Fund finance: evolution, insights & opportunities

For decades, fund finance has been the area in which large global banks operated. Nowadays, it is coming into the realm of institutional investors. For good reasons, says Shelley Morrison, who leads the Fund Finance strategy at abrdn: 'Fund finance is a versatile asset class, offering growing opportunities.'

By *our editorial team*

What is fund finance?

'Fund finance refers to fund-level debt provided to private markets funds, including private equity, private credit, infrastructure, and real estate funds. There are two main types of fund finance: subscription-line facilities, also known as capital-call facilities, and net-asset value (NAV) loans. Large, global banks have dominated fund finance for several decades. However, the asset class is now opening up to institutional investors looking for low-risk, income-generating assets that can deliver attractive risk-adjusted returns and capture high illiquidity premiums.'

What is the difference between subscription lines and NAV-backed finance for return expectations and risk?

'Subscription lines, or capital calls, are loans secured against a fund's limited partner commitments. They are usually multi-currency, revolving credit facilities with a legal maturity between one and three years. These are high-quality assets with first-ranking collateral and the diversification of credit risk across a large pool of committed investors.

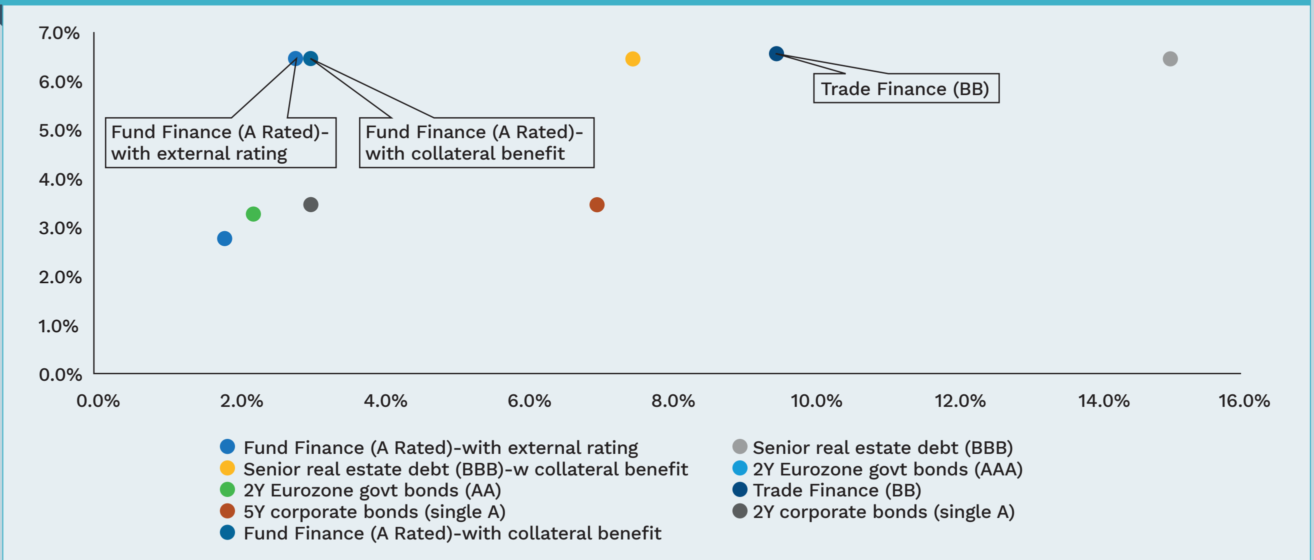
Subscription lines are typically investment-grade quality, with a low correlation to equities and other credit assets. They also have a stable credit risk profile: the asset class has a near-zero loss rate and performed well during the global financial crisis and the Covid-19 pandemic.

Investors should not confuse subscription lines with fund-level NAV loans, which are a form of structural leverage. Fund finance NAV loans are secured by the portfolio assets and are repaid from asset sales or the cashflows from those assets. These have a different, usually higher, risk profile and are typically longer in tenor.'

Why do general partners use fund finance?

'General partners, or GPs, use subscription lines to bridge a fund's investment activity. This includes funding an acquisition or investment rather than

FIGURE 1: EXPECTED RETURN VS ESTIMATED SOLVENCY CAPITAL REQUIREMENT



Source: abrdn, as at January 2024.[1]

‘Fund finance refers to fund-level debt provided to private markets funds.’

calling capital from investors with a 10-day notice period. This finance provides certainty and flexibility of funding, short-notice access to liquidity and reduces administrative complexity.

GPs use this finance to ‘batch’ capital calls to avoid drawing down on investors too often. Such activity ‘smooths’ the capital call process and reduces the number and frequency of capital calls. Subscription-line facilities are now an integral part of a GP’s strategy – it’s increasingly rare to see a fund without this arrangement.’

What is the benefit of fund finance to limited partners?

‘A squeeze on liquidity is a growing concern for limited partners, or LPs, in the current environment. The lack of a clear, detailed understanding of how and when the fund will call capital increases uncertainty.

The GP’s use of subscription-line facilities means LPs no longer need to hold their capital commitments in highly liquid, lower-yielding investments pending an uncertain and unpredictable call timetable. Greater certainty around the timing of capital calls allows LPs to be more strategic with their liquidity and better manage their cashflows.’

How are investors using fund finance in their portfolios?

‘Fund finance is a versatile asset class. Investors are making allocations to subscription-line loans to achieve many different objectives. These include portfolio diversification, optimising risk-adjusted returns and, where relevant, capital efficiency. By investing in subscription-line loans, it’s possible to achieve higher yields without compromising credit quality or taking on excess credit risk. This asset class is therefore an interesting alternative to assets like shorter-dated government bonds.

Based on our client conversations with European insurance companies and our in-house insurance solutions team’s expertise, we understand fund finance to be one of the more attractive investments from a capital efficiency versus expected return perspective. Depending on the loan’s tenor, rating, and the insurer’s ability to model the collateral benefit of asset backed lending strategies such as fund finance, the solvency capital requirement, or SCR, is approximately 2 to 3%.

Figure 1 illustrates the relationship between estimated expected returns and estimated SCRs for commonly held public and private credit investments in Europe.’

What are the attributes of a good investment manager in the fund finance space?

‘A good investment manager in this asset class will work with a team of dedicated specialists across all stages of the investment process. These are specialist assets, so investment professionals should demonstrate a deep understanding of the specific risks for subscription-line facilities and strong origination channels.

The investment manager must be experienced in managing the operational aspects of subscription lines. These include short-notice loan requests, multi-currency revolving credit facilities, and more.

>

PHOTO: ARCHIVE ABRDN

CV

Shelley Morrison

Shelley Morrison leads the Fund Finance strategy at abrdn, drawing on extensive experience in fund-level debt facilities across multiple asset classes. Before joining abrdn in 2019, she served as a Director in RBS’s Fund Finance team and worked in structured asset finance at RBS and Lloyds. She holds CFA Investment Management, CISI Corporate Finance, and CFA ESG Investing certificates. Morrison serves on the Fund Finance Association EMEA Executive and Women in Fund Finance Committees and holds degrees from the University of Edinburgh.

Additionally, it's necessary to conduct high-quality due diligence of the fund and credit documentation.

Investors should look for managers who have in-house specialist counsel or who outsource risk management to specialist firms.

We also recommend focusing on the quality of the manager's relationships with other market participants.

Finally, maximising returns from the asset class requires a steady, predictable deployment of capital into loans. A good manager should have extensive relationships with banks and financial sponsors to ensure ongoing access to high-quality deal flow through multiple channels.'

Why is the opportunity set particularly rich now?
'There's an insufficient supply of subscription-line finance to meet the growing demand from GPs and financial sponsors. Bank balance sheets have not been able to keep pace with the demand. Furthermore, the 2023 bank failures in the US and Europe removed significant supply from a growing fund finance market. This sudden supply-side contraction had two positive impacts for institutional investors.

First, loan margins for new issuance of investment-grade quality transactions have increased by more than 50 basis points since the first half of 2022. Fund finance lenders can now capture more attractive illiquidity premiums than before.

Second, GPs and financial sponsors are understandably sensitive to bank counterparty risk. Many are broadening and diversifying their lender groups, removing reliance on one or two key lenders.

'There's an insufficient supply of subscription-line finance to meet the growing demand from GPs and financial sponsors.'

'Based on our client conversations with European insurance companies, we understand fund finance to be one of the more attractive investments from a capital efficiency versus expected return perspective.'

Subscription-line facilities are floating-rate assets and typically priced above SOFR, SONIA or EURIBOR, depending on the currency of the loan. Many facilities also benefit from a floating-rate floor, protecting investor returns in a falling interest rate environment.'

What are the possibilities for ESG and impact investing within fund finance?
'There's a growing demand for ESG or sustainability-linked subscription lines. Here, the loan margin charged depends on the fund's performance against agreed ESG KPIs or objectives. For example, delivering a measurable reduction in carbon consumption across portfolio companies. These structures are designed to incentivise a positive change in investing or operational behaviour. We've also seen an increase in funds with impact-led investment strategies closely aligned with the SDGs.

It's now possible to invest in a diversified portfolio of fund finance facilities that can help investors achieve their sustainability objectives.' ■

1 Indicative only. Target return estimates are gross of fees and the source of the information is abrdn's experience of investment management outcomes, as well as Bloomberg for corporate and government bonds. Tenor has been used as opposed to duration, given the relatively short-dated nature of the instruments illustrated. Further potential benefits in the estimated SCR from diversification with other market and non-market risks has not been considered for any of investments shown, given that this is highly specific to an insurers' investment portfolio and constraints. Benefits from the use of an insurers' internal model are also not included. Collateral benefits must be assessed by an insurer based on their own regulations: guidance is only indicative. Currency is assumed to be hedged. External ratings are assumed to be from an external credit assessment institution (ECAI). Information is subject to change and is not a guarantee of future results.

SUMMARY

Fund finance provides low-risk, income-generating assets with attractive returns and high illiquidity premiums, opening new opportunities for institutional investors.

Subscription-line facilities offer stable credit risk profiles and near-zero loss rates, while NAV loans have higher risk profiles and longer tenors.

ESG and sustainability-linked subscription lines incentivise positive change, aligning with the SDGs and enabling investors to achieve their sustainability objectives.