CADWALADER

Cayman PF Game Day

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Fund Finance Outlook 2H 2020: Working with a Proven Formula

August 7, 2020 | Issue No. 89

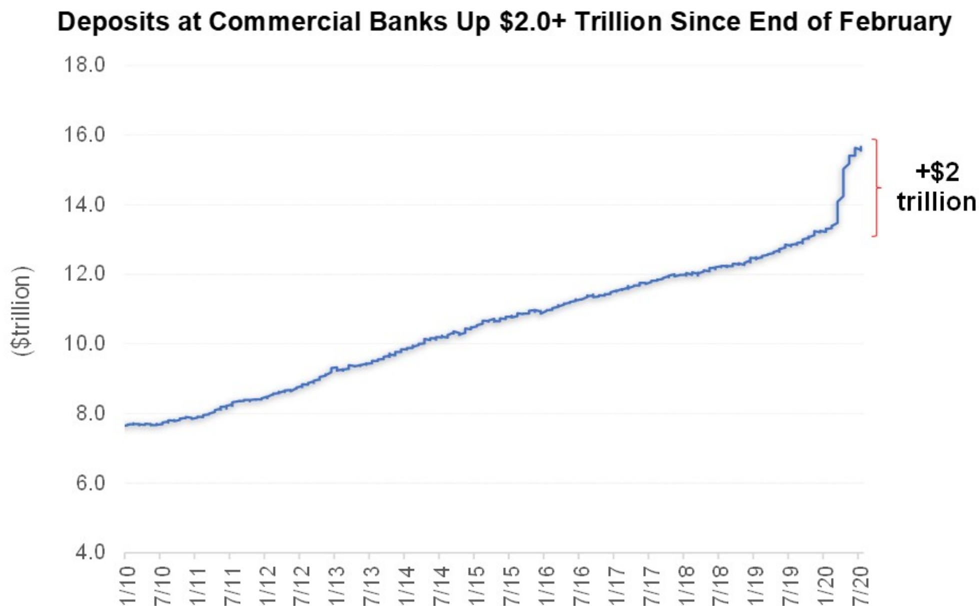
By Chris van Heerden
Associate | Fund Finance

- Banks are sitting down to 2H 2020 hungry for assets but are required to order from a limited and mostly unappetizing menu.
- COVID stimulus programs have translated into the greatest buildup in bank deposits in U.S. history.
- While banks are awash in low-cost funding, attractive income-earning assets have proved elusive because loan demand has collapsed and credit standards have constricted.
- For lenders, fund finance is uniquely positioned compared to the evolving credit risks in business, consumer and CRE loan portfolios.
- While fundraising slowed in 1H 2020, LPs, on net, reported expectations for increased allocations to alternatives in the long term after COVID, according to a Preqin survey.
- This is intuitive, because the same formula that has supported a rotation into private capital in recent years is still in full effect: yields are historically low, valuations are historically high, and liability-matched investors are reporting disappointing realized returns.
- Added to this, cross-asset correlations in public markets pose a real challenge for portfolio managers, as markets from equities to high yield have moved up in sync to date in 2020. The search for uncorrelated returns favors increased allocations to private funds.
- In 2H 2020, LPs may sense a limited window within which to acquire discounted assets. The perceived opportunity is on the private side.
- Our LPA review experience shows, even with the slowdown in fundraising in 1H, lenders found plenty of prospects to pursue.
- From a fund perspective, the cost-of-funds advantage from a LIBOR-indexed subscription facility and the operational efficiencies (*e.g.*, speed to execution) are indispensable in the current investment environment.

Bank Deposits Have Soared But Attractive Assets Are Scarce

U.S. banks have experienced an unprecedented influx of deposits since the onset of COVID. Stimulus programs explain the increase, as does the preference by companies and individuals to hold cash during uncertain times. Total deposits at commercial banks are up more than $2 trillion since the end of February, and, in April alone, deposits grew at a 74% annualized rate. Banks responded immediately to this abundance of low-cost funding by expanding holdings of Treasuries and MBS – the most readily scalable assets. These assets, however, earn paltry

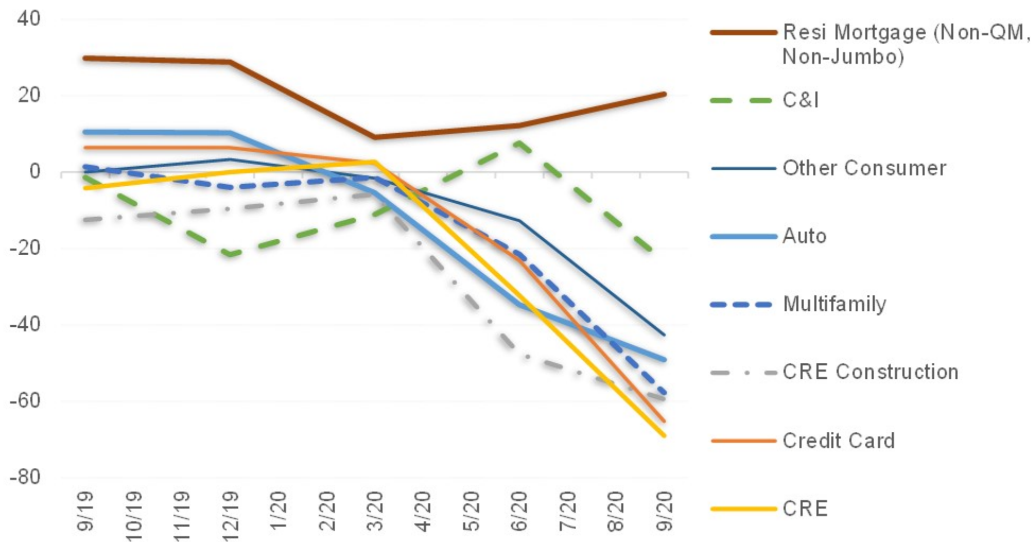
returns, even in the context of the Primary Dealer Credit Facility and the reduced discount window rate. Depository institutions are graded on net interest margin, which means that over time, pressure will mount to deploy balance sheets into income-earning assets. Bank engagement in fund finance originations should continue to be high, consistent with the first half of the year.



Source Federal Reserve Bank of St. Louis.

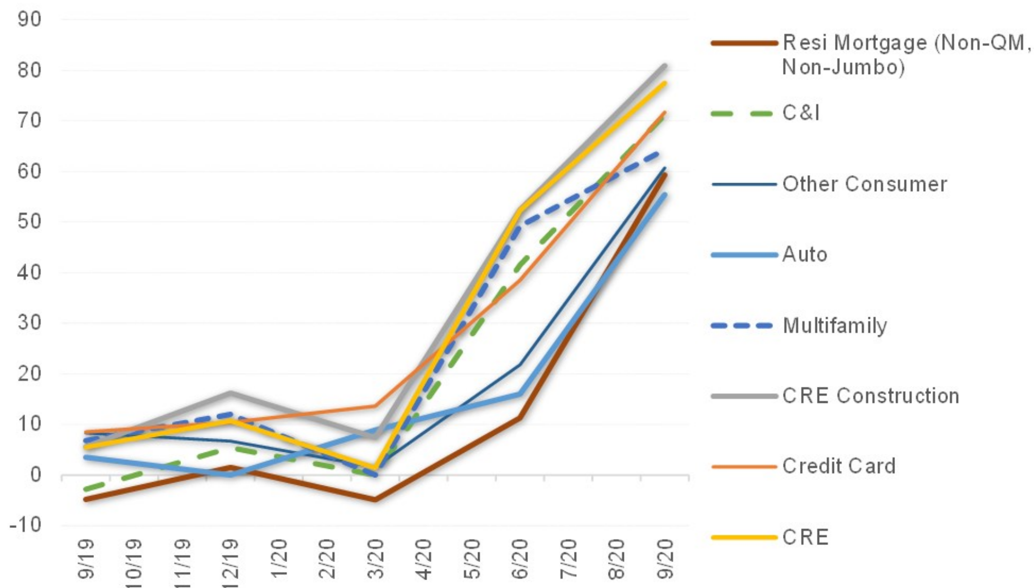
While banks are flush with deposits, loan origination is proving challenging, in part because loan demand has collapsed (with the exception of demand for residential mortgages where refi burnout will eventually come into play). At the same time, credit standards have ratcheted tighter across the board. Borrowers are now more scarce and the credit approval hurdle higher. We see this dynamic as favoring fund finance origination where fundraising is providing a steady stream of borrowers and credit conditions have been far less eventful than in business, consumer and CRE loan portfolios.

Deteriorating Loan Demand (% of Banks Reporting Stronger Loan Demand)



Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices.

Tightening Credit Standards (% of Banks Tightening Lending Standards)

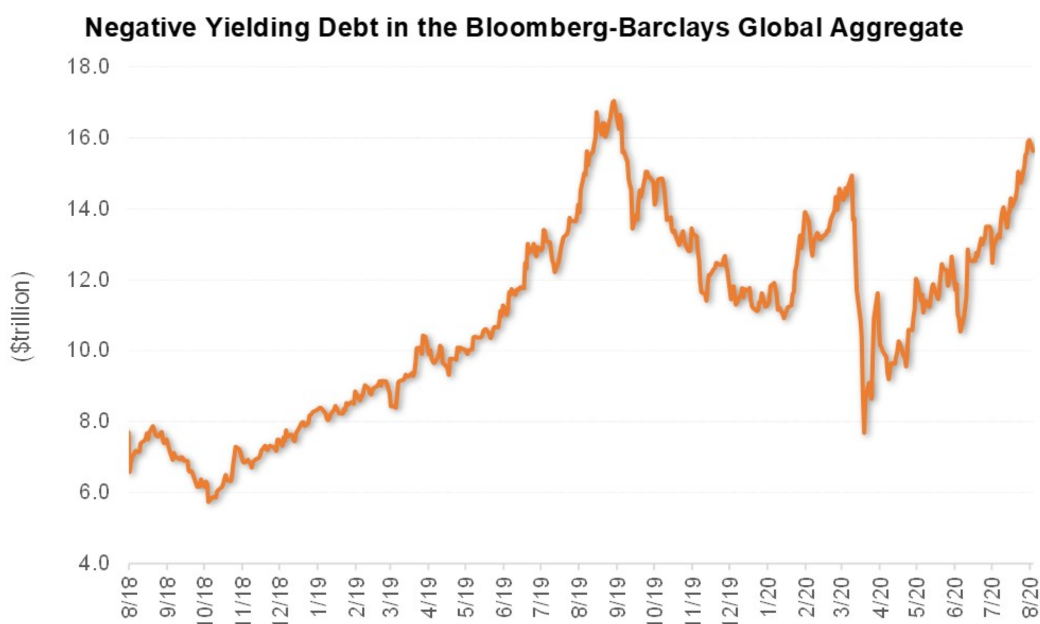


Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices.

Persistently Low Rates, High Valuations and Public Market Cross-Asset Correlations to Support Further Private Market Capital Inflows

Private market fundraising slowed in the first half of the year, with the number of funds closed down 40% in Q2 compared to the prior-year period, according to Preqin data. Worldwide, 861 funds closed in the first half, raising $443 billion in capital. LPs decreased the number and size of commitments as COVID rippled through markets. That's not the whole story, however. Nearly a third of LPs expect increased exposure to alternatives in the long term following COVID, and an even higher share of fund managers expect a long-term positive impact on the alternatives industry. The same formula that pushed private market assets under management to a record $7.2 trillion in 2019 remains in full effect in 2020.

That formula includes low real returns, soaring public market valuations, and disappointing realized investment performance for liability-matched investors. At the end of July, the global supply of negative yielding debt in the Bloomberg-Barclays Global Aggregate Index sat just shy of $16 trillion. Pension funds, insurance companies and other liability-matched investors are hard-pressed to replace investment portfolio income that historically came from the fixed income portfolio. For the first half of 2020, U.S. institutional pension plans posted a mediocre median return of 3.36%, according to Wilshire Associates. Larger plans with greater allocations to alternative investments fared better than small plans. On the whole, liability-matched investors are likely to turn further to private funds as the spread between the 8% preferred return offered in the typical private fund has never been higher compared to the ten-year Treasury yield than in 2020.

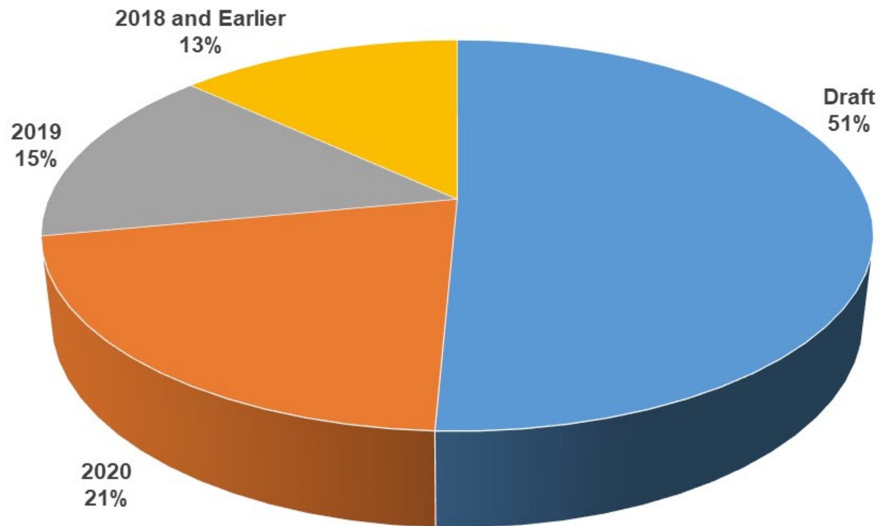


Source: Bloomberg LP.

This Outlook is Consistent with Our 1H Experience

As Mike Mascia and Wes Misson **reported last week**, our deal volume in the first half handily exceeded the prior year. While fund formation slowed, lenders have been able to find ample opportunities. Of the LPAs we've reviewed year to date, nearly three-quarters were from funds closed or slated to close in 2020. The slowdown in fund formation so far hasn't been a significant encumbrance to fund lending.

Year-to-Date LPA Reviews by LPA Vintage



Source: Cadwalader, Wickersham & Taft LLP.

Conclusion

The same wave of macro drivers that the fund finance market has been riding is carrying over into 2H 2020. Added to this, banks have a flood of deposits to digest – additional rounds of stimulus could add more – while originations in other bank loan categories may be challenged. Together, these all point to an outlook for strong origination volume in the remainder of the year (and, with that, a competitive market between lenders). For funds, the cost advantage and operational efficiency from a credit facility are now as important as ever.

Back to Business (as Usual) for Cayman Vehicles – But What Is 'BAU'?

August 7, 2020 | Issue No. 89

By Kurt Oosterhouse
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By Derek Stenson
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For those of us who have been lawyers for a while, certainly you have heard or used the answer "tax reasons" or something to that effect to explain the unexplainable. This, of course, is the quick and easy answer when it comes to explaining why entities are formed in the Cayman Islands, which is unfortunately reinforced reasonably regularly by script writers for Netflix**. "Tax reasons" is, of course, a gross oversimplification of the complex cocktail of ingredients that make the Cayman Islands the financial center it has become, and why so many companies and partnerships are formed in the Cayman Islands (as opposed to other jurisdictions).

We wanted to use this opportunity to take a step back, to look at the history behind Cayman's growth and to consider, following the recent introduction of the Private Funds Law ("PF Law"), whether those same underlying, historical reasons still apply and what "business as usual" may look like going forward.

***Our strong recommendation is not to seek, receive or act upon tax or legal advice from Netflix!*

When did Cayman become such a big thing?

With the risk of sounding a little like a Ron Burgundy quote (although we do have a few "leather-bound books")***,*** the history of the Cayman Islands as a tax-neutral jurisdiction can be traced in local folklore back to the brave actions of local inhabitants in saving the lives of shipwrecked sailors on one of Cayman's many coral reefs in 1794. This allegedly resulted in a grant of immunity from Crown taxes as a thank-you to the Islands' people.

In reality, however, the Cayman Islands financial services sector, as we know it today, really came into existence from the 1960s forward when political instability in neighboring British overseas territories (namely, Jamaica and the Bahamas) led a number of financial services professionals to identify the Islands as a politically stable and forward-thinking jurisdiction, with the benefits of oversight and support from the British government, and to assist the Cayman

Islands government in developing its legal framework to facilitate the offshore banking and financial services sectors.

The 1990s brought the introduction of the Mutual Funds Law and the Exempted Limited Partnership Law, and the resulting increased use of the Cayman Islands in North American fund structures. While the business conducted in the Islands today (which is almost entirely institutional-level work and heavily weighted towards investment funds and international finance vehicles) is unrecognizable from the work done in the 1970s and 1980s (when descriptions of Cayman accounts and Swiss levels of privacy may have been more apt), the key drivers of success from the early days remain true today.

These reasons are simple, but often overlooked: (1) Cayman is a politically, economically and socially stable jurisdiction which uses English common law principles; (2) Cayman has an advanced regulatory framework which meets international best practices; and (3) Cayman has a deep bench of experienced and responsive financial services professionals who understand international and cross-border financial transactions (as well as many attorneys in the Cayman Islands who will have first trained and worked at some of the best-known commercial law firms in the world before leaving the cold winters behind in search of a sun tan!).

Why do sponsors form Cayman vehicles?

The Cayman Islands exempted limited partnership is a globally known and understood fund vehicle for both investors and their advisors, and has over time become the "gold standard" in choosing an investment vehicle for many international managers and their investors. It's also true to say that Cayman is chosen for "tax reasons," but not for the reasons you might think. The fact that Cayman levies no tax on profits, capital gains or income of its own means that Cayman Islands vehicles can be used to co-mingle capital of various groups of investors without such investors paying tax on two levels (*i.e.,* their home jurisdiction and also in the Cayman Islands).

This ability to group together certain investors (who may be subject to different taxes or administrative filings in their home jurisdiction) or segregate certain groups from one another in separate tax-neutral vehicles allows for administrative efficiency and avoids any possible contagion of taxation, legal or regulatory issues from one type of investor to another. The capital of such vehicles can then be invested directly or in the main fund vehicle while keeping intact the various administrative differences between investors.

What about the Private Funds Law? Does it change anything?

The introduction of the PF Law in February of this year brought Cayman Islands private equity funds into the sphere of regulation by the Cayman Islands Monetary Authority ("CIMA") for the first time. The introduction of the PF Law (and the July amendments) may have left many of us shouting (or screaming) at our computers, but now that August 7 is upon us and the registration deadline has passed, what does the PF Law change?

In short, it changes very little and, in a number of respects, makes the use of Cayman vehicles in private fund structures even more attractive. For example:

- ***Sponsors*** will now be able to point prospective or current investors to the regulatory enhancements which now apply to Cayman vehicles, but the day-to-day operation of Cayman funds is largely unchanged. Additional service providers may be brought in to deal with the added regulatory burden (*i.e.,* annual audit sign-offs in the Cayman Islands) but aside from this, the normal operation of Cayman vehicles continues;
- ***Investors*** will now be able to take comfort that they are investing in a regulated fund vehicle which benefits from the oversight of an internationally recognized financial regulator;
- ***For lenders***, despite a tumultuous summer of document negotiations and heartburn over certain contractual provisions relating to the PF Law, there is of course the silver lining that, given that borrowers are now in many cases subject to prudential supervision, annual audits, and continuing obligations under the PF Law, such entities could be said to have become more desirable from a risk/credit perspective now that they have emerged into the regulated space.

One of the key aspects to the success of Cayman as a fund domicile has always been its "speed to market." This ease of formation of Cayman vehicles (which can be achieved within 24 hours) will not be affected in any way by the PF Law and, while the added step of CIMA registration is now required for certain funds, it is fully expected that once the initial deluge of registrations is complete, turnaround times for registration will be extremely fast and will not impact on the ability of sponsors to form and utilize Cayman vehicles for investors or close financings for such funds in the same expeditious manner that has always been the case.

So it's back to business as usual for Cayman then?

The PF Law has certainly challenged the ability of the industry to deal with large-scale changes over a short period of time but, despite the growing pains of undertaking such a large project in a post-apocalyptic "working from home" world, things are now already returning to normal.

The enhancements to the regulatory regime remain, as do the reasons why sponsors use the Cayman Islands. From a fund finance perspective, the days of heated battles over credit agreement wording are now also behind us (for the most part!), to be replaced by an additional condition precedent and enhanced covenant protection in respect of PF Law compliance, which are quickly becoming boilerplate.

Summer 2020 will always remain, as described by one unnamed Cadwalader associate, as the "Summer of Cayman." But even though the hurricane season continues, the PF Law storm is quickly passing and, following some celebrations on August 8, 2020, it's back to business as usual for Cayman.

'Fund Finance Friday: Industry Conversations' – A Borrower's Perspective (13 Minutes)

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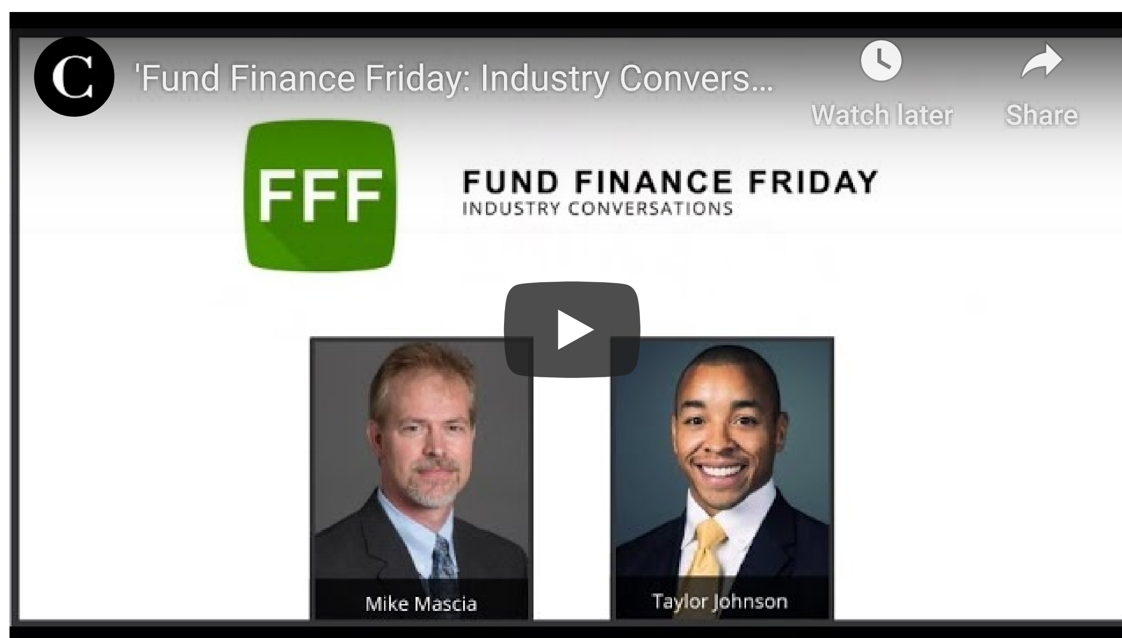
Industry Conversations

In this week's *FFF: Industry Conversations*, Taylor Johnson of Nuveen Investments joins Cadwalader's Mike Mascia and offers his fund finance and property-level market observations, including where he sees gaps in available lender-side supply and where he thinks banks could innovate to bring value to fund borrowers in the current environment.

If you cannot access the video below, please **click here** to watch.



Women in Fund Finance: Fireside Chat with Shellye Archambeau

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Join Women in Fund Finance on Monday, August 10 for a virtual fireside chat with Shellye Archambeau to discuss *Unapologetically Ambitious*, her upcoming book on how to achieve your personal and professional goals. Ms. Archambeau is one of Silicon Valley's first female African American CEOs and a current member of the boards at Verizon, Nordstrom, Roper Technologies and Okta. This WFF U.S. event begins at noon EDT. Join the waitlist for the event **here**.

Private Funds CFO Article on 17Capital Partnership

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Private Funds CFO published an article on London-based 17Capital entering into a partnership with a significant American institutional investor to create a $1 billion NAV-lending platform. This is yet another indication of the continued growth of NAV-based lending and its increased popularity going forward. Click **here** to read the full article.

Private Funds CFO Article Examines Sustainability-Linked Financings

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Private Funds CFO featured an article this week in which Fried Frank partners Kathryn Cecil and Jons Lehmann cover sustainability-linked financings, including ESG-linked subscription lines, and highlight helpful considerations for negotiating ESG-related terms. The article provides insight on the increasing popularity of sustainability-linked financings, addresses the search for consistent ESG standards and describes emerging themes. Click **here** to read the full article.

FFA Announces New Monthly FFA Market Update

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The Fund Finance Association announced a new monthly FFA Market Update webinar via Zoom. This monthly series will share current information in the Fund Finance space amid the rapidly changing world. The first webinar, featuring a market update by Preqin, takes place on Wednesday, August 26 at 10 a.m. EDT. Register **here**.