EXPERT COMMENTARY

The global fund finance industry will continue to grow to keep up with the demand from fund sponsors for liquidity solutions, say Haynes Boone's Albert Tan, Aleksandra Kopec and Brent Shultz



The future of fund finance

As an asset class, private capital has experienced exponential growth in the past few decades, more than doubling its assets under management from less than $10 trillion globally in 2012 to more than $24 trillion in 2022. The fund finance industry has grown alongside it, starting from a nascent product in the late 1980s to an almost universal part in every fund's capital structure today.

Fund sponsors now routinely include 'bankable provisions' for subscription line facility lenders in fund documents as anticipation for the use of this product by each of their funds, and are increasingly adding flexibility to expressly pledge their assets for use in net asset value (NAV) facilities.

Latest estimates put the global fund finance industry at more than $1 trillion. Many leading lenders in the space are operating at their maximum internal capital allocation. Nevertheless, they want to continue to maintain and expand their relationships with key sponsors. To that end, these institutions are turning to structured finance tools to reduce their capital reserve requirements, including credit facility ratings, conduit lending structures, securitizations, silent participations and capital relief trades.

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Several leading rating agencies have expanded the scope of finance products they rate to include subscription line facilities, collateralized fund obligations and NAV financings. Once a predominantly European concept, ratings have been gaining ground in North America, with public and private ratings being requested by both borrowers and lenders. This trend is an attempt to attract different lenders, allow for higher holds from syndicate members due to enhanced capital treatment and offer more competitive pricing and terms.

Securitizations, capital relief trades and other capital market solutions are being explored by banks to help alleviate capital reserve requirement constraints. Early users of these tools are facing difficulties securitizing portfolios of facilities in an industry with private and bespoke terms, but as the pressure for solutions offering capital relief increases, the industry may begin to coalesce around a set of standardized terms that allows these capital market solutions to flourish.

Finally, a somewhat recent development in the industry has been the introduction of various non-bank lenders, primarily insurance companies. This has come with its own set of challenges, including the need to structure some deals with term and revolver components or include USD and alternative currency tranche lenders. But it has also come with opportunities to syndicate deals to a much broader pool of institutions.

NAV financings

The growth in NAV financings reminds market participants of the early stages of subscription line facilities. Many of the same criticisms once levied against subscription line facilities (which are now an industry-wide accepted and beneficial leverage and cash management tool) are being raised with respect to NAV financings. Despite all the criticisms, there has been growth on both the supply and demand side for NAV financings, with lenders and borrowers highlighting the legitimate uses and trying to educate LPs, rating agencies, regulators and others on the benefits of this form of leverage.

More than 70 percent of sponsors and lenders at NAVember (an annual NAV-focused event hosted by Haynes Boone) expected growth in their NAV financings portfolio in 2024. Lenders that offer this product include traditional subscription line lenders expanding into NAV financings, but also specialized non-bank lenders, offering flexible and tailored terms and structures.

Interest rate environment

Rising interest rates and higher pricing has been one of the most significant changes in the fund finance market in recent years. Our data shows that pricing has largely stabilized over the last two quarters, after adjusting for the anticipated regulations surrounding the capital reserve requirements that banks must hold for these products and some of the supply side issues caused by regional bank failures in 2023. While rates and pricing have increased at a much faster rate than prior business cycles, it's important to note that current rates are not unprecedented, and markets have weathered high rates in the past and continue to do so.

Funds are still actively utilizing the product, with industry surveys from H1 2024 indicating that 81 percent of PE funds are maintaining the use of their subscription line facilities notwithstanding the higher interest rate environment and, as of September 2023, more than 95 percent of private capital funds have access to subscription credit facilities. A survey by Haynes Boone of 120 sponsors, lenders and other fund finance market participants found that 74 percent of institutions are expecting some level of growth in their fund finance exposure in 2024, with 63 percent expecting an overall increase in the fund finance market in 2024.

And even if pricing does not return to the lower levels seen in the past decade, subscription line financings still provide certainty and flexibility of funding, quick access to liquidity and reduce the administrative burden. With higher rates, funds are more judicious on the sizes of their facilities and increasing/decreasing the size to better match their predicted needs, and also on the tenor of outstanding borrowings.

Geographic expansion

The fund finance industry is well established in North America and Europe, with the Fund Finance Association hosting its 13th and eighth annual symposium in these respective geographies. Additionally, the Asia-Pacific region has been an area of recent growth, both domestically in APAC, but also with regional lenders entering the European and North American markets. This year, there was enough interest and participation in the Japanese market for FFA to launch a separate fund finance conference focused on Japanese sponsors, lenders and investors, and a discussion on some of the nuances and market practices in Japan – in addition to FFA hosting its sixth annual Asia-Pacific symposium in Singapore.

With the continued expansion of private capital and renewed fundraising efforts on specific types of investors and new geographies, fund finance lenders are adapting to the regional needs of private capital firms and the shifting supply and demand of financing in different regions, while law firms are expanding and gaining expertise across various jurisdictions as a response to the increased diversification of investor jurisdictions that funds are exploring. ■

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Artificial intelligence

Artificial intelligence is poised to disrupt almost all industries and markets, and the private capital, banking and legal industries are no exception

In the coming years, funds will develop AI tools to analyze potential deals and suggest optimal leverage levels/techniques and employ AI strategies to add value to existing portfolio companies. Lenders will utilize AI to assist with diligence and underwriting, monitor portfolio exposure and run risk assessments. Lawyers and law firms will use AI to assist with due diligence, drafting and negotiating documents, reviewing large volumes of data, and more readily identify market trends. Although AI cannot replace the judgment, experience, common sense and analytical capabilities of our industry's experts, it will continue to be a tool to enhance those capabilities and become more accurate, efficient and productive.