Fitch Ratings 2021 Outlook: Global Private Equity Collateralized Fund Obligations

PE CFOs' Cash Flows and Liquidity Poised for Recovery

Sector Outlook: Stable

Fitch Ratings expects private equity collateralized fund obligations (PE CFOs) to receive more consistent cash flows in 2021, as distributions from underlying PE funds (defined as including all strategies, including buyout, credit, real estate, energy and others) recover from the impact of the COVID-19 pandemic in 2020. Underlying funds with exposure to sectors less affected by the pandemic, such as healthcare and technology, are likely to continue providing a baseline for distributions to PE CFOs, even if market volatility returns.

Valuations of PE funds, and therefore PE CFO net asset values (NAVs), are likely to be supported by the projected global economic recovery, COVID-19 vaccine development and low interest rates. Despite these initial positive indicators, Fitch's stable outlook for the sector reflects an expectation that fund holdings more affected by the pandemic could experience depressed valuations and extended holding periods heading into 2021. Risks of additional market volatility or further economic impact from COVID-19 remain, which could again disrupt distributions to PE CFOs and impact valuations more broadly in portfolios.

Rating Outlook: Stable

Fitch's 2021 rating outlook for PE CFOs is stable, reflecting funds' ability to weather the negative impacts of the coronavirus, with distributions and valuations on an initial path of improvement. PE CFO distributions and available cash balances have been sufficient to satisfy capital calls and liabilities so far, and have left contingent liquidity lines across all Fitch-rated transactions undrawn.

Capital calls to support underlying funds' portfolio companies and pay down subscription facilities are expected to moderate in 2021, which could put PE CFOs in a better liquidity position in the coming year, absent material capital deployment by PE funds for acquisitions. Due to the market volatility in 2020, valuation markdowns triggered loan to value (LTV) covenants for some PE CFOs, but a relatively quick market recovery and note amortization allowed these PE CFOs to return to compliance with LTV covenants. We expect credit enhancement to continue to increase as valuations are marked up to levels in line with improved market conditions and normal debt paydowns continue.

What to Watch

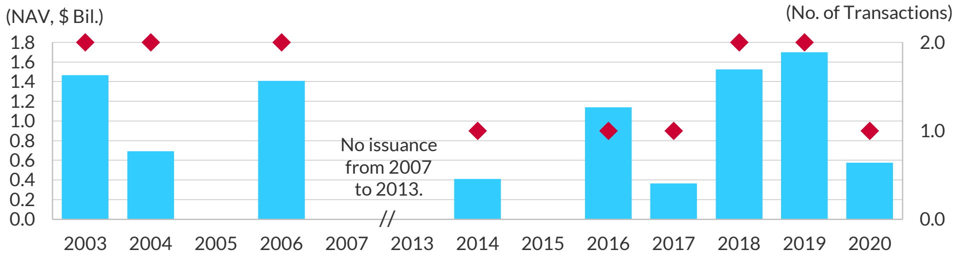
- Pace of PE fund exit activity and length of holding periods, particularly in more stressed sectors, and the impact on PE CFO liquidity levels.
- Developments in the regulatory risk-based capital guidance for PE CFO obligations.

Greg Fayvilevich, Senior Director

"Fitch expects cash flows to PE CFOs to be relatively more stable in 2021, supported by exposures to the strong-performing technology and healthcare sectors, projected economic recovery and low interest rates."

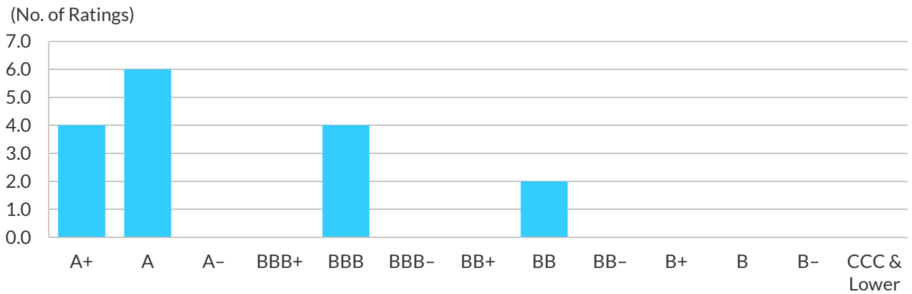
PE CFO Market Continues to Gain Traction

(PE CFO Issuance by Year)



Source: Fitch Ratings.

Rating Distribution: Largely Investment Grade



Source: Fitch Ratings.

Holding Periods Expected to Lengthen; Some Distributions Delayed

Fitch expects holding periods of PE funds' portfolio companies to lengthen amid the market downturn in 2020. For portfolio companies, funds' general partners (GPs) identified growth opportunities through bolt-on acquisitions during the market volatility in the second quarter. The value-add for these investments will take time to be realized, extending holding periods beyond GPs' initial projections. Additionally, GPs have marked down valuations for companies in COVID-19-affected sectors such as energy, hospitality and transportation. Holding periods are expected to increase significantly for these companies, as the sectors recover and reposition in a post-pandemic environment. Fitch does not expect delayed distributions due to increased holding periods to affect PE CFO ratings in 2021, as they may be counterbalanced by continued exit activity in sectors less affected by COVID-19, and as such stress scenarios are considered in Fitch's analysis. However, if the economic and market recovery reverse course, significant increases in delayed distributions could cause negative rating pressure.

According to Fitch's Global Economic Outlook, GDP growth rates for 2021 in the U.S., Europe and China are forecast at 4.5%, 4.7% and 8.0%, respectively. The continued economic recovery and low interest rates may support improving valuations, leading to increased credit enhancement for Fitch-rated PE CFO transactions. However, Fitch forecasts a 5%–6% default rate for the leverage finance market by YE21, with a cumulative rate of 15%–18% from 2020-2022, slightly below the 22% rate between 2008 and 2010. Heightened defaults would negatively affect the value of some underlying positions in PE CFOs, in both equity and credit strategies.

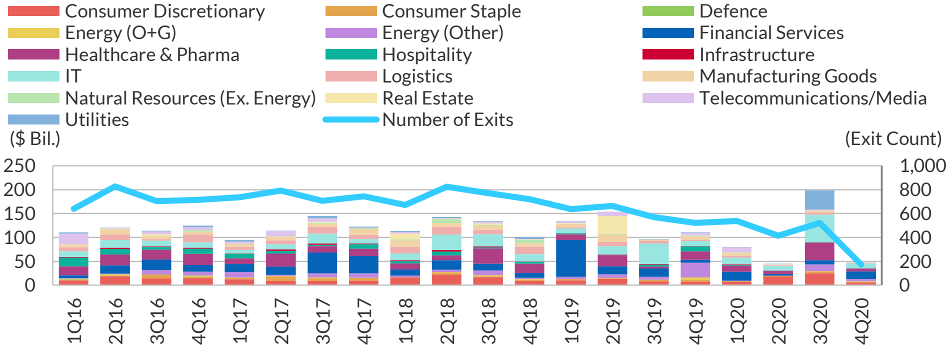
Regulatory Uncertainty Remains Despite Progress for PE CFO Insurance Investors

More than a year ago, the U.S. National Association of Insurance Commissioners (NAIC) published a proposed rule to apply equity-like capital treatment to PE CFO liabilities held by insurance companies, as opposed to the current debt-like capital treatment. The proposed rule also puts forth a prohibition on insurers sponsoring PE CFOs. Since insurers make up a big portion of the investor base in PE CFO notes, the proposed changes had the effect of curtailing demand from insurers in investing in PE CFOs.

Since then, the NAIC received feedback from the industry, published a revised proposal and, in October 2020, published a further-revised proposal. Under the latest proposed rule, the NAIC introduced a principles-based approach for determining which types of asset-backed securities (ABS) will receive debt-like capital treatment. Defining characteristics of the ABS to be treated as debt-like include: the assets collateralizing the debt issuance are expected to be the primary source of cash flows for debt repayment; and the securitization redistributes the credit risk of the underlying assets through tranching and subordination.

The revised proposal is subject to public comments through December 2020. While the progress made on this issue so far has helped clarify the expected regulatory treatment for PE CFO notes to some extent, until the proposal is finalized some level of uncertainty will remain and is likely to remain a headwind for sector growth. Fitch does not envision the finalization of the rule having any rating impact on existing transactions.

Global Buyout Exits by Sector



Source: Preqin Pro.

Applicable Criteria

Private Equity Collateralized Fund Obligations (PE CFO) Rating Criteria (December 2020)

Related Research

2021 Outlooks

Global Economic Outlook -December 2020 (December 2020)

PE CFOs: Securitizing Private Equity Fund Interests (A Primer Based on Questions from Market Participants)(October 2019)

MCA Fund III Holding, LLC (October 2020)

Nassau 2019 CFO LLC (September 2020)

Astrea V Pte. Ltd. (June 2019)

Analysts

Greg Fayvilevich
+1 212 908-9151
greg.fayvilevich@fitchratings.com

Domenic Bussanich
+1 646 582-4874
domenic.bussanich@fitchratings.com

Peter Gargiulo
+1 212 612-7762
peter.gargiulo@fitchratings.com