Fund Finance—the Year Ahead: Will Borrower Friendly Trends Continue in the Expanding Market?

28 January 2019

The fund finance market continues to grow, even as the number of fund raisings decreased last year. In this update, we consider how fund financing terms are developing in the expanding market.

DEVELOPING FUND FINANCE MARKET

The first question, however, is why the use of fund financing is outstripping fundraising. There are a number of factors at play. In our view, the primary reason is the development of fund finance products in the market and increasing borrower awareness of the benefits of the growing options.

Historically, funds typically raised a subscription line financing ("sub-line") to bridge capital calls through the first part of their investment period. Now, funds turn to a multitude of other fund finance products, both at the start and end of their investment period. Funds increasingly raise NAV or hybrid facilities, GP-level and management company facilities, portfolio recap facilities and other products. At the same time, market commentators (both positive and negative!) raised awareness of fund financing, leading to some funds coming to the fund finance market for the first time. Adding to this dynamic, there is an influx of new lenders—new banks and, increasingly, LPs and other nonbank lenders. Put simply, the fund finance market is maturing.

SUB-LINE TRENDS

How have terms of fund facilities developed within this backdrop? Generally speaking, fund facility terms are increasingly borrower friendly.

Financial Covenant

The key operative term in a sub-line is the borrowing base mechanic. In short, the lender agrees to aggregate the uncalled capital (or a proportion thereof) of specified eligible investors, above which amount the borrower cannot borrow. In Europe, this type of provision is often documented as a financial covenant that uncalled capital of all eligible LPs may not reduce below an agreed percentage of debt of the fund.

One trend, arguably one of the most useful for borrowers, is the willingness of lenders to accommodate step-downs in the financial covenant coverage percentage once a certain percentage of the capital commitments of the fund are called. Some recent facilities have step-downs to a coverage percentage of 120 (or lower). This allows a fund to use its sub-line for longer, and borrow a greater amount, towards the end of the life of the fund.

In some facilities, lenders may also agree that certain types of debt (for example, indebtedness between obligors or a limited amount of hedging exposure) do not count to the financial covenant test. This gives the fund even more room to operate within the financial covenant limit.

Stay on Enforcement

In many sub-lines, after an event of default leading to acceleration by the lender, historically, the lender assumes all rights of the manager or GP under the fund documents with respect to the fund's LPs. At that point, the manager or GP is not able to call capital to remedy the default or repay the facility, as those powers pass to the lender. A trend, which historically developed in U.S. sub-lines, and has more recently evolved in Europe and Asia, makes this position more favourable to the borrower. If a borrower defaults, lenders may now agree to a standstill on taking enforcement action over the right to call capital from LPs for a short period of time. During such time, the manager may instead issue a drawdown notice for the purposes of curing the default and/or repaying any outstanding loans. We increasingly see this borrower-friendly provision in European and Asian sub-lines.

Other Terms

Other borrower-friendly terms becoming more prevalent include:

- more flexibility around LP transfers (with transfers permitted provided the transfer does not trigger a breach of financial covenant);
- express limitations on recourse to the manager and/or GP;
- increased flexibility for the fund to amend its fund documents without lender consent (often without needing to provide up-front notification);
- the restriction on distributions (which blocks distributions when an event of default is continuing) increasingly applies only to distributions to LPs and only restricts distributions in such circumstances if amounts are outstanding under the facility;
- increased willingness of lenders to accommodate practical issues in side letters (such as bespoke LP notification obligations); and

- increased willingness of lenders to accommodate one-off issues with respect to giving security (for example relying on a power of attorney in the event that capital call security cannot be granted).

Expectations for 2019

With more lender entrants expected in the fund finance market during 2019, and with room for the fund finance market to mature further, we expect the trend towards borrower-friendly terms to continue.

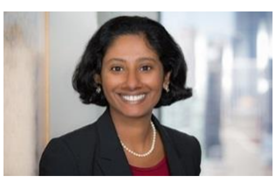
We have two notes of caution. At a macro level, the fund finance market is expanding notwithstanding recent financial and political volatility, but the impact of future market events is of course uncertain. In addition, lenders continue to watch the fallout from Abraaj carefully. We expect lenders to request limited, bespoke changes to their capital call security protections to deal with lessons learned from Abraaj.

If you have questions on any of the topics covered above, do get in touch with a member of the team.

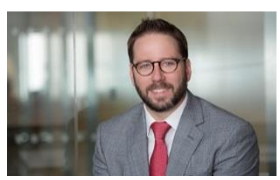
Alan J. Davies
Partner, London
+44 20 7786 9087
ajdavies@debevoise.com

Pierre Maugüé
Partner, London
+44 20 7786 9190
pmague@debevoise.com

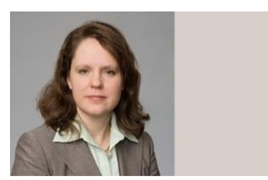
Thomas Smith
Partner, London
+44 20 7786 9174
tsmith@debevoise.com



Ramya S. Tiller
Partner, New York
+1 212 909 6204
rstiller@debevoise.com



Michael P. McGuigan
Counsel, New York
+1 212 909 6217
mpmcguigan@debevoise.com



Margaret M. O'Neill
Counsel, New York
+1 212 909 6475
mmoneill@debevoise.com

Almas Daud
Associate, London
+44 20 7786 5456
adaud@debevoise.com