E X P E R T Q & A

Greater specialisation will lead to an enhanced toolkit for operators in the market over the next five years, say Kate Sinclair and Katie McMenamin, partners in the fund finance group in Simpson Thacher & Bartlett's London office

Innovation escalates as fund finance comes of age

SPONSOR
SIMPSON THACHER & BARTLETT

Q How would you describe the fund financing market today as it moves into a new phase of maturity?

Kate Sinclair: Fund finance as a concept has been around for a while, but for a long time it was a niche part of the credit market. Over the past five years, growth has accelerated and it is now much more on the radar as a distinct credit strategy. In addition to its core product lines, there are innovations and technologies being adopted to broaden the appeal of fund finance to providers, investors and users.

In the core part of the market, the demand for subscription lines, NAV facilities and GP and co-invest financings – and all variations and hybrids of these product types – remains steady and set for sizeable growth. These are well-established tools for managers across strategies and asset classes to manage operational investment needs and tactically solve for timing and liquidity challenges that arise in their portfolios and at the house level.

Q What innovations are you seeing in different parts of the market?

Katie McMenamin: Starting with the subscription line space, the challenge that market participants have been trying to solve is balance sheet capacity. For various reasons, some traditional bank lenders have faced difficulties meeting demand for the scale of sub lines that larger fund managers need. We have seen innovative approaches to overcome that, a lot of which comes down to opening this space to insurance and institutional capital.

Market participants are looking at various technologies to appeal to that more liquid part of the market, but it does require some additional structuring to effectively tap the right available pools of capital. The use of securitisation technology in the fund finance

> *"The demand for subscription lines, NAV facilities and GP and co-invest financings remains steady and set for sizeable growth"*
>
> **KATE SINCLAIR**

context is a good example, with various market participants now adopting and adapting relatively established securitisation technology, and applying it directly to portfolios of subscription lines.

In simple terms, these pools of receivables are being packaged into a bankruptcy remote vehicle that issues notes on a tranched basis and that allows institutional investors, particularly insurance companies, to gain exposure to these assets in a form and structure that meets their requirements while simultaneously freeing up balance sheet for the underlying originators.

KS: Another innovation is building in term loan technology to secure participations in facilities from institutional providers where term loans are more favourable structurally and where they also provide certain lenders with the most advantageous capital treatment. Layering term loan debt into revolving credit facilities is an obvious way to maximise borrowing capacity for sponsors. Again, this is established technology that is not unusual in other parts of the credit market, but embedding it into fund finance structures is a slightly newer use case.

Q What is driving that need for innovation?

KS: Sheer volume of subscription line activity will always track in some way the rate of overall fundraising and, as this picks up more broadly as anticipated in 2025 and beyond, the expectation is that solving for balance sheet constraints will be a key challenge in this part of the market.

KM: The more recent and longer-term market trends driving pressure on balance sheet capacity for subscription lines are well documented, including larger average fund sizes, the retrenchment (for a range of reasons) of certain historically significant bank providers and, particularly importantly looking forwards, the effects of the Basel III Endgame on appetite for this type of committed lending.

Q How are new tools and structures being used in practice?

KS: The use of ratings is playing a key role in increasing liquidity in the fund finance market. In this regard, it is important to build a detailed understanding on all sides of the ratings processes and methodologies being adopted by leading ratings providers so as to maximise outcomes and ensure efficient implementation. Examples of this include managing the information flow to rating agencies, as well as allowing sufficient time for the rating to be obtained if required as a condition to a

Q Do you see the range of NAV and GP financing products expanding going forward?

KM: We expect to see the NAV and GP financing markets becoming increasingly specialised in different asset classes, as the lending structures and technology provided to infrastructure, credit, secondaries or private equity funds becomes slightly more targeted. The market will become larger and more sophisticated, with certain providers becoming more suited to certain asset classes and developing technologies that work better for some parts of the market than others. We will, I think, move away from talking about NAV lending as a single product towards talking about it in a credit context versus a private equity, infra or secondaries-specific context, for example.

We are already working with our clients on designing optimised fund structures for credit funds targeting these markets (with the tactical use of rated-note feeders and collateralised fund obligations being good examples), and designing sophisticated back-leverage arrangements in order to allow providers to most effectively fund themselves and maximise returns. Many of these again, where appropriate, harness institutional capital through the innovative use of private placements and bond technology, as applied to the NAV-lending and GP financing context.

We will also see GPs thinking about fund finance alongside a whole tool kit of solutions for generating liquidity at the house level, with the use of leverage and GP stake sales also part of that menu of options.

facility, and carefully crafting fund and finance documentation that is mindful of the key assessment factors and required day-one and ongoing disclosure requirements.

KM: As we've highlighted, layering in term loans to sit alongside traditionally revolving subscription facilities is another potential means of building in insurance-backed lending vehicles into a sponsor's borrowing capacity. Here, we are increasingly seeing participants repurpose already established architecture in the broader credit markets to solve for largely intercreditor related points and practical scenarios that need to be provided for in documentation when combining different tranches of debt into a lending structure.

Structural considerations need to be addressed early in a facility process, whether parties are looking to combine revolving and term tranches into a single facility structure with shared security and pari passu ranking and waterfalls, or to build in second-lien structures and advance rate top-ups with common or overlapping transaction security packages alongside agreed ranking and voting positions.

With purposeful planning and stakeholder management, all of these types of more nuanced debt packages can be effectively designed and structured to meet the requirements of sponsors and providers alike in the subscription line space, and we are seeing various market participants think carefully about the optimal approach for their particular fund vehicles and portfolios.

Q What are you seeing in terms of the adoption of securitisation-style and bond technology in fund finance?

KM: With eyes still on maximising balance sheet efficiency, various securitisation style structures have emerged to package sub line-related receivables and issue tranched exposure to these cashflows to appeal to institutional capital providers and, primarily, insurers. These structures are coming to market now and the ability to achieve the commercial aims of a range of stakeholders will be a key test over the short to medium term for the use of these structures in the fund finance space.

> *"The challenge that market participants have been trying to solve is balance sheet capacity"*
>
> **KATIE MCMENAMIN**

We are seeing bond issuances and the securitisation of mainly subscription facility loan portfolios by, as mentioned, the sale of loan receivables into orphan or bankruptcy-remote SPVs, which in turn issue securities to third-party investors. We have also seen on-balance sheet synthetic replication of these cash-funded structures through the application of derivatives, credit default and related insurance products to these receivables.

In another variation on the theme, participants are also considering structures where the underlying loan receivables are constituted by the uncalled capital commitments of funds themselves. Here we see sponsors potentially acting as risk retainers for, and subordinated lenders to, an SPV into which they transfer their beneficial title to a fund's uncalled capital commitments. This then allows the sponsor and their lenders to structure their subscription line debt at the SPV level with associated optimised capital treatment for providers where securitisation treatment is preferred.

Q What about innovation outside of subscription facilities?

KS: Whether you call it Fund Finance 2.0 or use other terminology, NAV, preferred equity and hybrid products are now an established part of the fund financing toolkit. Market participants are thinking about what is next, and some of that is about education or using existing technology for different use cases. For example, we are seeing NAV facilities being used for a wide variety of purposes and there are conversations going on in the LP community around what events in a portfolio or fund vehicle's life might lend themselves best to being solved via the use of these fund finance products.

There are private credit managers fundraising for dedicated NAV lending strategies, so naturally LPs are looking at these products from an allocations perspective and therefore building their understanding of the market and how these facilities perform in practice. The entry of these managers and expansion of this product will help to raise awareness and increase the general understanding across the LP and sponsor community.

Q Where do you see fund finance going five years from now?

KS: Fund finance is now well established in its own right as part of the debt market, with specialist banks, providers and lawyers. Continued market and product sophistication and specialisation is inevitable, and we expect it to continue to fully come of age over the next five years as a dedicated and established strategy spanning broader credit and capital markets. ■