CADWALADER

FUND FINANCE FRIDAY

All Oars in the Water

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Rough Waters for Asset-Based Loans

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With the end of March came the close to a quarter that many investors will be eager to forget. Down more than 23%, the Dow Jones Industrial Average suffered its worst first quarter in 124 years and its worst quarter overall since the 1987 “Black Monday” stock market crash. The S&P 500 didn’t fare much better, declining 20% during the first quarter, its worst decline since the 2008 financial crisis. The price of a barrel of oil dropped to $20, energy, airline, and hotel stocks plummeted, and bitcoin fell by 10%. Other than gold and toilet paper, there were few places to hide. This overall decline was punctuated by bouts of extreme volatility, with equity markets whipsawed up or down on a near-daily basis. All of which contributed to an interesting few weeks in equities finance. Below are some observations as to what we have seen and what we expect to see in the near-to-medium term.

- Loans against securities generally held up. Overall, loan protections have worked as expected. Investment guidelines, concentration limits, financial covenants, LTV triggers and cure mechanics have generally provided sufficient cushion for parties to avoid outright default by renegotiating terms, supplementing collateral or liquidating assets to deleverage.
- Closings were delayed. There was a lot of focus around short-term spikes for interest rates in the commercial paper market, as well as on stale valuations on underlying assets. Parties are still looking to get deals done, but have delayed closings until funding costs stabilize and/or updated valuations have been received.
- LIBOR fluctuated. 3-month USD LIBOR touched a low of 0.74% on March 12 before recovering back to 1.45% by the end of the month. The fall in LIBOR presented additional challenges for lenders as their costs of funding in the commercial paper market diverged materially from the rates they are receiving on loans.
- Pricing was a hot topic. Discussions around pricing included firming up expectations as to utilization levels, raising zero floors on LIBOR and increasing spreads. Some lenders looked to reduce spreads by agreeing to shorter maturities or looked to improve liquidity coverage ratios by capping the term for which advances could remain outstanding, imposing longer notice periods for advances or adding a lender right to demand loan repayment with advance notice.
- Margin loans hit triggers. Margin loans breached price and LTV triggers almost daily, setting into motion frenzied efforts by both lenders and borrowers to react:

    - Lenders issued margin calls, carefully monitoring share price movements during the margin call period.
    - Forbearance agreements were hastily negotiated. Additional credit support was provided and took many forms, from guarantees to cash to less liquid collateral, including restricted share positions, stakes in private companies, real estate and works of art. Investment guidelines were relaxed, LTV triggers were revised, share price floors were reduced and payment amortization schedules were imposed.
    - Margin positions were liquidated. Lenders issued default notices, dusted off enforcement plans and refreshed on their Rule 144 analyses for restricted stock positions.
    - Block sales were arranged at discounts, and market makers sought to sell shares into markets quickly under threat from further price declines.
    - In some cases, lenders found themselves underwater on concentrated, illiquid positions. The mutual risk inherent in liquidating those positions has encouraged parties to work cooperatively to delay enforcement, supplement with alternative types of collateral and wait for market conditions to improve.

- NAV and fund of fund loans were not affected . . . yet. For funds of funds and private equity funds, recognition of March's market declines has been deferred:
    - Funds of hedge funds deliver monthly net asset value statements on a delayed basis, typically five weeks after the close of a month. End-of-March valuations won't be reflected until statements go out in early May. In the meantime, top-tier funds have been marketing the selloff as an investing opportunity to raise capital. We've seen actions to upsize credit facilities in order to increase available firepower or obtain bridge financing in anticipation of receipt of additional subscription proceeds from investors.
    - For private equity funds and secondaries funds, impaired asset values will not be reflected until first-quarter valuation statements start trickling in during the back half of the second quarter. How market events are reflected in valuations will vary, as valuations of privately held companies don't necessarily track short-term movements in the listed equities markets. While a lot of analysis has speculated that the secondaries market will slow overall until the effects of the coronavirus are fully reflected in valuations three-to-six months from now, there may be near-term opportunities as sponsors look to provide liquidity to LPs seeking to rebalance their portfolios, generate cash and/or avoid defaults. In the meantime, we are seeing strong interest in NAV loans, as private equity funds look to shore up liquidity to meet the needs of portfolio companies or to generate near-term liquidity for investors.
    - LTV triggers on fund of fund loans as well as secondaries and NAV facilities may be breached. Most such loan agreements include mechanics for flexible cure plans to be implemented over an extended period after valuation statements first reflect a breach. Borrowers and lenders should focus in advance on parameters for cure plans, including assessing access to more liquid assets, availability of uncalled capital from investors and the level of discounts being sought in the secondaries market.

We hope everyone stays safe and healthy. And avoids peeking at their retirement accounts. This too shall pass.

'Fund Finance Friday: Industry Conversations' – Podcast with ILPA's Jennifer Choi (25 Minutes)

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Industry Conversations

With all the press reports on subscription facilities and investor liquidity, Cadwalader's Mike Mascia sits down for this week's "Fund Finance Friday: Industry Conversations" with Jennifer Choi, Managing Director of Industry Affairs at the Institutional Limited Partners Association (ILPA). In the podcast, Jennifer gives updates on how the investor community is weathering the disruption, the state of capital call activity, communication levels between GPs and LPs and investor sentiment on their liquidity positions. While some of the data is sobering, Jennifer's message for collective effort and cooperation across the market is uplifting and productive.

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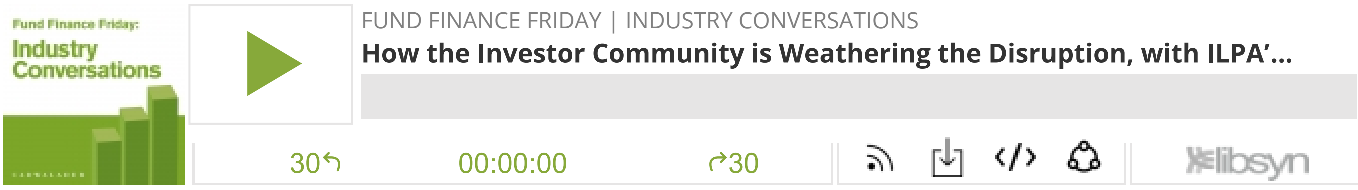

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What About Me? Private Funds See Mostly Tangential Benefits from the Recent Round of Stimulus

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By Chris van Heerden
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The Federal Reserve has moved quickly since mid-March to expand the use of conventional monetary policy along with adding a slate of temporary programs to support specific capital markets and intermediaries. For once, fiscal policy has moved in step, with the $2.2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act making a relatively expedited trip through the legislative process.

How have private funds fared so far? Here are the key takeaways:

- The CARES Act allocates $349 billion in cash-flow assistance through federally guaranteed loans to employers to pay their employees during the emergency through the Small Business Administration (SBA).
- Existing affiliation rules can lead to portfolio companies exceeding the size standards for qualifying for an SBA loan by aggregating a portfolio with all other controlled portfolio companies of the same sponsor for the purpose of determining its size. There are a few limited exceptions.
- These loans will be made available to businesses with 500 or fewer employees, and loan size is capped at the lesser of 2.5x monthly payroll or $10 million. In other words, the loans will primarily benefit businesses sized below the institutional private market strike zone.
- The Fed has launched a number of loan facilities that backstop the primary corporate credit market, the secondary corporate credit market, ABS, commercial paper, money markets and primary dealers.
- These facilities have helped to restore liquidity in targeted markets, but they’re not an antidote to the uncertainty around fundamentals.
- The Fed programs primarily support highly rated securities, limiting their direct relevance to private market sponsors. Funds that rely, for example, on ABS, agency CMBS, or corporate market debt financing will be more directly affected than the industry as a whole.
- Tax changes in the CARES Act have the potential to be meaningful in specific cases. These include changes to net operating loss rules, limitations on business interest deductions, depreciation of qualified improvement property, corporate alternative minimum tax credit refunds, excess business loss deductions for individuals and new payroll tax credits.
- Future initiatives may be more directly relevant to the private market on a large scale. The CARES Act includes a $454 billion appropriation for “loans, loan guarantees, and investments in support of the Federal Reserve’s lending facilities to eligible businesses,

states, and municipalities." This appropriation may support future lending programs from the Fed and may be used on a leveraged basis to increase the impact. Future programs could address additional markets and may potentially reach further down the ratings spectrum.

- The Main Street Business Lending Program may be one such program. The program has been referenced as an anticipated future initiative from the Fed. While details have yet to be unveiled, the program may expand the Fed's support to include medium-sized businesses.
- Finally, discussions of a Phase 4 legislative package has been percolating over the past two weeks and could include spending initiatives that may be directly relevant to the private market.

LSTA Webinar on Fund Finance (52 Minutes)

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The LSTA this week hosted a webinar on Fund Finance. Cadwalader's Mike Mascia joined Meyer Dworkin of Davis Polk, Joel Denny of Nomura and Tess Virmani of the LSTA to provide a high-level overview of subscription facility and NAV-based lending structures and terms. The panelists also provided insights into how the market is adjusting in the current disruption. The LSTA is making all of its COVID webinar replays available to the public. The webinar is available **here**.

Private Debt Investor Article on Fund Finance

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Some fund managers are taking action to address liquidity concerns and find solutions in a market impacted by the COVID-19 pandemic. In a conversation with *Private Debt Investor*, Fund Finance Partners identifies key dynamics that have developed in the fund finance market as sponsors focus on liquidity. The article is available **here**.

First Republic Bank Article Discusses COVID-19 Impact on Subscription Lines and Fund Finance

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Scott Aleali and Jeff Maier of First Republic Bank published an **article** earlier this week on LinkedIn discussing the impact of COVID-19 on subscription lines and the fund finance market. Despite discussions of potential limited partner defaults and general partners making rash decisions, they have seen both lenders and general partners remaining calm and rational during this period of uncertainty, and provide practical advice on how to address potential issues.

Multiple PEI Articles On Fund Finance

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Private Equity International (PEI) and *Private Funds CFO* (PFCFO) published and distributed multiple articles this week about limited partner liquidity and the private equity space in light of the COVID-19 crisis. *PEI* **reports** that limited partner defaults have begun with two European limited partners having already defaulted on capital calls, with more defaults rumored to be around the corner. *PEI* offers insight into the basis for such defaults and what options and remedies are available to general partners. *PFCFO* followed up on the article about limited partner liquidity to **state** that limited partners are reporting high levels of satisfaction with the communication they are receiving from their investment managers and general partners. Furthermore, *PEI* has **aggregated** a number of articles and memos published by various news organizations, law firms and trade publications related to the crisis, as well as the CARES Act and the impacts to the private equity market.

On the Move – Fund Finance Tidbits

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On the Move

Annabella Kwei has joined Citibank, N.A. as Vice President/Specialist Lead on the Sponsor Finance team as part of the firm’s initiative to expand its growth in fund finance.

Recommended Reading

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In Fed We Trust: Ben Bernanke's War on the Great Panic, by David Wessel, is an insider view of the Federal Reserve during the great financial crisis, including how Ben Bernanke, Tim Geithner and Hank Paulson orchestrated the acquisition of Bear Stearns by JPMorgan, allowed the collapse of Lehman, facilitated the acquisition of Merrill Lynch by Bank of America, funded the survival of AIG, permitted the acquisition of Wachovia by Wells Fargo and much more. Wessel's writing is terrific; he combines a complete fluency in monetary policy and Fed history with total insider access to the key principals and the confidence to critique the decisions of the world's greatest economists and business leaders. The book is a great education on the basics of monetary policy and the expansion of Fed powers. But it also reads like a fast-moving novel; the story is genuinely fascinating. In addition, and somewhat unexpectedly, there is a ton of great advice for leadership during a difficult and fast-moving crisis. The book is available on barnesandnoble.com **here**.

Atrium Health Organizes 'Make Noise to Make a Difference' in Support of COVID-19 Healthcare Providers

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Atrium Health, the largest healthcare provider in the Carolinas, has created an initiative called “Make Noise to Make a Difference” to support all of the healthcare providers battling COVID-19. Today at 7 p.m. EST, we are asking those who are willing to join our firm to step outside anywhere in the greater Charlotte metro area and make some noise in support of our healthcare heroes. You can share photos and videos on social media with the hashtags #ThanksHealthHeroes and #AtriumHealthProud. For more information, the event flyer can be found **here**.