FUND FINANCE association

Fund Finance Association – Covid-19 Response
(April 9, 2020)

Introduction

The Fund Finance Association (the "FFA") has been monitoring the market disruption caused by the coronavirus. In our view, some of the press reports addressing the impact on the fund finance markets, particularly around limited partner ("Investor") liquidity and capital call defaults, have taken on a narrative that is not well-aligned with what we see happening in practice. Thus, this week, we convened a call of the FFA's highest level sponsors with most active banks in fund finance participating in the call. They collectively represent in excess of approximately $150 billion in fund finance loan commitments. They were joined by leading fund finance and fund formation law firms, representing both borrowers and lenders. Members of several preeminent fund sponsors ("Fund Sponsors") also participated. Below we provide an update on what these market participants have actually experienced since the commencement of the disruption. We also provide some suggestions for best practices as we all work through these challenging circumstances.

Credit and Liquidity Concerns

Both the mainstream and private equity press have been raising concerns around Investor liquidity and questioning whether Investors are sufficiently liquid to honor their capital commitment obligations. In turn, the press reports call into question the creditworthiness of subscription facilities ("SCF's") extended to private equity funds ("Funds") backed by these capital commitments. Several articles have even reported that Investors have actually defaulted on capital calls. This narrative is wholly inconsistent with what the industry has seen play out in practice to-date. Despite last week including the end of a quarter (traditionally quarter-ends involve a heavy volume of capital call activity), no participant on our FFA group call reported having seen a single institutional Investor default on a capital call. In fact, many of the lenders on the call have extended SCF's to Funds whose Investors are constituted of only high net worth individuals. Even in those SCF's, the lenders reported that the high net worth Investors have been funding their capital calls to-date normally (there are a few minimal high net worth delinquencies, as from time to time was the case pre-disruption as well). The Fund Sponsors also reported no Investor defaults across their platforms. Thus, no participant reported having had any material borrowing base adjustments or events of default in their SCF portfolio as a result of Investor funding issues. Thus, the best we can tell, Investors have been managing their liquidity responsibly despite the difficult environment to ensure they can meet their capital call obligations.

Capital Call Activity

There has also been a narrative in the press that Funds are calling capital earlier than otherwise planned and at an increased volume, in some cases it being suggested that these capital calls are being made to get out in front of future Investor funding challenges. While members of the FFA have heard of this happening in a few instances, we do not believe that these few specific instances make a trend. Rather, we are not sure capital call activity through the date hereof has in fact actually even been occurring at an unusually high rate or volume at all. One of the lenders on our call presented data to the group on the capital call behavior of the lender's SCF portfolio. This lender has one of the largest, if not largest, portfolios of SCF's in the world. The lender reported that historically, capital call activity is the highest at the end of each quarter. But at the end of the first quarter of 2020, the amount of capital called by Funds in its portfolio was only about 50% of the amount called at year end. In addition, the amount called at the end of the first quarter was less than both the amount called at the end of the 3rd quarter of 2019 and at the end of the first quarter a year ago. This lender's portfolio is large enough to be a reasonably-sized proxy for the market as a whole. In addition, every lender indicated that the utilization of its SCF portfolio has either held flat or ticked up since the start of the disruption. If capital call amounts were unusually high right now, it would be reasonable to expect that SCF utilization would be trending at least somewhat downward. Thus, we do not think there is a macro trend of Funds calling capital down on a more accelerated timeline than normal out of concerns around Investor liquidity. Rather, this normalcy of capital calling behavior is productive and likely helpful in allowing Investors to best manage their liquidity.

Borrowing to Hoard Cash

In the corporate market, many borrowers are drawing down their revolvers to hoard cash on the balance sheet. While in a few specific instances that has been observed in fund finance, it is not happening in any meaningful way. Borrowings are occurring, but they are in connection with investment activity. Debt funds are drawing under their SCF's to fund drawings from their own borrowers. Opportunistic Funds are making new Investments. But wholesale borrowing under SCF's to put cash on Fund balance sheets is not occurring.

Market Activity

The market activity participants on the FFA call actually reported seeing is somewhat more mundane. The fund finance market remains very active right now. A lot of transactions that normally would have closed later in the year have been accelerated in light of the uncertainty and are rushing to close. There are a large number of facility size increase requests and facility extensions in process. Many Funds are looking to add portfolio companies to SCF's as "Qualified Borrowers". Bankers are busy servicing both their existing clients as well as responding to information requests from their management teams surveying portfolio exposures. As such, response times can be longer than typical. While no one amongst the call participants reported seeing a draw on an uncommitted Facility be denied, there was a report that the funding of some draw requests on uncommitted SCFs has been conditioned. The Sponsors reported that fundraising for new Funds continues successfully. Some Funds seeking new SCF's have been turned away by lenders at capacity and there is a lot of interest in NAV-Facilities right now, but not a lot of lenders are servicing the need. Secondaries trades of Investor interests in Funds has been very, very low.

Suggested Best Practices

For the most part, the fund finance market is managing thru the disruption quite well.

1) Our fundamental guidance for market participants is for all parties to communicate as early and robustly as possible with their counterparties. If a lender is not able to do go forward with a prospective transaction or extend a facility, notify the Fund Sponsor as soon as possible in the process to enable the Fund Sponsor to have time to find alternatives.

2) Fund Sponsors should give lenders as much notice as possible in advance of wishing to join a Qualified Borrower.

3) Fund Sponsors should provide Investors a forecasted capital call schedule as far in advance as possible.
4) When it is feasible, Fund Sponsors should extend their capital call notice period for longer than the standard ten business days provided in their partnership agreements.

Accelerating capital call time frames would be unproductive for the market as a whole. Where possible, Fund Sponsors should stick to and not accelerate previously forecasted capital call schedules. Borrowing to keep cash on the balance for Funds should be discouraged. Lenders should make good faith efforts to accommodate requests for Facility extensions and amendments.

As to the press that covers fund finance, the FFA Board believes that the vast majority of writers and teams are making a good faith effort to fairly and appropriately cover the market and are doing a great job. We understand that catchy headlines and provocative themes generate a lot of readership. At the same time, if we can be helpful providing balanced information as to what is actually happening in transactions, please call us.

The Board of the Fund Finance Association