EXPERT Q&A

As insurance capital looks to access private credit strategies, rated-note feeder funds are becoming more commonplace, say Greg Myers of Alter Domus and Jason Kolman of Ropes & Gray

Rated-note feeder funds: All you need to know

One of the big talking points in private debt has been the growing appetite of insurance companies for the asset class. But given that they have unique regulatory requirements, being able to access such investments is not straightforward. Jason Kolman of Ropes & Gray and Greg Myers of Alter Domus explain how an innovation known as the rated-note feeder fund, which offers both equity and rated debt to insurance investors, can help.

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Q What are the key considerations for managers to be aware of in relation to rated-note feeder funds?

Jason Kolman: The first thing is factoring in the appropriate lead time, especially if it is your first time dealing with one of these products. The structure is somewhat bespoke and complex, and it involves various stakeholders, including ratings agencies and sometimes external administrators and subscription lenders. So building in the time to make sure the product can be launched in a way that is consistent with the capital-raising timeframe is important.

The landscape for these products is also a bit of an unknown: they are relatively new with little history and we haven't really seen many play out to completion. There is some residual uncertainty as to whether or not the structure will be respected from a regulatory or National Association of Insurance Commissioners perspective. Typically, managers address that by building in a broad ability to revise the terms or, in some cases, collapse the structure to deal with future events.

Managers will need to consider the administrative burden of a note feeder. There is additional complexity compared to an equity-only structure, as you now have a debt component with interest rate calculations. Can you self-administer that or do you need external help, and should you be charging a fee to cover the incremental costs?

We are also often asked how much of a change this requires to core documents, and the answer is not as much as you might think. The primary difference is the addition of a note purchase agreement governing the debt. There are ways to streamline the documentation to make it relatively painless and consistent with the standard fund documents.

Finally, we have seen most of the interest in these products from US and South Korean insurance companies to date due to their regulatory regimes, so sponsors should be aware that the structure may be less appealing to insurers in other countries.

Greg Myers: One of the biggest considerations is the operational requirements for these types of structures. If you are outsourcing it, you need to make sure your fund administrator has the systems and capabilities to support it, because it is vastly different to a simple closed-ended capital equity structure. You have got to be able to model it out appropriately, support the reporting to the rating agencies and manage the structure efficiently and cost effectively.

There are quite a few costs that are going to be borne specifically by this feeder structure so the more you know about that, to socialise it with the investors, the better off you will be. From a fund perspective, you need to think about how those expenses will be allocated within the fund complex; we typically see them borne solely by the insurance investors that are accessing the structure on the basis that there is a lot of additional architecture required.

We see more and more demand, both from the funds we administer and the structures we administer, and that continues to grow. This is not just going to be a private credit solution, but for secondary LPs interests as well. The main thing people need to think through though is the fact that you have to have a cash-flowing asset running up through the feeder structure for these to work. They are not going to make sense for a lot of private equity funds, where there are not realisations for five or seven years. These have to be based on something that can produce current income but also reference assets that can be rated efficiently.

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GREG MYERS

Q What is driving the growing appetite for these structures?

JK: This is driven by insurance capital looking for a way to access private credit strategies that is efficient from a regulatory capital perspective. Generally, debt is better than equity from that perspective, and note feeders allow the investment to be recast primarily as debt in a relatively painless way. These structures can be a win-win in the sense that they let insurers access these strategies in a more regulatory capital-efficient manner, and also allow managers to bring in insurance capital with minimal disruption to their typical fund setup.

Q When it comes to structuring, what are the pros and cons of feeders vs parallel funds?

JK: It is usually quicker and more cost effective to launch a feeder fund – most managers have feeder funds already so the note feeder is just another one and the documents can be largely duplicated.

The main drawback is that you can't customise the terms of the fund to get the right rating or address insurance issues, because the feeder is interposed on an existing product and there is lots of non-insurance money in the structure that doesn't care about those issues.

The parallel fund is the opposite: it's typically a little more time consuming and more expensive to form an entirely new fund complex, with more entities where you have to replicate agreements. So it has a longer lead time but the benefit is you have more flexibility to manage the fund or craft the terms to get the right rating or address insurance issues. If you have a main fund that is unable to obtain the desired rating due to its use of leverage, you could potentially form a less levered or unlevered parallel fund to solve for this, for example.

Today, most clients are going down the feeder fund route but there are some that like the additional flexibility of a parallel structure and don't see the cost difference as significant.

GM: If a client has a levered and an unlevered fund that are relatively close in strategy and sharing assets, they will put the rated feeder on the unlevered fund just because it makes their lives a little easier. Leverage adds operational complexity.

Q What about multiple underlying funds vs a single fund?

GM: When we think about rated feeders for secondary LP purchases, we see institutional investors rebalancing their portfolios and selling interests to the secondary limited partnership markets. We have seen a couple of deals where the assets of the rated feeder are a low number of LP interests in larger underlying funds and that essentially becomes a fund of funds issuing liabilities against those LP interests.

That presents its own complexity: how do you predict the cashflows on the underlying LPs, which you're going to need to set the liability requirements of the rated feeder itself, for example. We have also seen some large European fund of funds issue rated feeders as an entrée into the US, issuing debt that will go via an LP structure into an underlying strategy in another jurisdiction. That becomes exponentially more complex, but the simplicity of having a singular asset that can rely upon the rating of another fund makes things a little easier. The rating is derived from the tranching of the cashflows.

Q Do you see additional work coming from the rating agency aspect?

JK: Yes. Many credit fund clients are used to working with rating agencies, but not necessarily for private fund products, so the ratings agency involvement is a big factor not seen in a typical fundraise. It is an iterative process: the rating agency will typically want to see background information on the manager and predecessor funds and will need to be looped in on the note feeder documents to ensure that terms support the rating.

There are a wide variety of factors that go into the rating, including what the fund is investing in and the types of investment, how levered the underlying fund is and the priority the notes have over the equity in the feeder fund waterfall. It is also typically easier to get a rating on a closed-end fund as opposed to a hybrid or open-end fund, given that the fixed term and lack of redemption rights correspond nicely with note terms.

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JASON KOLMAN

You need to get ahead of this and liaise with the rating agency throughout the process. It can help to start with a term sheet to focus the various stakeholders on the core terms and issues, to get alignment without driving out costs on longer documentation.

GM: The experience of the manager in the credit space will drive a lot of the work that goes into getting everything up and running. Some clients with traditional PE backgrounds and nascent credit strategies find this more difficult.

Q What are the subscription facility implications?

JK: If your fund has a subscription facility backed by commitments, it is important to involve lenders early. There are some bankruptcy considerations related to note commitments that don't apply to equity or LP commitments, with the basic concern that if the fund files for bankruptcy, the LPs may have some defences to funding a note commitment that they would not have with respect to equity commitments.

We have seen workarounds, with one common one being the flexibility to have a note commitment convert into equity at the lender's discretion in the case of a default under the subscription facility (which could include a bankruptcy scenario). But you shouldn't assume subline lenders will view the note product the same as a plain vanilla equity-only product and should loop them in as soon as possible. ■

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