EXPERT COMMENTARY

The value in the range of liquidity options available to private equity managers lies in their bespoke nature. Details of the offered terms and their practical operation should be carefully scrutinised, write Katie McMenamin and Ed Ford

Inside dual-track fund liquidity processes

Pre-covid-19 an increased appetite for innovative portfolio-wide liquidity solutions was emerging among private equity managers. The classic approach to leverage in PE fund structures comprising short-term subscription lines at fund level used mainly for bridging capital calls, paired with long-term individual asset-level debt packages, was increasingly starting to be supplemented with a range of more structured liquidity products.

Broadly these solutions can be broken down into (i) debt products, such as NAV or hybrid facilities, collateralised in whole or in part by the net asset value of the investment portfolio, (ii) equity-style investments at fund (or common holdco) level via preferred equity products or bespoke co-investment arrangements and (iii) whole fund or portfolio restructuring options via investment in continuation vehicles by secondaries players active in the GP-led space.

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Leaving aside broader GP-led fund restructurings for these purposes, which of these routes proves attractive to a manager depends on the exact drivers behind the liquidity play. Is acceleration of distributions to investors or additional fire power for follow-ons the overriding aim? Is this a short-term liquidity need as a bridge to exits or asset-level refinancings, or a broader end of fund life solution or re-alignment of incentives?

There are obvious differences in terms of the typical providers and style of documentation as between these debt and equity-like products. However, given the overlap between them as regards their scope to address some or all of the same liquidity challenges and their marketing as flexible and tailored solutions for any given manager's needs, it may not be

straightforward to immediately spot all the relevant distinguishing features beyond headline pricing and funding quantum. The crux of the relevant differences (and similarities) often lies in the detail.

Trend towards dual-track processes

Post-covid-19 outbreak there has been a definite uptick in managers (and relevant intermediaries) running dual-track preferred equity/NAV facility processes in order to quickly cut through to the detail of the relative merits of each offering. Looking beyond the differing forms of documentation typically used for each (loan agreements familiar to lenders providing NAV facilities versus limited partnership agreements incorporating the portfolio controls and distribution waterfall provisions required by preferred equity investors), there are some close similarities in the substance of the protections required by both types of provider.

The intersections

These parallels include:

- Common portfolio diligence requirements focused on ownership of the funded assets, asset transfer restrictions, potential value leakage and asset-level debt terms;

- Regular loan to value covenant testing and drawdown conditions linked to agreed asset eligibility criteria;

- LTV and/or return-linked distribution cash sweeps or waterfall provisions;

- Negotiated parameters and rights relating to asset valuations;

- Controls over portfolio concentration and material amendments to underlying asset documentation;

- Restrictions on additional debt incurrence and the grant of security collateralised by the funded assets;

- Mandatory prepayment or redemption rights following breaches of material undertakings, insolvency events, a change of control or manager removal.

Beyond these key intersections, however, the relative suitability of the following (to name a few) practical and economic characteristics of each product should also be considered carefully by managers in the context of their particular liquidity needs.

The divergences

The typically lower pricing of NAV facilities relative to preferred equity broadly tracks the respective risk metrics of secured lending versus unsecured equity investment. NAV lenders will usually require security over the funded assets somewhere in the fund structure (typically over a common holdco) and all parties will need to be comfortable that such security is permitted under the asset-level documentation and the relevant fund documents. While managers may achieve that security enforcement rights of a NAV lender following temporary or curable breaches of LTV covenants are meaningfully delayed or paired back (and commercially not lightly exercised anyway), the theoretical position remains that underperformance of certain portfolio assets could result in enforcement by a lender over the wider portfolio.

Equally, while the absence of a fixed maturity on preferred equity investments is a headline difference when compared with NAV facilities, managers should be cognisant of the economic consequences that may apply under a preferred equity instrument if the provider's minimum multiple on invested capital (MOIC) is not achieved in the agreed timeframe, including waterfall adjustment events and, in some circumstances, mandatory redemption rights.

Return calculations

Again in large part reflecting the nature of debt versus equity providers and their own internal funding sources and return hurdles, non-utilisation fees (being typically only a percentage of the interest costs payable on drawn amounts) on committed but undrawn facility amounts are likely to be required by NAV facility lenders.

In contrast, while the flexibility of multiple draws can often also be accommodated in preferred equity arrangements, a provider's minimum return requirements may mandate that deemed drawing mechanics (and associated pricing) are applied at the end of the agreed availability period. Managers should, therefore, consider carefully the likely quantum and timing of their future funding requirements in order to ensure their NAV facility or preferred equity investment is sized, and related drawdown conditions and economics are designed, accordingly.

Careful thought should also be given to the expected distribution profile of the funded portfolio and likely timeline to repayment to ensure the chosen product includes the required flexibility or otherwise for early repayment. NAV facilities are likely to include some prepayment fees or non-call protection and preferred equity investments may be structured with a fixed minimum return unlinked to actual repayment timeframes.

The value in the range of liquidity options now available to private equity managers in no small part lies in their scope to be designed to fit the particular liquidity needs of the manager and portfolio at hand. As part of the increasingly sophisticated transaction processes run by, or on behalf of, managers to identify the best fit in terms of provider and product, careful attention should be paid to the detail of the offered terms and their practical operation to ensure their potential as valuable liquidity tools is maximised. ■

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