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Fund Finance Friday

Acquisition Financing Techniques in the Fund Finance Context

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Over the past few years, the fund finance market has seen net asset value (NAV) financing grow alongside more established “subscription line” facilities, to become an established part of the fund financing toolkit and an increasingly accepted leverage option for use at many points across the fund life cycle.

As the use of NAV facilities has expanded, so too has the range of purposes for which they are used. As an asset-based financing technique, NAV has often been used to provide portfolio-level leverage on established pools of private investments such as private equity or infrastructure holdings. However, of late we have also seen increasing use of NAV as a means of acquisition finance.

This article considers the particular structural and documentary implications of the use of NAV as an acquisition finance tool. We consider these issues in the context of two transaction types that are increasingly commonplace in the European market: secondaries portfolio acquisitions and continuation vehicle transactions.

Secondaries portfolio acquisitions and continuation vehicles

As a starting point, it is worth noting that the use of fund level debt to finance the acquisition of investments is not itself new. Subscription line facilities have commonly been used to finance the fund’s equity contribution to new investments. However, such financing has typically been short term, bridging to the funding by the fund’s limited partners of their capital commitments. Because subscription lines are fully collateralised by uncalled capital commitments, it is not typically necessary to take security over the assets being acquired or otherwise to make detailed provisions in the financing documents for recourse to such assets.

On the other hand, in secondaries acquisitions and continuation vehicle transactions, we see fund level debt incurred as a permanent part of the capital structure financing the portfolio as a whole. These two transaction types are quite different, and raise distinct structural and legal issues, which we now consider in turn.

Secondaries acquisitions

While not yet approaching the level of structural standardisation seen in the leveraged finance market, it is possible to draw some generalisations about secondaries portfolio acquisition structures. A typical deal structure will involve a borrower that is a special purpose vehicle, typically a limited partnership. The borrower very commonly then holds the limited partnership interests in another SPV limited partnership (the “Bidco”), which is the entity which will buy the secondaries assets, which usually consist of a number of limited partnership interests in private funds managed by third-party sponsors (“GPs”). The Bidco, which ideally from the Lender’s perspective will give a guarantee of the Borrower’s debt facilities, enters into a sale and purchase agreement ("SPA") with the seller, and legal completion takes place by way of the individual LP interests being transferred to the Bidco and the Bidco being admitted as a limited partner by each of the different GPs.

The debt facility will be structured with NAV-type terms; typically the net asset value of each asset will be that reported by the relevant GP to the Bidco. The terms will broadly reflect NAV facilities generally, but an additional feature of secondaries portfolio financings is the need to ensure the Borrower and Bidco have sufficient liquidity to cover uncalled capital commitments that may exist, now or in the future, on the LP interests acquired. A failure to fund a capital commitment due to liquidity issues could result in the Bidco and/or Borrower becoming “defaulting investors” in respect of the relevant LP interest, which could impair its value as collateral. One mitigant used in a number of transactions is the use of a liquidity cover ratio that assess the ratio of the Borrower’s own uncalled capital commitments, from entities of substance in the fund structure above it, to its uncalled capital positions on the acquired portfolio. This should be combined with robust “change of control”protection to ensure that the relevant fund entities of substance continue to own, and commit capital to, the Borrower and that the day 1 sponsor remains in control of the borrower and Bidco.

Security may be taken by the Lenders over the acquired LP interests directly, although this is often not the preferred approach, because consent will typically be required from the underlying GPs under the terms of the limited partnership agreements (LPAs). Rather, it is customary to take security over the limited partnership interests, or other equity interests, in the Bidco, and over the ownership and control interests in the Bidco’s own general partner. While this taking of “indirect” security over the acquired LP stakes will often still require underlying GP consent (something that will need to be evaluated in due diligence), in our experience, underlying GPs are often more comfortable consenting to this form of security than to a direct pledge of the LP stakes.

Continuation vehicles

While now fairly common, continuation vehicle transactions are far from standardised. While it is not possible to set out an archetype, some generalisations can be made.

A typical continuation vehicle transaction will involve the transfer of one asset, or a number of assets, from a seller fund to a new limited partnership (the “CV”) managed by the same sponsor. “Rolling” investors (limited partners in the seller fund who are electing to remain invested in the relevant asset) will subscribe for limited partnership interests in the CV. The SPA and related documents signed between the CV and the seller fund will typically include provisions for a “cashless roll” of these continuing investors, with their entitlement to proceeds of sale from the seller fund netted off against their obligations to contribute an equivalent amount to the CV.

New investors will then enter the CV structure in exchange for cash capital contributions to partially fund the CV’s acquisition of the relevant assets. Structures vary, but the new investors may come into a separate limited partnership (a “feeder”), again managed by the same sponsor. The feeder then itself becomes a limited partner in the CV. One advantage of this structure is that the new investors may wish to incur permanent leverage on their investment into the structure, and for this reason, the debt facilities financing a CV transaction may well be incurred by the feeder as borrower, sitting above the level of the rolling investors.

Such facilities will typically contain NAV-type covenants, with a loan-to-value requirement based on the net asset value of the acquired portfolio (or the new investors’ share of it). However, one important difference between a CV and a secondaries financing is that CV financings usually include security over the new investors’ capital commitments as well as over underlying assets, making them “hybrid” in nature. Typically, this is required by Lenders to reflect the fact that many continuation portfolios are more concentrated than typical private equity fund portfolios; indeed, many of the continuation vehicle transactions completed in Europe to date relate to single assets.

The asset security in a continuation vehicle structure will usually consist of security over an ownership interest sitting immediately below the level of the debt facilities; for instance over the LP interests held by the feeder in the CV.

Acquisition finance themes and techniques

The use of NAV financing to finance continuation vehicle and secondaries acquisition transactions has led to the use, in the NAV lending context, of various acquisition finance techniques commonly seen in, for instance, leveraged finance documents. Each of these has needed to be, and continues to be, adapted to suit the fund finance context.

Due diligence factors

It is commonplace in NAV transactions for Lenders to obtain a due diligence report from legal counsel (either counsel to the borrower or counsel to the lenders) covering, among other things, the investment documentation (e.g., shareholders’ agreements and any co-invest agreements) in respect of the portfolio assets. Such reports are especially common in secured transactions, and typically cover issues such as whether transfer prohibitions, pre-emption rights, defaulting investor provisions, etc. might restrict or impose any adverse consequences upon the taking and holding of the security or its enforcement (including any disposal of the secured assets).

Since CV and secondaries financings typically include ownership security over the portfolio assets at some level (whether direct or indirect) such due diligence is often required by lenders in these contexts.

It is important to ensure that the scope of due diligence reflects the unique aspects of these acquisition-oriented structures. In particular, in either type of transaction, it will be necessary to perform due diligence on the SPA. This is necessary in order to, among other things, understand the mechanisms for closing and payment or consideration, to ensure the financing documents harmonise with these; to understand any risk of liability on the Borrower or Bidco (e.g., under reps and warranties or deferred consideration mechanisms) and any risk of the acquisition process failing or of any changes being made to the assets being acquired or the consideration payable. If it is intended that the lenders will take an assignment of the Bidco's rights under the SPA then it is important to ensure the SPA permits this. In secondaries acquisitions it will be essential to have diligence performed on the underlying LPAs, among other things to ensure that they permit the proposed transaction security and that any required consents are obtained.

Changes to transaction perimeter

One common factor with many secondaries acquisitions and CV transactions is that the assets in-scope the transfer, and the total consideration payable - that is, the transaction perimeter - may change. For instance, in a secondaries transaction, underlying GP consent may be a prerequisite for the transfer of specific assets. The obtaining of such consent may be a purchase condition with regard to each specific asset under the SPA. SPAs will sometimes provide that, if consent is refused, an asset may drop out of the acquired portfolio, with an attendant reduction in total consideration payable. In a CV context on the other hand, the SPA and indeed the Facility Agreement may be signed before the exact amount of capital raised from new investors is known. Some SPAs provide for the proportionate interest to be acquired by the Bidco in the continuation portfolio, and the consideration payable, to be reduced rateably in this scenario so that, if less capital than hoped is raised, the CV transaction may still proceed but for a lower percentage of the assets.

The loan documentation should accommodate these potential changes by, for instance, ensuring that if the value of the assets acquired is reduced, the amount that may be borrowed is also reduced, whether by operation of the LTV requirement or otherwise. The SPA and related documentation will typically impose a "floor," if the transaction size falls below the floor, the consent of the buyer and seller will be required to proceed with the transaction. If this is the case, then the consent of the lender should normally be required in order for the Bidco to agree to any deviation, and to agree to other variation of key parameters, for instance an extension to any long stop date for completion. Generally, material amendments to the acquisition documents without lender consent will be subject to restrictions.

Closing process and attendant risks

Leveraged and acquisition finance documents typically include a range of provisions designed to coordinate the financing documentation and process with the acquisition closing mechanism, and to reduce the risks to the Lenders of deviation from the documented acquisition process or failure of the acquisition to complete.

Generally, NAV finance documentation that is used to finance an acquisition, in either the CV or secondaries context, will adopt similar protections. These will, for instance, include representations as to the accuracy and completeness of the acquisition documentation delivered to the lenders, and restrictions on the modification of such documents. In terms of conditions precedent, acquisition finance documentation will usually require certification, or other evidence, from the borrower that the acquisition has become unconditional save for payment of the purchase price, and that any equity component of the cash consideration has been funded into the Borrower / Bidco by limited partners. These facets should generally be replicated in NAV acquisition documentation, in a manner appropriate for the particular transaction structure.

Some specific issues may commonly arise in the CV and/or secondaries acquisitions contexts. In secondaries, the consent of underlying GPs may be obtained on different assets at different times, and the SPA may, if agreed by the buyer and seller, provide for phased completion, transferring individual assets as consent is received. Lenders may require protections in these scenarios, such as a stipulation that loan funding cannot be used until a minimum number and value of assets have been transferred, and ensuring that loan drawings are always governed by a pro forma maximum LTV requirement. In a CV context, there will typically be conditions precedent to the new investors' obligations to make their cash contributions. These may, for instance, include that substantially all conditions precedent to the loan agreement have been fulfilled prior to limited partners being required to fund. Care should be taken to ensure there is no conflict or circularity between loan, equity, and M&A closing conditions.

The closing process and conditionality set out in the SPA and other acquisition documents should be understood in detail to evaluate any risk that the transaction might not complete after the loan has funded and/or the consideration been paid, or any risk that the transaction might be unwound, delayed, or that liability might arise after completion upon the Borrower / Bidco, in order that any such risks that might exist can be addressed in the loan documentation.