SLC Management

INVESTOR INSIGHTS

Perspectives on fund finance: opportunities and challenges

OCTOBER 2024

Examining the possible benefits, risks and features of an expanding asset class in IG private credit

Fund finance, a category that includes strategies such as net asset value (NAV) lending, has become a fast growing tool employed by asset managers seeking financing for their investment goals. Likewise, these strategies exhibit potential benefits to institutional investors as well.

Consequently, investment grade (IG) private credit investors may find themselves exposed to such financing strategies. This makes developing a stronger understanding of the potential upside and risks of these complex, illiquid and dynamic investment structures increasingly important.

Definition and evolution of a growing asset class

Before drilling deeper into the risks and potential benefits of fund finance, we should first define this investment universe. Fund finance can be broadly characterized as a form of financing supported by some combination of an investment fund's assets, cash flows and ability to call capital from its limited partners (LPs). As borrowers, asset managers might seek this type of financing to achieve a variety of objectives. These might include: (i) optimizing the cash management and capital deployment processes for a fund and its LPs; (ii) enhancing returns through leverage; and (iii) generating liquidity for additional investments in the portfolio or for distributions to LPs.

On the side of the lender, fund finance strategies have further evolved to incorporate investment features and structures that may be more attractive to institutional investors. From this perspective, fund finance can be viewed as occupying a middle ground between corporate credit and securitized asset-backed products, incorporating many of the most attractive characteristics of both of those markets.

Fund finance transactions can benefit from a number of features that make them appealing from a risk and return perspective:

- **Multiple credit support layers** – Fund finance facilities potentially benefit from multiple layers of credit support. These can include the cash flows of the underlying assets, the collateral value of the assets (which can be sold to generate distributable proceeds) and, in some cases, a guarantee by the asset manager. The support generated by these sources of value is further enhanced through overcollateralization provided by junior capital, which absorbs losses first, and the spread between the cost of financing and the cash flow yield of assets, which can be diverted to lenders in the event of a covenant breach or default. When thoughtfully implemented in the deal structure, these features can produce an attractive risk profile.
- **Diversification** – The collateral typically found in fund finance facilities is comprised of many individual assets combined to create a diversified source of cash flows. Transactions typically incorporate mechanisms to ensure that a desired level of diversification is always maintained, such that no one individual asset can disproportionally impact the outcome of an investment.
- **Covenants and cash flow waterfalls** – Loan-to-value (LTV) based covenants and cash flow sweeps provide lenders with priority over cash flows and ensure that target LTV levels, which often decrease throughout the life of the loan, are maintained. Other measures such as concentration limits, minimum number of assets, interest coverage and leverage levels of underlying assets can also help monitor and maintain the quality of the collateral.
- **Bankruptcy remoteness** – Collateral in fund finance transactions often benefits from legal separation from the asset manager. Assets are typically contributed into a special purpose vehicle (SPV) against which lenders have a priority claim. The performance of these assets is separated from any risks or tangential issues related to other assets and funds managed by the asset manager. This separation has multiple benefits including: (i) the ability to cleanly structure and establish cash flow priority and security; (ii) expediting of credit remedies due to the clear establishment of claims on the assets by the lender; and (iii) minimization of spillover risks associated with the asset manager in other parts of its business.
- **Lower refinancing/tail risk** – Fund finance transactions generally attempt to match the cash flow profile of the assets with the maturity of the credit facility. They do so while also incorporating mechanisms to avoid scenarios in which difficult to monetize assets are the only source of repayment available to lenders near the end of a facility's term. As a result, most transactions are designed to fully amortize upon maturity, which eliminates refinancing risk.
- **Complexity premium and relative value** – Investing in the fund finance market requires expertise across multiple layers. Investors must have expertise in not only assessing individual assets, but also portfolio-level credit risk, drawdown fund structures/mechanics, and the structured credit markets in general to manage and price risk appropriately. This complexity limits the universe of potential investors, allowing those that do possess the requisite expertise to earn attractive returns.

Major types of fund financing facilities

Although the universe of fund finance strategies is broad and evolving, we've identified three core areas of the asset class that institutional investors may encounter with increasing frequency:

1.	2.	3.
Lender finance	**Subscription lines**	**NAV lending**

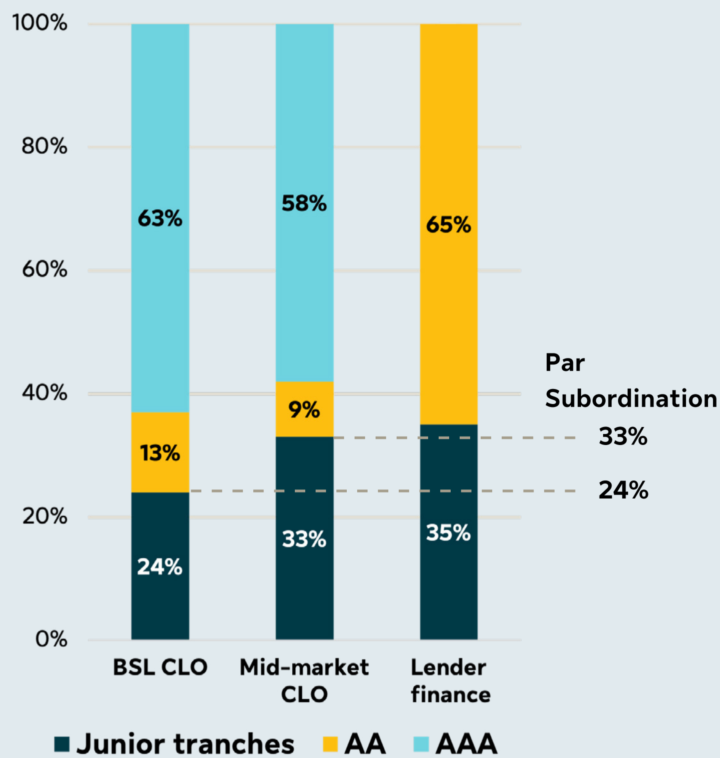
1. Lender finance

These are credit facilities secured by diversified portfolios of private credit loans. The facilities are often revolving in nature and require a minimum level of equity subordination that is typically 30%–40% of total asset value. Lender finance facilities benefit from a number of structural enhancements, which include but are not limited to:

- Significant equity subordination.
- Minimum diversification requirements.
- Priority over disbursements of principal and interest within the portfolio.
- Mechanisms to exclude or discount underperforming loans from the collateral base.

These facilities can be compared to the AAA/AA tranches of collateralized loan obligations (CLOs) as they benefit from a similar or better level of overcollateralization, as indicated in the following exhibit. However, private lender finance transactions also include additional lender friendly mechanisms that are absent from CLOs (such as the active monitoring and management of collateral to maintain collateral quality). This allows them to generate returns above equivalent broadly syndicate CLO tranches.

Subordination of CLO tranches versus lender finance



Source: Market estimates derived from Natixis, Scotiabank and Bloomberg data, as of January 2024.

2. Subscription lines

This category describes credit facilities secured by the uncalled capital commitments of LPs. These commitments are primarily used by funds to streamline the capital call process and, in some instances, to enhance the fund's internal rate of return. A fund manager uses the subscription line to fund investments, which eliminates the need to call capital from its LPs until the subscription line needs to be repaid. The principal form of lender protection is that in the event of a default, lenders have the right to compel the general partner (GP) to call capital from LPs in order to repay the facility. Additional protections for lenders often incorporated in these facilities include:

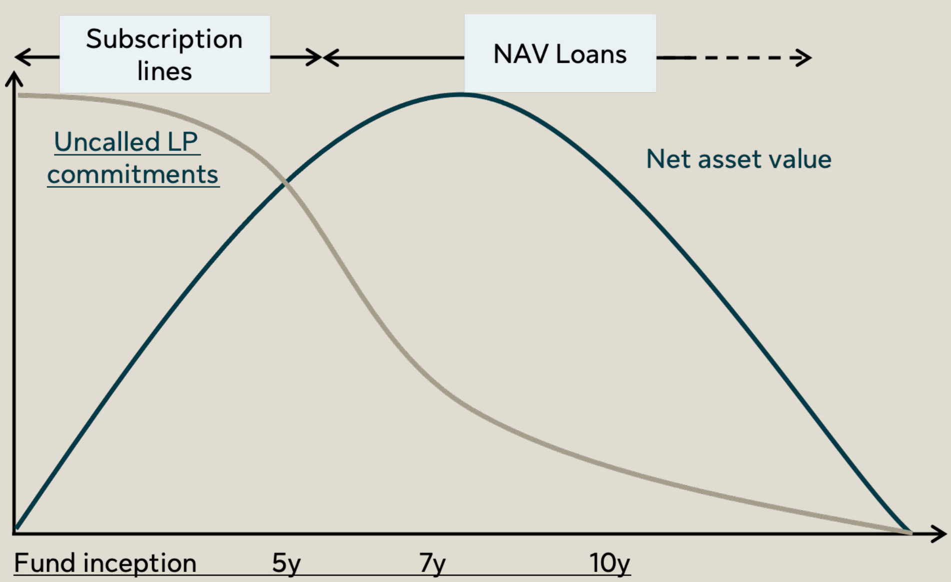
- Covenants, such as the ratio of uncalled commitments to outstanding debt, and value tests that measure outstanding debt relative to the value of assets.
- Lender control over bank accounts of the borrowing fund.
- The ability to block distributions to all LPs if the facility is in default.
- The assignment of other rights of the GP to the lenders, creating significant incentive for LPs to promptly cure a default and for GPs to facilitate that cure.

The key credit considerations when assessing a subscription finance facility therefore include the credit quality of the underlying LPs, diversity/concentration of the LP base, level of overcollateralization and quality of the fund manager.

3. NAV lending

NAV loans are an emerging and fast-growing financing solution that can help private equity managers as borrowers address various capital needs, including the financing of portfolio investments, refinancing of portfolio company debt and funding distributions to LPs. NAV loans are secured by the cash flows and value of the underlying assets in the fund. As such, based on our observations and market activity, NAV loans are typically most suitable for funds at a later stage of their life when sufficient NAV has accumulated in the fund to pledge to lenders. This is illustrated in the following exhibit:

Private equity funds typically have sufficient NAV for lenders later in their life cycles



Graph is for illustrative purposes only.

NAV loans are repaid with proceeds from the sale and/or realization of the underlying investments in the fund. Other distinctive features include conservative LTV ratios and cash sweep mechanisms, which can provide downside protection through credit enhancement and accelerated paydown features. NAV loans also benefit from concentration limitations and eligibility criteria, which help ensure that underlying assets are diversified and of high quality.

NAV loans can broadly be classified into two categories: single-fund and multi-fund NAV facilities.

- Single-fund NAV facilities – A type of financing is advanced to single funds, in which the collateral pool typically includes 5–20+ portfolio companies and the LTV ranges between 10%–20%.
- Multi-fund NAV facilities – Financing advanced to private equity funds focused on secondaries, as well as to LP portfolios or funds of funds, in which the security consists of LP interests in multiple unique funds. On a look-through basis, the collateral pool may consist of interest in dozens to even thousands of individual companies. These facilities can benefit from potentially stable and more predictable cash flows due to portfolio and vintage diversification, which enables higher LTVs, ranging from 35%–50% with coupons that are cash pay.

Risks, challenges and other important considerations

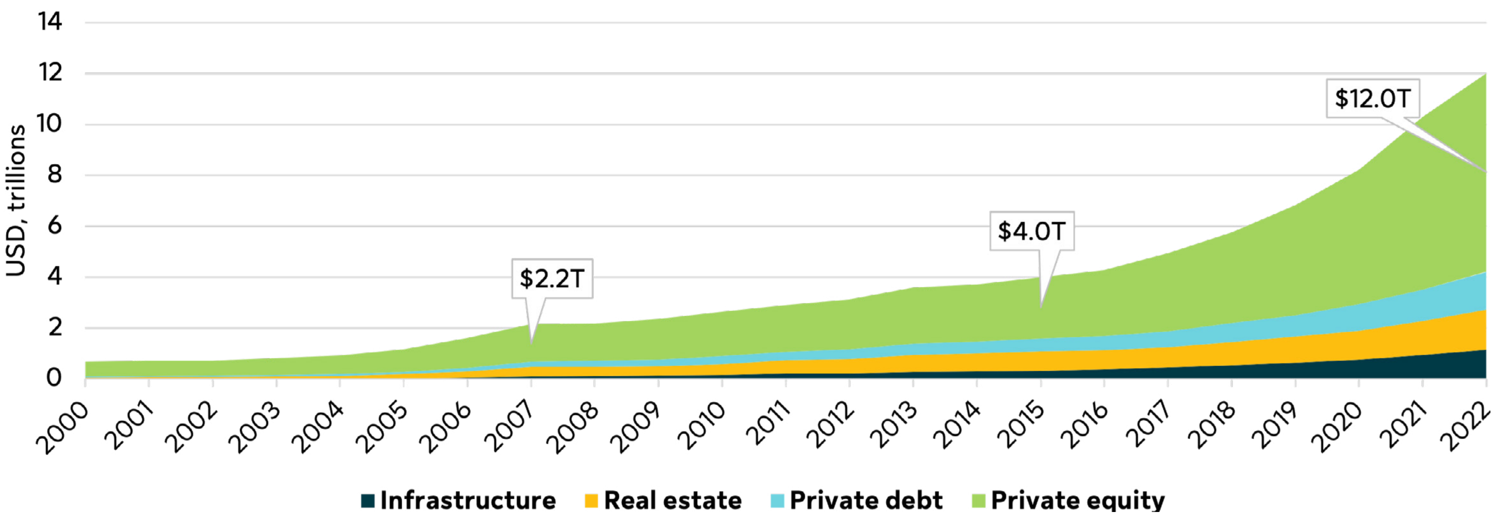
The fund finance market offers investors an opportunity to generate attractive returns relative to traditional corporate loans. In addition to general macro credit factors that impact credit investors, some additional factors to keep in mind with respect to fund finance include:

- **Breadth of strategies and unique risks** – Although all fund finance strategies at their core seek to help asset managers manage capital more efficiently and enhance returns, each strategy does so uniquely. The type of collateral, deal structure, cash flow profile and attachment/detachment points can vary significantly from one strategy to the next. Moreover, given the nascent nature of some fund finance strategies such as NAV lending, there is meaningful variation even across deals in the same vertical. It is therefore critical to understand fund finance more broadly and be specifically knowledgeable about the subtle differences that exist across transactions to more accurately calibrate risk and return.
- **Deal complexity** – Fund finance transactions often use complex structuring and the advantage of diversification to engineer an investment grade profile from non-investment grade collateral. This requires that investors active in this market have a deep understanding of investment grade and non-investment grade credit markets, as well as of legal and financial structuring considerations.
- **Valuation transparency and governance** – Underwriting to and maintaining an appropriate level of overcollateralization is a critical component of deal structuring in fund finance. This can sometimes be challenging due to the illiquid nature of the underlying assets, which can make assessing asset value more difficult. This is typically mitigated through negotiating appropriate valuation and governance provisions in transactions, using independent valuation sources to estimate asset values and relying on firsthand knowledge and expertise of the assets to sense check GP and third-party valuation estimates.
- **Revolving nature of some facilities** – Some facilities, particularly in the lender finance and subscription line segments, can be revolving in nature. This has both administrative and financial implications for investors.
- **Uncertain timing of cash flows and payment-in-kind (PIK) flexibility** – Although many fund finance strategies are cash pay, single-fund NAV facilities often provide the borrower with PIK flexibility. This can allow the asset manager to add interest payments to the principal balance versus paying them in cash; the borrower repays the PIK interest in full either through cash flow sweeps or at maturity. The appropriate level of flexibility is a function of the cash flow profile of the underlying fund. Investors should therefore be prepared to incorporate PIK optionality into their assessment of investment opportunities.

Current growth drivers in fund finance

The demand for fund finance facilities has grown rapidly in parallel with the growth of privately managed capital, as indicated in the following exhibit. As asset managers raise more vehicles to manage private equity or private debt strategies, the need for tools to better manage capital deployment, enhance returns and utilize accretive financing solutions to fund incremental portfolio investments and distributions to LPs has also increased.

***Global private capital by assets under management** (USD, trillions)*



Source: Preqin, as of June 2023. To avoid double counting, fund of funds and secondaries are excluded.

Specifically, with respect to NAV lending, three factors present in today's markets are creating a significant need for liquidity that NAV facilities, with their ability to be tailored to the needs of specific GPs and LPs, are positioned to fulfill:

- The higher cost of operating company loans incentivizing a search for other sources of financing.
- A challenging merger-and-acquisition environment – leading to general partners holding on to assets for longer.
- Limited partners seeking distributions and recalibrating portfolios to achieve asset allocation policy targets between private and public holdings.

Some of the growth drivers for NAV lending specifically are unique to current market conditions and may fade, in our view. However, secular motivations (e.g., more efficient capital deployment, return enhancement, accretive financing for incremental investments) for utilizing NAV loans and more broadly other fund finance facilities should continue to propel these strategies.

Opportunities ahead for selective investors

The fund finance market is changing across multiple axes. The sheer number of transactions is growing, while at the same time deal terms continue to evolve. Some segments of the market (like NAV lending and subscription lines) are increasingly rated, but also have shorter default histories from which future default rates can be inferred. The dynamic nature of the market therefore is creating opportunities for investors. At the same time, investors should approach these assets with a well-informed understanding of the market as it exists today and the trends that are shaping the future of the strategy.

Follow us on LinkedIn

Subscribe to Receive More Insights

This document is intended for institutional investors only. It is not for retail use or distribution to individual investors. The information in this document is not intended to provide specific financial, tax, investment, insurance, legal or accounting advice and should not be relied upon and does not constitute a specific offer to buy and/or sell securities, insurance or investment services. Investors should consult with their professional advisors before acting upon any information contained in this document.

Sun Life Capital Management (Canada) Inc. is a Canadian registered portfolio manager, investment fund manager, exempt market dealer and, in Ontario, a commodity trading manager. Sun Life Capital Management (U.S.) LLC is registered with the U.S. Securities and Exchange Commission as an investment adviser and is also a Commodity Trading Advisor and Commodity Pool Operator registered with the Commodity Futures Trading Commission under the Commodity Exchange Act and Members of the National Futures Association. In the U.S., securities are offered by Sun Life Institutional Distributors (U.S.) LLC, an SEC registered broker-dealer and a member of the Financial Industry Regulatory Authority ("FINRA"). BentallGreenOak, InfraRed Capital Partners (InfraRed), Crescent Capital Group (Crescent) and Advisors Asset Management (AAM) are also part of SLC Management.

BentallGreenOak is a global real estate investment management advisor and a provider of real estate services. In the U.S., real estate mandates are offered by BentallGreenOak (U.S.) Limited Partnership, who is registered with the SEC as an investment adviser, or Sun Life Institutional Distributors (U.S.) LLC, an SEC registered broker-dealer and a member of the Financial Industry Regulatory Authority ("FINRA"). In Canada, real estate mandates are offered by BentallGreenOak (Canada) Limited Partnership, BGO Capital (Canada) Inc. or Sun Life Capital Management (Canada) Inc. BGO Capital (Canada) Inc. is a Canadian registered portfolio manager and exempt market dealer and is registered as an investment fund manager in British Columbia, Ontario and Quebec.

InfraRed Capital Partners is an international investment manager focused on infrastructure. Operating worldwide, InfraRed manages equity capital in multiple private and listed funds, primarily for institutional investors across the globe. InfraRed Capital Partners Ltd. is authorized and regulated in the UK by the Financial Conduct Authority.

Crescent Capital Group is a global alternative credit investment asset manager registered with the U.S. Securities and Exchange Commission as an investment adviser. Crescent provides private credit financing (including senior, unitranche and junior debt) to middle-market companies in the U.S. and Europe, and invests in high-yield bonds and broadly syndicated loans.

AAM is an independent U.S. retail distribution firm that provides a range of solutions and products to financial advisors at wirehouses, registered investment advisors and independent broker-dealers.

The information provided is intended for informational purposes only and represents the views and opinion of the author(s), which may differ from those of other investment teams at SLC Management and its affiliates.

The material does not consider the suitability or needs of any person or entity, and is not a recommendation in any asset class or strategy. Diversification and asset allocation do not protect against loss nor guarantee returns.

Any financial indices referenced as benchmarks are provided for illustrative purposes only. The use of benchmarks has limitations because portfolio holdings and characteristics will differ from those of the benchmark(s), and such differences may be material. You cannot make a direct investment in an index. All referenced indexes are shown for illustrative purposes only. Factors affecting portfolio performance that do not affect benchmark performance may include portfolio rebalancing, the timing of cash flows, credit quality, diversification, and differences in volatility. In addition, financial indices do not reflect the impact of fees, applicable taxes or trading costs which reduce returns. No representation is being made that any investor will or is likely to achieve profits or losses in any asset class described or based on any benchmark. Past performance is not necessarily indicative of future results.

The information provided may present materials or statements which reflect expectations or forecasts of future events. Such forward-looking statements are speculative in nature and may be subject to risks, uncertainties and assumptions and actual results which could differ significantly from the statements. As such, do not place undue reliance upon such forward-looking statements. Any hypothetical data provided is for illustrative purposes only and does not represent actual client portfolios.

Efforts have been made to ensure that the information contained in this report is obtained from sources believed to be reliable and accurate at the time of publication. However, SLC Management does not guarantee its accuracy or completeness. All, opinions, commentary and information is subject to change and SLC Management accepts no responsibility for any losses arising from any use of or reliance on the information provided herein. SLC Management does not provide tax, legal or investment advice and the information within does not consider the reader's investment objectives or needs. Investors should consult a professional based on their unique situation. All opinions and commentary are subject to change without notice and are provided in good faith without legal responsibility.