KEYNOTE INTERVIEW

The rise of securitization in fund finance



The proliferation of rated note feeders and CFOs is bringing new capital to the market, say Haynes Boone's Albert Tan, Perry Hicks and Greg Cioffi

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Q Are we currently experiencing an oversupply of subscription finance capital?

Albert Tan: We represent over 90 financial institutions ranging from tier one US banks to international banks. Through that lens, the market is certainly competitive. At the same time, however, many lenders are extremely disciplined in terms of who they are prepared to lend to.

The volume of our clients' deal activities comes from the top-tier, private fund sponsors with multi-strategy product lines that span private equity, real estate, infrastructure and credit across North America, Europe and Asia. There is strong competition to lend to these fund sponsors because of all the ancillary business that it can generate for the lending banks. Market dynamics are notably different in the mid-market where lending appetite tends to be more discerning.

Q How would you describe demand and supply side dynamics in NAV finance?

Perry Hicks: The dynamics favor growth in the NAV space. Private equity firms continue to face a challenging exit market, which generates demand for NAV facilities. Private investment firms can use proceeds from NAV facilities to provide an alternative liquidity source in place of traditional investment exit strategies (such as M&As), allowing funds to avoid selling assets during periods of volatility. Interestingly, some of the attention on anticipated and future high-profile IPO activity may provide additional near-term support for NAV facilities.

Private equity firms and other investors are sitting on significant preferred share equity. These investors will want to realize the full value of their investment through the IPO but may face liquidity constraints, especially if there are lock-up arrangements. Given the high valuation of some of these IPOs, there could be a significant appetite for NAV facilities that can monetize the value of such investments for private investment firms.

That monetization process can require some advance planning to address potential transfer and pledge restrictions, as well as liquidity issues. However, the expected IPO activity is just one factor likely to lead to an uptick in activity in the NAV market.

Q What evolutions are you seeing in sub-line facilities and securitizations?

Greg Cioffi: We're seeing developments in UK banks that can achieve better regulatory capital treatment if a NAV facility constitutes securitization under UK securitization rules. Securitization and fund finance is a hot topic in the US and UK. Fund finance-related securitization can take different forms, including rated note feeders, CFOs and rated NAV and sub-line facilities.

In addition, an area of particular interest is the securitization of subscription line loans. Goldman Sachs introduced the first of these securitizations a few years back. We are currently working with a number of clients on the next step in the evolution of this type of securitization.

The rated note feeder market is also evolving rapidly. A few years ago, insurance companies who sought better regulatory capital treatment for their private funds investments through rated note feeders were limited to acquiring "vertical strips," which are proportionate percentages of all classes of notes of the rated note feeders capital structure. This also meant that such noteholders could only sell their notes in the secondary market. That has now changed.

Most rated note feeder issuances are issued on a "horizontal" basis. This means that investors can acquire any portion of notes of any class in the capital stack. This has helped to broaden the investor base for these notes.

We are also seeing a lot of innovation in enhanced ratings on these rated note feeders. Historically, they were capped at a single "A" rating, but we are now working on a number of AA/AAA structures with enhanced ratings.

Q Are securitization trends positive for the market, or do they introduce added risk?

GC: If properly structured, all you are doing is bifurcating an exposure to a private equity fund through a rated note feeder or CFO note. I view this as positive for the market.

A couple of years ago, this market was dominated by insurance companies; now there is a real mix of international banks, private funds and family offices investing in these structures. The fact that with the purchase of horizontal issuance, investors can now tailor their investments to their desired risk-reward profile is opening up a huge amount of additional capital.

Q What impact is current macroeconomic and geopolitical volatility having on the fund finance market?

AT: We are seeing opportunities amidst the volatility. In the aftermath of war breaking out in the Middle East, there was a sense that the regional SWF investors may pause or withdraw commitments to private fund sponsors.

What we have seen instead is a noticeable increase in SMAs being established for these SWF investors by some of the top-tier private fund sponsors, and our lending bank clients are capitalizing on meeting such increased demand in terms of arranging subscription financings for these SMA vehicles.

Q What does the future hold for the different fund finance product lines?

PH: I think current market forces will continue to challenge exit markets, and adoption rates for NAV facilities will continue to expand, particularly with respect to private equity funds. Lender supply for these facilities is more limited than in the sub-line space, creating opportunities for market participants who execute these facilities efficiently.

GC: There are growing pains as securitization techniques are more broadly utilized. Sub-line lenders are being asked to include rated note feeders and CFOs in the borrowing base computations. This requires lenders to understand the securitization technologies and associated bankruptcy risk.

When rated note feeders and CFOs are structured as bankruptcy-remote special purpose entities, the bankruptcy risk is minimal. For example, rating agencies have factored this in when rating ABS securitization transactions and found that this risk is consistent with the "AAA" investments risk. But, some lenders are reluctant to embrace bankruptcy-remote structures.

Rated note feeders are structured in such divergent ways, under differing documentation, that it can be confusing for market participants. We've seen many forms of documents utilized in the rated note feeder market. Some facilities are secured using bankruptcy-remote special purpose issues, while others are unsecured and do not utilize a bankruptcy-remote issuer. However, more uniformity will emerge over time. In fact, it has already started to happen.

AT: We have been in the subscription finance market for over three decades. Subscription finance has come through each economic cycle and is now so widely used by sponsors that it comes with a great deal of consistency and resilience. We anticipate that to continue but with more competition.

The key question is the impact that the Fed holding rates, or even bumping them up, will have on economics of fund finance. Pricing has clearly been compressed over the past couple of years, but it remains to be seen how much correlation there will prove to be between the available supply and sponsor demand should we see further interest rate movements. ■

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