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Innovation in Fund Finance 2022

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The fund finance market has grown rapidly in recent years with more and more funds looking to generate higher returns for their investors using subscription line financing and other types of fund finance products. This, coupled with demand competing with supply, means 2022 is likely to be a year of further growth and strategic innovation.

Market Update

In the height of the COVID-19 pandemic, some banks (temporarily) pressed pause on new transactions and instead focused on supporting existing relationships with a view to reducing balance sheet risk and addressing liquidity concerns. The capital adequacy requirements which were put in place after the 2008 great financial crisis were posing an unwanted restriction in the face of keeping otherwise viable industries afloat during unprecedented times of lockdown. On the fund side, larger fund groups indicated that they were encouraging their portfolio companies to fully draw their revolving credit lines, in anticipation of a ‘liquidity gap’. Whilst the temporary suspension of bank lending subsided, the appetite for debt didn’t. This appetite has been spurned on since by the investment opportunities that the pandemic created, and also by the continued steady pace of fundraising as investors didn’t cease looking for returns. The last couple of years have therefore highlighted an inevitable part of the debt cycle; increased demand for debt with limited supply. In turn this has produced a very fertile opportunity for alternative lenders and service providers, as well as alternative products and innovative solutions.

With the rising demand for financing arrangements for new fund clients and the pressure on banks to fulfil existing financing obligations, the European market has seen (i) new non-European bank entrants into the market, (ii) an increase in syndicated and club deals in order to meet the large amounts of debt required, (iii) an increase in non-bank lenders (including institutional investors) participating in deals as well as direct lending, (iv) an increase in the use of innovative financings tailored to funds, and (v) new and more experienced funds employing the use of debt advisors to either make introductions or delegate the some of the administrative burden of a financing.

Innovative products

There’s a misconception outside of the fund finance market that ‘fund finance’ just refers to subscription-lines, and that such subscription-lines are ‘vanilla’. It would be hard for anyone to hold on to that belief when examining the sheer volume and variation of the types of deals which have been executed in the last 2 years.

SMAs:

There has been a large uptick in the number of separately managed account deals as lenders get more comfortable with the concentrated investor pool by requiring additional provisions such as tightening transfer restrictions and relying on investor letters.

ESG-linked loans:

Whilst ESG-linked loans were very much a new product in the fund finance space 2 years ago, it is fair to say that they have become the 'norm' now with lenders employing ESG specialists to discuss targets with fund clients and with a widening array of environmental, social and governmental KPIs being linked to the margin ratchet.

Preferred equity:

Preferred equity financings are on the rise due to the element of control they allow the fund to maintain and the ability for such financings to be put in place at a more mature stage in a fund's life cycle. This bridge between debt and equity provides an innovative solution for funds looking increase their liquidity by realising equity without selling assets or over leveraging.

NAV deals:

There has been an increase in structured NAV deals in the fund finance space. These differ from the traditional NAV financings that have dominated the market in the last 20 years and have been born out of the need to be adaptable in the face of portfolio destabilisation following the global lock-downs caused by COVID-19. As the demand for NAV facilities has increased over the last few years, in part to preserve liquidity and support underlying portfolio companies, the structuring of such facilities has had to adjust to deal with potential loan-to-value covenant breaches, as well as lenders finding innovative ways to price underlying assets.

Hybrids:

As with NAV deals, 'hybrids' are nothing new in the fund finance space, but akin to all other types of debt financing over the last few years, demand has increased in order to leverage all assets available to the manager in order to maintain liquidity. A particular feature of hybrid facilities which adds to their attractiveness in the current climate is the ability to maintain liquidity for a longer period as they provide debt to more mature funds long after the borrowing base of a subscription line would be reduced to zero.

Innovative services:

Alternative lenders:

Slade Spalding, Co-Founder and Chief Investment Officer of No Limit Capital, has provided his perspective on the market with respect to the alternative lender space:

The private capital market is forecast to double in the next five years as GPs raise larger funds, in quicker succession as well as introducing new strategies which in turn will increase the financing requirements at all stages of a fund's life. The fund finance market is maturating which is attracting new capital sources as the banking market is pushed to keep up with the demand. Over the past five years, non-bank lenders have played an important role in the fund finance market by creating new market segments like preferred equity and GP stake financing while pushing innovation and providing new pockets of capital for concentrated NAV transactions. However, the largest part of the market being capital call financing has seen little change in financing options for GPs. NLC is changing this by working with the banking market to provide structures that allow both traditional RCF and institutional capital to work seamlessly together. This creates a win-win-win situation for all parties:

- GPs – cheaper cost of financing and access to institutional capital;

- Banks – higher utilization on their committed RCF and maintain their primary relationship for ancillary business; and

- Institutional Investor – structure that allows them to invest at scale.

Additionally, non-bank lenders offer funds the ability to tailor a product to their needs without being bound by internal cross-selling targets for ancillary services or capital adequacy regulations. Non-bank lenders also often have the ability to be more flexible when it comes to credit terms due to not being part of a larger institution. The diversity of funding sources available to non-bank lenders also safeguards against situations where one funding source dries up due to a disruption event.

Debt advisors:

Whilst traditionally it may have been more common for first time managers to employ the use of debt advisors to either assist with introductions or provide advice on structuring, we are now seeing more and more experienced fund managers look to advisors to take certain 'admin heavy' parts of the financing off the plate of the manager.

Sarah Lobbardi Founding Partner of Avardi Partners, an independent debt advisory firm that specialises in providing this service to fund managers has provided her perspective on the market:

2021 has been another record year for the fund finance market as strong fundraising activity led to an unprecedented number of fund finance transactions. We have seen this trend continuing since the beginning of 2022. The size of these transactions is increasing, with large fund managers raising larger than ever funds, leading to multi-billion capital call facility transactions. In some instances, we have seen deals involving over 15 lenders, increasing the complexity and the need for intermediation. Fund managers increasingly require help to coordinate their club deals and align all lenders' credit appetites.

We anticipate further growth of the NAV market, reflecting the increased appetite for leverage to enhance returns, increase flexibility and provide further liquidity. This is particularly true for some asset classes like private equity, private debt and secondaries. This trend is partly driven by an increased sophistication of fund managers and the emergence of non-bank lenders providing bespoke funding solutions. We expect that the fund finance market will become more sophisticated and innovative in the next few years with fund managers taking advantage of the full range of financing options available in the market.

2022 Predictions

Over the last few years, the number (and types) of lenders offering fund finance facilities has significantly increased as these products have become more established. With the increasing demand for additional capital in the market, existing non-bank lenders and new market participants have identified a gap for them to fill in this space. Such non-bank lenders, will provide the additional capital needed to satisfy the current liquidity shortages in the market and we expect that their participation in these facilities will be by way of joining a syndicate of other banks and alternative lenders, as well as venturing into direct lending.

In addition to the growth in the market leading to a liquidity gap, it has also led to a talent gap. The fund finance market has grown to such an extent now that there are a limited number of professionals at senior level who focused their career on fund finance back when it was a new burgeoning market, as well as there being a need for a large number of juniors (in both banks and law firms) to enter this market and be trained up in this specific and unique area of financing. As such, following the trend of the last few years, 2022 is likely to be a very competitive year in terms of hiring.

We also anticipate continued growth in the use of NAV facilities throughout the rest of this year and post the COVID-19 pandemic, as more lenders enter the space, given the returns are more attractive than those for subscription line facilities.

As the market continues to become more experienced and sophisticated, funds will likely take (and will receive pressure from their investors to take) a more strategic approach in choosing the right fund finance product for the financing arrangements, often enlisting the help of specialist advisors. This shift will inevitably lead to more 'bespoke' financing arrangements, tailored specifically to the fund's specific investment strategies and lenders will likely be required to consider a more flexible approach on more of these financing facilities going forward. Whilst we expect more variety and innovation in the fund finance space, we do not expect this to be at the expense of more standard subscription-line transactions, which we suspect will continue to be widely used.

Conclusion

In summary, 2021 (despite the global climate), was a successful year for the fund finance market, featuring (i) the introduction of new non-bank lenders (like No Limit Capital) and an uptake in existing non-bank lenders (like pension funds and insurance companies) supporting traditional bank lenders with their financings, (ii) substantial growth in the use of fund finance mechanics and (iii) the continued sophistication of the fund finance market with guidance from expert industry advisors (like Avardi Partners). We anticipate that this success will continue in 2022 and, as the dust of COVID-19 begins to settle, we predict that 2022 will be a milestone year for the fund finance market globally.

***Sarah Lobbardi, Founding Partner, Avardi Partners**

Sarah has worked in private debt markets and corporate finance for over 15 years. She has more than a decade's experience in the fund finance space, originating and structuring over 80 transactions globally. After 7 years at Lloyd's bank delivering financing solutions for the largest financial sponsors globally; she launched in 2018 the first dedicated fund finance advisory team in the world. Prior to that, she held different roles within leveraged finance, M&A and private equity. Sarah holds a BA in Business and a Master in Corporate Finance from EM Lyon business school in France. **E: sarah.lobbardi@avardipartners.com**

***Slade Spalding, Co-Founder and serves as Chief Investment Officer for No Limit Capital**

He is responsible for leading and managing GP relationships across the firm. Slade, has over 15 years of private equity and banking experience and prior to co-founding No Limit Capital, Slade was Co-Head of Capital Call Financing and the Head of GP Financing at Investec's Funds Solutions team. **E: slade.spalding@nolimitcapital.co.uk**