GLI GLOBAL LEGAL INSIGHTS

Fund Finance 2023

Seventh Edition

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glg global legal group

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Newer liquidity solutions for alternative asset fund managers – increasingly core

Charles Bischoff, Danny Peel & Katie McMenamin
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In previous iterations of this chapter, the original of which was written in late 2020, we concluded that the combined impact of COVID-19 and other developments in the market was that the concept behind some of the more innovative liquidity solutions adopted by alternative asset managers during the COVID-19 pandemic had been proven. The economic headwinds currently facing global financial markets will add further drivers for the increased use of these liquidity products. We now assess again the current fund finance market and liquidity solutions available to alternative asset fund managers – from traditional subscription facilities through to net asset value (NAV)/hybrid facilities and preferred equity products, as well as broader general partner (GP)-led fund restructurings – each in light of the impact of current economic pressures and prevailing market trends. We also now explore in more detail some of the considerations that liquidity providers may have when looking to enforce security over a fund's NAV.

Introduction

It became clear almost immediately that the impact of the COVID-19 pandemic in 2020 would be severe and long-lasting. Many asset managers, nervous about the potential of their (fundamentally healthy) investments to weather the storm, were forced to seek ways to ensure they had the ability to shore up the balance sheets of their portfolio companies if this was required.

In the short term, that meant finding liquidity. Some managers found themselves considering funding sources that had previously been talked about, but not seriously explored, which were suddenly seen as genuine and potentially the only options for providing that much-needed liquidity to support portfolios. That, in turn, had a longer-term impact, to which the prevalence of these solutions (long after the initial liquidity concerns caused by the pandemic abated and indeed the pandemic more generally ceased to be such a significant driver of behaviour) attests. These sources of liquidity, having been given the chance to prove concept and to demonstrate that they are both structurally feasible to execute and sufficiently flexible to suit a broad range of liquidity requirements, have increasingly cemented themselves in the asset manager's toolkit of core financing options throughout the traditional fund life-cycle. COVID-19 had a permanent impact on how some asset managers structure their funds and finance their investment activity and, with recessions looming across the globe, these types of financing solutions will only becoming increasingly prevalent.

A changed market

The fund finance market has undergone significant expansion in recent years. NAV facilities in particular, traditionally the preserve of secondaries fund managers looking for leverage

to finance their portfolio acquisitions of limited partner (LP) interests, have increasingly become standard fare across other asset classes. More recently, preferred equity structures have been used by fund managers willing to embrace more structured solutions. COVID-19 not only accelerated the uptake of these types of products for fund managers that had already started using them, but also meant that others began viewing them as viable options.

The subscription finance arena remains a huge and thriving market that is utilised by the overwhelming majority of fund managers. Subscription facilities constitute a cheap, flexible and now (broadly) investor-accepted route to putting debt in place at the fund level. However, subscription facilities are predicated on a fund having enough uncalled capital to borrow against to enable it to obtain a facility at the quantum required. When COVID-19 hit, funds of a certain vintage that were fully (or mostly) invested had little or no remaining uncalled capital. For these funds, a purely subscription facility-based solution was off the table.

In a volatile economic environment, cash is paramount. As COVID-19 spread rapidly across the globe, fund managers undertook an urgent review of their investment portfolios in order to ascertain (i) which of their portfolio companies were likely to need additional funding as a result of their business being hit by the pandemic, and (ii) whether their funds had sufficient firepower to meet those requirements. The conclusion, in the case of some older vintage funds in particular (and especially those with retail and/or leisure-heavy portfolios), was that the worst-case scenario could see the short-term funding quantum required far exceeding the financing currently available (whether from existing cash resources at portfolio company level, headroom on asset-level facilities, additional leverage at the asset level, or investor capital (especially if this had largely been deployed already)). Fund managers feared the value they had created during years of sourcing, investing in and developing businesses would be destroyed overnight – not due to investment decisions they had made, but due to the immense strain arising from an almost entirely unforeseeable global pandemic that threatened the financial health of even the best businesses.

The liquidity solutions that gained the most traction in the market were NAV or hybrid facilities and preferred equity solutions. These products look to tap liquidity from assets other than investor commitments, principally the fund's equity in existing investments within its portfolio, as a means to generate immediately available cash. These tools have gained increasing popularity in recent years due to the greater flexibility they afford asset managers in maximising returns from their investments. For example, a fund later in its life (and therefore with limited investor capital available to call upon) may not have funding available for follow-on investment but may hold assets that would benefit from bolt-ons or additional capex. Rather than the arbitrary timing of the stage of the fund's life-cycle meaning these assets are left underfunded, NAV facilities and preferred equity products can be used to release capital for this purpose. COVID-19 meant that, for different reasons, readily available cash was a premium asset, and so unlocking value from the equity in the portfolio via a NAV facility or a preferred equity product became a necessary option to explore for a broader range of funds. A similar fact pattern is likely to arise again as global markets navigate increasingly uncertain economic conditions, challenged by rocketing inflation, rampant interest rates, supply chain issues and the war in Ukraine.

NAV facilities *versus* preferred equity – the details

In simple terms, the distinction between these products is that NAV facilities comprise fund- (or fund holdco-) level debt secured against the value of the assets in the investment portfolio (paired with, in the case of a hybrid facility, uncalled investor commitments),

whereas preferred equity products comprise prior ranking third-party equity invested in the fund in return for priority claims over future distributions. Managers using these products for the first time might choose to run dual tracks until relatively late in the process (to ensure they have a full understanding of the pros and cons of each) before settling on the most appropriate solution for their specific needs.

NAV facilities, being a debt product, are typically cheaper. However, the lender will usually take at least some security (direct or indirect) over the assets and will require a reasonably wide-ranging suite of covenants that partially restrict the fund's ongoing activities. In addition, the facility will have a fixed tenor (which may be difficult to refinance at expiry if exit horizons are not clear) and there are likely to be ongoing finance costs such as servicing cash-pay interest payment obligations (which may be challenging for a non-cash generative portfolio).

In contrast, a preferred equity provider will not require security or typically as much by way of behavioural controls. Equally, it is unlikely to require payments of principal or cash-pay interest on set dates (although, where the cost of capital becomes increasingly punitive as time passes, funds may be so heavily incentivised to realise value and return capital to the provider that these effectively are time-limited products). Instead, the provider will receive a specified percentage of future distributions from investments until it has received a pre-agreed return on the capital provided, typically set at an internal rate of return (IRR) hurdle with a minimum multiple on invested capital requirement. Preferred equity products are by their nature very flexible and will often be bespoke, with providers marketing themselves as having the creativity to tailor solutions to suit the specific requirements of individual funds.

The principal trade-off between these two products is cost of capital (which can be a challenge for preferred equity providers to justify) *versus* loss of control over the portfolio (which is a preferred equity provider's sell to managers when compared with a debt product). However, there are a number of other detailed considerations for fund managers when putting in place these types of products, including:

- Investor relations considerations: Even if investor consent is not required (or the transaction can be structured such that consent is not required), keeping investors fully appraised of the rationale for (and impact on investor returns and risk profile of) putting a product of this nature in place is of paramount importance. In particular, managers should have regard to (i) investors' concerns around assets within the fund being cross-collateralised, which runs contrary to the general expectation of a series of silo'd investments, and (ii) the fact that the different products can have different impacts on individual investors – for example, some investors' cost of capital will increase if a fund in which it has invested becomes "leveraged" for the purposes of the Alternative Investment Fund Managers Directive (AIFMD) (and it should be noted that AIFMD II will bring further regulatory considerations on this front). From a commercial perspective, key messages a manager needs to be able to give to investors are that (i) the manager will retain control of the assets, even following a loan-to-value (LTV) breach, such that it can avoid a fire sale, and (ii) the nature of their investment in the fund as part of a non-leveraged, long-term investment strategy remains.
- Fund documentation considerations: It may be the case that the fund documentation does not specifically envisage this type of product and so LP/Limited Partner Advisory Committee (LPAC) consent is required (which, depending on the consent threshold required, will impact on timing). For newer funds, a NAV facility will often not require investor consent, but leverage limitations in the fund documentation will invariably apply to a NAV facility and so managers must ensure these will be respected. Preferred equity products typically require an amendment to the waterfall set out in the fund's

limited partnership agreement (LPA), which would always require investor consent, but it may nonetheless be possible to execute such a transaction without requiring investor consent – particularly where undertaken at a holdco/aggregator level (see below).

- Structuring considerations: Both NAV facilities and preferred equity deals are simplest to structure where there is an aggregator vehicle in place between the fund partnership and the underlying portfolio assets. The existence of such a vehicle enables a single clean security interest to be granted over the equity in that vehicle (in the case of a NAV facility) or that vehicle to issue the preferred equity instrument (in the case of a preferred equity transaction) without the direct involvement of the fund. If there is no such existing aggregator, then ideally one would be introduced into the structure. This requires an analysis of any transfer or change of control provisions in the underlying equity or debt arrangements relating to each portfolio asset. It also requires consideration of any tax implications of doing so to ensure that dry tax charges are not inadvertently triggered. Ultimately, if it is not practicable to put this structure in place, it may still be feasible to execute a NAV facility where the investment agreements in relation to the various investment holdcos do not prohibit the grant of security over the shares in that investment holdco, but the cost of this may be significant – especially if the holdcos are incorporated across multiple different jurisdictions.
- Regulatory considerations: It may be that putting a product of this nature in place impacts the regulatory status of the fund – for example, causing a previously non-leveraged fund for AIFMD (and upcoming AIFMD II) purposes to be "leveraged" for the purposes thereof (which may also impact the manager itself if it was previously a manager only of non-leveraged funds). If Financial Conduct Authority (FCA) (or its equivalent in other jurisdictions) approvals are required, this will of course impact on timing, but in addition it may affect the compliance requirements applicable to the manager, reporting requirements (to regulators and investors) and (as alluded to above) the capital treatment of investors' own interests in the relevant fund.
- Valuation considerations: Agreeing which assets will be (and will remain) "eligible" for inclusion in the LTV covenant, and the basis on which those assets will be valued, is fundamentally important to the viability of the transaction. A manager will push for its own internal valuations to be used for all purposes, but a liquidity provider is likely to require a third-party valuer's input either at the outset or (at the very least) if there is subsequently a dispute over valuation or a default. These valuations will be used to size the funding that will be made available originally and to set the financial covenants and/or drawdown conditions going forward – with the value of an asset in default or forecasting a covenant breach under its asset-level debt often excluded from these calculations. In addition, certain assets (such as credit assets, which are more liquid) are much easier to value than others (such as buyout assets), with more liquid assets having obvious appeal to financiers. Providers of these products need to understand both fund structures and the underlying asset class in order to price the risk correctly. It is for this reason that such providers often combine internal expertise from their fund finance and asset-level debt teams when negotiating the commercial terms of these facilities.
- Enforcement considerations: If security is granted (directly or indirectly) over a fund's underlying portfolio assets as collateral for a NAV facility, the debt provider will have enforcement options and priority of repayment *versus* other creditors of the fund (though typically not asset-level debt providers) in a distressed scenario. The position is different for holders of a preferred equity product, who typically do not have direct enforcement options and would be subordinated to other agreed creditors of the fund. Managers

must be acutely aware of the rights of NAV facility lenders before entering into these arrangements, especially given the investor relations considerations referred to above. As noted above, lenders under a NAV facility may request security over the equity in the aggregator vehicle, which itself ultimately holds the equity in the underlying assets and security over the bank accounts of that aggregator vehicle, into which any distributions and other proceeds from the fund's investments will be contractually required to be paid. NAV lenders may or may not also require direct share security over each individual portfolio asset holding company stack. Depending on the jurisdiction(s) involved, the nature of the equity holding in each relevant portfolio asset (for example, majority *versus* minority) and the direct or indirect nature of the agreed security package, this may mean that the lenders have powers in an enforcement scenario to sell the shares over which they have security and/or exercise the powers of shareholders, which can include the ability to replace board members and therefore take control of underlying investments. Lenders may also be able to appropriate the value of any funds standing to the credit of the secured bank accounts at aggregator vehicle level to the extent that distribution proceeds are received from the underlying portfolio assets.

Whilst some clearing banks were prepared to consider providing products of this nature during the pandemic, it was only for their most valued and long-standing customers (and only on a NAV facility basis). For the most part, managers had to look to institutions that, for some time, had been specifically focusing on NAV facilities and preferred equity products – including funds dedicated to these strategies, traditional secondary players and investment banks. These institutions were in many cases far better placed to design and provide the bespoke solutions individual funds needed. Many of these entities have been extremely successful at grasping the opportunity to demonstrate their structuring capabilities and knowledge of the underlying portfolio asset classes – such that they are now very much part of the mainstream fund finance universe.

As an aside, it is interesting to note that – although some clearing banks have selectively widened their offering (including making available products that they would not previously have had the risk appetite to provide, to both existing and to new customers) in order to compete with the newer liquidity providers – there remains a relative paucity of providers of NAV facilities, particularly in the mid-market. Subscription finance remains the primary offering of the clearing banks. Investment banks may require a minimum ticket size that is well beyond the liquidity a fund requires and is willing to pay for. Sector focus may limit what other banks are able to provide. All of which means that the field remains open for specialist providers to continue to embed themselves in the market. However, it also means that there is an opportunity for lenders who, through different parts of the same institution, understand (and likely frequently leverage) a fund's underlying assets, and have (or are building) expertise in the subscription finance market, to develop an attractive and lucrative line of business through internal collaboration.

All of this means that managers have become increasingly familiar with products of this nature and are more actively seeking them out. Whilst remaining some way off the subscription facility as the staple debt facility for a fund, these products are becoming increasingly mainstream. Far from being a source of liquidity available as a last resort, these products are now being seen by managers as an option to be used in the ordinary course.

In addition, more sophisticated LPs have recognised the benefits of using products of this nature to leverage their portfolios of LP interests, not least to help them better manage the capital call profiles of the funds in which they have invested and to navigate recent

intense liquidity squeezes. A NAV facility to an LP secured by its investment portfolio is fundamentally similar to a NAV facility to a secondaries fund. This area of the market is ripe for further expansion, with those institutions that have, for some time, underwritten facilities to secondaries funds well placed to take advantage of current liquidity demands amongst the wider institutional investor universe.

A shout-out to GP-led restructurings

Those funds employing the most sophisticated financing structures have, for some time, been using NAV facilities and preferred equity products not just to protect value, but more proactively to create, release and extend value. For example, by generating cash for distributions to investors earlier in the fund's life-cycle than would otherwise be available because exits from investments are not envisaged in the imminent future – which can be used to enhance IRRs or release capital to investors at an opportune moment when fundraising for a successor fund. In these respects, these types of products are a legitimate alternative to secondaries transactions, which are used to generate liquidity for investors as well as (potentially) the funds themselves.

Trading in LP interests on the secondaries market has become a mainstream method for new entrants on the investor side to gain exposure to alternative assets without having blind pool investment risk, as well as for investors with large portfolios of LP interests to manage their cashflows and asset allocations by realising value in advance of receiving distributions. The emergence of GP-led fund restructurings, whereby a continuation vehicle is managed by the same GP and funded by new investors and/or investors in the existing fund that choose to roll their position into the new vehicle, is testament again to the increasing proactivity that managers are showing in finding different liquidity solutions, both for themselves and their investors. These are involved and complex transactions, requiring delicate structuring (for example, to ensure any rollover structured as tax-free genuinely does avoid any tax obligations being crystallised – noting that the position may be different for individual investors – and to ensure that the assets are transferred to the new vehicle at the correct value).

GP-led restructurings have the significant benefit of allowing managers to offer their investors a liquidity option (but not a requirement) – roll into the new structure, thereby maintaining their exposure to the portfolio, or realise value and cash-out now. In that respect, they differ from NAV facilities and preferred equity products in that they can give rise to different outcomes for the existing investor base. They also enable fund managers to hold on to assets for longer where they see additional value-creation opportunities, rather than being forced to exit because the closed-ended fund is reaching the end of its defined life-cycle.

Another key difference is in relation to valuations. Secondaries transactions necessarily must land on a fixed value for the NAV of the portfolio, with the purchase price typically being a set discount to that NAV. These transactions therefore require greater conflict management, with increasingly sophisticated investors expecting robust, market-tested pricing and typically fairness opinions to ensure they are not being prejudiced – whether they are an existing investor exercising the option to take liquidity out, an existing investor rolling into the new structure, or a cornerstone secondary investor providing liquidity to capitalise the continuation vehicle.

In our view, the trend towards increasing volumes of secondaries transactions (with GP-led solutions forming an ever-larger part of that) will continue. Investors will continue to look to more actively manage their investment portfolios, and the denominator effect is felt

from proportionate allocations to alternative assets increasing as public markets continue to fall. In complete contrast, and to demonstrate the complexity of what underpins market participants' engagement with these types of products, where a NAV facility or preferred equity product is being put in place, some investors are actively seeking to participate as providers of these – thereby further blurring the boundaries between investors, traditional lenders and providers of capital throughout the fund structure.

Conclusion

These products are now firmly in the consciousness of managers that had not previously considered using them and are now, beyond doubt, here to stay. Fund managers across asset classes have, for some time, sought an array of funding solutions provided on a fund-wide basis that are more flexible than the traditional pairing of a subscription facility at fund level (used to bridge capital calls) and asset-level debt packages (put in place for each investment individually). As fund managers navigate the increasingly uncertain economic outlook, these funding solutions will become an increasingly important and core part of their toolkit.

The market is also reacting to the increasing prevalence of whole portfolio financing structures, including the use of technology from the securitisation markets. At a purely documentation level, LPAs are increasingly providing for much greater clarity and flexibility in what liquidity solutions the fund may put in place. At the other end of the spectrum, there are questions as to whether funds using these types of structures as a matter of course (with leverage throughout the capital structure of the fund rather than just at asset level) have a different risk profile from that traditionally associated with "unlevered" funds.

Expect these products to become ever more commonplace and, given the range of institutions that provide them and their innovative approaches in doing so, to continue developing to adapt to fund managers' increasingly sophisticated requirements.

* * *

Acknowledgments

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