TALKING POINTS

As GPs and LPs wake up to the benefits of subscription lines and other fund finance solutions, there is a need for more transparency, say Ryan Crowell, product manager for private debt, and Yuriy Shterk, chief product officer, at Allvue Systems

The reporting challenges for fund finance

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Q As we emerge from the pandemic, how have the events of the past year impacted the demand for fund finance solutions, and how is the market developing?

Ryan Crowell: The biggest driver of demand in the fund finance market is, and always will be, the volume of private capital assets under management. Fundraising dipped slightly in Q2 2020 but picked up in Q3 and Q4, and long-term growth trends remain positive.

On top of that, nearly 70 percent of the capital raised last year went into billion-dollar-plus funds, and those tend to be the ones with most demand for leverage. Before the pandemic, this market was benefiting from substantial tailwinds, and based on anecdotal evidence that emerged in March and April of last year, it held up in the face of extreme volatility. This combination of factors – structural tailwinds from private capital fundraising along with a demonstrated resiliency under extreme stress – suggests we are unlikely to see any slowdown in issuance.

The other big driver is the rate of adoption on the GP side, specifically for subscription lines which remain underutilised in this market compared to traditional asset-based facilities. In many ways, the sub line market has parallels with the direct lending world. While the availability of credit increased in a low-rate environment and issuance rose, there was concern about structural risks emerging from some corners of the market.

However, sub lines, like leveraged loans, performed better than expected through the pandemic. There were no widespread defaults despite the unprecedented spike in capital call activity as GPs drew down their lines in anticipation of potential liquidity constraints at

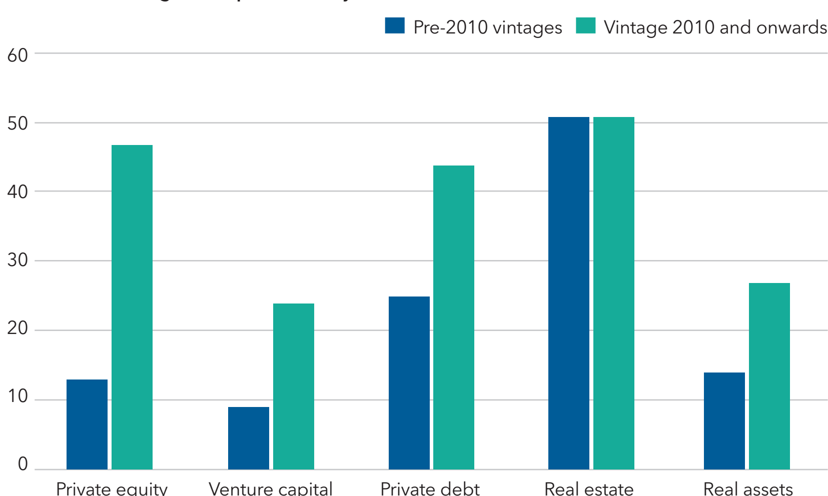
their LPs. However, ultimately, those constraints did not materialise, and LPs continued to meet their obligations.

The last thing to highlight is the importance of relationships. To the extent that there were hiccups, we saw lenders willing to amend terms and provide temporary waivers, particularly for the larger GPs they know well. That will impact how managers view these relationships going forward and who they choose to do business with, while also reassuring LPs about potential risks.

Yuriy Shterk: With all the uncertainty created by the pandemic, folks have realised that these facilities allow them to fund deals with certainty, faster than they have in the past. In the direct lending world specifically, speed of execution is so important, so GPs need to move quickly once they've done their diligence to remain competitive. That's where sub lines became very important, especially coming out of the pandemic.

Wider adoption by GPs led to a realisation on the bank side that this was an opportunity to make money in an area that was traditionally viewed as niche.

Private funds using subscription lines by asset class (%)



Source: Preqin

Q How did the experience impact GP perceptions of subscription lines in particular, and how is that likely to drive adoption going forward?

RC: With GPs, the biggest barrier to sub line adoption are the additional fees, and scepticism from the LP community. While the attitudes have shifted significantly in the last five years, enough LPs remain sceptical that it presents a real obstacle. Even for large GPs with diversified LP relationships, there is a need to deal with different LPs in a single vehicle who may have varying opinions on the matter, which introduces complexity.

Looking back five years, the structures and terms available in the sub lines space were fairly consistent, whereas we are now seeing more esoteric offerings being extended to meet the needs of certain fund vehicles and LP preferences.

Adoption going forward will be driven by the comfort of LPs. The biggest thing that managers can do to provide that comfort is offer transparency into their use of credit facilities and show how they impact IRR and fund leverage. In June 2020, the Institutional Limited Partners Association published updated guidance on standard recommended disclosures, amending the previously released guidance from 2017, and we see adoption continuing to increase as that disclosure becomes more standardised.

As the market becomes more complex and structured facilities become more common, the pressure on GPs to increase transparency in adherence with industry guidelines will intensify, especially as LPs become more demanding in today's highly competitive fundraising environment.

> *"Sub lines, like leveraged loans, performed better than expected through the pandemic"*
>
> **RYAN CROWELL**

YS: Our experience is that a few years ago, very few firms were interested, but in the last 12 months that has changed and people are positively embracing these facilities. GPs are focused on transparency and helping their investors to visualise the data and reporting so that they can justify the expense and decision-making behind sub lines. LPs are also actively performing due diligence on how sub lines are managed by GPs and looking to see the best operational grasp of the management of these facilities on a daily basis.

Q Similarly, how have LP attitudes to subscription lines evolved, and what can GPs still do to address concerns from investors?

RC: Even among those LPs willing to accept sub lines, there is still

scepticism. Through the pandemic, sub lines proved their value as a cash management tool, but investors worry they are being used to juice returns or increase IRR. Structurally, that means they are more hesitant to embrace facilities with longer-term borrowing periods, and practically, that means they are asking more from their GPs in terms of reporting and visibility.

Most sub lines are structured in a way where the covenants and reporting requirements to the lender are consistent with existing reporting requirements to the fund's investors – meaning a lower compliance burden for the manager. However, given the microscope that sub lines are under, combined with the general increase in competition for private debt fundraising, GPs now find they must go above and beyond if they want to use these facilities.

YS: LPs are becoming more scrupulous – in the past the GPs simply shared the report they had produced for the lender and then they were left alone. Sophisticated LPs now expect a lot more in addition to the quarterly statements. The private debt managers that we speak to tell us that LP reporting is their biggest pain point, and the requirements around fund finance are certainly not an exception.

Q Given the increase in demand, how have banks adapted to grow their businesses in an increasingly competitive market? What are the biggest drivers of the supply side?

RC: Private capital markets have exploded since the global financial crisis, so the need for these facilities has increased. This was historically a slightly niche specialism, but as banks have had to pare back some of their riskier business lines, fund finance offers a means to support growth in the alternatives space alongside better risk-adjusted returns.

> *"Sophisticated LPs now expect a lot more in addition to the quarterly statements"*
>
> YURIY SHTERK

That means we have seen a reactionary move, and those with teams in place have expanded their desks while others have moved in. There are around 10 banks that still dominate, but we see from our clients that there are more and more mid-market banks entering the space, first as participants on bigger deals, then moving into bilateral lending with smaller GPs. There is an opportunity to develop relationships with smaller BDCs, for example, where they might provide more esoteric tailored solutions, and grow from there.

We are also seeing insurance companies coming into the space, which is more common in Europe but less in the US. Again, this is viewed as complementary to their core investment strategies and presents an appealing risk-adjusted return on an opportunistic basis.

YS: With this level of specialisation and sophistication come challenges. If a single bank dominates the market, everybody follows the same format and covenants. With multiple players and more borrowers and lenders coming in, you have different formats, technologies and standards, which introduces the challenge of keeping track of commingled exposures.

Q Finally, can you explain some of the unique challenges of managing capital call and asset-based subscription lines for lenders, from both a risk management and regulatory perspective?

RC: This is something we are heavily focused on as a technology vendor, and it comes down to the reporting on the underlying collateral for these facilities. That may be a fund's capital commitments for a capital call facility, or a portfolio of middle market loans for a traditional leverage facility – either way that collateral is inherently opaque and difficult to track.

Said differently, lenders need accurate, timely information from borrowers to evaluate credit risks and exposure, but they don't have direct access to the underlying collateral data. From a risk management perspective, that was manageable years ago when this was a small business, but now there is an emphasis on validating borrowing base calculations, confirming the value of collateral, and moving reporting out of Excel into more scalable technologies.

The other nuance is that this is not a one-to-one loan-to-collateral relationship, it is one-to-many because you make a loan to one counterparty, but the collateral pool is broad, and may overlap across different facilities with different counterparties.

To get a great view of your risk exposure, you need to be able to get down to that underlying collateral level across multiple counterparties, and many banks simply don't have a good way of tracking that. That's where we come in.

YS: There has long been a very distinct set of participants in this market, in terms of lenders, borrowers and collateral holders. All of them have had to work together for deals to go forward, and it will be interesting to see how those interactions evolve as the market gathers pace and complexity. ■