CADWALADER

Rest and Remembrance

May 22, 2020 | Issue No. 78

Table of Contents:

- Blurred Lines
- Cayman Private Funds Law – Drafting Issues and Implications
- ‘Fund Finance Friday: Industry Conversations’ – Podcast with Jan Sysel and Adam Summers (32 Minutes)
- FRB Article on Subscription Facility Market
- Arthur Cox Article on Fund Finance Market Trends
- Private Funds CFO Newsletter Discusses LP Credit Lines to Meet Capital Calls
- Mourant Hosts Webinar on Fund Finance

Blurred Lines

May 22, 2020 | Issue No. 78

By Samantha Hutchinson
Partner | Corporate Finance, Fund Finance

By Amrita Maini
Senior Attorney | Fund Finance

NAV-backed facilities have been the talk of the town for several weeks now in the fund finance world. It seems not a day passes without this financing solution being touted as one of the key liquidity options GPs are currently considering. Whilst NAV facilities have been around for a long while, they have historically been used to finance large diversified portfolios of assets, particularly in the secondaries, fund of funds and private credit spaces. However, many primary managers are increasingly looking to these facilities for both defensive and offensive purposes. Why is it that these facilities are becoming so popular with primary managers and what are the challenges to putting one of these types of facilities in place?

Historically, a lender providing a NAV facility to a primary fund would expect to be able to exercise traditional enforcement remedies, including enforcement of security over the entire portfolio, where the LTV covenant is breached. The cash sweep and margin may vary depending on the level of the LTV but, until relatively recently, it was rare for there not to be a single LTV covenant, a breach of which would result in the lenders taking control of the fund portfolio. Whilst we saw many of these deals done with mid-cap and smaller managers, for many large managers this was perceived as a difficult risk to take on. In a post-COVID world, the risk is even greater given the uncertainty around how valuations marks will play out over the coming quarters.

As a result, what we have seen develop even more rapidly post-COVID is a hybrid-NAV/Pref product which, whilst retaining some of the traditional bank downside protections and certainty around maturity, also seeks to incorporate some of the features of preferred equity to give primary managers additional flexibility. Naturally, there is a pricing adjustment as a result, but this is emerging as a clear alternative for GPs who are concerned about protecting their portfolios but, at the same time, do not want to pay the mid-double-digit coupon traditionally attached to pref solutions.

The key feature of these trades is that lenders do not have an immediate right to enforce their collateral package once the LTV threshold is reached. Instead, there is flexibility baked-in to allow for LTVs to rise in ratchets which trigger increased cash flow sweep and ultimately a controlled sales process, giving GPs the ability to work out the covenant breach over a period of time.

What are the challenges in implementing a primary NAV facility?

There are still far fewer primary NAV financings as compared to secondaries transactions due to the challenges presented to lenders when trying to structure a primary NAV financing. The main challenges relate to the ability to (a) due diligence the assets and structure around the results of that diligence, and (b) accurately value the assets.

Due Diligence

Taking these in turn, in our experience, conducting due diligence on the assets usually raises a number of complicated issues.

Security and Control

One of the main issues is ensuring that security over the underlying assets is effective and taken at the right level of the underlying asset structure, as these assets are often held indirectly through a number of holding and intermediate companies, which makes the decision regarding at what level to take security important. Added to this, there are usually complicated shareholding arrangements and, in particular, third-party investors (or co-investors) or management that hold stakes (directly or indirectly) in the underlying portfolio companies. Therefore the key is to ensure that security is taken as close to the actual portfolio company itself, but without capturing the stakes of these third-party investors.

The inclusion of third-party investors in the chain can also raise other issues that need to be diligenced and catered for. For example, consents may be required from these third-party investors in relation to the giving of security. In addition, these third-party investors can make it difficult to assess the actual level of control that the fund has over the ultimate asset (*e.g.*, there can be minority shareholding rights that could block the sale of an asset, or the existence of tag-along or drag-along rights could impact on the enforcement of the security; or in the reverse, if the fund only holds a minority position in the asset, then it may be able to assert only those rights of a minority shareholder).

Certain assets may also be held by several parallel funds, and so assessing where the borrower is situated in the larger fund structure is important from both a control and a security-effectiveness perspective.

Cash Leakage Potential

Another key diligence point is to understand where there is potential for cash leakage before dividends reach the borrower or another obligor. Generally, the more complicated the underlying asset holding structure, the more there is potential for cash leakage that lenders should take account of and, if possible, seek to regulate in the finance documents. Examples of this leakage can include payments of management or investment advisory fees, payments to minority shareholders and payments to joint venture partners.

Underlying Leverage

The underlying assets themselves are often leveraged and review of the financing documents in relation to that leverage can throw up thorny issues, such as when change of control provisions in the underlying financing arrangements can be triggered, and ensuring that the security package put in place doesn’t trigger these provisions on day one.

The underlying finance documents can also help paint a clearer picture of the funds that are expected to be available to repay a primary NAV facility. Therefore, the constitutional documents of both underlying holding and intermediate companies and the underlying finance documents should also be reviewed to ensure that the lender understands the circumstances under which there may be a lock-up or potential dividend stops (*i.e.*, mandatory prepayments or a block on distributions).

Enforcement Analysis

As a general point, lenders should also engage in a jurisdiction analysis on what enforcement over the assets would look like in the jurisdictions where those assets are located. This may not be required in a common law jurisdiction where there is greater clarity on the enforcement process but more critical, and perhaps harder to do, in a civil law jurisdiction (especially where there is no public register of assets subject to security).

Valuation

Another potential stumbling block to primary NAV facilities is that lenders can find it challenging to correctly value the underlying assets. We have seen lenders rely on the fund's own valuation of their assets and use the numbers in the borrower's financial statements. However, in a post-COVID-19 world, and in the case of certain lenders even prior to the current crisis, we have seen lenders develop their own methodology and independently value the assets. In addition, we now invariably see an ability for the lender to appoint a third-party valuation agent in certain circumstances – for example, when there is a percentage decline in a relevant index.

Even where lenders have relied on the fund's own valuation, there are certain additional criteria which lenders invariably seek to include to haircut the value of assets in certain circumstances. For example:

a) stipulating exclusion criteria or other events that, if they occur, would result either in a reduction of the value of the relevant asset or the exclusion of that asset from the net asset value of the fund for the purpose of the borrowing base. These can include, for example, deducting any deferred consideration that may be due, or excluding the value of any asset where its underlying documents cease to be in force or where it is subject to an insolvency type event; and

b) if the facility can be used for further acquisitions, the lender will typically seek to veto which assets come into the borrowing base.

One thing is for sure: It seems long gone are the days when a GP's only whole fund financing solution was either a subscription line, a NAV line or a preferred equity solution. There are many banks and alternative lenders able to offer a much more bespoke liquidity solution which better suits the particular concerns and requirements of GPs. We would be happy to discuss our experience on these types of deals with you.

Cayman Private Funds Law – Drafting Issues and Implications

May 22, 2020 | Issue No. 78

By Katie McShane
Associate | Fund Finance, Corporate

By Fiona Cheng
Associate | Fund Finance

On February 7, 2020, the Cayman Islands Private Funds Law, 2020 (the "PF Law") came into effect, requiring certain closed-ended Cayman-domiciled funds ("Funds") to register with the Cayman Islands Monetary Authority ("CIMA") by August 7, 2020.

With the August 7 deadline fast approaching, Lenders are increasingly seeking the inclusion of language to safeguard the enforceability of their security, and there is certainly no shortage of negotiation involved in this process.

While we have seen various *Fund Finance Friday* articles from Cayman counsel on the new PF Law itself, this article focuses on drafting concerns and mechanics in subscription credit facilities, and the implications for Lenders and Funds alike.

Drafting Issues and Implications

If a Fund has not registered by the deadline, that Fund will not be able to accept capital contributions for the purpose of investments, and in that vein, a contribution for the repayment for indebtedness to a Lender may be similarly captured, potentially rendering the Lender's security interest unenforceable.

The inclusion of affirmative covenants and corresponding event-of-default provisions provide Lenders comfort that Funds will undergo registration in compliance with the PF Law. One such example is registration by the date that is 30 days before August 7, with failure to comply being an immediate event of default under the credit agreement.

There is no immaculate formula for determining the appropriate timeframe for registration; however, 30 to 60 days is often the starting point for any healthy negotiation, and many Lenders have updated their form credit agreements accordingly. Practically speaking, at least a 30-day lead-in provides sufficient time for Lenders to either step in or require the Fund to call capital at least twice to repay the facility, as a remedy to the default.

While counsel on the Fund side may argue that existing covenants as to compliance with law are sufficient to capture the requirements under the PF Law, without a buffering period, Lenders are faced with the possible challenge of being prevented as a matter of law from receiving capital calls necessary to make whole their loan commitment post-August 7.

A well-informed LP may have reservations towards meeting a capital call for the repayment of debt due to failure to comply with the PF Law. If the LP withholds its contribution, after August 7, the Fund may in any case be barred from accepting such contribution. Taking into consideration the average notice requirement under the Fund's limited partnership agreement for responding to a capital call, and the time required for a bank to initiate remedies after an event of default (including giving effect to any negotiated capital call standstill period), 30 days is by no means a panacea, but at the very least provides a reasonable amount of time to initiate an appropriate solution.

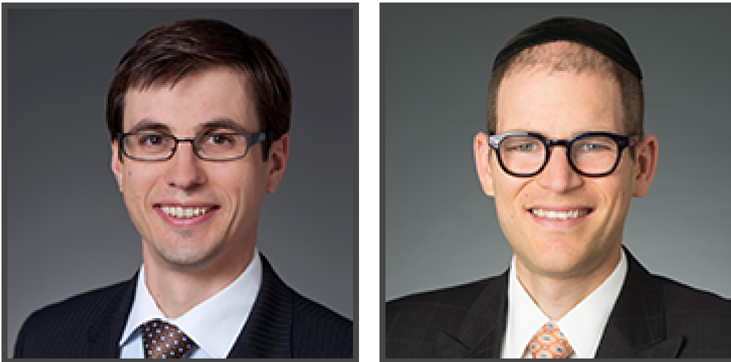
What next?

At this point, there is no indication that the registration deadline will be pushed back as a result of the coronavirus pandemic. As the deadline approaches, this will require counsel to revisit the mechanics of credit agreements in order to continue minimizing risks to Lenders' collateral. We may begin to see registration with CIMA becoming a condition precedent to drawdown, with evidence of registration and ongoing maintenance becoming a requirement akin to the provision of certificates of good standing. Another solution we have seen proposed is requiring a full mandatory prepayment if registration does not occur 30 days prior to the deadline.

With financial penalties in play for noncompliance, and the ultimate consequence being the inability to accept capital contributions for the purposes of investments, both Lenders' and Funds' interests are very much aligned when it comes to the PF Law: Funds captured under the law must register ahead of the deadline.

‘Fund Finance Friday: Industry Conversations’ – Podcast with Jan Sysel and Adam Summers (32 Minutes)

May 22, 2020 | Issue No. 78



Jan Sysel and Adam Summers, Partners at Fried Frank, join Cadwalader’s Mike Mascia in this week’s podcast edition of *Fund Finance Friday: Industry Conversations*. Jan and Adam cover what Fried Frank is seeing in fund formation and fund finance as the market stabilizes into month three of the disruption. They cover the current fundraising market and the pipeline for subscription facilities, and give forecasts around the impact on NAV facilities of mark write-downs when 2nd quarter financials become available. Adam also provides an update on the leverage finance markets.

Subscribe on **Apple Podcasts**, **Google Podcasts** or **Spotify** to never miss an episode.

FRB Article on Subscription Facility Market

May 22, 2020 | Issue No. 78

Jeff Maier, Senior Managing Director – Private Equity Finance at First Republic Bank, published a May 15 article on LinkedIn titled "Sailor! I Order You to Give Me a Market Deal! – The Subscription Credit Facility Market in the COVID-19 Era." The article discusses the application of "market" concepts within the context of bespoke fund structures and investor scenarios. It also includes a recipe for a Fund Finance Mai Tai. Available **here**.

Arthur Cox Article on Fund Finance Market Trends

May 22, 2020 | Issue No. 78

Arthur Cox recently published “Fund Finance: Market Update,” providing a summary of issues and trends they are seeing in fund finance during the pandemic, including changes observed in market activity, expectations with regard to pricing, and how regulators have been responding to issues caused by the disruption to business. You can view it **here**.

Private Funds CFO Newsletter Discusses LP Credit Lines to Meet Capital Calls

May 22, 2020 | Issue No. 78

Private Funds CFO circulated a newsletter Monday highlighting, among other things, a potential trend for limited partners to use leverage as a way to meet capital call obligations, including lenders providing NAV loans to help manage cash flows during low distributions and continuing capital calls. Take a look **here**.

Mourant Hosts Webinar on Fund Finance

May 22, 2020 | Issue No. 78

Mourant hosted a webinar panel last Friday, discussing COVID-19's impact on private equity and fund financing, with a focus on Asia-Pacific as well as potential industry-wide effects. The panelists discussed the lack of LP defaults, COVID-19's impact on the secondary market, lender appetite for financing new subscription facilities, the importance of GP-LP and sponsor-lender relations and future opportunities in fund finance. The webinar is available for video replay **here**.