EXPERT COMMENTARY

With fund finance surging during the pandemic, Samantha Hutchinson and Brian Foster examine how the likes of 'PRAV' facilities, preferred equity solutions and continuation financings can be utilised

Navigating alternative liquidity solutions

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2019 had drawn to a close as another bumper year for private markets. Managers had raised over $1 trillion of new capital (for the third consecutive year) and were sitting on an estimated $3 trillion of dry powder. Starting off with high levels of investment and fundraising activity, 2020 looked set to continue the winning streak. And then came March – the pandemic hit and the world, quite literally, stopped. M&A activity ground to a halt, fundraising activity was interrupted, portfolio companies faced cash crunches, alarm bells sounded around investor liquidity and a number of banks paused or restricted their lending activities – all of which contributed to an urgent need for liquidity for many fund managers.

While other parts of the finance markets dried up, fund finance activity surged. In the years since the last crisis, non-bank financing providers have proliferated. And funds and fund finance providers innovated, developing a range of financing products that were well suited to the needs of fund managers with portfolios that had seen years of investment gains who suddenly struggled with uncertain valuations and limited options to realise those gains.

Financing markets have stabilised, but the global pandemic put a spotlight on these products, highlighting their usefulness to fund managers. In this article we highlight some of these financing trends – PRAV facilities, preferred equity solutions and continuation financings – and how they work for particular liquidity needs.

'PRAV' facilities

The pandemic period has seen a dramatic increase in demand from mid- and large-cap primary funds for NAV facilities. These facilities have been deployed to support struggling portfolio companies, finance opportunistic tuck-in or bolt-on investments,

accelerate distributions to satisfy investor liquidity demands, retire asset-level debt and permit the continuation of mature investments until delayed IPOs or strategic sales can be completed. With managers facing uncertainty as to how valuations might fluctuate in the short- to medium-term, many of these facilities combine features of traditional NAV facilities with more flexible terms seen in preferred equity-type products. Key features that distinguish these facilities from traditional senior loans include:

- The list of Events of Default may be narrower, and traditional Events of Default may be framed as mandatory prepayment events that trigger an obligation to repay the facility over a specified period.
- Certain Events of Default (including LTV breaches) do not give lenders an immediate right to enforce on the collateral. Rather, the consequences may include an increase in the cash sweep percentage, an escalating interest rate and/or an obligation of the manager to commence a controlled sale process. These features incentivise the manager to cure the breach while leaving the manager in control of the portfolio investments and the cure process.
- Some facilities are uncollateralised, with lenders relying on a negative pledge. Lenders have no rights to seize and sell the portfolio assets in a default scenario.
- Asset-level due diligence may be less robust, with lenders taking a more holistic view across the portfolio and relying more heavily on the quality and track record of the manager.
- Interest rates are higher. Depending on the facility features and the profile of the investment portfolio, rates range from mid-single digits into double digits. This is more expensive than traditional senior secured loan financing, but is cheaper than an equity solution and preserves most of the upside performance for existing investors.

Preferred equity solutions

Preferred equity solutions are one of the newest entrants to the fund finance market and have been particularly popular with managers of secondaries funds. Preferred equity can be used for the same purposes as asset-backed debt facilities, but may provide certain advantages for managers compared to traditional senior loans. Distinguishing features include the following:

- There are no set maturity, servicing costs, security or debt-like covenants or restrictions. This can be particularly useful where valuations are volatile – as we saw during the early months of the pandemic.
- Preferred equity purchasers have a priority right to receive distributions, but the benefits of upside performance can be largely or entirely reserved for the benefit of existing investors (depending on the agreed economics of the deal).
- Preferred equity purchasers typically agree to higher advance rates against the underlying investments, allowing for greater effective leverage.
- Preferred equity solutions can address adverse tax consequences (for example, UBIT) that would otherwise arise from loan financing.

Due to the increased risk profile, these products are more expensive, with pricing in the low to mid-teens. As the preferred equity purchasers receive a preferential return on distributions, managers must be mindful of conflict-of-interest and fiduciary considerations. Also, the need to amend constituent documents and update offering documents of the fund may result in delays.

Continuation financings

In the early months of the pandemic, opportunities to sell or take companies public were limited. With their investors unwilling to delay realisations of investments, some managers moved assets into new vehicles with fresh capital and used financing to pay out investors in the original funds. Those financings often took the form of subscription lines or hybrid facilities, secured by capital commitments to the continuation funds as well as, in some cases, the asset being transferred.

In contrast to traditional subscription lines backed by diverse investor bases, these facilities are tailored for funds with smaller investor bases and more concentrated asset pools. The scope of lenders positioned to provide such facilities is more limited as well. They are typically offered by lenders that have experience lending against investor commitments, understand the issues that arise in fund level loans and have the expertise to evaluate the risk inherent in concentrated investment positions.

2020 was a year of continued growth and development for the fund finance industry, with newer financing solutions gaining more widespread acceptance and the group of providers of those solutions further expanding with new alternative lenders. It took a long while for market participants to fully embrace subscription lines and the benefits, if used prudently, that they provide. Now they are invariably used across the private markets.

The past year has provided market participants an opportunity to see the potential for these niche fund financing products to address liquidity needs. While we perhaps didn't see the volume of closings as initial conversations over the summer would have suggested, it is clear these products are now at the forefront of managers' minds when considering which financing options to pursue, and we anticipate that their usage will continue to grow in 2021. ■

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