

funds europe

Special report: Trends in fund finance

in partnership with



THE REMARKABLE GROWTH OF FUND FINANCE

A FUNDS EUROPE SPECIAL REPORT ON THE FUTURE OF FUND FINANCE IN THE AGE OF ESG AND ECONOMIC TURBULENCE

We've helped fund opportunity for years

No matter where our technology goes, relationships will always be at the heart of our business.

For day to day banking, for borrowing, for keeping your assets safe – all through one point of contact. We'll bring you ideas to help manage your money and protect your investors, and be there when you need a financial sounding board. Always thinking about what more we can do for your business now, and in the future.

Working with:

- Private Equity
- Private Equity Real Estate
- Infrastructure and Renewable Energy
- Private Debt
- Asset Managers
- Corporate Service Providers

Visit rbsinternational.com to find out more



The Royal Bank of Scotland International Limited ("RBS International") is incorporated in Jersey and registered on the Jersey Financial Services Commission ("JFSC") company registry as a private company with limited liability. It is authorised and regulated by the JFSC with registration number 2304. Registered and Head Office: Royal Bank House, 71 Bath Street, St. Helier, Jersey, JE4 8PJ. Tel. 01534 285200. RBS International London Branch is registered in the United Kingdom as a foreign company with registration number FC034191 and branch number BR019279. United Kingdom business address: Level 3, 440 Strand, London, WC2R 0QS. RBS International London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority (reference number 760675) and limited regulation by the Prudential Regulation Authority. Details about the extent of RBS International's regulation by the Prudential Regulation Authority are available on request. Guernsey business address: Royal Bank Place, 1 Glatigny Esplanade, St. Peter Port, Guernsey, GY1 4BQ. Tel. 01481 710051. Regulated by the Guernsey Financial Services Commission and licensed under the Banking Supervision (Bailiwick of Guernsey) Law, 1994, as amended, the Insurance Managers and Insurance Intermediaries (Bailiwick of Guernsey) Law, 2002 and the Protection of Investors (Bailiwick of Guernsey) Law, 1987, as amended. Isle of Man business address: 2 Athol Street, Douglas, Isle of Man, IM99 1AN. Tel. 01624 646464. Licensed by the Isle of Man Financial Services Authority in respect of Deposit Taking, Investment Business and registered as a General Insurance Intermediary. The Royal Bank of Scotland International Limited, Luxembourg Branch, (RBS International Luxembourg Branch). Business address: Espace Kirchberg, The Square, Building A-40 Avenue J.F. Kennedy, L-1855 Luxembourg. Tel. +352 270 330 355. Authorised and supervised by the Commission de Surveillance du Secteur Financier. NatWest International is the registered business name of The Royal Bank of Scotland International Limited under the Business Names Registration Act. Gibraltar business address: NatWest International House, 57 Line Wall Road, Gibraltar. Tel. 200 77737 or 200 73200. Regulated and authorised by the Financial Services Commission, Gibraltar to undertake Banking and Investment Business from 55 and 57 Line Wall Road, Gibraltar. Our services are not offered to any person in any jurisdiction where their advertisement, offer or sale is restricted or prohibited by law or regulation or where we are not appropriately licensed.

A bright future for fund finance

FUND FINANCE IS ENTERING an era of change. Recent market volatility is symptomatic of a global economic shift, with inflation rising to levels not seen in a generation and higher interest rates. At the same time, the sustainability agenda is becoming ever more urgent, both for our environment and for financing itself.

After years of rapid growth, fund finance must adapt to address these challenges and to meet the demands of funds for greater flexibility and sophistication.

This report investigates these issues through a panel discussion of specialists and an analysis of the issues, including in-depth interviews with sector experts. The overwhelming conclusion is that fund finance faces a bright future, but one in which it must and will evolve.

Sustainability is becoming an embedded feature in fund finance. Those that wish to make their ESG credentials a core dimension of their fund need to address the issue at the outset and do so with rigour and meaningful metrics.

Meanwhile, the development of innovative forms of finance is expected to accelerate. This trend is already underway with the recent rise in net asset value (NAV) financing, and it will continue as funds become more complex.

The sources of finance are also set to increase as new entrants, including major institutional investors, look to expand their fund financing activities.

This report delves deeper into these trends, but these factors all point to a new landscape for fund finance – one of closer and longer-term relationships. Finance providers must become partners to their fund clients, working together on sustainability and creating more sophisticated and flexible solutions.

Such a partnership approach will ensure both that fund finance continues to grow, and that it continues to deliver ever greater value to the funds industry.



Emerging trends in European fund finance

FUND FINANCING HAS BEEN ONE OF THE STRONGEST GROWTH STORIES IN THE FUNDS INDUSTRY OVER THE PAST DECADE. AS SUSTAINABILITY HAS BECOME A VITAL DIMENSION OF FINANCE AND AS NEW UNCERTAINTIES ARISE IN FINANCIAL MARKETS, WHICH TRENDS WILL SHAPE THE FUTURE OF FUND FINANCE?

RISING ALLOCATIONS TO alternative assets, low global interest rates and an increasing demand from managers for sophisticated and flexible solutions have led to growth, not just in the sheer scale of fund financing but also in its sophistication.

Today, rapidly changing macroeconomic conditions, highlighted by rising interest rates and the recent bout of turbulence across financial markets, have posed fresh challenges and herald a new environment for investment and finance. But while market turbulence has dampened the pace of growth, fundraising remains high by historic standards, and the demand for more sophisticated financing solutions is, if anything, expected to strengthen.

To understand the scale and pace of these emerging trends and the effect of recent market events, *Funds Europe* spoke to experts across the funds sector, from advisers to legal experts, asset managers and fund financiers themselves, to hear their insights on this fast-changing landscape.

Key trends and factors

The global economy is at an inflection point. Central bank rates are rising across the developed world while geopolitical uncertainty continues to cast a shadow over investment; the cost of funding, FX rates and even sanctions were raised

as issues by many of our interviewees. But, despite the uncertainties, the view was unanimous that fund finance would weather the turbulence.

Nevertheless, these uncertainties provide the backdrop to fund financing trends over the coming months and beyond.

Aside from the macroeconomic environment, three key trends emerged from our in-depth interviews; some already established but set to accelerate and develop, others nascent and yet to show their full ramifications.

• Sustainability

Green funds and an environmental dimension to investment have been features of the funds sector for at least a decade, but in the past few years, the focus on sustainability has intensified. Both finance providers and sponsors are increasingly keen to link finance explicitly to ESG targets. This in turn is raising concerns and challenges around the risks of greenwashing and the rigour and metrics required.

• Innovation and complexity

Net asset value (NAV) financing has been increasing in recent years. NAV financing links finance to underlying assets, rather than funds deals. But NAV is just one aspect of the innovation in the market. Many of the experts we spoke to attested

to a general increase in innovation and complexity in financing and expected those trends to continue, including the emergence of financing structures previously unthought of.

• New capital and new entrants

Fund financing has been dominated by bank lenders, but the attractive risk-return profile and the desire among non-bank investors to diversify into alternative assets is drawing new entrants to the market from smaller banks to insurers and other institutional investors. Demand for fund finance is inexorably linked to the overall scale of the fund market, initial fundraising is booming, and mega-funds are now commonplace. Major fundraisings in 2022 include Advent International (US\$25 billion), KKR (US\$19 billion) and Blackstone (US\$30 billion).

Each of these trends has many aspects, but combined they amount to continued growth in private equity funds and in the demand for credit financing, rising complexity in the structures of that finance and the need for sophisticated solutions.

SUSTAINABILITY

Sustainability is no longer an afterthought in fund financing. Questions around ESG, the potential for explicit sustainability-linked finance and the metrics required

▮ INFLECTION POINT - The demand for more sophisticated finance solutions is expected to strengthen.

to build ESG into the heart of the process have become a core issue in fund finance.

As Georgina McCreadie, assistant director, funds advisory at Deloitte, explains: "ESG is only continuing to grow as an area of attention for PE managers. We are seeing this translate into a growing interest and focus on ESG and sustainable linked financing for funds. Managers are increasingly looking for ESG to be one of the initial discussion points when considering how to structure their subscription facilities and will see it as an important capability when reviewing lenders' offerings."

Much of the impetus for pushing and maintaining ESG issues high on the fund financing agenda is coming from lenders themselves, who have made environmental issues in particular a priority. McCreadie points out that bank lenders are likely to refer fund financing deals not only to their credit committees but also, and with equal emphasis, to their own ESG committees. And McCreadie points to rising demand from LPs for an ESG dimension to their investments.

Lynn Alzin, partner in the finance and capital markets practice of Luxembourg business law firm Arendt & Medernach, agrees. "What's driving the increase in ESG is greater investor engagement," she says. "Investors are becoming more engaged in general, which is obviously then driving the pressure on funds to line up their ESG objectives and have that at the heart of their strategy."

An emerging metrics system

As well as continuing to rise in importance as an issue, ESG itself is also developing into a more complex and sophisticated aspect of finance. Warm words and broadly framed intentions are no longer sufficient. Hard key performance indicators (KPIs) are now at the core of sustainability-linked loans

in which rates are directly connected to achieving key performance indicators.

Melinda Perera, capital markets and banking partner at law firm Linklaters, says: "One of the biggest trends we see currently is the continuing intellectual investment that we and our clients – both sponsors and lenders – are making in understanding how best to structure ESG-based KPIs in sustainability-linked facilities. This comes with complexities, given that there is a very wide range of sustainability frameworks. Different sectors will have very different KPIs, and recent historic levels for certain targets – for example, greenhouse gas emissions – might not be appropriate, given the impact of Covid-19.

Perera adds: "There is also a real variation across different markets in Europe around the use of sustainability-linked lending. In centres for funds and fund financing, such as Luxembourg and London, margin adjustments with reference to ESG-based KPIs is pretty common. In others, it is more early stage."

The global market is even less homogeneous. Ian Harcourt, country head and head of institutional banking at RBS International Luxembourg, says the US is still far behind the European market in its adoption of ESG metrics in their funds. "The US is clearly lagging behind Europe in regard to measurement plus reporting standards because the subsidies, along with the support the US government was giving and how long they would last, was unclear."

But Harcourt is hopeful the disparities between Europe and the US on ESG issues will reduce and argues the US Inflation Reduction Act (IRA), passed in August this year, has created important incentives, as well as visibility on that support, for 15 to 20 years ahead.

Despite variations between markets, common ground is emerging, and the direction of travel is clear – ESG-



"THE U.S. IS CLEARLY LAGGING BEHIND EUROPE IN REGARD TO MEASUREMENTS PLUS REPORTING STANDARDS BECAUSE THE SUBSIDIES, ALONG WITH THE SUPPORT THE U.S. GOVERNMENT WAS GIVING AND HOW LONG THEY WOULD LAST, WAS UNCLEAR."

Ian Harcourt

based KPIs are becoming a core factor in fund financing. Crucially, says Stefan Szczurowski, director of institutional banking at RBS International, rigorous KPIs and Sustainability Performance Targets (SPTs) will be essential in the battle against the risk of greenwashing.

"The key thing is ensuring that the SPTs that the agreed KPIs are being assessed against are the right targets and that they reflect material improvement – it has to be about driving real change. We've seen an increase in the average number of ESG-based KPIs in sustainability-linked facilities – it's now an average of two

or three per deal, including social and governance metrics as well as the more common environmental and climate ones. We're seeing more enquiries from sponsors about how they can incorporate ESG-linked terms into their facility. But the key is that these features are rigorously challenged with appropriate due diligence," says Szczurowski.

And there is a growing army of experts involved in that process. Each deal team will be examining ESG risk, the fund sponsor will typically have an ESG team, and the lender will have their own dedicated team focused on the structuring of ESG-linked facilities.

To date, the marginal difference in rate available through a sustainability-linked loan has been very modest, and the primary benefit has been in reputation and in meeting the ESG expectations of investors. But this may be changing, first in its complexity and second in its materiality. The use of two-way ratchets is increasing, where funds not only secure a marginally lower rate for achieving ESG KPIs but may also face penalty rates in the event of failure to hit those targets. Meanwhile, Jen Yee Chan, specialist in fund finance at the law firm Simmons & Simmons, says she is seeing some signs that the marginal rate available for meeting ESG KPIs may be widening.

"Initially you were only talking about a couple of basis points, so people were saying, 'This is not worth it.' Now I am sometimes seeing differentials in the double digits," says Chan.

Sustainability-linked finance becoming truly material would mark a step forward for sustainability. But whether this happens in the short or long term, the investor demand for an ESG dimension to investment and the pressure from authorities to build ESG targets into investment terms mean sustainability is now an unstoppable force in fund finance and no one can afford to ignore it.



THE FOCUS OF SUSTAINABLE INVESTMENT

The focus of sustainable investment is rapidly evolving as new priorities emerge both from an environmental and economic perspective. Melinda Perera, capital markets and banking partner at law firm Linklaters, outlines the key areas where sustainable funds and sustainable fund finance will need to play a role – and some key unknowns that may yet move the goalposts.

"A big focus at the moment is energy transition, in light of the situation in Ukraine. Energy transition is a very important challenge for European funds from an ESG perspective: for example, this year we have seen the EU's plan to achieve European independence from Russian fossil fuels by 2027, within the EU's broader net-zero goal by 2050. Clearly, funds have a huge role to play in supporting energy transition through their investment activities, but it may well be that in order to support energy transition, complex ESG issues will need to be weighed up.

"For example, materials such as cobalt, which are key to battery technology, require supply chains in countries that mine them, the two biggest of which in the case of cobalt are DR Congo and Russia, which clearly raises questions from an ESG perspective. To take another example, there are ongoing questions about the role of gas and nuclear. From an EU law perspective, they have been labelled as transition fuels in the Green Taxonomy, enabling investors to market them as green investments, but what proportion of institutional investors will see it that way, and for how long?"

INNOVATION AND COMPLEXITY

Fund finance comes in a range of structures but can be categorised into three broad groups.

Firstly, there are subscription lines – financing at fund level. Secondly, there are NAV or asset-backed facilities, which are secured against the value and cashflows of the underlying assets and may be combined with sublines

to form a hybrid form of finance.

Thirdly, there is GP financing, typically secured against GP-owned assets or management fees.

These different types of finance play different roles in the market, but sublines remain the bread and butter of the business. Haakon Blakstad, chief commercial officer at fund advisory group Validus, says the true global scale



“INVESTORS ARE BECOMING MORE ENGAGED IN GENERAL, WHICH IS THEN DRIVING THE PRESSURE ON FUNDS TO LINE UP WITH THEIR ESG OBJECTIVES AND HAVE THAT AT THE HEART OF THEIR STRATEGY.”

Lynn Alzin

of subline financing is unknown, but undoubtedly vast.

“The subscription line market is the largest and it’s the one that is being used by almost everyone in the private capital and alternative investment space,” says Blakstad. “No one has ever been able to estimate the total size of that market in monetary terms – how many billions or trillions exist in those facilities across the world.

“There is just such a wide variety in how people use these facilities, how much they might borrow and how long they might have the facility. That is the other thing that makes it complicated to assess the market size, because for

every manager, the outstanding amount can vary from hundreds of millions one month to zero the next month, because they’re being repaid quite quickly.”

The Covid pandemic saw a sharp rise in subline pricing, which according to Blakstad dropped back temporarily before rising again in anticipation of central banks and market rates rises. Speaking before the market turbulence of October, Blakstad was already expecting tougher times ahead.

“There’s war in Europe, there’s inflation unchecked, there’s rates going up. People in all financial markets are concerned and there’s troubling clouds on the horizon. For that reason, people are being a bit more cautious, and some banks are curtailing lending. That’s one very clear reason pricing is going up. But there’s another reason: we’ve got a very large and increasing demand. There is certainly no slowing down in fundraising. It seems like every month there’s news of a new mega fund with 10 billion plus being raised and of course, all these funds need this kind of financing, because it’s become part of how they live and breathe.”

Blakstad is just one of several experts who point to an increased demand from funds for solutions to market uncertainties, such as rate rises and FX volatility, even before the recent market turbulence.

Funds backing their assets and seeking asset-backed

The challenges of the Covid pandemic also prompted many funds to hold on to strongly performing assets longer than originally planned rather than exit during the economic slowdown. Research from the financial software provider eFront found that private equity holding periods rose to an average of 5.4 years in 2020, from an average 3.4 years a decade earlier¹.

This prompted two further trends, both

of which have continued as the pandemic has waned and new uncertainties have emerged. The first is GP financing, typically to bridge GP investment as existing funds extend while allowing LP exits. The second is asset-backed or NAV finance, which since it is secured against underlying assets, proved attractive for those holding assets with strong fundamentals.

Chan at Simmons & Simmons explains: “A number of funds, and in particular PE funds, were concerned about what the valuations were going to look like for their portfolio companies and whether this was the right time, even if the fundamentals were sound, to try and achieve an exit. So, you had funds that would ordinarily have been moving into the harvesting phase thinking: ‘This is not a good time to be harvesting anything.’

“So, they decide to buy and build. And maybe if they are in year five of the fund, they don’t have any uncalled commitments – that’s a situation ripe for a lot of NAV-type financing activity.”

NAV financing is still a minority activity in fund financing, but its growth has been conspicuous and was mentioned by almost all our interviewees. Most think it is only likely to grow. The base of assets upon which NAV finance can be built is vast, with private equity alone estimated to be sitting on US\$5 trillion of unrealised assets².

Steve Burton, treasurer at investment management group ICG, says: “Sublines have become well understood and accepted by LPs, and NAV deals are now going down that same route. They’ll take a while to get anywhere near the subline acceptance, because there’s a lot more complexity in them, but they’re becoming another very common tool for somebody looking for fund finance.”

In the coming months however, Burton suspects the economic uncertainty might put a temporary brake on NAV



“PRIVATE DEBT IS AN EMERGING SOURCE OF INNOVATIVE LIQUIDITY, WHICH WILL BE A FORCE DRIVING THE EVOLUTION OF THE MORE STRUCTURED END OF THE FUND FINANCE SPECTRUM GOING FORWARD.”

Jamie Mehmood

finance. “In periods like this, it will slow down because assets have to go through greater scrutiny. So, I think that the NAV market might struggle a little bit more than the subline market in the next six to 12 months.” Overall, he believes NAV will continue to grow.

Solutions for uncertain markets

NAV is also indicative of a broader trend towards greater complexity in fund financing. Covid, and now a renewed macroeconomic uncertainty of rising rates and increased market volatility, is leading sponsors and managers to seek added components to their financing to help mitigate risk.

“Another important component of financing is certainty,” says Perera at

Linklaters. “With the volatility we are seeing at the moment, leveraged loan and high-yield markets might become increasingly challenging and expensive to access. Fund financing is therefore an alternative and complementary source of finance, which is arguably less prone to market volatility and can be used in parallel with deal-level funding to ensure access to liquidity.”

These developments in structures and risk perception vary between markets, Perera adds, but the direction of travel is common. “Different jurisdictions in Europe will be further up or down the curve of these trends, but the one constant is that anyone working in fund financing must have a deep bench of global multi-jurisdictional expertise to help them navigate the evolving landscape,” she says.

In terms of the sources of funding themselves, matters are also growing more complex. The sheer scale of funds now being created means meeting their financing needs is sometimes beyond the appetite of a single lender and syndication of fund financing is on the rise.

GROWTH IN NON-BANK LENDERS

The rise in sustainability issues, the growing scale of fundraising and the demand for greater sophistication and complexity in financing are helping to drive the third key trend in fund finance – the growing presence in the market of non-bank lenders.

For Szczurowski at RBS International, this is in fact one of the most important developments.

“The main trend we’ve seen is the recent entry of non-bank lenders, such as insurers, pension funds and other institutional asset managers, into the market to fill the supply demand gap between the amount of capital being raised and the financing that can be provided by the traditional bank market.

According to Preqin, US\$320 billion was raised by European managers in 2021, that’s up fourfold in ten years from US\$78 billion raised in 2011, outpacing the growth in financing capacity across the traditional banking markets,” says Szczurowski.

As well as demand from the fund sector itself for new financing sources, there is a rising supply. Institutional investors have a growing appetite for alternative assets as a way to diversify away from traditional markets. A survey by private asset research group Preqin found that the top 25 global institutional investors planned to increase their allocations to private markets from 9% in 2021 to 10-15% by 2025 and then further to 15-20% by 2030, twice today’s level.

According to Burton at ICG, the arrival of new entrants in fund financing is also being stimulated by the perception that non-bank institutions may have more regulatory flexibility. “Insurance companies, pension funds are coming direct, they have a different view on how they want to lend,” he says. “There is a view that they might have less stringent requirements around KYC (Know Your Customer) and documentation and they’re certainly finding their place less so on sublines and more on the secured asset base.

“Ignoring the immediate environment, they are definitely going to be players in this,” Burton adds.

Jamie Mehmood, head of funds advisory at Deloitte, points in particular to debt funds becoming financiers of private equity funds: “Debt funds are very keen to deploy now into private equity NAV financing opportunities. When you look at fund finance, private debt is an emerging source of innovative liquidity, which I think is one of the major changes that we’ve seen over the last two years and will be a force driving the evolution of the more structured end of the fund finance spectrum going forward.”



“YOU’VE GOT A WHOLE BUNCH OF NEW LENDERS, PEOPLE LIKE INSURERS AND PENSION FUNDS, REALISING THAT FUND FINANCING IS A GOOD WAY FOR THEM TO DEPLOY THE CAPITAL THEY’VE GOT.”

Jen Yee Chan

Chan at Simmons & Simmons agrees, adding that the entrants can also play a role in the growing complexity of fund financing and in the growing use of syndicate financing. “You’ve got a whole bunch of new lenders, people like insurers and pension funds, realising that fund financing is a good way for them to deploy the capital they’ve got,” she says.

The desire among institutions to diversify into alternative assets and private equity has regulatory ramifications, and EU and UK authorities are looking at ways to increase the access of institutional investment, most notably pension funds, to private markets as those markets have become an increasingly significant part of the global economy.

The exact progress and evolution of regulation remains one of the unknowns, but few doubt that the desire is there among many authorities and governments to increase institutional access to private investment and therefore to fund finance. Hopes are high.

What do sponsors want?

Fund finance has been growing at pace for several years and while the immediate economic environment might create some headwinds, the consensus is that fund financing will continue to grow. That growth will be both in scale and in sophistication. The medium to long-term outlook for asset-backed finance is positive and NAV may yet prove to be only the start of a broader wave of fund financing innovation.

There is also the rise of sustainability. While some experts ponder whether the current turbulence will distract from the ESG agenda, there is unanimity that ESG can only grow in prominence and become a basic essential in fund financing arrangements. The sophistication of those sustainability targets will evolve, becoming more tailored to each asset or fund and therefore possibly more stretching. At the same time, the science of climate change

and the regulatory environment are themselves developing rapidly.

For sponsors, this all adds up to a complex range of needs, but they can be best captured in two words: flexibility and partnership.

Mehmood at Deloitte argues fund-financier relationships will benefit from being long-term and strategic. “When we talk to our clients, the engagement may centre on a subscription line, but we’ll also be thinking more holistically, considering what financings and relationships they might need further down the line, always trying to think a couple of steps ahead.”

It is a view echoed by Szczerkowski at RBS International: “Flexibility and commerciality are now the primary considerations of sponsors selecting long-term fund financing partners. The lender’s ability to understand, work collaboratively with their clients, and support them over the longer term is absolutely fundamental.” **fe**

1 – Fund finance: Harnessing NAV finance in new ways | White & Case LLP (whitecase.com)

2 – NAV Financings: A Review of the Year | Q2 | 2022 | Publications | Insights & Publications | Debevoise & Plimpton LLP





Bringing data to life

We provide institutional investors, including pension funds, insurance companies and consultants, with data and analysis to assess, research and report on their investments.

CAMRADATA is committed to fostering and nurturing strong, productive relationships across the institutional investment sector and are continually innovating new solutions to meet the industry's complex needs.

info@camradata.com



CAMRADATA



Fund financing roundtable

FIVE INDUSTRY EXPERTS DISCUSS THE FUTURE OF THE FUND FINANCE MARKET IN THE AGE OF ESG AND ECONOMIC TURBULENCE.

PANEL

BRADLEY DAVIDSON
ESG lead, RBS International

JAMIE MEHMOOD
Head of fund finance advisory, Deloitte

SARAH LOBBARDI
Founder, Avardi Partners

SHELLEY MORRISON
Head of fund finance, abrdn

BRONWEN JONES
Fund finance partner, Reed Smith

Funds Europe – How do you see ESG in fund financing developing? In particular, do you expect a growth in hard metrics for environmental targets and/or a greater focus on the social and governance dimensions?

Bradley Davidson, RBS International

– There are funds who have had ESG strategies for years, but current market dynamics show us that a robust response to environmental and social factors is becoming a prerequisite for any fund to remain competitive.

As funds develop and implement their strategies, there's an increasing number of customers looking to link ESG KPIs to their financing or to attract cheaper

cost of funding if they're investing in specific green assets or projects. I expect sustainable finance structures will be commonplace in the short term as managers look to evidence the benefits of their ESG approach.

Over time, I wonder whether there will be a place for sustainable finance as we see it today, because if we think more broadly about what the market is trying to do and where we are shifting to, the end goal is to deliver a truly sustainable economy. Therefore, long term, sustainable finance should just be finance.

In the interim, what's going to drive that change is that lenders, us included, set ambitious climate

targets and allocate capital towards decarbonisation. Climate and carbon emissions are the focus of the market right now.

As lenders set their own targets, they'll be assessing their customers' climate credentials.

So, even if you aren't applying for a specific sustainability-linked or green loan, you are going to be assessed based on your climate impact and how you're accounting for climate risk. Increasingly, those assessments will be quantitative.

There's been a rise in ESG assets globally – roughly a 150% increase over the last decade. So, we're at a crossroads now where we're considering a double materiality.

The question is not just: 'Are you accounting for ESG or climate risk?' It's also: 'What will the impact of the decisions you make have on the outside world?'

People sometimes conflate the two, which can lead to confusion. There are those taking the approach that ESG is a risk management technique and lenders will ask for that information to understand the financial impacts of ESG risks.

But on the other side, you'll see more of those hard targets and those stretching goals where the fund is saying, 'Here's what we're going to achieve across environmental and social development.' This approach may appeal to investors and other capital providers aligning their portfolio with broader societal requirements.

Ultimately, if you are not accounting for ESG risk at all, your cost of capital will go up as we'd expect to see for lack of risk management across any stripe.

Jamie Mehmood, Deloitte – The change in the adoption of ESG linkage in fund finance is being driven by a societal shift. Even three to five years ago, most managers had an ESG

department and a stated position on ESG. But we're on a journey and now it's about embedding ESG, so it becomes mainstream and [part of] every decision.

From a finance perspective, ESG metrics are evolving, but there's also a broader piece, which is about societal change and expectations from the consumer. The consumer will drive the expectations of the investor, which in turn drives the expectations of the manager, and that then drives the expectations of the financing. It goes all the way through that chain.

As Bradley says, we're still on the journey of raising the bar and standardisation around ESG metrics in fund finance, and the more society is pushing for these things, the more the decisions of the borrower and the investor will have ESG embedded at the core of what they are doing.

Shelley Morrison, abrdn – There's three main trends. The first is the two-way margin adjustment. When ESG facilities were first shown to us, we saw a lot of one-way margin adjustment, and it's good to see that borrowers will now get a benefit, or a penalty. That's important.

The second is the emergence of hard metrics, not just at the portfolio-company level, but at the sponsor or the manager level too. So, people are getting their own house in order as well as their portfolio companies.

Finally, there's a trend I am uncomfortable with. We see a lot of good intention from funds and lenders, but we also see credit facilities where the ESG framework is documented, but the specific metrics of the reporting is not.

That's dangerous, because if that intention isn't quickly translated into action, it becomes at best just a PR exercise with little substance. Potentially, that is damaging to the



“THE END GOAL IS TO DELIVER A TRULY SUSTAINABLE ECONOMY – THEREFORE, LONG TERM, SUSTAINABLE FINANCE SHOULD JUST BE FINANCE. IN THE INTERIM, WHAT'S GOING TO DRIVE THAT CHANGE IS THAT LENDERS SET AMBITIOUS TARGETS AND ALLOCATE CAPITAL TOWARDS DECARBONISATION.”

Bradley Davidson, RBS International

credibility of ESG-linked fund finance.

Mehmood – External verification has also been an important development. That has been driven very much by the Loan Market Association standards, which have helped raise the bar in everyone's best interest.

Against the backdrop of 'greenwashing', which is a key concern for lenders and borrowers alike, we want this to be future-proof, so that

when people look back at it in five years' time, they're not saying, 'That wasn't fit for purpose.'

Sarah Lobbardi, Avardi – We've had a different experience. Every time we speak to clients, they have this sustainability and ESG angle that they market to the investors and it's something that is important for them. But we found that between having that conversation and putting ESG in place, there's a different story.

Some of our clients want to do ESG and that means going back to the starting point and doing the real work upfront – we're not going to start by just ticking two or three boxes. But they don't have the metrics, and then they realise it's a lot more work than they expected.

So, then they say: 'Well, we don't have time for this; it's not the right time, so let's leave this for the next round.'

We have had a few transactions where we started doing an ESG facility, but things took so long that it was dropped in the middle of the process. The time constraints of the fund managers didn't allow the work needed. We've done green loan financing, which is quite different. Its whole purpose is environmental, and it works because the client is a green manager, and they have everything embedded.

But there are still a high number of fund managers – and here I'm speaking about quite large funds – that have ESG embedded in their investment strategy, but don't yet have it [properly] embedded within the firm itself, which is what they need if they want to translate it into financing at the fund level.

So, we still have a way to go before the expectations on the financing side match the fund manager's strategy and process.

Bronwen Jones, Reed Smith – In my role, I come in at the end of the process and draft what's been commercially agreed. Certainly, over the last two or three years, the drafting I'm doing in relation to ESG has moved from a wishy-washy, feelgood idea to much harder measurable metrics.

For example, one I was looking at last year had requirements for the fund to appoint female directors to each portfolio company. There were also other measurements like ensuring portfolio companies use fewer high-energy light bulbs and less paper.

The metrics have become more specific than [in the past]. And I agree completely with the two-way margin, so it can be a bit punitive as well as a bit positive.

Funds Europe – What impact have the EU taxonomy and the Sustainable Finance Disclosure Regulation (SFDR) had? And do you expect the UK's Sustainability Disclosure Requirements (SDR) to align?

Jones – I am beginning to see talk about taxonomy creeping into discussions, which has the potential to be helpful, assuming it's adopted widely. The terms and phrases will crop up more frequently in finance documents and using a consistent set of terms to describe what you're looking at will benefit everybody. To pick an example: 'increasing diversity'. What does that mean [exactly]?

You must start getting quite specific to break that down into actual measurable components. That's where the EU taxonomy will come in. As to the UK SDR, the UK will either adopt the EU taxonomy or just use the same words and phrases.

Mehmood – While there's



“WHEN ESG FACILITIES WERE FIRST SHOWN TO US, WE SAW A LOT OF ONE-WAY MARGIN ADJUSTMENT, AND IT'S GOOD TO SEE THAT BORROWERS WILL NOW GET A BENEFIT, OR A PENALTY. THAT'S IMPORTANT.”

Shelley Morrison, abrdn

standardisation, there's also differentiation. It's important with ESG-linked parameters that the manager can make sure that the KPI measures they put in place for fund financing dovetail with the specific ESG priorities of the manager/fund, hence not creating a secondary set of measures. What you don't want is a standardised set of KPIs. Bronwen's example of diversity is an interesting one.

For one manager, it might be about gender representation on boards, but for another it might be broader than gender. It might also include ethnicity

and disability. The manager must be in a position to decide what the important parameters are and measure against that.

Morrison – It's a frustration when I look at what on the surface appears to be well-structured ESG-linked fund finance, but when you look closely, the metrics that have been chosen aren't exactly a stretch and are not material to the financial performance of that fund.

They're easy to measure, but what does it mean for your investment activity? There is a danger that we could force too much standardisation and it becomes meaningless. It's got to be very specific to the investment strategy of that fund, that manager and what they're trying to achieve.

Davidson – One of the risks of SFDR is the way it can be interpreted as defining whether activities are either good or bad. Actually, the bulk of what we need to do is support existing companies and assets to transition. We need to see capital flowing to help what we might call 'brown assets' find their place in a sustainable economy and because of the nuance required for those conversations, we haven't seen specific transition finance instruments developing at the same pace as green structures, but I expect we will as the market matures.

What we can't do is create a bubble of bright green investment, without looking at the rest of the economy. If we find ourselves trying to boil down environmental issues to one single metric, we need to question ourselves, because that won't get us to where we need to be.

Morrison – Fund finance has a potentially transformative role to play here. When I read trade press or

commentary on the market, everyone talks about how difficult it is to put ESG-linked fund finance together because we can't standardise things, or we might not have the data.

But they underestimated the impact of being able to engage strongly with a financial sponsor. They're investing in potentially 20, 25 or 30 portfolio companies, so there's a multiplier effect of strong ESG engagement at this level, which is much more powerful than engaging directly with one corporate, for example.

There is a huge responsibility here on financial sponsors, but if you take the time and put in the hard work at the start, it's going to be transformative.

Funds Europe – What are the growing sectors or assets for fund investment and how are these trends altering the attitude of fund financiers?

Lobbardi – If I look at the assets that are using fund finance, we are seeing a lot more real estate and infrastructure than five or ten years ago.

There is also a shift in the type of finance product. Five years ago, the market was dominated by capital call facilities. Since then, NAV financing and other more complex financing has exploded. And we see that across all asset classes. We see that through the secondaries, which are doing NAV while they're still deploying capital to increase their investment capacity. We've seen that a lot in the last 18-24 months and the volume of this type of financing has increased rapidly.

Likewise for the private equity funds, nearly every private equity manager wants to have that conversation about NAV financing.

There is no exact number because no one really tracks the exact volume, but NAV and similar types of products



“THERE ARE STILL A HIGH NUMBER OF FUND MANAGERS THAT HAVE ESG EMBEDDED IN THEIR INVESTMENT STRATEGY, BUT DON'T HAVE IT [PROPERLY] EMBEDDED WITHIN THE FIRM ITSELF, WHICH IS WHAT THEY NEED IF THEY WANT TO TRANSLATE IT TO FINANCING AT THE FUND LEVEL.”

Sarah Lobbardi, Avardi

maybe represented 20% of the market five years ago. Today, 50-60% of the market is NAV or another type of more complex or sophisticated financing.

What does that mean in the next 12-18 months? Well, a technical recession is already here, and the rates are going up. So, there is going to be pressure in terms of capital requirements and liquidity for fund managers. Some are already thinking about how to answer

ROUNDTABLE

those needs. That means we will see more of these complex products.

Davidson – From an ESG perspective, we're seeing borrowers expecting innovation and customisation to a greater degree now. Increasingly, they want a financing partner that's able to create structures that work for them and their own ESG strategies. It's no longer a case of taking products off the shelf; it's about taking time to look at how you want to finance your business and how lenders can help accelerate the transition.

There are also emerging sectors. Infrastructure and renewables are clear examples of that. There's a huge demand for renewables assets and you've also got energy transition assets like large-scale battery storage, which is complex and often requires specialist financing. Lenders will need to adapt with the market to support the technological development we need to achieve a net-zero economy.

Mehmood – The opportunities and challenges presented by the market since the onset of Covid have also changed the shape of the fund finance landscape over the last couple of years, bringing a broader pool of liquidity to certain parts of the market.

The NAV [segment] has [experienced] a big influx of interest from debt funds and institutional liquidity. NAV transactions have been particularly attractive for debt funds as they provide an opportunity to deploy over a portfolio of assets rather than a single individual exposure, which is their normal *modus operandi*, whilst achieving a similar return.

At the same time, we've seen an acceleration in institutional capital available in the market. The liquidity coming to the market has proven

itself to be increasingly flexible and innovative, something we are now seeing spread to other parts of fund finance.

We've seen a real shift in the market over the summer with the reality of the economic outlook now coming home to roost. My private equity colleagues have seen the liquidity in that market tighten quite significantly, which is also something we've seen clear signs of in fund finance around subscription line appetite in particular. There will also be different sectors and opportunities that emerge in the future. For instance, we're starting to see some Special Situations funds being raised. The broader economic headwinds will mean that the opportunities within fund finance may shift slightly. In turn, that might drive more product evolution.

Jones – We saw some of that innovation at the beginning of Covid when everyone thought the world was going to stop completely in its tracks. Everyone needed to hold on to assets for longer because valuations had gone through the floor. Everyone was asking where the money was going to come from. So, our biggest year for NAV facilities was the first year of Covid in terms of documenting and getting deals to fruition.

By 2021, people got their heads around the idea that a portfolio of say 12-15 assets was a manageable size, or even a smaller portfolio of, say, five assets. That then gets into very bespoke financing arrangements. And the different lenders coming to the market also make a difference – the debt funds, and the insurance and pension funds. We're going to see more of that with a possible recession phase coming up.

Morrison – Fund finance is now frequently used outside of the



“WE’VE SEEN A REAL SHIFT IN THE MARKET OVER THE SUMMER WITH THE REALITY OF THE ECONOMIC OUTLOOK NOW COMING HOME TO ROOST. MY PRIVATE EQUITY COLLEAGUES HAVE SEEN THE LIQUIDITY IN THAT MARKET TIGHTEN QUITE SIGNIFICANTLY.”

Jamie Mehmood, Deloitte

investment period, so the timeframe in which a sponsor would use on finance is being stretched. One consequence of that is the emergence of GP-led continuation structures which are increasingly common. Lenders and sponsors now realise the benefits of these and are getting more comfortable with them. And my view is that they're here to stay long term.

Lobbardi – We're having conversations



“THIS IS AN INCREDIBLY INNOVATIVE SPACE WITH VERY SMART PEOPLE. NOTHING IS OFF THE TABLE IN TERMS OF THOUGHT PROCESS. THE BASKET OF THINGS THAT FUND FINANCING CAN ENCOMPASS KEEPS GETTING BIGGER.”

Bronwen Jones, Reed Smith

with our clients around the economy. There are so many numbers thrown out there by economists about where this will land, but we're going to see an interest rate increase that we didn't see in 2008. What does that mean in terms of how fund managers think about financing?

We asked that question to some of our clients. When we ask about the capital call facilities, which are used by 95% of the fund managers, the answer is different depending on the size of

the fund. Large managers are saying that even if interest rates become high, they will still use this financing because it makes sense for them. They have so much flow that from an admin perspective, not having to call the investors still makes sense.

In the case of small or mid-market fund managers, it's a different story. They are not as active in terms of deploying capital, so going through all the sophistication of putting financing in place for one or two transactions a year in such uncertain times does not make as much sense.

And there are differences between asset classes. We have so many deals we're working on where clients have not followed through the investment because the valuation is not right, or they are not sure about the macroeconomic situation. So, things are being cancelled or delayed.

I don't have the answer to what happens from here on. It will be interesting to see.

Furthermore, higher interest rates and increased cost of capital are putting more pressure on the banks. Banks are telling us they are increasing their pricing and their appetite is being stricter. So, we'll see more non-bank lenders taking market share under NAV financing, but also on capital call facilities. We know some non-bank lenders are launching these kinds of products in the next few months.

Morrison – The current macro conditions create very strong opportunities for institutional investors to move into fund finance. The returns are now higher due to rising benchmark rates and the tightening in bank liquidity we have observed is important because suddenly there's this increased demand for institutional or non-bank capital within credit facilities

to close the funding gap.

Mehmood – Given their funding model and assuming their assets are on a floating rate, a lot of the institutional lenders and debt funds can capture the benefit of the upside of the rates, with the increase in “all in” pricing (Sonia plus margin) feeding directly into the income they are deriving.

Morrison – In certain investments, it can almost double the total yield our investors can obtain from fund finance. There will be winners and losers in these macro conditions. Certain sponsors will deploy heavily during these market conditions and others will decide it's just too uncertain. Otherwise, we see this as an opportunity.

Jones – I was talking to a legal recruiter last year in our hunt for associates, and it was a recruiter that wasn't used to the fund finance market. He said to me: “Tell me what the cycle is like in the fund finance market because I don't know very much about it.” And I said: “All I can tell you is it's 20 years old, and it just keeps going up. We haven't had a cycle yet.”

That's telling. This is an incredibly innovative space with very smart people. Nothing is off the table in terms of thought process. The basket of things that fund financing can encompass keeps getting bigger.

Mehmood – While there are many challenges coming out of the current situation, I believe it will show how private debt markets can see through a cycle. There will be winners and losers, but it will give the market the credibility to then go into the next cycle because it will have demonstrated that it can survive a full cycle whilst maintaining target returns. **fe**



Implementing science-based targets

PRESSURE IS MOUNTING FOR ALTERNATIVE FUNDS TO ACT, WRITES BRADLEY DAVIDSON, ESG LEAD AT RBS INTERNATIONAL.

THE CLIMATE EMERGENCY is the greatest challenge of our time. The answer is simple, we must reduce global carbon emissions, but delivering a sustainable future requires us all to work together towards a common goal. From government bodies to consumers, everyone has a part to play as we take meaningful action to decarbonise the economy.

Alternative investment funds (AIFs) recognise their crucial role and have begun placing science-based targets (SBTs) at the core of business strategies.

Are SBTs a way forward?

The Science-Based Targets initiative (SBTi) launched in 2015 to provide

a framework for businesses to set science-based targets and benchmark the pace of greenhouse gas emissions reduction. The SBTi aims to mobilise the private sector to take meaningful climate action and outline sector frameworks that can be followed by entities across the world.

Targets are defined as 'science-based' if they follow the latest science and are in line with the ambitions of the Paris Agreement: limiting global warming to well below 2°C while pursuing efforts to limit further, to 1.5°C above pre-industrial levels.

It is vital that corporations and financial institutions implement SBTs as a pillar of wider environmental, social and governance (ESG)

strategies, with success crucially being determined by the delivery of these commitments.

Not only do SBTs provide businesses with a clear pathway to transition but the framework introduces a new lens to assess the climate-related financial risk and opportunities present. Furthermore, SBTs are a powerful articulation of ambitions which can be used to engage with investors, improve a company's reputation and potentially gain a competitive edge.

Why now?

Although the dust may have settled on COP26, the Glasgow summit underlined the investment gap in climate initiatives and called upon

banks and other financial institutions to invest in the transition to net zero.

The alternative investment industry plays a key role in this effort towards decarbonisation, and pressure within the industry is mounting for fund managers to act. However, the question is, are funds prepared for the challenge?

Through our latest research report, RBS International set out to address this question and better understand the extent to which AIFs are implementing SBTs, as well as the barriers to doing so.

Between February 2022 and March 2022, we surveyed 125 key influencers on decisions relating to investment strategy in AIFs and interviewed six industry experts across a range of sectors.

The sample covered funds domiciled across five jurisdictions (the UK, Jersey, Luxembourg, Guernsey, and other Western Europe) and five sectors (real estate, private equity, infrastructure, renewables, and private debt).

Conducting this research was crucial to help those working within the industry identify where they sit in their journey towards SBT adoption, whilst also identifying a clear path ahead.

Pressure is increasing for funds to act

As pressure mounts on fund managers to scrutinise their investment activities, SBTs are poised to become the leading framework in the alternative funds space. This is reflected in the results of our report: almost three-quarters (74%) of survey respondents agree that the financial sector must set clear targets for achieving net zero, and 35% believe that regulatory pressure is the primary driver for adopting SBTs.

However, despite this pressure, according to the research, fewer than half (42%) of AIFs currently have set SBTs and have had them verified. Many feel as though they are behind the

curve when it comes to setting climate targets, with 70% stating that net-zero targets so far have been more focused on corporates than funds.

Although AIFs are clearly facing challenges in setting targets, the pressure to adopt SBTs is intensifying, with 76% of respondents saying that investors are looking for clear evidence that funds are setting SBTs.

Even though setting SBTs is voluntary, peer pressure and net-zero initiatives are also huge drivers to adoption. Almost a quarter (23%) of respondents say this influenced their decision to implement targets.

Bank/lender pressure is another crucial factor (18%), as many institutions have made public commitments to exit customers who fail to decarbonise or set robust net-zero targets. This factor will likely become more urgent in the future, with the inability to set measures potentially limiting access to financing at the right cost.

This means funds that hesitate to implement measures to combat climate change could potentially experience both reputational risk and competitive disadvantage.

Stumbling blocks: what stands in the way of setting SBTs?

Despite the current demands in the market and the clear disadvantages of not setting SBTs, take-up remains relatively low.

Although many AIFs see benefits from setting SBTs, the results reveal that a lack of in-house skills or expertise is a key obstacle for funds – almost half (49%) rank this within their top-three barriers to setting SBTs within their firm. Therefore, investing in the right resource, whether internal or external, will be crucial to the successful adoption of SBTs.

The time taken to implement (48%) and measurement difficulties (46%)

“FUNDS THAT HESITATE TO IMPLEMENT MEASURES TO COMBAT CLIMATE CHANGE COULD POTENTIALLY EXPERIENCE BOTH REPUTATIONAL RISK AND COMPETITIVE DISADVANTAGE.”

also appear in the top-three barriers.

The need for support was cited as another main cause of inaction: all respondents would value third-party support, as less than half (42%) plan to implement SBTs via their internal ESG team. The survey found that most (58%) are also looking to seek expertise outside of their organisation, whether from a consultant (32%) or another third party (26%), including their lenders.

The path ahead

There's clearly an appetite for adopting SBTs, but the need for support in implementing them and overcoming barriers is universal.

As a financial institution, we face many of the same challenges as funds. That's why we've embarked on our own sustainability journey and recognise the part we play in supporting our customers' journeys to net zero.

If we want to reduce carbon emissions and tackle global warming, it's time for us all to take action. It's by working together and setting meaningful targets like the SBTs that we can address the climate emergency, unlock new opportunities, and help to make our planet cleaner and greener.