CFOS AND RATED NOTES[1]

By Kirsty Harshaw

The "CFOs and Rated Notes" panel discussed their own experiences of each of rated note feeders and CFOs and what they are observing in the market.

RATED NOTE FEEDERS

Rated note feeders are an old product, and we do still see private funds with certain types of investors which prefer to hold debt rather than classic LP interests (a more conspicuous one would be insurance companies which are looking to get the regulatory capital treatment on the debt instruments). In a convenient world the basic note feeder would look just like a regular feeder except it issues debt alongside the LP interests classically in a vertical strip to the investor that is coming in, however, there has been an evolution where we have multiple tranches.

Of course, there have been various variations of rated note feeders, but the panel noted they are seeing rated note feeders into credit funds most often.

CFOs

Not to be confused with chief financial officers, at its core collateralised fund obligations are the same as rated note feeders, but the underlying risk is not an investment in a single fund but an investment in a diversified pool of funds. One instance where we see CFOs is when we have regulated insurance companies that are keen to get exposure to the asset class and they are looking for a fixed income product, as a result they are willing to lend against the equity risk in those private funds. Once we have leverage against the equity risk, the question is, will there be equity investors that are keen to invest in those product funds on a super level basis. If yes, then you can create a structure where equity investors invest in the SPV, debt providers provide financing to the SPV and then the SPV has ways to write commitments to underlying funds. As a fund manager, you have multiplied the asset under management and that is a great fundraising tool.

[1] Panelists included Simon Felton (Appleby); John Anderson (Goodwin Procter LLP); Matthew Maguire (Park Square Capital); and Pierre Maugüé (Debevoise & Plimpton LLP).

Is there demand for these products?

As private debt managers, Park Square Capital see a huge amount of interest from investors for rated structures when providing a solution to drive capital efficiency. With CFOs there is less of a use case in private credit land where investors already have access to a very diversified pool of assets.

Where does the interest for these structures come from?

The panel noted that they are seeing interest from three main jurisdictions (i) the US; (ii) Korea; and (iii) across Europe.

The US is an interesting market - insurance clients are looking to get the benefit from a reporting angle or from a capital efficiency angle. Different insurance firms/different subcategories take different views as to whether it is a single tranche or a multi tranche product. The panel noted the most important part is getting the mix of debt to equity in your feeder, this is probably a 90/10 split - 90% in note form and 10% equity being the most optimal.

In Korea there was a huge amount of activity up until a couple of years ago. When the US was making a lot of noise about CFOs, Korean regulatory regimes backed off and are a little more negative on single structure ratings, however, they still remain an important fund-raising tool.

In Europe there is a less obvious use case because of the Solvency II regime, and it requires you to take a look-through view. Having said that, there are a number of insurers that have additional internal models that mean having a rated structure allows them to get a better cost of capital on that non-cash paid element of the portfolio.

The panel did note that all the geographies require different structures and ratings and so it is not a case of one size fits all. It's a complicated process in the sense that when you think about investors you need to know the subset in each geography and find a fitting solution for the anchor investors, but in the opinion of the panel, it is worth it to unlock the additional capital.

How are these structures set-up and what are the costs?

It was discussed by the panel that you need some sort of investment capital beforehand. The process for getting a rating is very methodical and it takes around 6-8 weeks to get a full rating, with an initial rating costing between $100,000 to $150,000 and then an annual monitory fee of 5-10bps, so many

take the view that a feeder needs to have around $100M to $150M worth of interest before it makes sense to incur these costs.

Panel members have been exploring whether, given the demand for an 'evergreen' product, you can figure out the demand first and then when the product is ready, plug that (pre-existing) feeder in and avoid having to wait for a cycle of allocations.

It was noted that the market is aways looking at different types of products and there is a desire to try to focus on providing an investor led solution rather than the other way round, so we will have to see what happens. Either way, there is a lot of time and costs required, and you need to consider these with anchors and insurance companies in tandem with LPs as they all have different requirements.

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