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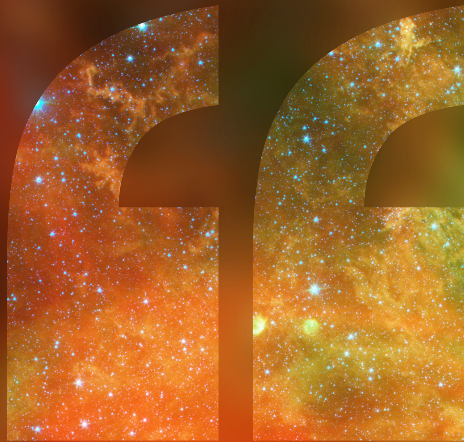

LIQUIDITY SOLUTIONS FOR PRIVATE FUNDS

— THOUGHT LEADERSHIP

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LIQUIDITY SOLUTIONS FOR PRIVATE FUNDS

In this update, we describe some of the new developments and trends on the spectrum of liquidity solutions available to managers/ GPs of private closed-ended funds. In particular, we address: (1) continuation funds and secondaries, (2) NAV financing and (3) asset level financing tools such as margin loans and repos. These alternative liquidity solutions have become increasingly accepted by market participants in recent years. We expect the macro factors that have driven the rise of these alternative liquidity solutions to continue to persist, leading managers and LPs to increasingly utilize this alternative exit technology as a more customary tool in their toolbox.

GP-led Liquidity Solutions

1. Continuation funds and secondaries

Continuation funds (CVs) and secondaries are not new concepts. However, there is increasing complexity in these transactions. Whereas previously the market had largely accepted CVs as solutions for single asset deals, there is greater acceptance for CV transactions that involve multiple selling funds, with multiple assets, rolling into the same CV, and optionality for rolling LPs to participate in dry powder or stapled commitments.

The concept of a "status quo" roll remains an area of focus. This is where, as opposed to a "reset" roll, the economics – management fees, carried interest and progress through the distribution waterfall – remain substantially the same for the rolling LPs in the new CV. Although a "true" status quo does not really exist, given that the hold period for the assets will likely be pushed out as a minimum, this roll option helps manage certain conflicts of interest inherent in these transactions. The key for GPs is to ensure that the LPs in the selling fund are not prejudiced by facing a dilemma of selling at a price they do not like or rolling on materially worse terms.

The tax analysis for a status quo roll option is complex, particularly when dealing with a global investor base and investments located in different locations. A tax neutral roll, particularly for the fund management team, can be difficult depending on the laws of the relevant jurisdictions.

Although still a relatively nascent market, private equity secondaries technology is increasingly being adapted for a wider scope of asset classes, including credit funds (despite the fact that credit assets, being self-liquidating, are inherently different from private equity assets). On the buy side, buyers are usually buying into credit assets at a discount to par. The internal rate of return (IRR) can be attractive because the secondary investor can return capital quickly and mitigate the J-curve. In a GP-led liquidity solution for credit assets, a strip of loans can be moved into an SPV, which can itself bring on leverage to create a levered credit strategy. Often, the GP can simply move these loans without significant transfer restrictions that might otherwise apply in the case of equity assets.

2. NAV financing

There has been substantial development in the NAV financing (NAVs) space in terms of both use cases and structuring, and also in terms of the providers of such types of debt, with more and more non-bank lenders entering the fund financing market.

NAVs extended to equity funds have an increasingly wide use case, and we are seeing them used not just to fund follow-ons later in the fund's life cycle but also to fund new acquisitions in more recently launched funds. An accompanying feature has been the inclusion of "certain funds" provisions in some facility agreements to ensure that the initial acquisition financing made available by way of a NAV is available to the borrower with limited conditions. NAVs can also be valuable in bridging receipt of disposal proceeds for an asset where there is a

longer time frame between signing and completion.

One of the concerns for LPs with regard to NAV lending is enforcement risk – can the lenders step in and sell the investment portfolio, likely at a discount, in the event of a default? There are various ways to address this concern, both via documentary terms (including generous acceleration grace periods) and structuring - NAVs can, for example, be lent to SPVs established alongside the fund structure, with recourse to distribution proceeds from the fund's assets via turnover arrangements with investment holding companies, rather than direct recourse to the portfolio assets.

NAV facilities for credit funds look quite different to those borrowed by equity funds, and they are more likely to take the form of a securitization, given that there can be fixed eligibility criteria in respect of the underlying portfolio. A key benefit of a securitization facility is that a borrower can borrow at a higher advance rate against its portfolio than a standard, non-securitized NAV. It also brings in a much wider pool of investors, particularly if the product is rated, such as pension funds and insurers. For banks, the regulatory capital treatment for a securitization tends to be more favorable, which pushes the pricing down. On the other hand, there are reporting obligations that go with securitizations, which may add to the administrative burdens of the fund.

It is prudent to bear tax considerations in mind when structuring NAVs as different arrangements can lead to very different tax impacts for LPs and potentially disturb structures put in place in respect of specific investments.

3. Asset level financings

Liquidity challenges have led some managers/ GPs to explore financing solutions for particular assets in their portfolio as a way of raising liquidity and, in certain circumstances, adding leverage to the portfolio.

In the context of equity funds, the most obvious example has been the use of margin loans to raise finance over "mature" assets such as post-IPO equity stakes. These listed shares (or baskets of them) have been used as security for bank loans where either the fund does not want to crystallize the current valuation of those shares or those shares are subject to a lock-up.

Margin loans present a challenge for funds because, by their nature, they embed a margin call mechanism with short timelines for posting additional collateral where the value of the secured shares falls. In the absence of a meaningful treasury pool of assets to call upon, the fund can in theory find its secured assets being liquidated to repay the loan where LTV triggers are breached. To address this, some managers are using derivative products to deal with the margin call element. For example, structures such as funded collars allow a loan to be combined with a put option which provides downside price protection. The put option negates the needs for margining as the lender will be protected from downside risk on the shares via the derivative.

In the context of credit funds, repos (or repurchase agreements) are an increasingly popular way of adding liquidity (and leverage) to a credit portfolio. Economically speaking, a repo works very similarly to a secured loan, albeit that the underlying assets are title transferred to the finance provider (under an English law repo at least) as opposed to being secured. Repo can be a very capital-efficient product for banks enabling them to offer competitive pricing to credit fund clients. Funds have used this to finance, among other things, their risk retention tranches of securitizations. In order to make the most of repo financing, some managers are repackaging loan and other assets in order to repo them, although we have also seen sophisticated managers develop bespoke repo structures under which unsecuritized credit assets are repo'd.

Mitigating Investor Concerns

There has been negative press around the use of certain liquidity tools employed by managers/ GPs of private funds. However, investor sentiment – a key consideration for fund managers, particularly in a tighter fundraising environment – may be more nuanced in practice.

Some commentators question the use of CVs, particularly as the GP is ostensibly acting on both sides of the transaction, being manager of both the selling and the continuing fund, giving rise to conflicts of interest issues. While, in the past, CV transactions were associated with more difficult assets, CVs today are mostly single asset funds, investing into one "trophy" asset; secondary investors are focused on quality, and these transactions are a means by which GPs can hold onto their flagship assets for longer in order to maximize value.

The market has also adopted a set of best practices in a way that helps mitigate the conflicts of interest issues. A GP can manage the CV transaction as a true third-party auction process by using a third-party intermediary, and some GPs may even opt to sell a minority strip to a third-party to facilitate price discovery. For many transactions, there will also be a fairness opinion issued by a third-party firm. In addition, fund managers now pay more attention to the importance of providing investors with a reasonable transaction timeline for assessing the proposed transaction.

Similar to GP-led secondary transactions, NAVs remain a point of sensitivity for some investors, particularly when these facilities are used for investor distributions. However, the picture is ever developing. For example, contrary to much of the press implying that LPs are instinctively averse to NAV lending, certain investors have sought to use NAVs and other forms of leverage against their LP stakes to raise liquidity for themselves. Likewise, as touched on above, there are various documentary and structuring means by which key LP concerns around NAVs can be addressed.

When using any type of liquidity tool, having early engagement with LPs and giving consideration to gaining the LP Advisory Committee's approval for the transaction is essential (even where approval may not be technically required under the fund documents), alongside robust disclosure to investors, including a full explanation of the transaction, the assets in question and the fund's methodology for valuing those assets. Ultimately, the key is that the right liquidity solution is used with the right portfolio at the right time.

Temporary Solutions or Here to Stay?

It is not inconceivable to think that the various liquidity products and technologies that have developed in the market in recent years amidst challenging market conditions are here to stay in one form or another, and that they will continue to apply and evolve even as M&A activity increases and IPO markets again become a viable exit option.

The GP-led secondaries space is widely considered to be an under-capitalized market. We may see increased levels of capital coming into these types of transactions (including from funds with a retail investor base), and more competition on the buy side. Going forward, investors will likely also pay more attention to conflicts of interest issues and put more pressure on GPs in their assessment of transactions, including whether a "true" status quo roll mechanism is on the table.

We expect NAVs to become ever more mainstream and LPs will become more comfortable with their use, within defined parameters, in the same way as with capital call facilities. Margin loans, repos and other derivative solutions have also found their place within the arsenal for some managers/ GPs, although more general adoption will be impacted by their pricing as compared with other liquidity products.

It is difficult to see managers and GPs disregarding liquidity tools as part of their toolbox, particularly if alternative funding sources both from the equity and debt sides continue to grow in private markets.

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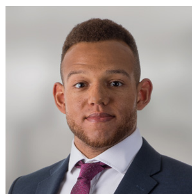

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