King & Spalding

Fund Finance

Key Takeaways from the Fund Finance Symposium

Greetings from the 12th Annual Global Fund Finance Symposium in Miami! After a wonderful evening of reconnecting with clients, colleagues and friends across the fund finance industry, my colleagues in the Fund Finance team and Private Credit team started the conference with an inspirational and informative fireside chat with Damien Dwin on how the leveraged finance and fund finance industry can provide capital and worker solutions to underserved communities.

Attendance at the global symposium increased significantly from 2022. We are seeing fresh faces from new market participants. And everyone is interested in learning more about NAV facilities!

We are still seeing a lot of activity in Q1 of straightforward subscription credit facilities – as this "vanilla" product in fund finance is the one that has historically performed with consistent yields. Our team actively works on fund finance products from both the lender side and the borrower side, closely collaborating with our investment fund partners from the initial stages of fund formation. We are well situated to advise on subscription lines given the broad perspective and experience we have in this space.

If you're not in Miami or were not able to make it to the panels, we have a brief synopsis on what we heard during the panels, and what we think you should know were the hot and interesting topics throughout the day.

We are not including any specific quotes or attributing any ideas to any individual or institution, because we would never do so without their blessing. Rather, this is a non-exhaustive summary of what our team thought were some key takeaways, coupled with some ***editorializing of our own***.

- The Rise of Private Debt: Unlike the global financial crisis of 2007 – 2008, debt capital is available to healthy, performing companies. Deals will continue to get larger as companies find the value-add associated with debt providers that employ a "storage" strategy as opposed to a "moving" strategy. There is optimism that rates will settle in the first half of 2023; in the interim, look for sponsors to be purchasing the companies without closing leverage, with an eye on refinancing the purchase price in 2024. As private debt providers deploy capital in 2023, look for true covenant packages. Private debt providers continue to invest in their teams and platforms and innovate in new product offerings to allow greater access to the debt markets.
- **New Sources of Capital:**
  - **Subscription facilities:** Certain historic lenders have pulled back on subscription lending due to the impact of new capital rules. On the flip side, certain region concentrated banks are making subscription lending a more prominent part of their investment strategies. Lenders active in this space are evaluating subscription lines in relation to other products being offered to relationship sponsors. Although there is room for new capital providers, the yields associated with subscription lines have not traditionally appealed to alternative capital providers.
  - **NAV facilities:** Higher risks and higher rewards! The yields in NAV facilities are attractive to insurance companies, pension funds and asset managers, who are increasingly participating in this space. Many of the alternative capital providers can provide more flexible terms in NAV facilities in terms of collateral package and tenor but may require facility ratings and enhanced reporting covenants. Ratings agencies, already experienced in evaluating collateralized fund obligations and feeder funds, are developing frameworks to rate NAV facilities. The entry of new participants is creating healthy competition in the market. ***We are well positioned to partner with our clients seeking to grow their NAV product offerings. We routinely coordinate with our colleagues to do a deep dive into limited partnership interests, real estate assets and infrastructure assets. We look forward to our clients growing in this space.***
- **Subscription Facilities:**
  - Despite the economic climate and the related rise in pricing, subscription line credit facility usage remains high and the expectations are that facility usage will increase as subscription lines are continuing to be put in place and used by managers. While there will be a point at which it will not be economically advantageous for funds to utilize subscription lines of credit, that level has not yet been reached, especially for savvy sponsors that have been availing themselves of hedging products to limit interest rate risk. The overarching relationship between lenders and borrowers, not solely in the context of the subscription line facility but also including the lender's relationship with a sponsor on a platform level also affects how lenders price these facilities despite the interest rate environment. ***Our team recently mobilized across multiple US, European and Asian offices to perform diligence on 170+ LPs on an expedited basis to ensure a timely closing. As the lender landscape evolves, we are actively standing by to assist clients in developing***

a diligence strategy. In addition, we routinely assist in deeper dives into limited partnership agreements and subscription agreements to assess the need for side letters and investor letters.

- Basel III (or perhaps III.5? or even IV?) constraints result in limitations on capacity. Historical players are being somewhat more selective as to their products. New entrants should become familiar with how to step into the shoes of a general partner if the circumstances arise. ***We have a team of experts who advise GPs and their Funds on operations on a daily basis, including capital call mechanics. We can help any lender understand the operational intricacies of a limited partnership agreement.***

- **NAVs, Hybrids and Preferred Equity:**
  - What practitioners are commonly referring to as hybrid facilities can be characterized as subscription facilities with an element of NAV, but practically should be viewed as two distinct facilities sitting in two separate parts of an institution with distinct credit committees, requirements and constraints. The NAV market continues to evolve, but its general utility remains for open-ended funds, funds that need big access to letters of credit but the traditional subscription line collateral is insufficient, and late stage funds. While there are different understandings around what NAV really means, there is a fundamental difference between NAV and preferred equity.
  - From a structuring perspective, diligence of the underlying assets is of critical importance, especially understanding underlying change of control issues.
  - From a valuation perspective, it is easier to ascertain values in certain asset classes, such as real estate, where an appraisal is readily available. For other asset classes, facility documents should include a mechanism for appointment of a valuation firm, coupled with the ability to appoint a replacement firm in the event of a divergence between a borrower's and lender's valuation (often 10 – 20%).
  - **Trends**: Fund documents are beginning to evolve to support "NAV-friendly" language, but there remains work to be done. The European NAV market is more advanced than the US NAV market, as evident by the volume of deals.
  - **MORE!** That is the biggest takeaway – expect to see more borrowers, more lenders, more appetite, more questions, and perhaps most importantly, more creativity in structuring NAV products for sponsors, thus allowing greater access to debt capital investments by traditional and alternative capital providers.
  - ***We are actively engaging with our fund formation partners to dig deep into fund documents to figure out how to structure and paper these deals in a way that is favorable to funds but also protective for debt providers. In addition, our contacts at rating agencies would be happy to meet with our clients to discuss methodologies used in preparing ratings for NAV and subscription facilities.***

- **Evolving Lender Landscape:**
  - In looking at the historical development of fund finance over the past decade until now, there has been a shift from initially solely providing subscription line credit facilities to more asset level financing. There is anticipation about what the next step in creating solutions for sponsors in fund finance will be and whether it will involve capital markets opportunities such as securitizations or other bespoke financing structures. Since lenders (both banks and private debt funds) understand their sponsor client's needs on a platform level, lenders are expected to play a leadership role in developing these solutions.
  - Lenders that have amassed large portfolio exposure and are subject to balance sheet constraints due to regulatory requirements may look to trades with insurance companies as a potential solution to provide relief through financial guarantees to work past these constraints and satisfy regulatory capital requirements.
  - **Biggest Opportunities in the next 12 Months** – The potential for a soft recession is being modeled into credit underwriting, but industry professionals are optimistic that the market will settle in the next six months. Sponsors generally use subscription facilities to manage cash flows and understand that rates will increase on such facilities. Given the pullback in subscription lines by historical players, there is real opportunity for growth from new providers of capital. Interest in NAV facilities will continue to grow as the hold time gets longer and sponsors use NAV facilities, among other reasons, to manage IRR. ***We are very focused on the relationship fabric that supports the fund finance industry. It is ever more important to strengthen existing relationships while exploring new ones. The K&S team is uniquely positioned with many relationships on the fund side as well as the lender side, and we are ready to make thoughtful introductions across the table.***

We're happy to discuss any of the above or any other conference questions or takeaways, and, of course, would love to hear your views here as well. Please reach out to Aleks Kopec (akopec@kslaw.com) and Dev Ghose (dghose@kslaw.com) if you would like to discuss. A big thank you to Olivia Stewart, Katy Berger and Noel Thomas, valuable members of the King & Spalding fund finance team, for their invaluable assistance in preparing this update.

Thank you for your time!