HEDGE FUND
legal & compliance digest

Direct Lending

Direct Lending Managers: A Conversation with Dechert's Matthew Kerfoot

Direct lending strategies have grown in popularity in the post-financial crisis investment environment due to their decisive returns and reliable periodic distributions. As investor demand for the strategies continues unabated, hedge fund managers seeking lucrative, risk-adjusted returns have sought to fill the void traditional commercial banking institutions left after they withdrew from the space.

The Hedge Fund LCD recently spoke with Matthew Kerfoot, a partner at Dechert, about the state of direct lending, how hedge fund managers are accessing the space and the most pressing operational, tax, fund structure and regulatory concerns managers implementing direct lending strategies should heed.

What is the current state of the broader fund finance market? What aspects of fund finance are experiencing the most growth?

The term "fund financing" in this context primarily refers to private funds taking on leverage from commercial banks and other traditional sources of financing. There has been a great deal more participation from private funds in the fund financing space as a result of the dramatic equity raises for both private equity and private debt funds.

Why is direct lending by private funds increasing? What are its benefits for managers?

One of the reasons why private funds have in some sense become banking institutions is because many of the traditional banks have stepped back from smaller borrowers due to increased regulation. Another reason is that a lot of these smaller private borrowers don't have credit ratings, and so the banks would have unrated assets on their balance sheets, which just attracts additional regulatory capital. In many cases, regional banks that had previously served the small and middle market community have been acquired by larger banks, so they are no longer available to serve this market. That has created a vacuum that a lot of private funds have stepped into.

There has been a huge amount of equity capital moving into this space, and a number of managers have had tremendous success raising funds to conduct direct lending business. New funds, both hedge funds and private equity funds, are continuously entering this space. Once enough equity capital has been raised, it is deployed, loans are made and portfolios are built up. Managers often like to leverage up those portfolios to increase returns, and this is where we've seen banks in the fund finance market extending leverage against these portfolios. The fund may borrow at LIBOR +2, +3 or +4, but then they lend out at LIBOR +7, +8 or +9, and with a levered portfolio they may see returns in the double digits.

What we're seeing with the increase in direct lending by private funds is part of a larger trend in terms of the performance of different asset classes, namely active management of fixed income and equities, which has not been as attractive since the financial crisis. There has been a real hollowing out of alpha in actively traded, relatively liquid strategies. On the other end of the spectrum with illiquid strategies, we've seen a tremendous amount of outperformance, and that's where investors are seeing very attractive returns.

What products are hedge fund managers in the private debt space offering and to which types of borrowers?

Hedge fund managers are basically organizing funds to extend funding to these small- and medium-sized enterprises, the SMEs. It is a private credit business, and the credit is offered to private companies. In terms of product differentiation, it really just comes down to what types of borrowers the manager will be working with. Some managers will emphasize smaller, lower EBITDA borrowers, while others may focus on medium-sized businesses. There is also a focus on offering first lien versus second lien debt. With second lien debt, such as mezzanine debt or subordinated debt, the risk profile clearly changes, but the pricing changes too.

Are private equity managers involved in direct lending?

Yes. We're seeing a lot of interest from private equity managers who are running a credit arm or a credit sleeve, which is similar to what we're seeing from hedge fund managers. We haven't seen specific differences between what a private equity manager will offer and what a hedge fund manager will offer. There is a great deal of overlap.

A lot of funds entering the space are new entities that have hired teams or are doing a joint venture with a team to conduct a direct lending business.

It's not a situation where managers are changing the strategies of their funds, and so there is no need to seek investor approval to change the fund's strategy, or any other aspects of the fund, to allow for direct lending activities.

Why would investors want to participate in a fund, SPV or other vehicle a manager sets up for direct lending activities? What are the benefits?

Investors are increasingly concerned about performance, and the direct lending space to date and over the past several years has generated significant performance. One of the appealing aspects of direct lending is that there are usually distributions off the portfolio, which is a portfolio of loans with periodic interest payments.

The other side of this is that these assets and vehicles are completely illiquid with market dislocations with informational inefficiencies that managers can take advantage of, and this is where investors are seeing the outsize returns and where they will pay for that. You will still see fees at "2 and 20" for these funds.

What is the current market for terms regarding the loan-to-value of assets pledged, interest rates and restrictive covenants?

As I noted previously, a lot of these funds are set up as capital commitment funds. A standard hedge fund with quarterly liquidity presents some issues in the direct lending space in terms of maturity mismatch between investor liquidity and asset liquidity. To the extent they can, managers try to match the maturity profile of the investor capital and the portfolio assets. That's why many of these funds are set up as capital commitment-style funds. An investor is committed to a certain amount of equity capital and is committed to the investment period, which is usually three to five years.

There are still some hedge fund-type fund structures there. These vehicles will often have initial lockups, gates and side pockets because of the illiquidity of the portfolio. We also see some "slow pay" provisions, so that investors cannot get out until the assets attributable to their share class mature.

Are there any unique compliance issues for managers engaging in fund financing activities? How can managers address them?

I think valuations are the biggest concern, because these assets do not trade on an exchange, and they do not have large numbers of brokers covering them. Usually, third-party valuation agents are used, but then managers have to consider when, if ever, they can override the third-party valuation.

Managers also need to ensure they are clear to investors that these are risky credits, and that once they get in, they may not be able to get out for an extended period of time, and they may not be able to get out when they think they should get out.

What trends have you seen with respect to cross-border fund finance arrangements?

There are some cross-border finance arrangements, but those are usually handled by the operations in the relevant jurisdiction, because the issues are not always the same. For U.S. funds, there is more of a U.S. focus, driven in large part by the legal structure around insolvency.

What are some of the key issues with cross-border arrangements? How can managers address them?

The biggest issue is the bankruptcy concern. If a manager has to go into a work-out scenario, it is going to be very different outside the U.S. than in the U.S. Another concern is that different jurisdictions have very different market conventions when it comes to private debt. Obviously, those financings are going to be done in the local currency, then you have hedging issues to deal with when you convert that local currency exposure for dollar exposure if you're a U.S. manager with U.S. investors.

Have you observed any trends regarding partner loan programs?

We've seen these programs for years. I don't think there is new growth in this space with respect to private debt. I imagine there is some growth, because there are more managers and larger funds, but I don't see any correlation with the growth of the private debt industry as a whole.

What are some of the more common terms of partner loan programs?

There is often a key person provision. Usually the collateral is the fund itself, so these loans are often considered NAV-based loans. There are usually performance parameters around the LP interests that are being pledged to support the loan. We'll typically see events of default related to material adverse events at the fund level. There are also standard loan provisions relating to representations, warranties and restrictive covenants.

What are the most significant fund financing UBTI and structuring considerations?

I think the biggest issue for fund managers is effectively connected income. When a fund is engaged in direct lending activities, that is effectively the conduct of a business in the U.S. If you have a foreign investor that otherwise does not have a nexus to the United States, but is an LP in the fund that is conducting this business, then that investor can be viewed as having business in the U.S.—its income is "effectively connected," and could subject that offshore investor to U.S. taxation. There are a number of products and solutions that managers are looking at to block ECI. The structures that are used are unique to the individual managers. Some managers are looking at '40 Act registered funds as blocker entities for that taxable income.

The same is the case for UBTI, because U.S. non-taxable investors are unable to use debt financing in their investment activities. When a fund takes on leverage and uses that leverage as part of its investment activities, that can generate UBTI for those investors. The same structures being employed to block ECI are used in relation to UBTI concerns.

What is the current state of the subscription credit facilities market?

This is actually a significantly growing market, and it is growing dramatically for two reasons: one reason is the record private equity capital raises, and the other is that private debt funds are now taking on subscription line leverage.

What are the key issues in the U.S. subscription credit facilities market? Internationally?

From a purely regulatory perspective, I don't think there is much that managers need to worry about. There are a number of structural and contractual issues that come up. Notably—and this has come up a lot recently—there is some concern about GPs or sponsors using the subscription lines to help finance some of the portfolio, almost to use it as a term facility to increase the IRR on the portfolio. Some investors say that this could be misleading in terms of the expectations of investors looking to invest in the fund or that have invested in the fund.

There could also be some restrictions on the ability of LPs to transfer their interests. When an investor signs up as an LP there are transfer restrictions in the limited partnership agreement, but what has happened from time to time is that there are additional restrictions placed on the sponsor. Some of those restrictions include enforcing new transfer restrictions on the LPs indirectly through the credit agreement. Sponsors have been wrestling with this issue.

How are hedge funds utilizing credit facilities?

They will basically sign up to some type of revolving credit facility or a term facility, although these are less common. What happens is these funds are commonly set up as capital commitment-style funds, and when the fund has assembled a portfolio, it can draw down on the equity or the revolving credit facility.

Some funds are not set up as capital commitment vehicles, and they will just raise equity investments that they deploy as it comes in, and they also draw down on the revolver as it comes in. The revolvers are useful because there is so much capital moving into the direct lending space that there has been a wave of refinancings and re-pricings, so some managers are having difficulty redeploying capital. We've also seen spreads narrow across portfolios, which has some people thinking we've reached the end of the cycle in this space.

The revolving credit facility provides managers with some flexibility where if they do get repaid early on a financing or on a meaningful portion of their portfolio, then the revolver can also be paid down.

What are hedge fund managers' objectives when utilizing credit facilities?

In the direct lending space, the advances are being used primarily for enhanced returns on the loan portfolio. Managers and sponsors will rely on these facilities from time to time for short-term needs, such as cash flow management, but the real driver of these financings is to put structural leverage on the portfolio.

What subscription credit facility structures or offerings do hedge fund managers employ?

I would say the basic structure is still intact, which is a committed facility from a bank or a syndicated facility that is committed and set up as a revolving credit facility. More recently, we're seeing a few developments in the structure. First, we're beginning to see a number of banks considering offering the subscription line on an uncommitted basis because committed facilities attract a high capital charge under the new regulatory capital rules.

We're also seeing some banks working with hybrid structures so that the subscription line can then transition to an asset-based line during the investment period. The issue with this is that the desk that writes the subscription-based line is different from the desk that writes the asset-based line, so there are internal issues at financial institutions that need to be overcome.

Are you seeing an increase in willingness among GPs to offer consent for LPs to pledge their equity interests? If so, what is driving this trend?

The GP has to consent to the assignment of these LP interests. Nowadays, we're seeing more managers give consent. We've seen a number of GPs and sponsors that have their own secondaries funds or funds of funds, so they've become much more sensitive to the issue and are much more willing to play along and grant consent.

Are you seeing any change in the language in subscription agreements regarding assignment of equity interests?

We haven't been drafting our subscription agreements necessarily any differently than in years past. The key is that our lender clients have been more receptive to structural alternatives to the traditional consent-and-pledge, such as through the use of a subsidiary. We have also, in limited cases, put in place a structure in which the custodian of the fund holds the assets and the lender client obtains a perfected security interest through an account control agreement.