CFO and Rated Note Feeders[1]

By Mark Nesdill and Albert Tan

While this panel primarily focused on Collateralized Fund Obligations ("***CFOs***"), there was some overlap with Rated Note Feeders ("***RNFs***") and certain points, as indicated below, apply to both types of transactions. Our take-aways from this panel are as follows:

Why are CFOs and RNFs becoming more prevalent?

- As investment in private equity and alternative asset classes have matured, investment growth is dependent upon new sources of capital.
  - Investment by insurance companies has been tempered by regulatory/capital requirement constraints, and these structures are intended to provide access to these asset classes without the same constraints applying.
- With respect to CFOs, the securitization structure allows for a larger set of options for investors with different risk appetites.
  - Investors that want to exit illiquid investments can use CFOs as a strategy to sell a diversified pool of investments on the secondary market.
  - Sponsors are able to offer the same diversification to investors that don't typically invest in alternative assets.

Structures

- CFOs are usually structured with somewhere between 2-1 and 3-1 leverage, and the longevity of the vehicle is intended to match distributions and avoid the risk of getting paid down earlier than expected.
- RNFs are a single-fund investment strategy, and CFOs are a multi-platform strategy.
  - GP-led CFOs permit an investor to get access to all or many of a GP's fund strategies.
  - Investors can underwrite a RNF investment the same way it would a typical investment in a fund but underwriting an investment across multiple funds can be more challenging if the underlying funds are not seasoned or the investor doesn't have experience with the managers.

[1] Panelists included Jeremy Deutsch (Vice President at Neuberger Berman), Christopher Duerden (Partner at Dechert LLP), Pierre Maugüé (Partner at Debevoise & Plimpton LLP), Seth Perlman (Executive Director at Morgan Stanley) and Pramit Sheth (Senior Managing Director, Global Head of Funds at KBRA).

- Investors in CFOs have the option of coming into a fund either through a traditional equity investment, as part of a leveraged investment or as an equity investor in the CFO if there is more appetite for risk.

- For CFOs, the sponsor of the transactions and the investors will need to determine if the notes will be funded all at once or will be a delayed draw structure.

Comparisons with NAV transactions

- LTV for NAV investments are typically 15-20% LTV vs. 50-60% LTV for CFOs, and there could potentially be a mezzanine component as well.

- CFOs (and RNFs) are capital markets transactions vs. a direct pledge of assets for NAV transactions.

    - At its core, these transactions are asset-based lending, but because the assets are usually LP interests, liquidity sources are needed and that is where the issuance of structured notes and equity comes in.

Important considerations for transaction participants

- It is a long process to set up a CFO because consents will need to be obtained from underlying funds, there are potential confidentiality issues, transfer restrictions, etc.

    - Structuring is determined by both the investors and the underlying funds.

        - Cash flow considerations

        - Recycling features may be included in underlying funds or the CFO itself

            - Can the CFO invest in other funds in the future (i.e., will the sponsor have discretion to make other commitments)?

            - Can distributions from existing investments be used for later funds and the related drawdowns?

            - Investors may get some comfort in GP-led transactions as the GP already has a commitment in future funds or it will have a commitment to the CFO and interests are aligned.

            - If the CFO is a $500MM - $700MM investor in a $10BN fund, there is additional comfort because the new fund has an experienced manager.

            - If a CFO defaults on commitments to underlying funds, it is disastrous for both the CFO and the underlying fund, so commitments to new funds are generally limited to commitments that will work for all parties.

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<u>National Association of Insurance Commissioners ("***NAIC***")</u>

- RNFs and CFOs provide better regulatory capital treatment for insurance company investors, but this has been under review and depends on the analysis of the following two questions:
    - Do these investments constitute bonds?
    - If they do, what is the applicable capital charge?
- With respect to if an investment is a bond, investments that rely on equity are not bonds.
    - However, this is a rebuttable presumption and the market has been comfortable that an investment is a bond if it is supported by cash flows and over-collateralized.
    - With respect to investments that are bonds and the applicable capital charge, the NAIC has questioned if rated notes in these transactions should be exempt from filing these investments with the NAIC.
        - If the underlying investment is wholly dependent on equity, no exemption from filing is provided and ratings are not relied on for regulatory capital relief – the NAIC determines what the relevant capital charge should be.
        - The industry is concerned because if the NAIC does not have staffing available to analyze the volume of transactions that would be called into question.
  - The NAIC planned to release guidance in November of 2022, but this was delayed.
    - Comments on the proposed guidance ends the week of 2/13/2023 and hopefully there will be some clarity next month.
  - Currently, NAIC treatment is not purely a legal issue.
    - Structured products have well-established law and guidelines that can be relied upon.
    - Current NAIC guidelines can be interpreted.
        - Three examples have been provided of what not to do, but, other than that, there is no certainty with respect to CFOs and RNFs.
  - Luckily, while there is uncertainty in NAIC treatment, most of the doom and gloom in the market has dissipated and recognized that it may need to adjust after guidance is available. If rated notes are a problem, these transactions may need to be restructured.
    - All transactions are bespoke and solve for different issues.
    - There is a vocal lobbying to the NAIC and the panelists doubted that the continued uncertainty will chill the market.

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- Involvement of non-insurance investors with different appetites will help the market, as they can use the structures to pick the different tranches (i.e. rated notes, mezz or equity investments) that address their risk appetite.
    - These products can also be marketed to other ABS investors that don't typically invest in PE.
    - Investors that know and have experience with fund managers are now interested in these products (especially large/sophisticated investors with experience in securitization markets).

Current market environment

- Higher interest rates have changed the market and created new issues.
    - Structuring can help and creative solutions can be found to make these products work for each parties preferred yield, however, the more expensive debt tranches can eat into equity returns.
- If the structure of the CFO is set up in a manner that works for all parties then the economics can be adjusted to address these concerns.

Will the investor base grow through CFOs?

- The panel predicted the investor-led CFOs with large, diversified pools of investments across multiple sponsors with large amounts of NAV will make the asset class more appealing due to increased liquidity.
- Now, the investments become more liquid in tradable markets and that will attract hedge funds and other investors.

2023 Predictions

- There will be a reasonable number (6-7) of public CFOs that can be compared and that will help develop the market.
- These transactions will increase liquidity in the market generally, not just for investors looking to exit positions.
    - This means there will be a broader investor base for the asset class, including increased interest from pensions, especially of the asset class is now tradeable.
    - Traditional CLO/ABS investors will come to market.

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