Subscription financing update

The state of fund finance in 2020 amid COVID-19

by Jeff Johnston, Jon Peiper and Albert Tan

As the calendar turned to 2020, the global fund finance market — largely made up of subscription financing — was estimated to be approximately $600 billion, with more than 70 active lenders, and was increasingly used by all private capital funds on an annualized basis. The COVID-19 pandemic, however, has affected the fund finance market. This article summarizes the level of impact felt by the fund finance market and how it responded over the course of 2020.

Subscription financing is used to address the interim financing needs of private capital funds. Limited partnerships, limited liability companies and other entities can utilize this financing, in which credit availability is typically determined by an advance rate against the uncalled capital commitments of creditworthy investors. The primary source of repayment is the funding by the investors of their capital contributions to the private capital funds. Collateral for such financing is typically a pledge of the right to call, to receive and to enforce on the funding capital commitments of all investors; a pledge of the account information into which capital contributions must be deposited; and certain agreements of the investors, which may be documented in the partnership agreement of the fund, or in separate investor letters delivered by the investors to the lenders.

COVID-19's impact on the fund finance market

Since the outbreak of COVID-19 in the United States began in March, the fund finance market, like other industries, has experienced a roller-coaster ride with ups and downs, then a few twists and turns in the months thereafter, before settling down toward the end of second quarter. Below are some observations of what transpired:

- **Healthy volume in first quarter.** The first quarter was healthy from a capital-raising standpoint and in the broader fund finance arena, but as people started to become more fearful or aware of what was happening because of COVID-19, the potential for a liquidity crunch pulled forward a lot of activity that would have naturally taken place in the second quarter. As a result, first-quarter activities were amplified because second-quarter activities in the pipeline were pulled forward, along with new and unexpected requests, such as fund managers seeking to increase lines of credit or modify terms on existing financings to ensure liquidity to meet margin calls on underlying asset portfolios or financing needs to portfolio companies.

- **Responsible behavior by market participants.** In March and the beginning of April, banks, as well as investors, were concerned there would be panic draws on the subscription facilities for the sake of liquidity, as opposed to capital calls for liquidity. What the market saw was borrowings did increase, but panic did not. As fund sponsors needed additional capital, they borrowed from the subscription financing facilities. If they had to do a capital call for whatever reason, they made one. According to market participants, there was no feeling of "I have to do this now, or else I might not get my money." That meant investors didn't have to sell assets at the absolute bottom of the market to meet their capital requirements. Everyone was acting in the best interest of the funds, the investors and the banks.

- **Recovery since May.** As we moved from April into the heart of the second quarter and beginning of the third quarter, even though the normal pace and flow of capital fundraising slowed down, fund sponsors — particularly fund sponsors with long, established performance track records — were able to quickly raise capital from institutional investors to focus on distressed, dislocation, special or opportunistic strategies to capitalize on the dislocation and distress in the overall global markets. From a subscription-financing perspective, because of these segments of activities, these fund sponsors worked with their lenders to arrange subscription financing at a consistent pace during this period to help facilitate investments. From May through the end of the third quarter, the overall fund finance market settled in for a little bit of calm and steadiness.

- **A resilient fund finance market.** During the month of April, a limited number of participants in the fund finance market were reporting some minor investor delinquencies and some minor defaults. But based on the broader performance metrics of second quarter and third quarter, the general view is the fund finance market continues to persevere, remain resilient and show strength, with very limited material distress in the market.

Recalibration on subscription financing structuring and economic terms

Over the course of 2020, the demand for subscription financing remained very strong. A little bit of a pullback from a few key banks in the supply side caused a bit of a void in the market. The result is pricing increased, and the tenor of the financing reduced — some argued, more than the credit risk would otherwise dictate.

General sentiment among market participants is it's going to take a bit of time for the supply side of the fund finance market to get back to the pre-COVID-19 level (the 70-plus active lenders in the market). While pullback happens very quickly, the reverse takes more time because in each bank there are committees one must persuade to get the allocated capital and must convince the subscription financing product is more important than the other product teams.

As for economics, it will remain in favor of the lenders, but LIBOR was also kind of heading down before this. So, on an absolute-dollar basis, some lenders may argue the actual cost to the sponsors is probably about the same or even perhaps a little bit less expensive now.

As the fund finance market remains resilient with limited material distress, more banks will eventually return, which means the supply dynamic will lead to similar pricing contraction, along with the tenor of financing getting closer to where it was pre-COVID or at least back in that general direction.

Outlook as we close out 2020, and final parting thoughts

From a pipeline perspective, the expectation is the fund finance market will finish strong in 2020 due to the overall resiliency of the market. Lenders will have multimillion-dollar or multibillion-dollar facilities going out in the market in the fourth quarter. A lot is dependent on investment deal flow, which had taken a pause for many of these funds in the second quarter. Conversation for transactions picked up in the third quarter and, notwithstanding an election year in the United States, people are generally motivated to transact and close out their deals before the end of the year.

The number of defaults in the subscription financing market has been so small that whenever an unexpected event arises, such as COVID-19, the question is, at what point did defaults really happen? What we've seen so far is the marketplace is very resilient. Sponsors, lenders, investors and market participants all acted responsibly. Sponsors are generally pleased that they have subscription financings in place with strong lending relationships. The investors generally appreciate that their sponsors have subscription financing in place to help facilitate investment opportunities that might not have been otherwise available.

Based on what we have observed in the subscription financing market in 2020, it appears subscription financing remains (i) a resilient, safe and stable product for lenders to lend in; (ii) an effective and efficient financing tool for sponsors that permits them to act in a timely manner; and (iii) a benefit to investors to help manage their liquidity. In sum, COVID-19 has had a limited adverse impact on subscription financing, and it remained a robust financing product in 2020. ❖

Jeff Johnston is managing director – head of asset management at **Wells Fargo Corporate & Investment Banking. Jon Peiper** is managing director – head of subscription finance at **Mizuho Americas. Albert Tan** is partner and co-head of fund finance practice group **Haynes and Boone.** In addition, **Charles Zang,** counsel and member of fund finance group of **Haynes and Boone,** provided editorial support.