EXPERT COMMENTARY

Fund finance 2021: A CFO's toolbox

Emerging from the pandemic, private fund CFOs face numerous challenges. Thankfully, more financing tools than ever are available to drive success for their LPs, asset management platforms and principals, writes Zachary Barnett

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As the world plots its way out of the coronavirus crisis, now is the perfect moment to review some of the fund finance tools CFOs have at their disposal in 2021.

Subscription facilities

The core fund finance tool remains the subscription line: a loan to a fund secured by a pledge of the GP's right to call capital and the accounts to which those contributions are funded.

Once considered primarily a real estate fund financing strategy, subscription facilities are ubiquitous across all asset classes including buyout, infrastructure, energy, private credit and even venture capital platforms. They withstood unfounded criticism in 2018 and 2019 stemming from claims that GPs utilised them to inflate IRRs, and gained further acceptance through 2020. Similar to the great recession, the covid-19 pandemic proved just how valuable subscription facilities are to fund managers. They permitted funds to continue operations and effectively deploy capital without burdening their investors with capital calls while they may have been dealing with their own liquidity issues.

We never understood the criticism of the product. Subscription facility leverage is nearly universally less expensive than asset-level leverage. Rather than criticise, LPs should demand these facilities be fully used as leverage rather than mere capital call bridges.

One of the most common (and sensible) trends in subscription finance has been the rise of umbrella facilities. These aggregate several of a sponsor's subscription facilities, benefiting multiple investment vehicles, under one set of documents, in a single transaction. Umbrella facilities simplify subscription-backed credit facility documentation and utilisation, reduce execution timelines, lower transaction costs and improve pricing. They are a hyper-efficient tool that saves sponsors significant amounts of money and time.

NAV facilities

As fund investment and commitment periods age, and investors fund their capital commitments, subscription facility borrowing availability wanes. NAV facilities restore that availability by looking down to the net asset value of the fund's portfolio, instead of looking up to investor capital commitments. These facilities are increasingly desired by funds with ongoing liquidity requirements, or which benefit from expansion of the investment portfolio beyond mere total LP capital commitments.

NAV facilities extend credit to funds based on an advance rate multiplied by "eligible NAV" or the "eligible investments". The relative liquidity (or illiquidity) of the fund's collateral affects the advance rate. As with subscription facilities, concentration and other restrictions will apply.

For example, there may be limits on how much one portfolio investment or aggregate investments in a single industry can contribute to the borrowing base. The lender's due diligence will focus on each predecessor fund's historical performance and any "cash traps", or issues impacting the pledge and foreclosure on the collateral. The calculation of eligible NAV typically (a) excludes the fair market value attributable to investments subject to exclusion events, write-downs or concentration limits, (b) adjusts and recalculates availability based on financial statements delivered to the lender and (c) is adjusted with any adverse credit or exclusion event in the portfolio.

The private credit asset class has benefited from NAV financing longer than any other asset class. As the asset class has matured, many banks' lender finance businesses grew as dramatically as the largest private credit firms. Banks that as recently as five years ago agented $50 million-$100 million credit fund facilities, now only seek over $150 million portfolios. Others only accept collateral in which the portfolio company's TTM EBITDA exceeds a "middle-market" threshold. Relationships are as important as ever in this corner of the fund finance market, but there are emerging providers open to relationships with new credit managers, smaller portfolios or SMAs, or in lower middle-market collateral.

Hybrid facilities

Hybrid facilities maximise flexibility for fund borrowers in terms of satisfying liquidity needs and expanding availability and eligibility beyond uncalled capital, regardless of the stage of the fund's life cycle. Hybrid facilities also maximise credit support for lenders (a) by looking to uncalled capital commitments and (b) the fund's portfolio.

"The most exciting fund finance developments come from the continued penetration of life insurance companies as lenders to private funds"

Hybrid facilities, like NAV facilities, are useful to funds that are nearing termination of their commitment periods and have a meaningful investment portfolio. Unlike NAV facilities, however, hybrid facilities are useful to funds that are earlier in their investment periods. For example, private credit funds in particular are unable to obtain traditional asset-level leverage until they accumulate a requisite number of assets. A hybrid facility provides borrowing base credit for those nascent assets while the fund ramps, thus allowing the fund to grow assets at an accelerated pace and achieve optimum performance sooner than it otherwise would.

The flexibility offered by hybrid facilities is apparent in (a) direct advance rates against eligible portfolio investments as well as (b) accommodations in availability with respect to the traditional subscription-backed collateral. Many hybrid facilities effectively eliminate concentration limits and/or advance 100 percent against all unfunded investors (not just certain investors). A minimum NAV or debt-coverage-ratio covenant typically serves as a backstop covenant for lenders.

An important point to keep in mind regarding hybrid facilities is they are often the easiest path to a NAV facility, which can prove crucial to later stage funds. The bifurcated collateral package of the hybrid allows lenders to grow comfortable with the asset-level exposure while also relying on the uncalled capital, which may be a bit easier for them to underwrite.

Management company facilities

Up until this point we have focused on tools for asset managers' funds, but savvy CFOs also avail their management companies of leverage ("MC lines").

MC lines are collateralised by the borrowing sponsor's right to receive management fees under the management or advisory agreements it has entered into with its funds, joint ventures and separate accounts, together with a pledge of the deposit account(s) into which those fee streams are paid. Additionally, because sponsors generally have equity stakes in the funds, the sponsor should expect to pledge its right to receive distributions from the fund and, in some instances, its partnership interest.

The reasons for obtaining an MC line are as varied as the sponsors themselves. They range from practical, tactical working capital support, to financing strategic, platform-changing initiatives:

First, as operating companies, sponsors have fixed and variable expenses, which aren't incurred contemporaneous with management fee receipts. An MC line eases the liquidity burden of these obligations and smooths cashflows.

Second, investors increasingly expect meaningful fund commitments from sponsors. MC lines permit sponsors to finance and thus increase their "skin in the game", demonstrating an alignment of interests with their investors.

Third, sponsors are availing themselves of MC lines in order to facilitate long-overdue liquidity events for founders, partners and other senior management team members. In many cases, these facilities become critical in holding management teams together after years of hard work in building successful asset management firms. These facilities are also used to finance compensation schemes that further the retention of personnel integral to the platform's success.

Fourth, some sponsors access MC lines to front capital calls for employee or partner co-investment vehicles in order to ease the administrative and liquidity burden of meeting multiple capital calls in a condensed time frame.

Finally, MC lines are used to finance sponsors' acquisitions of other fund managers, key groups of individuals at other fund managers, or AUM, in connection with manager consolidations. Not too long ago, sponsors that had access to MC lines retained a competitive edge over their peers. They have become very popular over the last few years and thus we would now view obtaining an MC line as more of a requirement to keep pace rather than garnering an edge over the field.

> *"We have focused on tools for asset managers' funds, but savvy CFOs also avail their management companies of leverage"*

General partner facilities

Separate and apart from MC lines, CFOs are increasingly compelled to finance their general partner commitments. These facilities are secured by a pledge of the GP's right to receive distributions associated with its interest in the fund. This pledge is sometimes accompanied by a management company guaranty or a personal guaranty from the fund principals of the general partner.

These facilities are usually used to fund all or a portion of the GP's capital commitment to the fund. A percentage of the GP's distributions is often required to pay down the facility during the term of the loan, and a fund-level NAV covenant is typically included in the arrangement.

These can vary in size and complexity from loans to each of the five equity-owning principals to expansive partner loan programmes servicing capital commitments of hundreds of sponsor employees.

Private placements/Insurance company lenders

Perhaps we've buried the lead, reviewing the more traditional fund finance products first, but the most exciting fund finance developments come from the continued penetration of life insurance companies (LifeCos) as lenders to private funds.

These LifeCo financing transactions can take the form of traditional credit facilities, but are often executed as private placements. The key to these transactions is obtaining an investment-grade credit rating on the private fund or the pool of collateral, providing the LifeCo the required capital treatment and permitting it to offer competitive pricing.

LifeCos have certainly been seen in the subscription facility market, but they are increasingly active (and perhaps most valuable) as NAV lenders. One of the more important points to keep in mind with these LifeCo transactions is execution. Unlike investment banks or depository institutions, LifeCos don't necessarily like to "lead" transactions, so a bank or alternative lender may still need to be incorporated to handle loan document execution and administration.

Summary

The challenges CFOs face in 2021 are complex and ever-evolving. Whether you operate a late-stage fund in need of additional liquidity, a new fund looking to efficiently ramp or a management company seeking to normalise cashflows, you have plenty of liquidity solutions available. Managers that utilise these diverse tools at their disposal will prove invaluable to their respective fund, investor and management team constituencies. ■

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