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FFA spotlight

Evolution in the Investor Bases of Private Market Funds

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FFA spotlight

Evolution in the Investor Bases of Private Market Funds

Mention shifting investor bases in private market funds and most will assume you're talking about alternative asset managers' focus on targeting private wealth investors. But while this is significant, it is certainly not the whole story. Other trends are also emerging, such as a renewed focus on GP's commitment levels and the growth of secondaries strategies. Each raises unique considerations for lenders.

I The rise of private wealth products

It is hard to miss the management industry's focus on "retailisation", "semi-liquids" or – rather more grandly – "democratisation". A perfect combination over the past few years of growing demand from a broader investor base seeking access to private markets while maintaining access to liquidity, shifting focus of alternatives managers, user-friendly regulatory changes and product innovation have all led to a more than doubling of AUM in these products in Europe in the past year alone. But "retailisation" is something of a misnomer – these are not pure "retail" products. Rather, they are designed by alternatives managers to target semi-professional and high net worth investors through a global network distribution partners.

The products are typically structured as open-ended, Lux-domiciled companies which offer monthly rights of subscription and quarterly rights of redemption (subject to a cap which can be increased in specific circumstances). The increasing popularity of these products is throwing their unique considerations for lenders into sharp relief.

Importantly, each investor funds its commitment in full, upfront and so are not suitable for subscription facilities. Leverage into these funds is essentially a NAV facility. The key feature that lenders need to understand is that redemptions in these vehicles tend to be hard-wired as rights which attach to the shares or units in the fund. That means suspending redemptions is generally only permitted in exceptional circumstances where it is in the interests of all investors. This is a high bar, and the fund will likely therefore push to ensure redemptions can almost always continue in all but the most serious events of default, making the fund's ability to meet redemption requests both a central diligence point for lenders and a key point for upfront negotiation.

Servicing redemptions may also drive borrowers to push for their "liquidity pool" (the more liquid investments held to service redemptions) to be excluded from the security package. While that is straightforward in principle, thought should also be given to how that liquidity pool can be maintained in circumstances where investor outflows exceed inflows and distributions from the core portfolio are blocked.

Other considerations for lenders may include relaxing concentration limits in the LTV during the early years of a fund, ensuring leverage is only used for permitted purposes, and how facilities will be used at the inception of a fund when utilisation may be lower.

II Other shifts in the "classic" private markets investor base

But private wealth is not the only story. There are other trends emerging which bring with them their own idiosyncratic considerations for lenders.

- **Rated note feeders**

Rated Note Feeder (RNF) structures are becoming a familiar feature in private markets funds across a range of investment strategies, and they are often used to support fundraising from insurance capital. Rather than investing directly into a master fund through an equity LP interest, the insurance investor will subscribe for a rated note which may attract a lower regulatory capital charge compared to equity.

Insurance capital is typically considered high-quality credit risk and most borrowers (and lenders) will likely wish to include the RNF investor in the borrowing base. However, the traditional subscription line security package includes security over a limited partner's uncalled equity commitment to a fund rather than debt. This introduces additional underwriting and diligence considerations for subscription line lenders to ensure that any debt commitments from the RNF investor would be enforceable in the event of a bankruptcy of a fund borrower or feeder fund. RNF structures have been covered in depth elsewhere by FFA member firms, however, some key questions for lenders might include:

- Are the RNF investors 'dual-status' investors (both equity and noteholders)?
- Is the debt issued under the feeder's note purchase agreement subordinate to the subscription line debt?
- In the unlikely event of a facility default, would lenders have the ability to issue notes?
- Does the fund have permission to pledge the RNF unfunded commitment as security for subscription line lenders?

- **An increased focus on the size of GPs' commitments**

Determining the appropriate level of a manager's commitment and alignment with investors is of increasing importance. GPs are now often increasing their commitment percentage, with many stretching to 3-4% of the overall fund size (or even as high as 10%) as investors push back on the traditional c.2% level. But even for managers sticking closer to 2%, as fund sizes have increased, so too have the absolute cash value of GP's stake. As such, the ideal commitment level is under greater scrutiny. Too little, and managers will be deemed not to have sufficient skin in the game, too much and they risk being accused of expecting investors to subsidise the manager's own investment activities.

While not yet market standard, lenders are increasingly being asked to consider the inclusion of the GP commit alongside institutional investors

For lenders, the level of the GP's stake is important. With higher commitments, some borrowers are pushing for a move away from excluding the manager's commitment from the borrowing base and instead looking for an advance rate which includes it. While not yet market standard, lenders are increasingly being asked to consider the inclusion of the GP commit alongside institutional investors.

Where accepted by lenders, GP commitments are usually subject to significant haircuts, capped within the overall borrowing base and/or only recognised once a certain level of capital has been called.

Against the broader market backdrop, these changes have driven the need for more innovative GP financing solutions. As a result, liquidity has improved with the rise of alternative lenders who can provide GP financing on a standalone basis. These facilities often provide more flexible security packages, which may also look across multiple funds on an aggregate basis which may benefit the GP. Alternative lenders may also offer higher advance rates than those commonly provided by banks. Unsurprisingly, however, this added flexibility generally comes at a higher cost, reflecting the bespoke nature of these arrangements.

- **An exponential rise in the number of secondaries investors**

Secondary strategies have been gaining traction due to the overall growth of private markets and as a consequence of growing LP sophistication and increasing demand for liquidity solutions. As a result, secondaries' share of private equity AUM has almost tripled since 2000, and last year, transaction volumes for secondaries hit a record $226 billion.

This shift, however, brings its own set of considerations for lenders:

- There may be diligence challenges where an LP is transferring its interest in a fund where there are subscription lines in place, due to the limited information available. Practically, lenders are considering and consent to transfers more regularly, which may result in increased costs. For secondaries funds, borrowers may not have access to the same level of underlying portfolio data as lenders expect. Instead, they are dependent on the information rights of their underlying portfolio funds.

- There has been a significant uptick in the number of secondaries NAV deals, which has led to both sophistication and standardisation of terms for those facilities. Consequently, some lenders are prepared to take a lighter-touch approach to consent requirements and granting of security over the equity interests in the NAV borrower. Some lenders may be able to rely on a representation from the fund/borrower as to consent having been obtained, in lieu of undertaking their own diligence.

Whilst secondaries/fund of funds vehicles play a crucial role in facilitating liquidity across private markets, their inclusion as LPs brings a distinct set of considerations for lenders:

- The inclusion of secondaries or fund-of-funds vehicles as LPs introduces additional structural complexity, as lenders are unlikely to have full look-through visibility into the ultimate investors and their respective credit profiles. That said, many of these funds are themselves high-quality vehicles, backed by a broad and diversified base of institutional investors and managed by experienced sponsors. Consequently, lenders will often seek to accommodate them within the Borrowing Base, albeit with mitigants such as aggregate caps or look-through information requests.

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High net worth investors represent an increasing proportion of a fund's commitment base, so borrowers are actively pushing lenders to consider giving some credit to the commitments of these investors

- An additional consideration is that secondary funds may already have subscription line financing arrangements in place at the LP level. This dynamic is both a credit positive and a potential risk factor. On the one hand, the presence of a subscription line reduces near-term funding and liquidity risk within the secondary vehicle itself, supporting its ability to meet capital calls. On the other hand, lenders must carefully assess structural subordination risks, as uncalled LP commitments to the secondaries fund may already be pledged to another lender.

Overall, while secondaries funds represent a high-quality and growing LP segment, their inclusion necessitates a more nuanced approach from lenders.

- **An increasing number of HNWs in "traditional" closed ended drawdown funds**

High net worth investors represent an increasing proportion of a fund's commitment base, so borrowers are actively pushing lenders to consider giving some credit to the commitments of these investors in the borrowing base. Lower advance rates and second lien tranches are both possible options to provide an additional buffer and/or mitigate credit risk.

In addition, finance providers are often more comfortable incorporating HNWs in the borrowing base where those HNWs access the fund via a bespoke feeder vehicle. For lenders, the benefits of this approach include diversification of the HNW feeder (based on the number of participants), which can result in very low default rates, and immediate alignment of interests where investors' capital is contributed upfront to the HNW feeder.

- **Classic investors but with novel structures to protect liquidity**

A growing number of NAV facilities, subscription line facilities and hybrid financing structures are now being implemented higher up the fund structure, particularly at the feeder fund level. These feeder fund vehicles may draw on such facilities to fund a portion of their capital call obligations, with lenders typically benefiting from recourse to the investors' undrawn capital commitments to the feeder fund and/or the feeder fund's interest in the master fund. Subscription line facilities used to bridge investments, together with other bespoke financing arrangements, are therefore increasingly being established at intermediary levels within the fund structure, between the main fund and the ultimate investors. These facilities reflect a broader trend of investors seeking tailored financing solutions from GPs to address their specific liquidity and portfolio management needs

III Potential future changes

There are developments in motion that are also likely to result in further shifts in this area, including:

- **The impact of the UK government's pension reforms**

Under the Mansion House Accord, some of the UK's largest workplace pension providers have committed to investing at least 10% of their defined contribution (DC) default funds in private markets by 2030, with 5% of the total allocated to the UK. The new Pension Schemes Act gives teeth to the Mansion House Accord, empowering the government to mandate investment by defined-contribution, multi-employer pension funds in private markets where certain conditions are satisfied.

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For private markets funds themselves (and their finance providers), the resultant shift in investor base seems both inevitable and welcome.

- **The impact of tokenisation**

The investor base in private markets is also poised for transformation due to tokenisation by converting traditional private assets into digital tokens on blockchain platforms, which will enable a broader range of investors to participate, including "true" retail investors who have previously been excluded due to minimum investment thresholds. New institutional players may also be attracted by improved liquidity and transparency.

The increased liquidity and transparency brought by blockchain technology is likely to simplify fundraising processes and reduce costs. However, borrowers may face new regulatory complexities and will need to navigate potentially changing investor bases.

IV Final thoughts

The explosion in popularity of evergreen private wealth products has undoubtedly created a new landscape with bespoke considerations for fund finance providers. However, there have been a number of other market trends that have had equally significant consequences for lenders on how they approach the provision of finance solutions to the private markets funds sector. As ever, the trend for continued evolution and change in investor types and the need for innovative financing solutions which meet their needs looks set to continue.


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