KEYNOTE INTERVIEW

What the banking crisis means for fund finance

Subscription lines, NAV finance, and employee and GP loans are being impacted in different ways by current market turmoil, say Haynes Boone's Albert Tan, Deborah Low and Craig Unterberg

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Q How has the banking crisis impacted the supply of subscription finance?

Albert Tan: Coming into 2023, there were already some headwinds brewing in the US bank credit market with soaring inflation, rising interest rates, increased regulatory capital requirements, geopolitical tensions and recessionary concerns.

Then, of course, we had the "March Madness" that resulted in the collapse of Silicon Valley Bank, Signature Bank and First Republic Bank, which caught many by surprise. That combination has resulted in significant liquidity pressures, with demand for fund finance from private capital funds exceeding credit supply of lenders.

The banking turmoil certainly tested the resilience of the US subscription financing market. Yet, despite the challenges, lenders generally stayed very active in underwriting and closing transactions in the space.

At the same time, we are seeing a flight to quality, where tier one US and international banks are fielding unprecedented volumes of calls from fund sponsors seeking new relationships with quality, stable counterparties. This means that lenders with balance sheets can be very selective and strategic on their relationships – and opportunistic to capture new relationships and solidify existing ones.

Q Have you seen any reduced demand for subscription finance as a result of slower fundraising and the increased cost of facilities?

AT: Not from our vantage point. Based on our internal data, the subscription financing dealflow we are seeing from our banking clients in the first six months of 2023 is on pace with the past

couple of years. Our tier one US and international banking clients are particularly active underwriting and closing subscription finance deals.

That said, because it is taking longer for fund sponsors to close their funds with their investors, and we are in an environment where interest rates, and therefore the cost of financing, is increasing, lenders need to consider structuring necessary flexibility into business terms to avoid a mismatch where pricing is geared for a close within a certain time that then isn't met.

Equally, sponsors are being more cautious around the size of their subscription facilities. In an era of availability of inexpensive debt capital, the philosophy was to borrow as much as one can. Now, due to higher cost of subscription financing, fund sponsors are giving far more consideration on the size of a facility and use of borrowing.

Q How has the banking crisis impacted the availability of employee loans and GP finance?

Deborah Low: Employee loan programs are an area where barriers to entry are high, largely because of the resources required to underwrite and document loans for hundreds of employees across different funds. It quickly becomes uneconomical for banks to engage outside counsel to document large-scale employee loan programs for the relatively small amount per loan involved. SVB and FRB were able to generate high volumes of these loans by having sophisticated lending groups set up to service these transactions and were two of the biggest players in the market.

When the collapse first happened, there was concern about how these programs would continue. Many funds tried to move their employee loan programs to other lenders, but those banks didn't have the infrastructure required to service the product on a large scale. For now, as fallout from the banking turmoil continues, SVB and FRB programs seem to be continuing in their new homes – First Citizens and JPMorgan, respectively.

Q What are the common structuring issues involved in these sorts of loans?

DL: With employee loans, one large concern is the volume of paperwork and administration involved. You need a large internal bank team to service those loans or else you need outside counsel, which can be prohibitively expensive.

Meanwhile, as to GP loans and management fee lines, there are frequently issues pertaining to the underlying constituent documents. The mechanics for subscription finance are usually built into LPAs, but that is not the case for GP and management fee lines. In fact, there are often prohibitions against GPs or managers pledging security in their interest in a fund. One possible resolution is to seek investors' consent, but funds are often hesitant to discuss these matters with investors.

Q How has the NAV market been impacted by the macro environment?

Craig Unterberg: Valuations have declined in certain sectors, but sponsors and lenders are continuing to work well together on NAV facilities with respect to prepayments and modifications. This is positive for the NAV market going forward. There have been some workouts, but we are not seeing foreclosure or bankruptcy type situations, which shows the resilience in our NAV structures.

Meanwhile, lenders are also being more discerning about new deals due to capital constraints and tightening credit. Each NAV lender has distinct requirements, but we generally see lenders focusing on specific sectors, diversification of assets, performance of anchor assets, the NAV levels and collateral structures. Borrowers are also more discerning due to higher interest rates and are focusing on pricing, tenor and negative covenants to ensure there is enough value in a NAV facility.

Q What are the key structural issues to be aware of when putting NAV finance in place?

CU: Typically, the first question for a borrower is when to put on a NAV facility. Some borrowers may prefer a one-stop hybrid facility to minimize the risk of a financing gap, while others may want a subscription line before a NAV line due to pricing and other factors.

Collateral structures are another area of focus and vary significantly depending on a lender's ability to obtain direct or upper tier liens. In certain deals, the equity in the underlying assets may be pledged to the portfolio company lenders, so the NAV lender will focus on cashflow collateral. A lender's priority is to have a collateral structure that puts it in a strong position in a workout in the hopes of reaching an amicable resolution.

Appraisal rights can be heavily negotiated in NAV loans. Lenders may want to carry out an appraisal if the values are not being marked quickly enough or are inconsistent with comps. Some structures include triggers if there is a large deviation between a sponsor's valuation and the appraisal.

Negative covenants are a key focus, such as restricted payments and distributions. If a fund is doing well, it is generally permitted to make distributions and have operational flexibility, but if NAV declines, those provisions may tighten up to avoid value moving out of the fund. Another important negative covenant is the debt covenant. Some may permit non-recourse or subordinated debt, but, in general, NAV facilities restrict other material debt at the fund level. ■

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