The COMMENT

COMMENT

FINANCING FOR THE FUTURE

Proskauer's Cameron Roper and Paul Tannenbaum explain why it is vital to get the structure and financing right for secondaries

Uncertainty caused by inflation, rising interest rates, geopolitical concerns and ongoing supply chain issues has resulted in a slow IPO market and reduced M&A activity. Market conditions have left private equity fund managers with limited exit strategies. This, in turn, impacts investors through delays to distributions and an overexposure to private markets (the denominator effect). Against this backdrop, GP-led secondaries continue to increase in popularity.

For fund managers, GP-led secondaries allow for continued exposure to assets with additional growth opportunities beyond typical fund term limitations. Further, these transactions create liquidity needed for follow-on investments resulting in greater flexibility to manage portfolios. For portfolio companies, the additional liquidity created at fund level can be used to maximise potential and avoid changes in management at a less than opportune time. Finally, for investors seeking liquidity, GP-led secondaries can free up much-needed liquidity, helping to rebalance allocations between public and private markets.

On the flip side, for investors without liquidity constraints, there is the potential for further upside in relation to well-performing assets. For secondaries investors, these transactions create conditions for investment in high-quality assets, which would not otherwise be available for investment on the secondary market.

Historically, there have been some concerns around the use of this strategy for underperforming assets and ILPA has weighed in recently with guidance around best practice for continuation vehicles. However, as demonstrated above, where there is an alignment of interests, an appropriately run GP-led secondary process can create benefits for all parties involved.

Getting the right structure

In our experience, ensuring that the structure of these transactions is fit for purpose is essential. A continuation vehicle, established to acquire one or more of the existing fund's assets, is a common choice of structure. The continuation vehicle is managed by the same fund manager. Existing fund investors are given the opportunity to either: (1) take liquidity from the asset disposal; or (2) roll over their interests into the continuation vehicle. New investors seeking secondary acquisitions will also be given the opportunity to invest in the continuation vehicle.

The transaction structure can be customised to suit the needs of the stakeholders. For example, we have also seen fund managers source liquidity for investors through a preferred bidder process where a feeder vehicle, managed by the fund manager and capitalised by new investors, is established to purchase investors' interests from those investors seeking liquidity. This may be coupled with an obligation on new investors to acquire a stapled interest in another vehicle managed by the same fund manager.

Financing options

The proposed use of financing is another key consideration. Any financing put in place must be aligned to the needs of both the fund manager and the investors. Various financing options are available from an ever-increasing number of financing providers, ranging from traditional debt instruments to preferred equity solutions. Terms are typically highly bespoke and crafted to suit the needs of the fund manager and the preferred structure.

Despite a higher interest rate environment, our experience is that the use of financing options as a part of GP-led secondary transactions has increased during the last 12 months. We see this increase as a function of: (1) the continued search for new sources of liquidity; (2) a track record of proven use cases and enhanced returns generated

through implementing appropriate financing solutions; and (3) strong appetite for deployment from traditional banks, investment banks and, more recently, an expanding universe of alternative credit providers.

The terms of the financing arrangements will largely depend on what is most appropriate for the structure. We have seen a number of continuation vehicles established with a subscription credit facility in place from day one at the continuation vehicle level. This type of facility is backed by any remaining undrawn commitments of the investors rolling over their interests, plus the undrawn commitments of the new investors. As with most subscription credit facilities, the maximum duration of the outstanding debt will typically be 12 months or less, and will act as a short-term deferral of the new investors' obligations to contribute capital for the purpose of the underlying assets. It should be noted however that the amount of undrawn commitments may not be sufficient to support a significant amount of debt, and lenders may struggle to underwrite the risk profiles of some secondary investors.

Concentration risk

Some fund managers will structure the debt as longer-term leverage, with 'downward' security based on the underlying investments of the continuation vehicle. Concentration risk is a key consideration for lenders. While many investments will typically be high quality, often continuation vehicles are established for the purposes of holding only a single asset. Even for vehicles with multiple assets, some lenders will struggle to lend against a highly concentrated portfolio.

It therefore makes sense that hybrid facilities, which remain relatively rare for private equity funds, have a much better use case for continuation vehicles. Lenders providing hybrid facilities will have recourse both to the undrawn commitments of the investor base (with such investors already having significant skin in the game), as well as one or more high quality assets transferred into the continuation vehicle. Combining both a 'look up' and 'look down' security package reduces the lender's risk and is likely to result in better pricing for the fund manager – obviously a key consideration in a higher interest rate environment.

With the number of NAV lenders in the market growing extensively in the past few years, there is an increased focus from fund managers on identifying the most appropriate institutions to partner with, to find the optimal financing structure to match the lender's own strategy.

From a structuring perspective, understanding the potential layers of leverage in such transactions is key. Where a secondaries fund has in place its own subscription credit facility and/or leverage facility, for example, any leverage further down in the structure may be seen as sub-optimal, given the uncertainty of what might unfold in a distressed scenario. This can be further complicated where debt is being provided by an alternative credit provider with its own subscription credit facility and leverage facility in place.

Ultimately, with the convergence of market appetite, macroeconomic conditions, new debt provider entrants to the market and increased innovation for liquidity solutions, there is an even greater focus from GPs, investors, financing providers and advisers on finding the most appropriate structure and financing solution for each secondaries transaction. ◆

Paul Tannenbaum

Cameron Roper