EXPERT COMMENTARY

*With booming fundraising requiring ever larger commitments, institutional capital is now often essential, write Michael Hubbard, Samantha Hutchinson and Mathan Navaratnam at King & Spalding*

# Institutional capital: The future of fund finance

Although the fund finance industry is over 20 years old, prior to 2018, very few events had a major impact on the market. That year saw the first (and, to this day, one of very few) major subscription facility defaults with the collapse of the Abraaj Group. This provided the industry with the first real opportunity to test the voracity of the structures and collateral package, and resulted in our team at King & Spalding putting together a best practice guide with learning points, many of which are widely adopted across the European market.

Since then, we have seen more evolution in the fund finance space than ever before, with new products, technologies and – perhaps the most impactful development – the emergence and increased volume of alternative capital flowing in on the supply side from insurance companies, private credit funds and other asset managers.

For the subscription finance industry, structures that allow institutional capital to be harnessed have been essential for lenders to keep up with the increased demand from GPs (which has been partly mitigated by the slow fundraising environment and will become more acute as and when fundraising levels normalise). This pressure on liquidity is expected to only grow as regulatory changes come into play in the next couple of years for European and UK lenders in particular. Additionally, increased regulatory scrutiny of the banking markets' exposure to the private markets will exacerbate the usual cycle of product/client limits being hit. As fundraising levels require larger and larger facility sizes, institutional capital will be essential to fill this gap.

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## Lessons learned

Even top-tier GPs that aren't necessarily concerned about liquidity capacity

from debt providers look back to the lessons learned from the regional banking crisis of 2023 and are eager to supplement their lender relationships with increased diversity through alternative capital providers. Various banks and other platforms have developed structures with a view to harness this type of capital, and more solutions continue to come to market, including a solution created by our Capital Solutions platform allowing alternative lenders to access the subscription facility market through the traditional committed revolving credit facility (RCF) structure with a range of different fixed maturities/return profiles, depending on the requirements of a particular investor.

On the NAV side, alternative capital providers now represent a considerable proportion of available capital across all asset classes, particularly for buyout strategies. Many GPs are reserving portions of the facility for their own investors to such an extent that some considered this to be the start of a new co-invest strategy opportunity.

Similarly, GP financing – once the preserve of banks able to offer this product on a relationship basis – is increasingly being offered by alternative capital providers attracted to the returns.

*"GP financing… is now increasingly being offered by alternative capital providers attracted to the returns"*

## Reasons for growth

Why is it that, over the past five years, we have seen such a significant interest in fund finance products from alternative capital providers? And how are these providers making the relatively low returns attached to certain fund finance products (subscription financing and secondaries NAV, to name a couple) work from an overall return perspective? There are a number of reasons:

**Interest rates and spreads.** From a macro perspective, one of the biggest changes over the past few years has been the rapid increase in interest rates over a relatively short period of time. As most fund finance products comprise floating rate loans, the income attributable to these products has increased significantly, with private credit funds taking any increase in benchmark rates straight through to the total return.

Similarly, these types of lenders look to relative value when allocating capital. Many of the fund finance products offered to borrowers still offer an attractive premium to more liquid floating rate instruments. Conversely, asset leverage has become more expensive, resulting in less leverage finance and larger equity support – both of which can be provided by subscription finance and NAV facilities. Investors and private credit funds hungry for yield quite simply haven't been able to get it from their traditional hunting grounds.

Concerns for institutional capital around the variability of returns and operational burdens associated with RCFs have been mitigated by the inclusion of provisions guaranteeing a minimum return, make-whole clauses, and the inclusion of term loan tranches and extended drawdown periods in a number of facilities.

**Volatility.** The market has witnessed significant volatility from multiple sources over the last five years: a global pandemic and geopolitical issues caused persistent supply chain issues resulting in significant macroeconomic headwinds (particularly low growth and inflationary pressures); this then created downward pressure on both public and private equity markets; M&A activity has suffered; and GPs have been forced to hold assets for longer. Again, fund finance products have been used to fill the gap, offering liquidity to both portfolio companies and, more selectively, LPs.

**Private credit – a mainstream asset class.** The growth of private credit in the past five years has been phenomenal, with AUM estimated to have grown by up to 50 percent since 2020. More capital to deploy, coupled with few LBO opportunities from the benign M&A market, has forced alternative asset managers to look for broader opportunities to deploy capital.

**The value of uncorrelated returns.** With limited major defaults across the fund finance product spectrum and even fewer enforcements, the inclusion of these products in a private credit fund's existing portfolio/strategy can reduce the underlying volatility and improve the overall portfolio's risk-adjusted return.

## Strong future

Institutional capital will continue to be attracted to the relative value offered by fund finance products, which align well with their need for capital preservation and income generation to match their long- and short-term liabilities.

Fund finance products offer diversification and risk-adjusted returns superior to many traditional comparable investments. While these products are naturally more attractive when interest rates remain high, their inclusion in a portfolio is not necessarily just returns driven: they provide balance and stability, particularly when markets are volatile.

Alternative capital providers are here to stay, and will continue to play an increasingly important part of the fund finance ecosystem. ■

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