State of Fund Finance Amidst Covid-19 and Outlook for 4th Quarter of 2020

In August, Albert Tan, Partner and Co-Head of Fund Finance Practice Group of Haynes and Boone, LLP, spoke with Jeff Johnston, Managing Director and Head of Asset Management of the Financial Institutions Group at Well Fargo Corporate & Investment Banking, and Chairman of the Fund Finance Association; and Jon Peiper, Managing Director, Head of Subscription Finance at Mizuho Americas on the current global fund finance market – particularly as relating to subscription financing - and how COVID-19 pandemic has impacted the subscription finance market and what they see as we head into the 4th quarter of 2020. The following is an excerpt of that conversation.

Tan: Coming out of the 10th Annual Fund Finance Association's Global Symposium in February in Miami, we estimated that global fund finance market is approximately $500 billion with over 70 financial institutions widely active in the market. As the head of one of main financial institutions that is considered the leader in this market, please share with us how COVID-19 has impacted the fund finance market?

Johnston: When Fund Finance Association held its conference in Miami, COVID was starting to certainly take form in Asia, impacting the Asian markets. A lot of us knew that ultimately it was going to come to our shores and would have some impact. But not a lot of people had a great prognostication on how quickly and severely the financial and capital markets

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Jonathan Peiper is Managing Director and head of the subscription finance business at Mizuho Americas. In this role he is responsible for originating, structuring, arranging, and executing subscription credit facilities and other fund financings for the firm. Mr. Peiper has over 20 years of experience in subscription finance and was previously Managing Director & Group Head in Sumitomo Mitsui Banking Corporation's (SMBC) Subscription Secured Finance Department. He joined SMBC in 1997 as a member of the Public Finance Department where he focused on providing letters of credit, loans, and bond purchases for municipalities, hospitals, not-for-profits, and public and private partnerships. Mr. Peiper holds a BA in International Relations from Tulane University and an MBA in Corporate Finance from the New York University Stern School of Business.

Jeff Johnston, CFA, is the Head of Subscription Finance and is a Managing Director in the Asset-Backed Finance and Securitization group in Wells Fargo Securities. Mr. Johnston manages the Subscription Finance team which provides lending facilities to private equity style funds and is responsible for the origination, structuring and monitoring of these facilities for the institutional clients of Wells Fargo. Previously, Mr. Johnston ran the Origination group within Subscription Finance and is responsible for creating the team within ABF in 2010. Mr. Johnston was previously an Officer and portfolio manager for Structured Asset Investors, LLC and Structured Credit Partners, LLC, a wholly owned registered investment advisor of Wells Fargo when he was responsible for the portfolio and workout of legacy structured products for the bank, including cash and synthetic ABS and CRE CDO's, total return swaps and RMBS positions. Mr. Johnston is a CFA charterholder and received a BA from the University of South Florida in Physics, and is currently the Chairman of the Fund Finance Association, a global industry association for constituents in the fund finance space.

were to be impacted in the month of March, which turned out to be one of the busiest month I can remember our team having in years. Couple of things were coming into play. First, Q1 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, the potential for a liquidity crunch pulled forward a lot activity that would have naturally taken place in Q2. So, you had end of Q1 activities getting amplified, Q2 activities in the pipeline was getting pulled forward, and then plenty of new things were popping up. Fund managers wanted increased lines of credit or modified terms on existing facilities to ensure liquidity to meet margin calls on underlying asset portfolios or financing needs to portfolio companies. There was a massive of volume of activities. Second, I think it hit everyone that this was not going to just be something that was a short-term liquidity squeeze. The Fed injected a ton of money in support programs to the financial markets. From our perspective, April started to shift, and we thought about "what is the credit risk of the transactions that we have now?" There were some minor investor delinquencies and some minor defaults. But based on the broader performance metrics, we continue to persevere and show strength. While there was more stress in the system than there had been since the Great Financial Crisis of 2008 (GFC), most of subscription facilities were able to continue. As we moved from April into May and June, new capital raises occurred, particularly with any fund that had more of a distressed or opportunistic slant to it. The large sophisticated fund managers that had historical success in distressed markets were able to raise billions of dollars quickly. From a subscription financing perspective, even though the normal pace and flow of capital raising slowed down, this new segmentation was trying to put money to work. That kept people in this space busy. The public markets recovered, and we started getting second quarter marks coming out from the private fund space to see where people are positioning their portfolios. That'll enable a little bit more deal flow, but it was kind of an interesting roller coaster ride where you had the sharp drop just like a massive roller coaster, and then a couple of bumps and turns and twist in the months thereafter. Now it feels like we're in a little bit of a calm and steady state. It seems the broader market is trying to have a little bit of price discovery, which will hopefully get M&A and buyouts back up and running again to get the regular uses and activities on our facilities that we're all accustomed to seeing.

Tan: Interesting point on comparing to the GFC since many of us lived and worked through that crises. What are the similarities and differences in this crisis versus the GFC?

Peiper: This crisis is very different from the GFC because during the GFC the panic then was much more profound, particularly in the financial sector where the crisis was centered on. For a significant amount of time during the GFC, new funds were not being raised or were being raised very slowly. Lenders didn't have as much capital, the finance market, for a good amount of time, slowed down to an absolute crawl. Where I think it is incredibly similar is what happened as the GFC was ending, what happened to the market at that point. I think there's a lot of correlation between then and now. For example, Pre-COVID, banks would provide subscription financing to make money on the lending. And it was broad as to the types of deals that number of banks would be willing to do. That really changed after COVID. Most banks in the current environment have hunkered back. They're still lending, but they're really focused on their key clients. The other thing that's interesting is that during pre-COVID, the market had tremendous demand and supply so there was equilibrium. The supply has really subsided quite a bit. This happened also in 2010 and 2011. The current demand is still strong, but the supply decreased which resulted in pricing under subscription lines increasing are more than the credit would have ordinarily warranted had it not been for the supply and demand disparity.

Tan: The banks in general, because of the GFC experience, are much better capitalized this time around compared to the last crises. How does this crisis impact how lenders go about conducting its business?

Johnston: The bank aspect of it is obviously spot on, Albert. The banks are so much better capitalized and liquidity positions are so much stronger now. And a lot of that is because of the specific regulations that were put in place due to the GFC and banks are also more conservatively managed so that they're never in the position that they were 12 years ago again. There's just not nearly the amount of leverage in the system as there used to be at the banks. It was summer of 2007 when the loan market started to break. It took a year from then until the date of September 2008, where I think it hit the public and really started to impact GDP and unemployment and the consumer. We always think about it as the 2008-2010 crisis, but on the financial side of it, the bank pressures really started in 2007. You did see highs in the equity markets in October of 2007, a handful of months after a real stress had started to crack in the system. So, if you want to take the pessimistic view of where we are today, you could say that we're more reflective of October 2007 than some point in 2010. Currently a lot of stress remains in the system and with high unemployment for the foreseeable future, it's hard to really feel like we're going to get back to normal any time soon, but I do think the banks are substantially better able to continue providing capital. That's ultimately going to provide a higher bottom within the broader economic system. And I do think the amount of private capital that's out there is available to come in and provide both debt and equity to companies with need to restructure in the coming years.

Tan: Over the last several months your subscription financing team has been very busy, not only arranging and structuring deals, but also joining new facilities. What is your take on how things have progressed for the private funds since March?

Peiper: Well, I think in March and the beginning of April, the banks, as well as the investors, were concerned that there would be

About the Fund Finance Group
Haynes and Boone, LLP's Fund Finance Group is a global leader in the representation of commercial and investment banks acting as agents and lead arrangers in subscription secured financings for private capital funds in Asia, Europe, and North America.

Our group was instrumental in developing the structure and documentation for this type of financing in the late 1980's. Today, our clients benefit from our team's many years of industry experience in the global fund finance market, taking a multi-disciplinary approach to working with clients and their customers on each transaction, which includes preserving the lender-borrower relationship by conducting all negotiations with an understanding of the fund's business issues, while preserving each fund's relationship with its investors.

panic draws on the subscription facilities for the sake of liquidity, as opposed to capital calls for liquidity. What we saw was that while borrowings did increase, there was no panic increase. As the sponsors needed additional capital, they would borrow from the subscription facilities. If they had to do a capital call for whatever reason, they made one, but there was no feeling of "I must do this now, or else I might not get my money." That meant the investors didn't have to sell assets at the absolute bottom of the market to meet their capital requirement. I think that development gave all the banks quite a bit of comfort. Everyone was acting in the best interest of the funds, the investors and the banks.

Tan: Core collateral of subscription financing is the capital commitments of the limited partners and their ability to fund their capital contributions. As the Chairman of the Fund Finance Association, please share with us your discussions with the Institutional Limited Partners Association (ILPA) since COVID?

Johnston: For the last five to seven years, I've been trying to coordinate with ILPA and help, both on general education and ongoing discussions around subscription facilities. Some of their fundamental thesis around improvement in discussion and disclosure are all well founded and good for a conducive and healthy fund finance market.

I think there've always been a lot of rumors or concerns that have not fully been substantiated. I try to educate and get people comfortable with how banks think and how these deals are typically structured. One of the ILPA concerns historically had been that when there was a disruption, banks would pull their financing. That would then create additional liquidity stress on the LP community in a time when they didn't want it. There certainly were anecdotal whispers or stories around some of those types of financings where some banks might've been looking to pull back. Largely the fund finance market has moved to one that has had a committed structure and committed financing. With a margin call as an ideal example, a fund manager can have readily available access to its subscription facility to meet that margin call instead of an additional capital call. Ultimately what gets drawn on the subscription financing must get repaid by the investors, so those capital calls will come, but it gives the manager in conjunction with the LPs a little bit more visibility and time to do that when it makes sense. A decent amount of the market started to appreciate that a little bit more as that was happening. And we were trying quickly to get ahead of it as there were some negative stories or at least stories that didn't map up to the data that we have within our database, around pacing and volume of capital calls. There was an uptick that happened in March and into April, but not to a magnitude that was unprecedented. We had certainly seen periods or months in the prior year or two years that were as large, if not larger. Some limited partners just happen to be heavily weighted towards funds that had an increase of calls during that period. But, we've got a broad database for a lot of the years and felt reasonably confident in the information that we had. I think these facilities help managers manage liquidity, put less stress on the LPs, and give people the tools to be opportunistic from an investment standpoint.

Peiper: ILPA did a study where they asked 200 institutional limited partners about whether capital calls increased or decreased. Somewhere around 40 percent said that the capital calls increased somewhat and about 35, 38 percent said that it was no change. It was just the usual pace. Also, 7 percent said that capital calls increased dramatically, and 3 percent said it decreased a little bit. What makes the headlines is the 7 percent figure because it's not so interesting that the capital calls decreased somewhat.

Tan: Are you seeing a recalibration on how subscription financings are getting structured and on the general economic terms of the subscription financing market?

Peiper: I've seen these surveys where something like 80 percent of funds have subscription financing in place. The result of this large percentage is that the demand is strong for subscription financing. A little bit of pull back from just a few banks causes quite a bit of a void. And the result is that pricing really increased much more than the credit risk would otherwise dictate. So, what we saw were a lot of banks really focusing on their key clients. The European banks were the ones that pulled back the most.

Johnston: I think there's just a lot of other things at play too causing the recalibration. Certainly, the supply and demand imbalance are going to be a meaningful component and ultimately drives where pricing and terms are going for the next 6 to 12 months. A lot of institutions are trying to figure out where is a good place to grow a loan portfolio in fund finance. The current reality is that every single client in every industry, in every geography has some loan demand or financing needs. As such, the internal competition for capital and for balance sheet is something that's a lot different today than it has been in recent years. Different banks all have different

processes and what they care about and focused on.

Tan: Let us talk about why some of the lenders need to take a pause and why some of the lenders are solely focused on their core clients now when there is strong market demand?

Johnston: Reasons are just all over the place. Some are macro-stress concerns, some are just general conservatism, and some are just balance sheet allocation and reprioritization on what an institution's core focus and core client base is. Commentary around focusing on existing clients is candidly just out of practicality and comfort. If you've been banking someone for 5, 10 or more years, there's a regular rhythm and pace that you have. Doing the next facility with them and focusing on that is an efficient use of resources. It's the type of thing people can get comfortable with. You don't have to worry about due diligence meetings to deep dive into someone's operations and visit offices to make sure they exist. From a lender's perspective it's always easier to continue doing business with someone you know and like, and certainly in a time of stress like this. In a work from home environment like we're in now, I think that gets further amplified. The smart fund managers and borrowers don't want to just borrower money from anyone. They want to know someone's committed to the space. They want to know someone understands the product and is going to be there with them. I think it's a little bit harder to connect the dots and to meet new clients in our current COVID environment. Clients had to figure out where opportunities exist when people can't travel, when you must do meetings by zoom. There's some inherent limitations around that. As a result, the ease of doing business and allocating capital to where you feel more comfortable is a fundamental driver in all of that. I think that's likely to stay with us a little bit here. But if a lender is opportunistic and wants to fill in the gaps, or if they can figure out how to connect the dots on those opportunities or make it known what they're looking to do, I'm sure they would get some traction.

Asia and European Markets

Tan: North America is the largest fund finance market – what are you seeing in the subscription financing markets of Asia and Europe?

Peiper: Most of the mega sponsors have their home office in the United States. As such, I would say a majority of their Asian mega funds – and I'm talking about the 10, 15, even larger Asia-focused funds – they're actually run out of the US. While certainly there are some large fund sponsors based in Asia, most of the subscription finance that we see out of Asia are more midsize funds. And the result of that is the demand and size of the subscription financing are smaller. A lot of them could be taken down by 1 or 2 banks. The result of all this is that the supply-demand is not the same as it is in the US. It seems that to a large extent Asian sponsors that are investing in Asia still have their pick of banks with fund finance teams operating in the region. The result of all this is that it still seems incredibly competitive with pricing. For most of these funds, with just a few exceptions here and there, there just isn't the need to do a $3 to $6 billion subscription financing. Facility size tend to be $200 million to $400 million against $1 billion to $2 billion-size funds.

Johnston: For Europe, it just seems like there's been a little bit more of a slowdown in activity. We didn't quite see the same pick up from the opportunistic funds side as we did in the U.S. The U.S. is maybe three to four times the size of the European market, so you just have more transactions and you have more billion-dollar syndicated transactions. The US market in my mind just snapped wider on pricing and structure much more quickly than what the European market did. Part of that I think is just from a flow of transactions and banks waiting to see how things are getting done, more so than credit risk profile or lender appetite truly being different in those spaces. It does seem that the European fund finance market is opening again. While some large facilities that were actively engaged seem to be getting back to equilibrium to what it was in the US, deal flows continue to be slower than US. It's not as if the European market has much of an M&A and an LBO activity going on right now to cause more usage. I think other than the more slowly widening terms, the two markets between the US and Europe are starting to converge again.

4th Quarter 2020 Outlook

Tan: Overall, fund finance market so far in 2020 has been incredibly resilient considering the global impact of COVID-19 pandemic. What do you see for the subscription financing market for the balance of 2020?

Johnston: We had syndicated over $20 billion of deals in the first half of the year. And that was heavily skewed towards Q1 relative to Q2. I think from a pipeline perspective, we're starting to get to a healthy clip now on a forward basis. Even that is a little bit more skewed to, or back loaded, to Q4 versus Q3 from some of these multimillion dollar or multibillion dollar facilities that are going to be out in the market. A lot of it is just dependent on investment deal flow, which had grounded to a halt for so many of these funds in Q2. It's starting to pick up some conversation for Q3. But if a fund is 65 percent deployed and needing to find the last couple of assets before they raised a new fund, we're probably having subscription financing conversations about the new fund. That timeline just continues to push out a little bit because the sponsor is still trying to figure out when they're going to be able to make those last couple of investments. On the corporate investment banking side, there's been more conversation and traffic. Some recent leveraged loan and high yield deals have been better received to where people see a path towards some financing optionality and that starts to create a little bit more deal flow in Q3. I think there's going to be a handful of factors that are going to cause companies to need capital. Recapitalizations are going to happen to where the private equity players and private market players are going to be active. Depending on what happens in the US election you could take a view that 2021 tax season is going to be significantly different, which may motivate some people to transact later this year. I'm expecting a very active Q4.

Tan: Any thoughts on whether we'll get back to the 70 plus lenders we had at the peak and will the economics, covenants and the tenure of the facility get recalibrated again?

Peiper: Regarding the 70 plus lenders, I think it's going to take a bit of time to get back to that level. While pull back happens very quickly, the reverse takes quite a bit of time because in each bank there are committees that you basically must persuade to get the allocated capital and why your deals are more important than the product team next to you. 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 the actual cost to the sponsors is probably about the same or even perhaps a little bit less expensive now. No one likes the higher spread, and people view LIBOR as "it is what it is." And then there's a spread on top as well. No one wants spreads to increase, but I think overall that it's not really costing the sponsors any more money with the higher spreads.

Johnston: A lot of lenders are looking to use live LIBOR floors to both boost yield and capture a more accurate reflection of some of their funding costs. That is something the market hasn't sorted out yet. The fund finance market or the general investment grade syndicated loan market is still kind of a mixed bag on what the right level is and whether it has a floor or not. I don't have a strong prediction on what's going to happen there. I think it probably will be institution by institution. However, I would wager that additional covenants or mechanism intended to ensure some LP skin in the game are probably a lot more likely to continue to broaden and to stay in the next year or two. I'd feel more confident in that than saying that the pricing where these transactions are out right now being where it's going to be for any extended period. The reality is that we're just going to be dealing with economic stress and corporate defaults and probably some whipsawing in pricing in the equity markets that is going to have credit officers and people focused around the underlying investments that the funds have made, particularly for renewals on existing facilities where you have a large amount of the fund that is deployed on a pre-COVID basis where there's going to be some adjustment or multiple contraction. It's a little bit different today than where the market was 10 years ago. It wasn't that natural to continue subscription facilities three, five, seven years after the end of the investment period, which is where Jon and I and others are getting requests to continue to keep a subscription line in place, well past initial deployment. I think the market is trying to figure out where is the natural exit point? What should the continued performance of that fund look like to avail itself to a facility? On the new facilities, candidly, I feel a little bit better about a new fundraise and new LP commitments later this year. I don't know if I would be as concerned about getting some equities skin in the game day one, assuming it is a good manager, it has good documents and strong performance track record. But I completely understand where lenders would want to see some demonstrated LP performance before they would put debt into the system. On the pricing piece, I think eventually we'll have more banks come back in and eventually the supply dynamic will lead to similar pricing contraction and get back closer to where it was or back in that direction. But this market moves slow. The reality is this was really the first time in the last 10 years that we've had any widening of spreads in any material way. I just don't think that this market is one to react extremely quickly on its pricing. Once things have a clear economic picture, we'll be on a slow climb back in. I suspect that there's potentially some supply demand imbalance that could ultimately justify wider pricing later in this year for some of the managers that aren't kind of the tier one names that a lot of lenders feel like they need to allocate capital to. Finally, it makes more sense for this product to be a 3 or 4-year product. And again, where the core lifeblood is new facilities for newly raised funds that have investment periods that are three to five years long, then it makes sense to have a revolver that's generally going to align with that.

Tan: Do either of you have any final parting thoughts on the private capital market and the fund finance market before we wrap up?

Peiper: The number of defaults in the subscription financing has been so small that whenever a new situation arises, like COVID, the question is at what point did defaults really happen? What happens with capital calls when markets are shaky, and investors might have liquidity issues? Time and time again it's proven that sponsors, limited partners and lenders all act responsibly. I do think it's possible that things are going to last this way longer than any of us had expected. But what we've seen so far is that the marketplace is very resilient. People act responsibly. It remains a very safe industry for lenders to lend in, a very good means for sponsors to have capital that permits them to act in a timely manner, and also good for the investors to manage their liquidity. We've seen the market behave very well. And it's always reassuring to see the market participants act responsibly.

Johnston: Jon's point is a good and I'm optimistic about the outcome. The players continue to act responsibly and the market functions as it's supposed to. Sponsors will be happy that they had their facilities in place and strong lending relationships. The LPs will value that their sponsor had a facility in place that was able to facilitate some investment opportunity that might not have been otherwise available. They'll realize that this was a valuable product that was able to weather a storm. I've largely been focused on trying to make sure those macro dynamics are put in place to continue a healthy and functioning market. And this is going to be a real test around that. Hopefully we all get out on the other side a little bit better. Most important is that everyone continues to stay safe and healthy, of course. Hopefully private capital can ultimately be a beneficial source for companies that may need a lifeline or some additional support. It's a good time for alternatives and for private capital to show what they can do in this economy. ◆◆

SUBSCRIPTION SECURED FINANCE PRIMER

Subscription secured facilities are used to address the interim financing needs of private equity 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 credit-worthy investors. The primary source of repayment is the funding by the investors of their capital contributions to the fund.

Collateral for the facilities is typically a pledge of the right to call on the unfunded capital commitments of all investors, a pledge of the account information 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.

ADVANTAGES OF SUBSCRIPTION SECURED FINANCING

- **ABILITY TO ACCESS CAPITAL FOR ACQUISITIONS UPON SHORT NOTICE** without having to finalize the debt/equity structure for an investment, make a capital call on investors, or arrange for permanent financing prior to making an investment decision.
- **A HIGH LEVEL OF FINANCING FLEXIBILITY** typically reserved only for larger corporate borrowers *(i.e., revolving availability, access to letters of credit, alternative currencies, short-term "bridge" financing)*.
- **ACCESS TO DEEPER POOLS OF CAPITAL** from lenders that do not typically make loans to investment funds.
- **REDUCED ADMINISTRATIVE BURDEN** for the fund sponsor and investors as the number of capital calls can be decreased.
- **ELIMINATE "TRUE UP" OF CAPITAL REQUIREMENT** by utilization of a subscription facility for the fund's capital needs before the fund's final investor closing.
- **MINIMAL ADDITIONAL REPORTING REQUIREMENTS** for fund sponsors as facility covenants and reporting requirements generally match guidelines already contained in fund governing documents.

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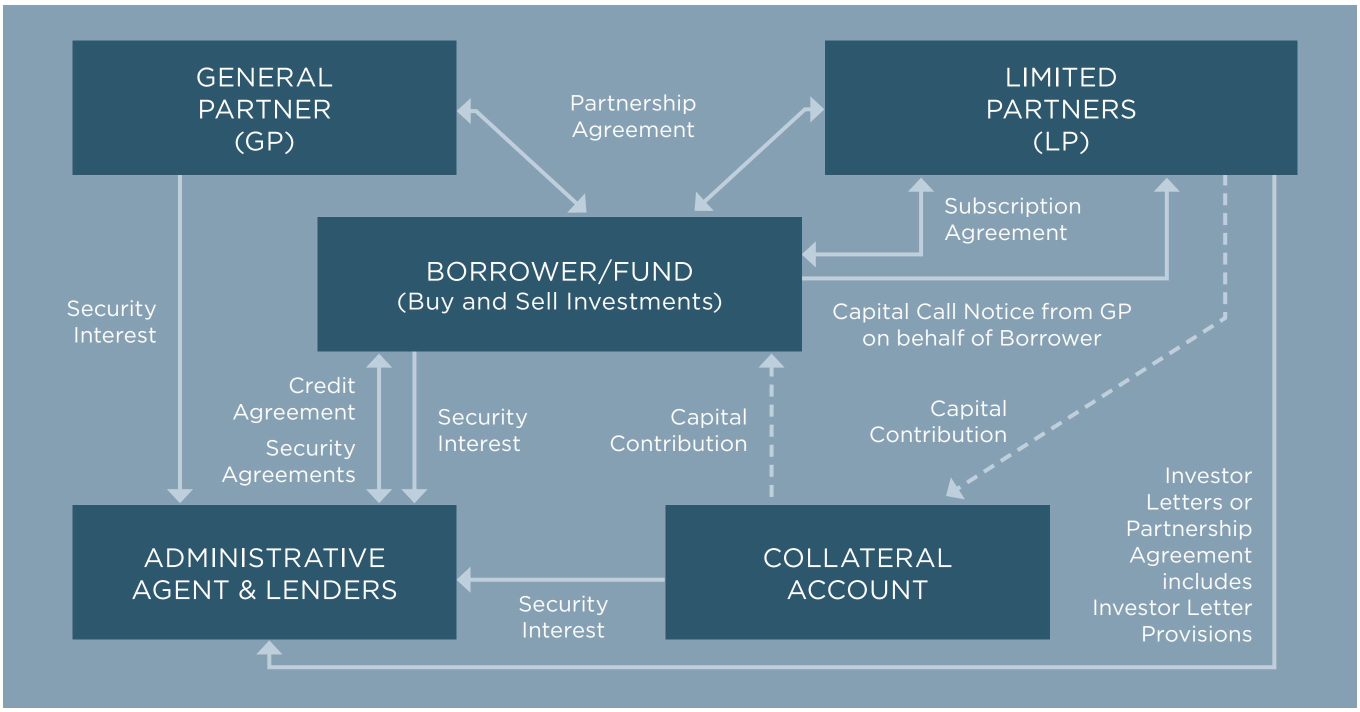
SIMPLIFIED SUBSCRIPTION SECURED FINANCING DIAGRAM



PARTNERSHIP AGREEMENT

Investment criteria (assets, investment period); capital call issues (purpose, amount, timing, overcalls, right to call); GP authority and limitations (ability to borrow, purchase, divest); amount of debt allowed; and general conditions for partnership. Determine if it contains "bankable" subscription financing provisions, including waiver of defenses to funding and other common provisions included in a typical Investor Letter.

SUBSCRIPTION AGREEMENT

Capital commitments of LP investors to Borrower/ Fund; investor questionnaire; and enforceability, authorization, other investor conditions.

SECURITY AGREEMENTS

Pledge of all of the Borrower/Fund's rights to the unfunded capital commitments; pledge of GP's rights to initiate and enforce capital calls; and pledge of collateral account(s).

BANKABLE PROVISIONS

Lenders will typically require Partnership Agreements of Fund Borrowers to contain "bankable" subscription financing provisions, including, among other provisions, acknowledge pledge of Fund's rights to the Capital Commitments and Capital Contributions and GP's rights to make and enforce capital calls; and partners' agreement to fund capital contribution to collateral account without counterclaims, offsets or defenses of any kind or nature and subordination of LP claims. Additionally, in separate managed account subscription financings, it is common for lenders to also request traditional investor letter from the sole investor due to the concentration limit of one investor.