EXPERT COMMENTARY

The case for loans to be underwritten based on both a fund's portfolio and its LP commitments is getting stronger, say Cadwalader partners Brian Foster, Samantha Hutchinson and Patrick Calves

Continuation funds and the hybrid solution

It has been a common refrain in the fund finance industry that "hybrid" loan facilities (that is, loans underwritten on the basis of both a fund's investor capital commitments and its investment portfolio) are constantly talked about, but are, at least in the private equity buyout space, seldom seen.

The reasons cited for this vary, but most significantly, buyout funds simply do not lend themselves well to hybrid facilities, no matter where they are in their life cycle. For early stage buyout funds, asset portfolios are not yet invested, while for later stage buy-out funds, the remaining uncalled capital commitments are insufficient. As a result, traditional subscription facilities or NAV facilities have largely been used to meet sponsors' fund-level financing needs, depending on the stage in the fund's life cycle.

The hybrid facilities that have been executed are primarily underwritten on the basis of either the fund's capital commitments or its investment portfolio, not both. Perhaps, though, due to the evolution of the fund finance market, and in particular the notable increase in the prevalence of continuation funds in the buyout space, hybrid facilities are finally ready to have their day in the sun.

Investor payout and delayed exit

Continuation funds are entities formed to purchase one or more assets from an existing fund, typically near the end of its term, and that are managed by the same fund sponsor (sometimes alongside another sponsor). Investors in the existing fund may elect to redeem their interests in the existing fund or to continue their investment by rolling their interests in the existing fund into the continuation fund.

The rise of continuation funds under current market conditions has been much discussed, as challenging market conditions continue to push managers to find alternative ways to create liquidity for investors in the absence of viable traditional exit options. Once considered the playground for "problem" assets, continuation funds are increasingly being used by sponsors to retain well-performing assets to sell at a later time in a more optimal market, while still providing an exit option for investors in need of liquidity.

Identifying a need

In order to affect a continuation fund's acquisition of assets and payout of existing investors, further capital is required. This capital typically comes in the form of equity commitments from new investors and increased commitments from rollover investors. Nevertheless, this equity capital may not be sufficient. In these circumstances, debt financing is an obvious solution to bridge the gap. However, continuation funds present unique challenges for traditional subscription and NAV fund finance structures.

With respect to subscription finance, new investors for continuation funds tend to consist of other alternative investment funds – most commonly, secondaries funds.

These investors often do not have ratings and will have a different risk profile compared with the rated institutional investors that form the core borrowing base for traditional subscription facilities.

It is also common for a majority of the investors in the existing fund to elect to redeem their interests (rather than roll into the continuation fund), and rollover investors may be reluctant to provide new capital commitments to the continuation fund, given the amount and duration of capital previously committed.

As a result, continuation funds tend to have less diversified pools of uncalled investor capital commitments to form the core of the borrowing base than is typical for subscription facilities.

With respect to NAV financings, such financings are often underwritten on the basis of the number of assets (and the diversity thereof) in the underlying asset pool and based on cashflow expectations from realizations of such assets. By their nature, continuation funds have concentrated investment portfolios – a single or a small number of investments.

Moreover, the driver of launching a continuation fund is to extend the exit timeline for certain investments until market conditions change for the better, making the timing of realization difficult to predict, albeit significantly shorter relative to primary assets. Finally, the subset of NAV lenders able to lend solely against such concentrated exposures is very limited.

Better together

Enter the hybrid facility. In instances where sponsors and their lenders find it difficult to implement a standalone subscription or NAV facility for a continuation fund, hybrid facilities that look to both the uncalled investor capital commitments and investment portfolios of continuation funds on a combined basis have proven to be a valuable solution.

On a blended basis, each of the capital commitments and the assets of a continuation fund have very desirable characteristics.

In the case of a continuation fund's investor base, these investors will often have funded a material portion of their capital commitments at the outset of the fund. This is either because they have rolled over a significant portion of their capital commitment from the existing fund or they are new investors funding a portion of their commitments upfront to pay for the acquisition of the continuation fund's portfolio.

As a result, continuation fund investors have immediate 'skin in the game,' creating a significant economic incentive to satisfy further capital calls. Additionally, since continuation fund investor bases tend to be made up of smaller groups of sophisticated investment funds, it is easier for lenders to obtain investor documents that provide lenders with additional comfort lending against these commitments (investor comfort letters, financial statements, etc).

In the case of a continuation fund's investment portfolio, these investments are often premium assets that have a robust track record of performance with the same sponsor and have a shorter remaining holding period relative to primary assets. So, while neither source of credit support may stand on its own, each diversifies the risk of the other, and together they form an attractive underwriting opportunity for lenders.

Competitive pricing

The pricing of hybrid facilities can also be attractive to both lenders and borrowers. While the increasingly elevated cost of borrowing in the leveraged finance markets has not yet fully fed into fund-level NAV financings, the cost of NAV financing for concentrated asset exposures may still be prohibitively high.

However, with hybrid facilities, the existence of uncalled capital commitments has helped lenders to offer competitive pricing packages. No doubt private markets managers are looking at hybrid facilities as a cheaper form of financing compared with pure asset-based leverage.

At the same time, spreads and fees are materially higher for hybrid facilities compared with traditional subscription facilities, offering lenders a strong risk-adjusted return, which is critical given the increased competition for limited lender balance sheet capacity in this market.

It is clear that current market conditions lend themselves to the strong growth of this much-hyped product. ■