HAYNES BOONE

FFA 2023 Global Symposium

Panel Summaries

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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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Fund Finance Market Update, ESG and Macro Developments[1]

By Brent Shultz and Eric Worthington

The "Fund Finance Market Update, ESG and Macro Developments" panel discussed a large range of topics relevant to current fund finance market trends, including pricing, alternative financings, credit utilization, ESG, and new market participants. Several key takeaways from the panel are below:

- **Pricing/Tenor Changes**: After Covid's introduction, subscription line pricing initially spiked but then settled back down in a range that was still slightly higher than pre-Covid pricing. In the last year, due to the dramatic growth of the industry and increased regulatory capital requirements, banks' subscription finance balance sheets have received heightened scrutiny, resulting in banks tightening their allocation of capital to the subscription product and spreads increasing to higher levels, with some increases to upfront fees as well. Subscription lines with 364-day tenors have grown in popularity as they require less regulatory capital reserves than facilities with tenors of 365 days or longer.
- **Alternative Financings**: Non-subscription line fund financing products are growing in popularity, including drop-down financings for special purpose vehicles. The CLO market has also seen increased pricing and, as such, increased activity as these products are becoming more attractive to banks. Finally, the proliferation of NAV financings has seen that product continue to develop, moving from the main credit support being investor interests/commitments and instead seeing more targeted collateral of the underlying collateral of the funds. The panelists anticipated that the NAV market will continue to grow and become more normalized, similar to the subscription line market over the past few decades.
- **Utilization**: Although some alternative lenders in private credit and BDC structures are claiming heavy deal flow at the moment, banks are generally seeing a meaningful decrease in subscription line utilization. Additionally, offshore activity has seen a drop-off, particularly with innovative products such as NAV facilities, and generally has indicated a more conservative market than last year.
- **ESG**: ESG initiatives have staying power. Certain large sponsors look at every investment from an ESG perspective because ESG should be a business principle outside of getting better pricing on financings. Some panelists purport that social responsibility is good business and results in better returns for investors. There are still concerns of "greenwashing" funds solely for the purpose of getting better facility pricing and it is important for lenders to manage that risk. This can mainly be done through the hiring of sustainability coordinators to work with business teams to set KPIs that are challenging and meaningful. While ESG has become much more commonplace in the US, it is still relatively behind Europe in making this framework standard in facilities. The prevailing theory for US lenders is smaller banks will follow the framework established by the largest banks, but larger banks are still hesitant to implement ESG structures without more regulatory guidance. Finally, from a Cayman perspective, ESG is still in its infancy with the framework being established.

[1] The panel was moderated by William Wallace, Managing Director at SMBC, with panelists Pallo Blum-Tucker, Managing Director at State Street Bank, Georgina Pullinger, Partner at Appleby, Patricia Teixeira, Counsel at Ropes & Gray, Samina Sajanlal, Managing Director at CIBC Capital Markets and Derek Dillon, Managing Director at Apollo.

- **Other Market Trends**: From a macro perspective, the fund finance market (and the subscription line product) is seeing more non-bank lenders entering the space (*e.g.*, insurance companies and private credit funds) due to the preferable ROI to investment grade lending even though the risk is similar; these non-traditional lenders are also seeing an increase in alternative fund finance products and structures, including: securitization of subscription lines, the proliferation of rated note feeders, collateralized fund obligations, and an increase in general partner financings.

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Fund Manager Developments[1]

By Robin Ladd, Karina Oshunkentan and Courtney Smith

The panelists provided mixed reports on the current fundraising climate: while fundraising for some flagship funds has seen an uptick due to a diversified pool of investors, other funds have seen a more challenging fundraising period in recent months. As investors have searched for yield, there has been a turn toward private credit to supplement their portfolios. Additionally, the "Denominator Effect" may be causing a slowdown in fundraising as certain investors and asset managers find themselves over-allocated to specific assets. However, sponsors have been able to mitigate the Denominator Effect through the use of mezzanine funds and entry into the business development company space or, in some cases, rebalancing to target allocation levels by selling certain portfolio assets.

For lenders, the push by sponsors to mitigate the Denominator Effect has led to more transactions to rebalance allocation levels and a more robust market for secondary transactions. The use of general partner-led secondaries and continuation funds is a significant part of the fund practice, but it is getting some pushback from some investors who prefer to take advantage of the timing and traditional exit on funds. Many institutional investors are decreasing the number of managers they are investing with or the amount they are investing in each fund. Rather than raising new funds, some sponsors are instead turning to other avenues, which means we are seeing a rise in co-investment facilities with some sponsors entering the public market.

Sponsors are also looking to employ NAV based facilities as part of their overall financing and liquidity strategy, a trend that began in 2020. Delayed realizations in the current market have led to an increased interest in NAV facilities as an effective tool for returning capital to investors. The panelists noted that there are more non-bank lenders (such as specialty finance companies) entering this market. Although NAV margins have gone up, the product remains attractive as funds search for creative ways to raise funds in a stale fundraising market. Hybrid facilities may also come to forefront for 2023.

The rising popularity of NAV facilities is also resulting in amendments to limited partnership agreements. Limited partnership agreements typically include restrictions on debt ratios tied to NAV or only explicitly permit subscription credit facilities. With the rise of these amendments to permit (or more explicitly address) NAV facilities, many investors are raising questions with sponsors in the fundraising diligence process regarding how the fund intends to use various credit facilities, and they are seeking to negotiate detailed debt limits up front. The panelists noted that in newer vintage limited partnership agreements, there is a trend toward including more robust language to permit NAV facilities.

One other area of focus among fund managers is how returns are presented to investors, especially in light of the new Marketing Rule which took effect in November 2022. The Marketing Rule prohibits the presentation of gross performance without also showing net performance. The gross and net performance must be presented with at least equal prominence, represent the same time period, and use the same calculation methodology and present the same type of return. The performance must also be accompanied by applicable disclosures.

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[1] The panelists included Matthew Chase, Partner at Latham & Watkins LLP, Flora Go, Partner at Fried, Frank, Harris, Shriver & Jacobson LLP, Ariel Goldblatt, Partner at Stepstone, Steven Hopchick, Managing Director at Barclays Bank PLC and Kevin Miller, CEO and Founder of Thorofare Capital. Vanessa Lawlor, Partner at Maples Group, moderated.

Increased regulatory scrutiny of private funds will likely continue in the coming year. For example, one proposed rule prohibits certain preferential treatment for private fund investors, which will heavily impact the use of side letters. Side letters are an important part of the fundraising process, so there is significant pushback on the adoption of this rule, the comment period for which is currently underway. Other proposed rules on continuation funds and reporting further demonstrate the more active regulatory monitoring of the private fund space.

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FX and Interest Rate Risk Considerations for Fund Managers[1]

By Deborah Low and Karina Oshunkentan

This panel focused on hedging from the perspective of sponsors, hedge providers and hedge advisors. The discussion focused on the different approaches to risk mitigation utilized by funds and how current market conditions have impacted strategy. Key takeaways from the panel are as follows:

1. For many sponsors, hedging was initially an afterthought. Funds were employing a decentralized approach where deal teams were managing hedges independently. Recently, however, more sponsors are moving hedging and risk mitigation into a centralized function which the panel agreed is proving to be more efficient and effective in developing hedge relationships and weathering the current volatility.

2. With a centralized approach, it is important that the risk mitigation team have strong internal partnerships with the deal teams from the start. Sponsors will also benefit from having a strict policy regarding trading to serve as a guidepost but retaining flexibility to allocate discretionary power and allow for strategic pivoting as needed. This allows for a balancing act in which the deal team has room to consider the specific asset classes in determining how best to approach hedging, while still being mindful of general parameters. Certain funds and banks may also benefit from having guidance from a hedge advisor with specialized knowledge of the market.

3. Determination of a hedging scheme is based on various factors, such as the type of fund, strategy, and mandate. For example, on the currency side, certain funds employ a more option-based approach for private equity funds and deploy forwards for evergreen funds. Meanwhile, on the interest rate side, funds approach hedging in a less formulaic way. As far as the amount hedged, this also depends on the type of mandate; it may not be necessary to eliminate all risk and instead opt to only hedge 50% of the investment. Another consideration is that certain transactions have a natural hedge in place internally through operations, balance sheet, and income statement and therefore may not require any structured hedges. The consensus is that a more programmatic approach to hedging also prepares the funds for market volatility.

4. The panel discussed the rising prevalence of open-ended funds, noting that they come with certain benefits for equity investment purposes including the ability of the fund to hold assets for a longer period of time. However, certain challenges arise with respect to open-ended funds and its different risk structure. Some of the key considerations are redemption dates, regular hedging settlements and liquidity needs, and recourse to main funds in the case of feeder funds. These questions trigger the need for more diligence regarding liquidity management to settle hedges that are typically shorter in duration for open-ended funds.

5. Hedging activity has ticked up in recent years, which requires closer monitoring of the portfolio and liquidity management. More and more funds are also requesting not to post collateral for hedges or to include a higher credit support threshold, resulting in higher costs for the funds and riskier positions for the banks.

[1] The panelists were Bryan Cohen, Managing Director, Head of North American Client Coverage at Validus Risk Management, Georgia Curtis, Vice President, Financial Sponsors FX Sales at Lloyds Bank, Shirley Liu, Head of Derivatives Risk Solutions at Mizuho Bank, James McDonald, Principal at TPG, Inc., Brett Morrell, Head of Risk Solutions at Derivative Path, and Jasjit Singh, Partner at Apollo Global Management.

However, from the fund's perspective, the increased cost of uncollateralized hedges or higher thresholds does not materially impact the internal rate of return.

6. The panelists anticipate a number of trends and concerns in 2023. There will be more focus from sponsors on how hedges are being implemented across funds given the market volatility and high interest rates. The panel also emphasized a stronger need for technology solutions to address hedging questions and provide visibility, monitoring, and reporting from both the portfolio companies and the limited partners as hedging activity not only reflects the risk mitigation strategy but also the liquidity exposure. Finally, the panelists raised concerns of the possibility of a "stagflation" (a stagnant economy coupled with high inflation), which could create hedging issues for funds if asset valuations and liquidity decrease.

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Global Legal Update[1]

By Brandon Spleen, Charles Zang and Mei Zhang

The Global Legal Update panel focused on legal developments over the past year in each of the United States, the Cayman Islands and Luxembourg. Here are our key takeaways.

- While use of a debt commitment in a private investment vehicle (including use of a rated note feeder vehicle) is not new as of the past year, panelists noted that New York and other United States jurisdictions have seen an increase in the popularity of such structures over the past three years. They noted that more fund sponsors are closing in commitments in this manner and having conversations with their lenders about including such commitments in the borrowing base. This, they noted, has resulted in an ongoing maturation and evolution of the diligence and legal provisions necessary to get such lenders comfortable advancing against debt commitments.

- As debt commitments and rated note feeders become more popular in the United States, U.S. counsel have found that certain insurance companies are rejecting the prospect of having their position converted to equity, due to regulatory concerns, even when an insolvency or default event occurs, requiring additional focus to ensure the debt commitments and note funding obligations are as close as possible to a special purpose vehicle and bankruptcy remote.

- While rated note feeders do not seem to be common in Luxembourg, the Luxembourg market has seen debt commitments utilized either with plain funds (either regulated or unregulated) or via securitization vehicles through Luxembourg law and European Union regulation. With the increase in debt commitments, Luxembourg attorneys would want to make sure they build into the fund documents conversion mechanisms whereby at the election of the lender or general partner during an enforcement scenario the debt commitment would automatically convert to equity.

- Attorneys in the Cayman Islands are seeing an increase in rated note vehicles becoming domesticated in the Cayman Islands due to investor demand. Panelists noted that such choice of domestication requires review and a thorough understanding of both the U.S. Bankruptcy Code and the Cayman Islands Insolvency Laws, and that these two insolvency regimes have fundamental differences.

- Within the U.S. market, attorneys are finding an uptick in requests for hedging mechanics built into the loan agreement governing the subscription line, as lenders are, in certain cases, expecting to provide such services to their borrower client over an outside lender. However, borrowers are pushing back on these requests and sometimes using a legal argument to do so, which is that lenders are prevented (with certain exceptions) from conditioning one financial product on another via the "anti-tying" laws.

- Cayman Islands markets are seeing an increase in private funds registering under the Cayman Islands Private Fund Act, requiring credit agreements to include additional protections, including a condition

[1] Moderated by Jad Nader, Partner at Ogier, the panel included the following: Finn Howie, Counsel at Mourant; Maude Royer, Senior Associate at Loyens & Loeff; Eric Schwitzer, Partner at Paul Hastings; and Jenna Willis, Counsel at Carey Olsen.

precedent that the Cayman entities register under this Act and an ongoing covenant for such entity to maintain its registration status.

- Luxembourg attorneys note that with the development of the Alternative Investment Fund Managers Directive, the number of parties in the fund has been increased and with it the distribution of roles amongst them (GP, alternative investment fund manager, portfolio manager, advisors, custodians and administrators, all being fund parties). This results in an increased focus on confirming the powers delegated to the alternative investment fund manager, including authorizations and powers to issue capital calls, borrowing and granting security, and making sure the right parties on the fund side are involved on a subscription deal.

- Sanctions generally cover any sanction enforceable by the U.S. government, United Nations, the European Union, and His Majesty's Treasury (U.K.). The general mitigants for sanctions risk within subscription facilities include exclusion events, ongoing covenants and events of default. Withdrawal from a fund when an investor becomes subject to sanctions has become a unique issue for Cayman Islands sanction specialists, as there is no general license to force an investor to withdraw from the fund except for extraordinary events and national security interest.

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Governance/Underwriting/Due Diligence[1]

By Monika Sanford, Isabella Shaw and Phong Tran

The "Governance/Underwriting/Due Diligence" panel covered questions relating to the subscription credit facility underwriting and due diligence process from the perspective of lenders and sponsors.

The panel discussed the following questions:

- **When should a sponsor start communicating with lenders?** Sponsors should consider credit facility needs well before the fund creation and fundraising process. Even as early as a year out, sponsors should start communicating with lenders to get a sense of fit. Starting this process early is especially important if the sponsor wants to have the line in place concurrently with the initial investor closing.

- **What are a lender's initial considerations?** Some key considerations for lenders include the fund's investment strategy, utilization needs, and the anticipated investor pool. While lenders will look favorably upon a fund with a large number of highly rated institutional investors, funds comprised of a single investor or significant commitments from high net worth individuals may have a more difficult time identifying interested lenders. Further, lenders will also consider whether the sponsor is looking only for a subscription line or could also be served with other bank products.

- **What initial diligence items do lenders focus on?** Lenders and their counsel will want to receive the limited partnership agreement (the "***LPA***") as soon as possible, along with draft side letters, structure charts and an anticipated initial investor list. Prospective lenders should engage their counsel early and have them review the LPA to ensure it contains the necessary bankable provisions as well as any side letters to identify problematic provisions and mitigating factors. If drafts are provided, lenders and their counsel may be able to propose revisions to smooth out the credit approval process, thereby enabling an otherwise ineligible investor or capital commitment to be included in the borrowing base. Further, reviewing the structure chart is necessary to structure the facility by revealing the applicable jurisdictions, the collateral structure (including whether a cascading pledge structure is needed), and applicable fund vehicles (*e.g.*, parallel funds, blockers, feeders, AIVs, etc.).

  Funds should note that material deviations in the LPA or initial investor pool from what is initially provided to lenders may cause significant delays. If the LPA is amended in a manner that is adverse to lenders or a key investor drops out, the prospective lender's credit approval process could be impacted. Further, if a creditworthy prospective investor subscribes to the fund via a bankruptcy remote vehicle with no obvious credit tie to its parent entity, this will complicate the underwriting process and may require credit linkage documentation. To avoid delays, the fund should promptly notify the lender of any changes to the investor pool or governing documents so issues can be addressed early.

- **What are sponsors' most important considerations when selecting a lender?** Many sponsors have multiple different funds with varying structures, investor pools, and investment strategies. In selecting a

[1] The panelists were Gino De Bernardo, Senior Vice President at Comerica Bank, Mike Henry, Managing Director at U.S. Bank, Joe O'Donnell, Partner at Morrison Foerster, Mary Jo Sanderson, Managing Director at Värde Partners, and Guy Simpson, Head of Equity Fund Resources at Bridge Bank. The panel was moderated by Anthony Pirraglia, Deputy Chair of the Finance Department at Loeb & Loeb LLP.

lender, the fund must ensure that the lender is comfortable with the structure of the applicable fund. While pricing is important, sponsors will also consider other terms, including anticipated utilization, commitment amount, clean down requirements, tenor, and whether the fund is seeking a flat advance rate or an investor-by-investor analysis. Relationships are key to lender selection, including a lenders' existing comfort with the sponsor and the ability of the sponsor to make use of other financial products offered by the bank.

- **What do lenders consider when looking at the investor pool?** Lenders consider a number of factors when reviewing an initial investor list from a sponsor. These factors include the investor pool composition, credit quality of the individual investors, whether there are any potential "problem investors" in the list, and anticipated fund size and percentage of first close in overall fund size. It is easier to underwrite a deal when the initial close makes up 30-40% of the anticipated fund size than if it only makes up 10%. One consideration for lenders when reviewing the investor list is the fund's desired availability at closing. For example, if not enough capital was raised in the first close to meet the fund's needs, a lender may agree not to include concentration limits in the calculation of the borrowing base until the fundraising period is over.

  The panelists also discussed the value to a lender of maintaining internal databases of investors. A database compiling information such as investor names, known side letter issues, jurisdiction of formation, and deals in which they appear can be invaluable to a lender – it permits the lender to spot issues in indicative borrowing bases as well as ensure consistency of investor treatment across deals. It also provides an efficient way to monitor concentration so the lender can ensure that any single investor is not overly concentrated across the bank's portfolio. If a historically creditworthy investor experiences distress in the future (for example, if an investor enters into bankruptcy proceedings or becomes a sanctioned entity), the lender can move quickly to identity impacted facilities and work with funds to solve the issue rather than being caught off guard.

  When maintaining these databases, it is essential to remember that the output is only as good as the input – if information is entered incorrectly or incompletely, the results will be unreliable. If a bank hires a service to aggregate the investor data rather than prepare the database internally, the bank needs to do its due diligence on the service provider as some are significantly more reliable than others.

- **Is there any appetite for facilities to a Separately Managed Account ("SMA")?** An SMA will typically be a fund with only one investor. Despite the inherent risk involved when there is a single investor versus a commingled fund of diverse investors, many banks are open to lending to SMAs. Sponsors have found that interest is generally high if the single investor is a well-known, highly-rated investor. Even for less prominent investors, banks may be interested if they believe the relationship with the sponsor or investor could lead to a broader banking relationship. In particular, SMAs offer an opportunity for a lender to get its foot in the door with a sponsor – the lender may not be able or ready to agent a multi-billion dollar facility to a large commingled fund, but they may be able to agent a smaller facility for an SMA.

  When considering whether to lend to an SMA, banks will first look at the creditworthiness of the investor. Banks typically want to see a highly-rated investor that would qualify as a "rated included investor" in a commingled facility. Additionally, banks will almost always require an investor letter addressed to the agent and in which the investor acknowledges the facility and its obligations to fund capital contributions to repay the facility. The investor letter is a key element of an SMA because it creates direct privity between the investor and the agent and puts the lenders in a stronger position in an enforcement scenario.

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- **How do lenders address sanctions issues that arise with respect to investors?** Sanctions has been an emerging issue in the subscription line market due to the sanctions that were levied against certain private equity investors in connection with the war in Ukraine. While a sanctioned investor can typically be replaced in the secondaries market, the sale process is time consuming and may interfere with the fund's intended plans for using the credit facility or trigger a mandatory prepayment event that requires an untimely capital call on fund investors. Addressing these issues has been a learning process for sponsors and lenders as best practices have started to develop in the market. In response to sanctions issues, loan documents often include provisions that allow the general partner to remove any investor that becomes subject to sanctions. Additionally, one key takeaway from the emergence of the sanctions issues has been the importance of having a great relationship between the sponsor and lenders. It is important for the parties to proactively spot issues as they arise and work efficiently to minimize the impact on the fund's ability to use the subscription facility.

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Market Evolution and Industry Perspectives[1]

By Dylan Glazier, Robin Ladd and Holly Loftis

The primary focus of this panel was to discuss market trends in 2022 and predictions for 2023, and the key take-aways from this panel were as follows:

2022 Market Trends

1. Panelists described 2022 as a tug and pull between "*supply versus demand*" and indicated that capital constraints facing many lenders that have historically been active in the fund finance space have effectively created opportunities for new entrants on the lender side. For those lenders facing capital constraints, many focused on deepening relationships with their existing, known-quantity clients rather than chasing new GP relationships.

2. While there wasn't a noticeable decrease in the demand for subscription financings for newly-launched funds in 2022, a good amount of the financing activity in 2022 was upsizing and syndicating existing facilities. Panelists attributed this shift in activity to the fundraising slowdown. With respect to newly launched funds, GPs are seeking to lock in financing earlier than ever in the fundraising process, which has resulted in short-term bridge facilities where one lender fulfilled a fund's needs early on in a fund's lifecycle prior to effectuating a longer-term financing solution or achieving a successful syndication.

3. Interest in subscription lines from LPs was still present in 2022 notwithstanding the rising interest rate environment, with one panelist noting that some LPs will only invest in a fund if the fund will have a subscription financing in place, as such financings help LPs with timing, spacing and consistency of capital calls.

4. Transparency between borrowers and lenders as well as timing has never been more important for all parties than in 2022. With certain lenders' having reduced capabilities, GPs recognized the importance of reaching out to their existing lender relationships early on to determine which lender, if any, could work with the proposed LP roster or whether the GP needed to continue shopping.

5. In 2022, GPs relied on their flagship products for purposes of fundraising, as LPs indicated a higher comfort level with respect to such strategies and were not necessarily interested in experimentation.

[1] Panelists included Hugh Anderson, Partner at Walker; Julia Kohen, Partner at Simpson Thacher; Greg Myers, Partner at Global Infrastructure Partners; Alexa Schult, Director at First Republic Bank; Lauren Gubkin Stein, Managing Director at J.P. Morgan Private Bank; and Ryan Troiano, Executive Director, Fund Financing at MUFG Investor Services.

2023 Predictions

1. The increase in conference attendees from ~ 900 last year to ~1400 this year is evidence of the market growth year over year, although last year's number may be deceptively lower because some market participants chose to or were not permitted to attend last year's conference for COVID-19 considerations.

2. This year may see a rise in refinancing of existing facilities, along with a heightened focus on how to implement such transactions in an efficient and cost-effective manner.

3. 2023 could see a marked rise in demand for certain "fund finance 2.0" products. One example is that panelists reported a rise in demand for general partner financings in 2022 and indicated that they expect such demand to continue into 2023. Additionally, panelists noted that more and more GPs are looking to put NAV facilities in place for the funds they manage and thus, ensuring that such fund's governing agreements contain proper authority language with maximum flexibility. At least one panelist did note, however, that some LPs have been skeptical of changes to a governing agreement for a fund's latest vintage and that negotiating such language has, in certain instances, resulted in delayed fundraising processes. GPs have had to take extra time to educate those investors on the new language and have tasked their in-house attorneys with fielding such calls.

4. A shift toward fund-level borrowing, as opposed to portfolio company-level borrowing may occur in 2023, due to rising interest rates.

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NAV, Hybrids and Preferred Equity[1]

By LeAnn Chen, Kayla Culver and Eric Worthington

The "NAV, Hybrids and Preferred Equity" panel discussed alternative non-subscription line financing options for funds, with a focus on NAV facilities. The following are a few key takeaways discussed by the panelists:

- The panelists agree that alternatives to a pure subscription line will provide more options and flexibility in structuring financing for funds;

- Such alternatives include NAV facilities secured by the underlying portfolio assets of the fund, hybrid facilities where lenders focus on uncalled capital in addition the portfolio assets and debt-like preferred equity, with NAV facilities currently being the most utilized alternative;

- Although there has been an increase in utilization of NAV facilities, the framework and market for this product are still developing in the fund finance space when compared to subscription line facilities. As an example, NAV facilities tend to be attractive to funds later in their life cycle, when unfunded capital commitments are lower and portfolio investments are generating significant value. While the subscription line market has standardized the inclusion of specific provisions in a fund's partnership agreement relating to usage of a subscription line, many funds are not building in language to allow for structuring of a NAV facility (which provisions could include providing for debt to be incurred following the end of the commitment period or permitting security to be taken over portfolio assets without significant restriction). As a result, implementing a NAV facility may require amendments to the partnership agreement and/or creative drafting in order to structure the facility properly;

- The popularity for NAV facilities is growing, as evidenced by such products being the focus of several panels at the conference, and mentioned to some extent in many others; and

- The panelists expect there to be increased conversations regarding NAV facilities, hybrid facilities and preferred equity products and hope that increased usage of these products in the coming year will help standardize and validate the market.

[1] The panel was moderated by Todd Bundrant, Partner at Mayer Brown and the panelists were Annie Wallis, Partner at Sidley Austin LLP, Jasen Yang, Managing Director of Apollo Global Management, Michael Hacker, Partner and Co-Head of Secondary and Portfolio Finance at AlpInvest Partners, Pierre Drolet, Portfolio Manager of Private Assets at The Canadian Medical Protective Association and Sarah Elliot, Executive Director of Client Coverage at National Australia Bank Limited.

NAV, Hybrids and Preferred Equity: An International Perspective[1]

By Dylan Glazier, Brandon Spleen and Craig Unterberg

The focus of this panel was the current state of NAV facilities in the market and expectations for years to come. What follows is a high-level summary of some key points discussed by the panelists.

- The panel started with a discussion of what constitutes a "NAV" or "net asset value" facility. While a NAV facility is akin to the subscription line, its key feature is that it *looks downstream* to a fund's portfolio investments for purposes of repayment of the facility (vs. *upstream* to uncalled capital of Investors/LPs in the case of a traditional subscription line).

- There are two financial metrics that are generally used to determine the financial health of the fund's investments and the collateral in a NAV facility: (1) the NAV test, which measures the net asset value of the fund's portfolio investments and (2) the LTV (loan to value) test, which, in simple terms, measures the fund's indebtedness against the value of the portfolio assets and indicates how collateralized the loan is at the time of the test. A failure to maintain specified covenant levels will result in an event of default, but credit agreements will often also provide for a tightening of terms in response to an increase in LTV, such as (i) restrictions on a borrower's ability to withdraw funds from collateral bank accounts, (ii) prohibitions on making restricted payments, and (iii) required mandatory prepayments, among others, to provide more protection for the lenders.

- Panelists are starting to see more NAV facilities entered into in tandem with subscription lines, which can result in intercreditor issues depending on how the facilities are structured and balanced. "True hybrid" facilities that utilize the full leverage capabilities of a fund (*upstream and downstream assets*), for collateral and borrowing base purposes, remain unique, but there is potential to see more of them in the coming years. Lenders who can effectively offer true hybrid facilities have significant opportunities to develop long-term relationships with sponsors by virtue of being able to offer financing throughout the term of the fund's lifecycle.

- While true hybrids can provide important benefits for lenders and funds, it can be difficult for the lender to get comfortable committing to an advance rate on portfolio assets at the outset of a fund's investment period without having certainty on the portfolio assets and timing for capital deployment. Additionally, borrowers will tend to gravitate towards traditional subscription lines if available, given their relatively lower pricing. Lenders may also utilize a hybrid facility to increase the advance rate, decrease the pricing or correct for concerns with the investor pool by gaining additional protection through the introduction of additional collateral. In these situations, although the facility is secured by portfolio assets, borrowing base credit will not be given to investments and uncalled capital will remain a lender's primary source of repayment.

- The uptick in NAV facilities to private credit funds secured by a portfolio of loans has been evident. These facilities will typically include heightened focus on eligibility criteria for inclusion in the borrowing base,

[1] Panelists included Juan Campos, Partner at Hg Capital; Bronwen Jones, Partner at Reed Smith; Ed Saunders, Partner at Goodwin Procter LLP; Michael Timms, Investment Director at 17Capital; Daniel Toblib, Vice President, Structuring, Fund Finance at Macquarie Group; and Craig Unterberg, Managing Partner – New York, Haynes and Boone, LLP.

including the jurisdiction of the borrower in the underlying loan, whether loans are currently being amortized or are interest only payments for a certain period, and tenor and type of loan. Additionally, lenders will often impose concentration limits regarding industry sectors, jurisdictions, types of loans and servicers and originators, among others. One key consideration is that lenders want to understand the asset class and composition of the portfolio, which can take some time to diligence and structure.

- The panelists moved on to discuss the development and increased usage of NAV facilities secured by pooled private equity fund assets. The panelists noted that private equity managers have historically utilized these facilities more towards the end of the fund's life cycle if there are restrictions on drawing down on unfunded capital commitments and market conditions that are not optimal for disposing of assets. These facilities provide liquidity to meet portfolio funding requirements, acquire portfolio assets, to the extent permitted by the fund partnership agreement, and make bridge distributions to investors. However, there is an increasing trend where funds will use these facilities earlier in their life cycle during the investment period to make distributions to investors, which can later be recalled.

- Additional facility structures are popping up in the market, including NAV facilities with a more concentrated pool of private equity assets, financing to continuation funds, co-invest facilities and preferred equity. These facilities will typically serve the same general purposes of fulfilling liquidity requirements and in certain situations can be utilized when a fund’s portfolio does not support a traditional NAV facility.

- Typically, in a NAV facility, valuation provisions will be a heavily negotiated point. The credit agreement should clearly provide mechanics for determining the net asset value of the portfolio assets, including the timing and frequency of valuations, when and to what extent valuations may be performed internally by the asset manager as opposed to a third-party appraiser, costs of valuations and conditions under which the lender can challenge a valuation or appoint its own third-party appraiser. Funds will usually push to have their asset manager be primarily responsible for providing the valuations and monitoring of portfolio assets in accordance with their customary practice, while lenders will want to retain rights to seek an independent appraisal in the event there is uncertainty over the valuation or other concerns over the method of valuation or financial health of a portfolio. Ultimately, valuing the portfolio assets is a critical part of underwriting a NAV facility, and a valuation error ought to be seen as a relationship error. Transparency and relationship value play a major role in NAV facilities.

- Projections for 2023 include: (i) an increase in hybrid activity, (ii) continued growth in the NAV industry generally, (iii) increased uniformity and market standards across NAV credit facility documentation, (iv) partnership agreements becoming stronger and better documented to support NAV facilities, and (v) borrowers being more strategic in conversations with lenders by assessing their leverage needs (including, size, tenor and purpose), prior to approaching lenders.

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New Suppliers of Capital in Fund Finance[1]

By Lindsey Hughes and Justin Keller

Large, traditional banks have historically served as the main suppliers of capital in the fund finance market. While these banks continue to dominate the space, particularly with respect to subscription facilities, as demand for capital continues to outpace supply, market participants are increasingly looking to the potential for non-banks—business development companies, private credit funds, insurance companies and pension funds, for example—to step into the gap. This panel focused on these alternative suppliers of capital—their place in the current landscape, their limitations and potential for growth, and the challenges these new lenders are predicted to face as they increasingly seek to participate in the market. What follows is a high-level summary of some the key points discussed by the panelists.

1) Evolution of the Market and Current Landscape. Regulatory capital requirements and a slowdown in the growth of deposits have contributed to a reduction in available capital within traditional banks, causing traditional lenders to pull back and forcing banks to be more selective in deploying capital, which has exacerbated the already high demand from borrowers and makes the potential for non-bank lenders' involvement ever more attractive. The panelists suggested that subscription facilities, however, will likely continue to be largely the domain of traditional bank lenders. In the near term, new banks, especially smaller, regional banks, will continue to enter the market and grow their capabilities, and established non-U.S. banks will likely continue to grow their market share. Non-bank lenders have had limited appetite for participation in subscription facilities due to typically lower pricing, but there has been increased participation by non-banks in other liquidity solutions in the space, including NAV and GP lines and collateralized fund obligations.

2) Buffet of Choice. The uptick in additional banks and non-bank lenders entering the market has created a "buffet of choice" for sponsors. Lenders' competition for market share is resulting in an evolution of product offerings and the need for greater flexibility from credit providers, with sponsors able to entertain different options in line with their respective strategies. This buffet of choice will continue to drive an increased diversity of credit products, flexibility, and competitive pricing.

3) Flexibility. While many of the non-bank lenders and smaller banks entering the space may have the ability to be more flexible and creative in structuring certain aspects of a facility than the larger banks that have traditionally supplied capital to the fund finance market, they will have operational challenges to overcome. For example, non-banks are likely to demonstrate greater flexibility with respect to features like facility tenors, advance rates, and concentration limits but may struggle to provide optionality with respect to certain operational features like availability of alternative currencies, letters of credit, same-day funding, and other borrowing mechanics.

4) Role of Ratings in an Evolving Market. The panelists emphasized the importance of ratings as a factor in increasing the availability of capital in the fund finance space. In addition to generally validating the market and helping to prove its strength to regulators, ratings permit better capital treatment for banks subject to

[1] The panelists were Ana Arsov, Managing Director, Global Co-Head, Banking at Moody's Investor Services, Mike Durnin, Principal at Ares Management, Greg Fayvilevich, Head of Global, Funds Group at Fitch Ratings, Ron Franklin, Partner at Proskauer, Marc Silva, Global Head, Private Equity Subscription & Partner Finance at UBS, and Sherri Snelson, Partner at White & Case.

such regulations (thereby freeing up capital), and they enhance the marketability of these facilities to a broader segment of participants (which increases the pool of potential lenders).

5) Regulatory Challenges. Regulations continue to pose a challenge to increasing the availability of capital in the fund finance market, for both banks and non-banks alike. The risk-based capital treatment for subscription facilities, for instance, remains more conservative than it likely needs to be based on the product's track record, which includes only a few instances of fraud and very limited investor defaults. However, the dearth of material defaults and lack of loan loss history cuts both ways. Bank regulators remain focused on prudential and systemic risk and continue to scrutinize G-SIBs' exposure to leveraged finance, and without this loan loss history, it is difficult to know the potential scope of loss or the systemic implications thereof, which leads to more conservative accounting treatment. With respect to non-bank lenders, the NAIC continues to scrutinize insurance companies' involvement in rated-note feeders, collateralized fund obligations and other structures aimed to deliver regulatory capital relief to these companies. The panelists expressed hope that as regulators' views become more settled, the increased certainty will result in a more robust market.

6) Securitization. During the question-and-answer period, the panelists noted that securitization could provide another potential source of capital in the fund finance market, but it faces significant challenges in the near term. Specifically, the bespoke nature and variability across facilities, lack of ratings, and low pricing are a few of the immediately salient practical barriers to development in this area. There would need to be significant resources dedicated to developing the model in this context and getting participants comfortable with the added complexity.

7) Predictions for the Future. The panelists acknowledged that the industry would continue to face certain headwinds in 2023, including rising interest rates and both geopolitical and economic uncertainty; however, across the board, the panelists expressed general optimism for the future of fund finance and the alternative asset class generally. The consensus seemed to be an expectation that while the fund finance market may not see much additional growth compared to recent years, it is unlikely that we will see a significant withdrawal of lenders in the space. Rather, near-term challenges will cause lenders to place an even greater emphasis on maintaining relationships with sponsors.

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Secondaries & Continuations[1]

By CJ Donald, Javier Martinez and Mark Nesdill

The panelists on the "Secondaries and Continuations" panel provided an update on the market, context on recent valuations and fundraising, and predictions for the future of the market. What follows is a summary of key insights discussed by the panelists.

1) Recent History and the Current Landscape.

- In describing the past few years of the private equity secondary market, the panelists explained that the Coronavirus pandemic accelerated the demand for liquidity. Compared to 2020, 2021 was a year of major growth with a record volume of $132 billion. 2022 was the second biggest year on record at $108 billion, but secondaries did not cash flow like they were expected to, especially in the fourth quarter.

- Activity and demand have increased. Panelists noted inquiries coming from new market participants, increased interest in sponsors helping investors manage liquidity. Although there was a decrease in deal flow in the fourth quarter of 2022, it has stabilized and is expected to increase.

- Loan to value ratios were generally stable, ranging from 25-50%, with less diversified pools of assets receiving lower LTVs.

- Pricing increased, especially in the fourth quarter of 2022, even though pricing is still not consistent due to variations in structure and investor mix, but pricing has started to stabilize after the latest increases.

- Historically, banks were the exclusive lenders in the secondaries market. Recently, banks' balance sheets have not increased as expected. Consequently, insurance companies have served as lenders and private equity funds are providing secondary funding on mezzanine financings at higher-than-expected prices. However, insurance companies are more reactive than banks and the expectation is they will move to other products if pricing becomes less attractive.

- At the fund level, NAV financing is being used for cash management, strategic investments, to over-invest until fundraising is complete and for dividend recapitalizations.

- At the acquisition level, NAV financing is being used to acquire larger pools of assets or entire portfolios.

[1] Panelists included Max Forton, Head of Trading of Fund Finance & Solutions, Americas at Nomura, Brian Foster, Partner at Cadwalader, Wickersham & Taft, Martins Marnaunza, Partner at Coller Capital, Ray Meyer, Managing Director, Head of Fund Finance Advisory & Origination at Natixis Corporate & Investment Banking Americas, Linda Rowland, Managing Director, Secondaries Group at Ares Management, and Darren Schluter, Managing Director at PJT Partners.

2) Valuations of Investments

- The panelists all follow private investor holdings and the public equity markets closely to draw price comparisons and review actual cash flows over time.
- Valuations may not have decreased the same way public markets did due to the nature of the asset, with one panelist comparing valuation multiples as more analogous to smaller cap stocks and another noting that many sponsors used hedges to offset the impact of higher interest rates (although as hedges expire, cash flows and, therefore, valuations will be impacted).
- The panelists agreed that there is no consensus on valuation methods, but the key statistic is the price at which the portfolio companies are actually sold.
- Private market valuations could be 10-15% lower than what sponsors say they are, and lenders pay attention to what investors pay on the secondary market. Currently, secondaries are trading at 80% for large buyout funds.

3) Trends

- Increased demand for NAV facilities as fundraising bottlenecks create opportunities to continue holding assets.
- Increased demand for GP/management company facilities to allow for earlier distributions.
- The panelists explained that the use of a deferred purchase price can impact deal flow and allows funds to achieve their target price for an asset. Financings would be used at the end of a deferred purchase price period.
- Currently, the biggest issue for limited partners is liquidity, so a deferred purchase price is useful because it lets limited partners retain cash until the purchase price becomes due. The panelists predicted that over the next twelve to eighteen months, the deferred purchase price mechanism will be used more than ever before.

4) Hot Topic in 2023: Credit Secondaries

- Historically, there was no critical mass of private credit in the secondaries market, but limited partners are starting to increase liquidity by using private credit.
- Secondaries are already a diverse asset class so banks and non-bank lenders are analyzing how new debt would be additive.
- Because secondaries are generally expensive, they are challenging to invest in and costly to finance, so the primary challenge for credit providers will be figuring out how to lower costs to make the credit worthwhile.

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Subscription Finance Hot Topics[1]

By Todd Cubbage, Maria Parker and Mei Zhang

The Subscription Finance Hot Topics panel addressed three main topics: industry demand, bank capacity and how different fund credit profiles may affect bank capacity.

Here are some of the key takeaways from the panelists:

- Despite rising prices and current economic conditions, there continues to be a healthy demand for subscription credit facilities and the alternative fund finance products market continues to grow. Some of the panelists predicted that NAV facility growth will outpace that of subscription facilities.

- When asked whether rising interest rates has had an impact on subscription facility usage, most panelists noted that usage had not been affected and remained quite high. Some predicted that utilization will eventually be impacted but that no trends had been noted to date. It was also noted that higher interest rates could have a bigger impact on NAV facilities, given the pricing disparity between such facilities and subscription lines.

    - What could affect bank lending capacity generally? Regulatory capital considerations, market growth, individual lender industry portfolio capacity and individual sponsor limits. However, panelists noted that currently, they had not perceived any visible market-wide capacity issues.

- If there are capacity issues in the future with respect to fund finance lending (due to regulatory considerations, internal lending limits or otherwise), panelists felt confident that smaller banks, foreign banks and non-bank lenders (*e.g.*, private debt funds, direct lenders and insurance companies) will continue to enter the market to satisfy demand. This has certainly been the case for NAV facilities where non-bank lenders are interested in higher yield investments. It was also noted that obtaining ratings for subscription facilities can positively impact capital treatment and help unlock additional capacity.

- In determining whether to extend existing facilities, refinance existing facilities that were previously with other lenders or enter into new facilities, banks will consider prior credit facility usage (it was noted that above 60% utilization is ideal) and the depth and scope of the relationship with the fund manager.

- The broader relationships that banks have with fund managers are currently, and will continue to be, the primary driver with respect to the decision of whether to extend credit (*i.e.*, are there multiple economic touch points and revenue streams?).

- Fund managers are trying to tap into the retail investor base as a source of capital growth. It will be interesting to see how this plays out in the next couple of years and the potential for growth.

[1] The panel consisted of Tom D’Orsi, Senior Vice President & Head of Treasury at Bain Capital, Alex Lambiotte, Global Head of Fund Finance – Solutions Engineering at Allvue Systems, Taylor Trotter, Director at Citizens Bank, Michelle Khalili Yuhas, Managing Director at PNC Capital Markets and Charles Inkeles, Head of U.S. Fund Finance at ICBC and was moderated by Peter Nealon, Executive Director at ANZ.

- In determining whether to include high net worth individuals, retail investors and fund-of-funds investors in borrowing bases, banks look for, among other things, transparency with respect to the underlying investors, investor pool characteristics (*i.e.*, the more diversification, the better), overcall ability, discretion of fund manager to take action to permit the investor to fund (*i.e.*, to sell public equity), liquidity from secondaries market and prefunding requirements. There was an expressed preference for “accredited investors” compared to “qualified purchasers”, which are regulatory designations related to certain income, net worth or licensure criteria. Such designations allow investors to access certain private market investment opportunities that are not available to many retail investors.

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Syndications Update[1]

By Kayla Culver, Isabella Shaw and Ellen G. McGinnis

The focus of this panel was the current state of the syndication market for subscription line facilities and anticipated trends for the coming year. What follows is a high-level summary of some key points discussed by the panelists.

2022 Recap

2022 proved to be a dynamic year for syndications across the fund finance market, with record deal volume and increased deal sizes. Many deals were oversubscribed as a number of new participants entered the fund finance space. In the first half of the year, pricing remained relatively stable.

However, the second half of the year brought more instability due to a number of externalities – the global economy, the war in Ukraine, fears of a recession, revisions to capital requirements, the strength of the US Dollar (making it more expensive for non-US banks to lend in Dollars), and inflation and rising interest rates.

Factors specific to the fund finance market also had an impact in the second half of 2022. Longer deal tenors for facilities closed in prior years had a compounding effect - in 2022 many lenders had significant capital allocated to older facilities, which contributed to the capital constraint and supply side issues experienced by several lenders. Additionally, the robust market in the first half of the year meant lenders reached capital allocations earlier in 2022 than in prior years. To navigate these allocation issues, the second half of the year saw new trends arise such as shorter deal tenors (typically limited to one year), higher pricing, and smaller lender commitments. Several panelists noted that it is also taking longer to close facilities. All of these factors have led to a strong focus on relationship lending over opportunistic book-building.

As many lenders are unwilling or unable to take the sole underwriting risk for the large facility sizes being requested, syndication remains a strong focus in the industry. However, the turbulent conditions in 2022 spurred lenders and sponsors to search for creative solutions during the syndication process. Bridge structures and temporary increase provisions have been used to meet funding needs while agenting lenders seek syndicate partners. These types of structures will often come with increased pricing as well as automatic reductions if not syndicated within a set period of time. New lenders have also entered the space – smaller banks and non-bank lenders who might previously have been overlooked for syndicate groups have been increasingly able to participate.

Looking Ahead to 2023

The consensus was that the syndication market will likely remain "choppy" in 2023. Panelists expect funds to continue to see longer fundraising timelines and a slower pace of fund investments, which may lead to delays in closing and syndicating transactions as well as challenges in attracting syndicate lenders. Additionally, with lender balance sheet constraints, it is taking longer to find lenders to participate in a syndicate group. Panelists noted

[1] Panelists include Nancy Becker (Managing Director and Head of Loan Syndications for the Fund Finance Group at Wells Fargo), Dipti Goel (Managing Director within Loan Syndications at City National Bank), Stanley Likver (Principal Global Solutions Group at Ares Management), Cecilia Luk (Head of Fund Finance Syndication at Sumitomo Mitsui Trust Bank), and Tom Nowak (Managing Director - Syndicated Finance Group at BofA Securities, Inc.). The panel was moderated by Shana Ramirez (Partner at Katten Muchin Rosenman LLP).

that despite increasing fund sizes, they expect deal sizes to remain fairly constant as lenders may not have sufficient capital to offer larger funding commitments.

Shorter tenors are also anticipated to remain for the time being. Longer deals are harder and more expensive for banks to offer, so sponsors need to be mindful of their true financing needs. Three- or four-year facilities may be available with the right group of lenders, but they will be expensive and harder to arrange.

Lenders will also have to continue making the case internally for capital deployment to subscription lines and chosen sponsors. Therefore, relationship development remains extremely important for sponsors. If participation in a facility is unlikely to yield more business for a syndicate lender, that lender may be less willing to extend or increase their commitment, especially if facility usage is low. Exiting a facility frees up capital for other opportunities, so staying in a deal needs to provide sufficient value to syndicate lenders.

Additional Lender Considerations When Determining Whether to Join a Syndicate

Pricing and utilization remain key considerations when evaluating new transactions, but syndicate lenders will also focus on other factors such as the investor pool, proposed advance rates, AUM (assets under management) and other indicators of fund financial health, and opportunities for ancillary banking products (including asset-level loans and deposit accounts).

While sponsors and agents are interested in partnering with lenders that are new to the fund finance space, new participants often present an intensive undertaking for syndication desks. New entrants require significant education on the product and the diligence and documentation process. Additionally, new entrants are typically only comfortable with smaller commitment amounts initially. Ultimately, sponsors and agents are focused on relationships and in finding lending partners who are committed to the relationship for the long term.

Key Takeaways for Syndicating Deals

With the above factors in mind, it is essential that sponsors focus on what they really need in terms of facility size and tenor. A smaller, highly-utilized line with a one-year tenor will be easier to sell to lenders as it will take up less capital and present less risk on rate movements given the shorter maturity. Sponsors should take the time to assess their financing needs and how they intend to use the facility early on so they can be best positioned to attract desired lenders.

Panelists also noted that the days of sponsors sitting back and waiting for the agent to syndicate the deal are over – it is vital for sponsors to have good relationships with banks and have a good understanding of what syndicate lenders need and expect. Additionally, sponsors should be aware that as supply tightens, lenders may start to roll back some of the more borrower friendly provisions from the past few years. These include provisions such as alternative currencies, multiple jurisdictions and complex structures, and large letter of credit sublimits. Over-negotiated documents that are very borrower-friendly may impair or delay syndication, as lenders are being more selective in which deals to join. A credit agreement that is more in line with market terms will be easier to syndicate and lenders may be more willing to provide larger commitments.

Sponsors should also be prepared for larger syndicates with smaller commitment sizes. A large syndicate has benefits and drawbacks – though harder to manage from an agent and fund perspective, it is also easier to replace capital if a lender departs.

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Perhaps the most important takeaway is that sponsors should start the syndication process early. Finding the right lenders will take time; bank committees are more involved than they were previously, and the syndication process is taking longer. This is particularly important if syndicate lenders are new entrants into the space. New subscription lenders will typically take longer to complete their review processes and their policies may change regularly. While new market entrants present great opportunity for syndicate growth it will come with some growing pains.

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The Evolving Lender Landscape & Impacts on Balance Sheet Management[1]

By CJ Donald Justin Keller and Laura Whitley

In describing the early days of the fund finance market, the panelists painted a picture of a small market dominated by a handful of large bank lenders pooling together in club deals to provide a novel product to pioneering fund sponsors who recognized the opportunities attendant in leveraging the uncalled capital commitments of investors in their funds. These lenders did not have centralized fund finance teams and were focused on the yield generated by any given credit facility rather than ongoing relationships with fund sponsors. In the years that followed, and especially following the global financial crisis, a flood of new lenders entered the space and the original product—the subscription line or capital call facility—has become nearly ubiquitous, and other products have been and continue to be developed to satisfy diverse capital and liquidity needs in a market that has exploded in size and scope. Against this backdrop, the panelists discussed the continued evolution of the market, the challenges faced by fund sponsors and lenders today, and the potential avenues for growth given the constraints faced by current market participants. Below are the key insights discussed by the panelists:

1) Defining Features of the Current Landscape.

- Over the last decade, the alternative asset class has exploded, with fund sponsors raising tremendous amounts of capital for their private investment vehicles. Subscription facilities have come to be expected, and demand for these facilities regularly outpaces supply.
- The increase in lenders in the space has, not surprisingly, brought with it an increase in competition amongst lenders and the development of additional credit products (e.g., NAV lines, GP co-invest lines, CFOs, etc.) to finance different pieces of the fund ecosystem at different times of a fund's life. Lenders have developed centralized fund finance teams that focus on the overall relationship with their sponsor clients and ancillary business opportunities on both sides.
- It is difficult for lenders to offer all types of fund finance products and typically they will need to specialize. Sponsors know this and work to stay abreast of lenders' specialties.
- While historically providers of capital in the fund finance market have been banks, challenges facing banks today have given rise to an increased interest by sponsors in seeking participation from non-bank lenders and other alternative sources of capital.

[1] The panelists were Steven J. Colombo, Managing Director at Goldman Sachs Asset Management, Missy Dolski, Global Head of Capital Markets at Värde Partners, Vicky Du, Global Head of Fund Finance at Standard Chartered, Steven Kahn, Senior Managing Director at Assured Guaranty, Michael Orphanides, Managing Director at BMO Capital Markets, and Laurie Lawler, Managing Director, Head of Capital Call Financing, and Deputy Head of FI Origination at Société Générale.

2) Current Challenges Facing Banks & Impact on Fund Finance Market.

- A tightening of the credit market has led to internal competition within banks for space on the balance sheet.

- Regulatory capital treatment and evolving bank regulations have also contributed to increased funding costs. Third party insurance can help with regulatory capital management and free up additional capital, but every institution's needs differ.

- Many banks are facing resource constraints, generally, and these constraints are contributing to longer timelines to get deals done. For example, fund finance teams in some financial institutions are not large enough to support deal flow and ongoing maintenance of existing deals, which is contributing to lenders being more selective, since they do not have capacity.

- Banks have competing priorities: abiding by capital requirements, managing balance sheets, and servicing existing clients. Consequently, fund finance teams must constantly prove internally that they can effectively distribute capital. Fund finance teams are also being asked to help generate interest in other bank products.

3) Non-Bank Lenders and Alternative Sources of Capital (Fund Finance 3.0?).

- As discussed earlier in the panel, with the diminished supply of capital available from banks, there has been renewed interest in participation by non-bank lenders.

- Banks remain the dominant capital providers in the fund finance market, but it is early, and it was suggested that, as has been the case in other asset classes, non-banks (e.g., BDCs, insurance companies, private credit funds, and pension funds) will increasingly find ways to enter the market and drive borrowing costs down. Particularly, regulatory capital relief trades could be a factor as more sponsors get comfortable with how these transactions work.

- The panelists discussed the potential for a capital markets solution to help meet the financing demand (which they christened "Fund Finance 3.0") but the consensus among panelists seemed to be that there are many hurdles to overcome for any such solution to be realized.

- Among the challenges involved in making Fund Finance 3.0 a reality, the panelists discussed the difficulties of securitization in the context of bespoke, non-standardized documentation, the legal distinctions between securities and loans and the scope of disclosure that would need to be made in the securities context, and the economic reality that current pricing of most subscription facilities would not support securitization.

- The panelists considered whether having subscription credit facilities rated could help attract non-bank lenders to subscription credit facilities. The panelists agreed that subscription credit facilities should not be rated unless such a rating would improve pricing or improve sponsors' ability to raise more capital.

- The panelists noted that for a capital markets-based solution to become a reality in this space, it would require leadership from an existing lender or lenders who understand the scope of the product and how the various funding solutions are intended to work together.

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Titans in Finance – The Rise of Private Debt[1]

By Kinne Manente and Phong Tran

This panel focused on the current state of the private debt market and covered a broad range of topics. Here are some key takeaways:

- The private debt market has exploded over recent years due to the following:
    - A pivotal point for successful private creditors was an early recognition that they needed to invest heavily in their teams and technology. Building out well rounded teams and investing in the infrastructure to manage all aspects of these relationships requires heavy input on the front end.
    - Diversifying investment structures to more readily access different markets. The panelists discussed how the original GP/LP structure does not fit the entire market, and exploring structural modifications has paved the way for BDCs, CLOs, SMAs and other fund structures to bridge this gap.
    - The perpetual structure of debt funds and diverse product offerings have opened up entire market segments and expanded existing segments, taking market share from the syndicated loan market. In 2022, this has significantly expanded in light of the syndicated loan market drying up due to balance sheet constraints and the high interest environment.
    - Investors are diversifying their portfolios and specifically allocating capital for private credit opportunities and doing so at significant scale.
- The largest private credit managers have increased their scale and diversity of offerings, making them more akin in the marketplace to the largest banks of 20 years ago. While the largest players used to enter transactions at approximately $100MM, the price of entry is trending up and now may require participation in the $300M to $500MM range.
- From a broader market perspective, the panelists noted that the significant rise in interest costs have created a challenging dynamic for companies. They expect collateral damage to many companies and foresee a choppy economic climate over the next 12 to 24 months. On a more positive note, however, the panel sees a difference from the great financial crisis, in that there is a significant amount of dry powder in the private equity market to deliver capital to companies in need.
- As lenders, private credit managers are underwriting with the expectation of a recession. Although they anticipate bad eggs must lie within existing portfolios, they noted that major market participants have yet to acknowledge underperforming assets. On the contrary, their portfolio of companies has seen significant growth year over year, with revenues up over 36% and EBITDA up over 20% on average. They expect this growth to continue as only non-troubled assets have a reasonable expectation of obtaining credit.

[1] Moderated by Jocelyn Hirsch, Partner at Kirkland & Ellis LLP, and Nick Mitra, Managing Director at Société Générale, the panel was made up of the following titans: Jonathan Bock, Senior Managing Director at Blackstone Credit, Ken Kencel, President and CEO at Churchill Asset Management, and Art Penn, Founder and Managing Partner of PennantPark Investment Advisers.

Accordingly, from the panelists' perspective, this is a great time to enter into transactions and be more selective on how they want to deploy their capital. With less competition from the syndicated loan market, yields from private credit instruments have doubled in recent years and it is easier to obtain better terms and covenants. For those portfolio companies that are struggling, it appears that sponsors are willing to sit tight and pay additional costs to presumably refinance once rates come down.

- Private credit managers are focusing lending efforts on companies with lower leverage as they anticipate the Federal Reserve will continue taking a hawkish position until inflation is under control. The panel optimistically anticipates the rise of interest rates to moderate over the coming months, though it will require the Federal Reserve striking a delicate balance. Notably, the SOFR curve suggests interest rates will come down in late 2023/early 2024.

- Looking to the future, the panelists see this as an expanding market with new horizons to explore. An area of keen interest is the democratization of private credit from institutional investors to high-net-worth wealth investors, as they see this as a significant driver in the private credit market going forward. In the short term, the biggest challenge for investors will be obtaining enough capital to invest now, as the panelists anticipate this will be an excellent vintage.

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