Fund Finance Calendar

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Fund Finance Calendar

Upcoming Events in Fund Finance

February 12-14, 2020	10th Annual Global Fund Finance Symposium, Miami, Florida

If you have an event that you would like listed on the *Fund Finance Friday* calendar, please email us at **fund-finance-friday@cwt.com**.