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Covid-19

Funding options for closed-ended fund sponsors

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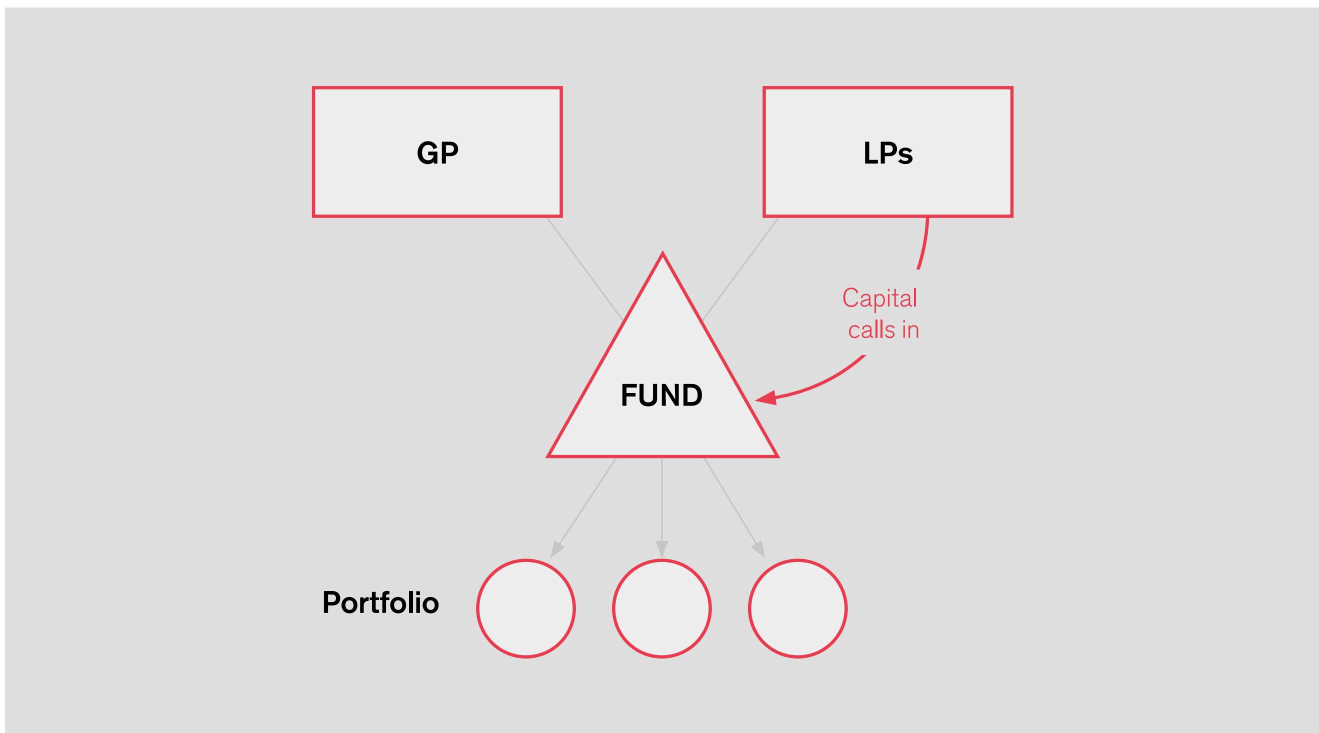
Introduction

The UK has now been in lockdown for almost a quarter of the year; a whole season devoted to preventing the spread of Covid-19. The easing of lockdowns during summer has illustrated the challenges policymakers face in balancing economic imperatives with prophylactic measures to guard against secondary waves. It is no longer possible to sit out the virus.

Similarly, closed-ended fund sponsors (GPs) face a more active third and fourth quarter. We anticipate GPs having to think about further capital injections for investee companies (particularly those impacted by: (i) continued lockdowns, (ii) the rolling back of government support schemes and (iii) market dislocation), at a time where finance sponsors are looking carefully at covenants and institutional investors (LPs) are fielding drawdown requests simultaneously from all of their GPs.

This note sets out the obvious (and less obvious) funding options for GPs, which some sponsors might want to start considering ahead of the autumn.

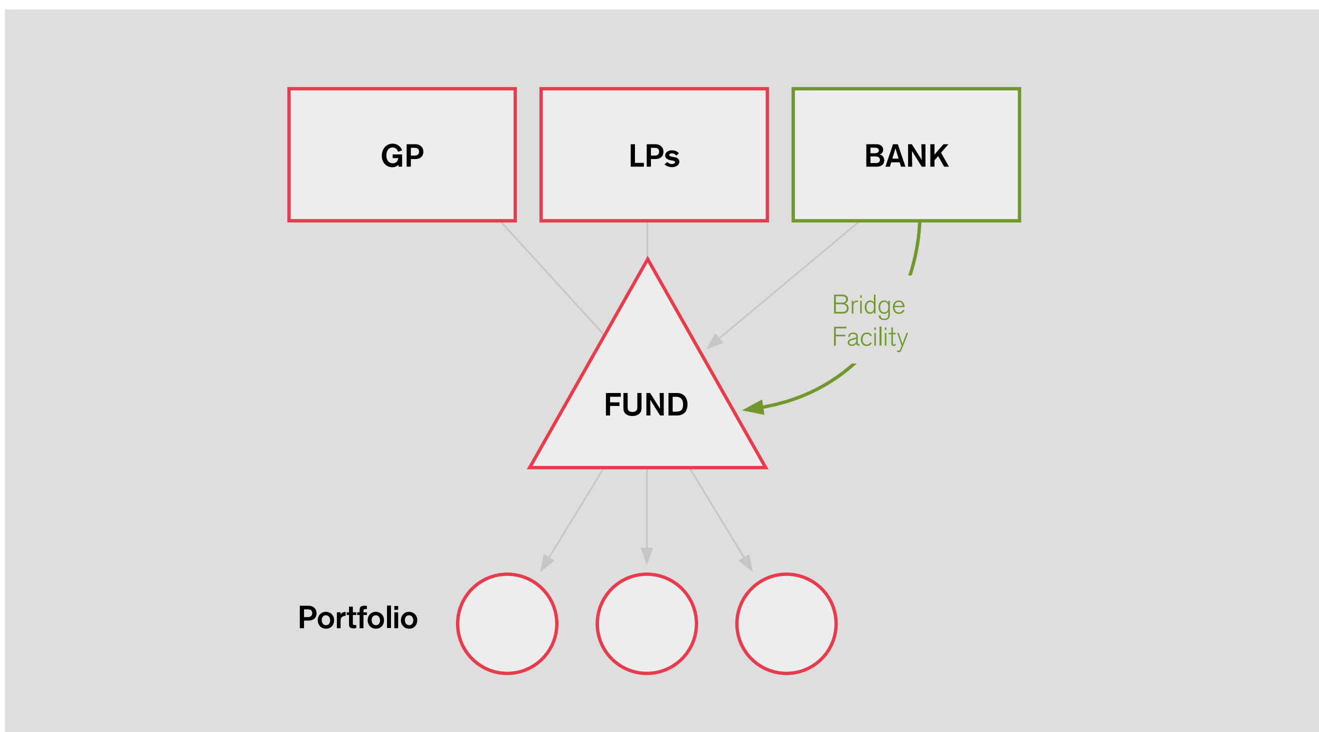
LP drawdowns and recycling



- Most GPs will be able to call on undrawn commitments from LPs to fund (i) acquisition costs for deals or (ii) general fees, costs and expenses, on 10 business days' notice.
- The ability to call will depend on LPA terms: often the LPA has restrictions on quantum/timing/uses of undrawn commitments once past the investment period. Some GPs are exploring extending the investment period or relaxing follow-on limits.
- GPs can also either retain distributions from realisations and re-invest that cash; or recall past distributions from LPs to re-invest. The LPA will normally stipulate pre-requisites that accompany recycling powers: in particular, GPs often have to signal at the time of a distribution whether that cash is recallable.
- Calling new capital, or retaining/recalling distributions obviously has a negative impact on the preferred return. Some GPs may be worried about key investors facing a cash-crunch as they field multiple drawdowns from all of their major sponsor relationships.

Pros	Cons
No structuring required – already catered for under the LPA.	Limitations in LPA may prevent you calling capital when needed, especially during the post investment period.
	Danger of LPs being called at the same time by multiple GPs.
	Implications for the preferred return.

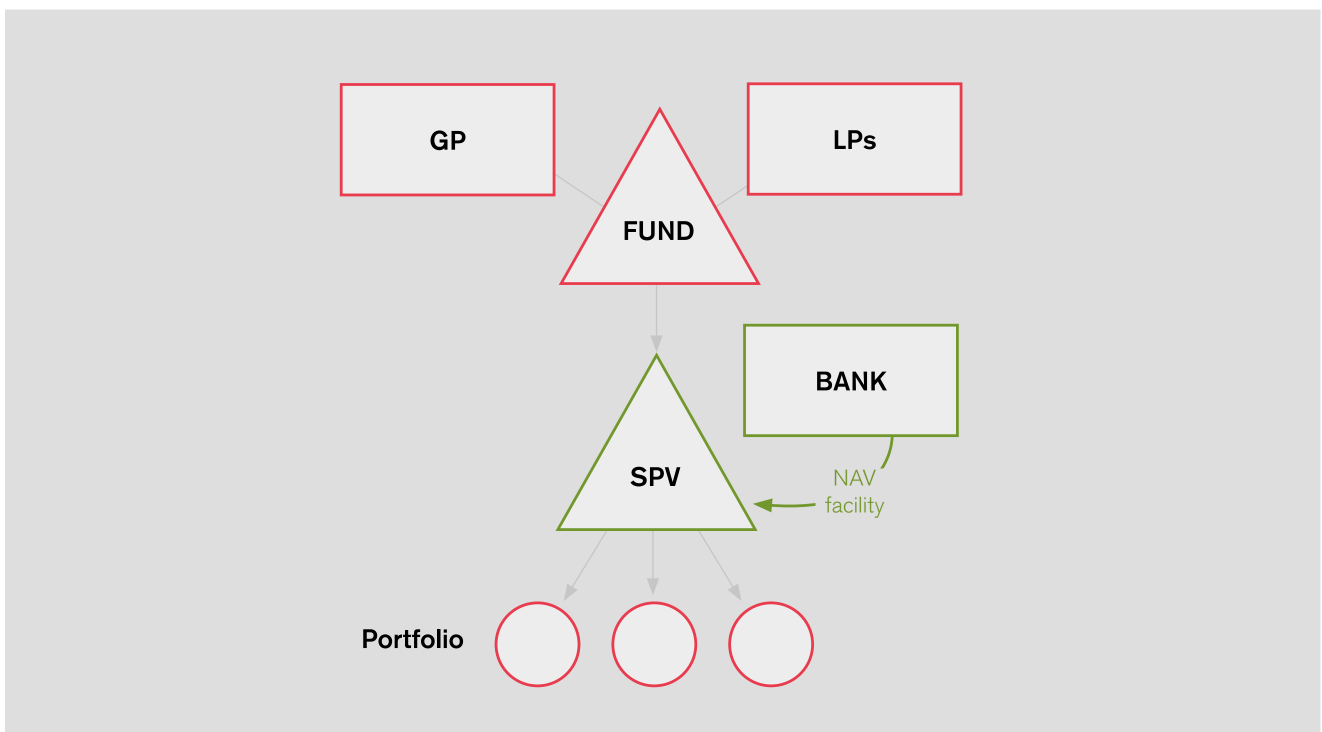
Bridging facilities



- It is very common for GPs to have a bridge (or "subscription line") facility at fund level. For AIFMD purposes, this does not count as leverage if backed by undrawn commitments.
- Recourse for the loan is to undrawn commitments, looking up to the investors rather than down to the portfolio. LPAs typically limit bridge facilities to the lower of (i) remaining undrawn commitments and (ii) 20–30% of total commitments (depending on fund size and strategy).
- Putting in place a bridge facility (or extending the scope of an existing facility) gives the GP the ability to drawdown on short notice for capital injections and other investments. Facilities typically require drawn amounts to be repaid within 12 months, which allows the GP to smooth out capital calls from investors. This may be helpful at a time when LPs are facing multiple calls from numerous GPs.
- There is a significant amount of due diligence done by the banks offering this product on the investor base, to assess such investors' credit worthiness and any carve-outs to capital calls included in side letters (e.g. in relation to excuse, default or ERISA restrictions).
- If the bridge facility is put in before the end of the fundraising, lenders will also want oversight on new fund terms or side letters that impact the ability to call on investors to repay the facility. Occasionally, depending on jurisdiction and security arrangements, LPs may be required to enter into acknowledgements and similar documents as part of the facility contracts.

Pros	Cons
Allows GP to smooth out drawdowns on LPs.	Lenders will need to analyse the LP base and very occasionally LPs may need to enter into legal documentation.
Capital can be called on faster than 10 business days' notice.	Lenders will want controls over future changes to fund terms and side letters.

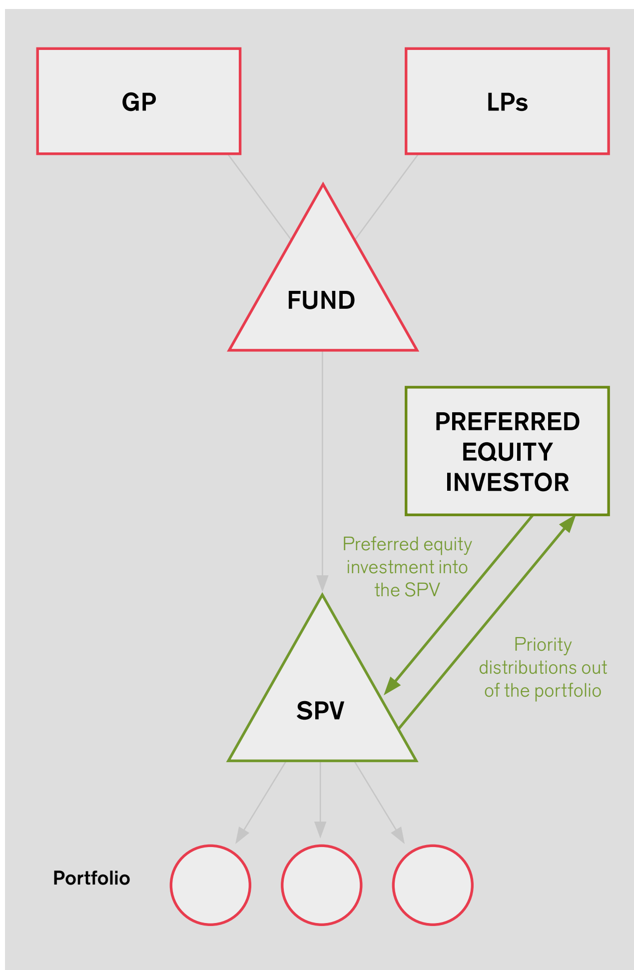
NAV facilities



- A more recent development than the bridge facility is the NAV facility. This lending can potentially be combined with a bridge facility at fund level, but the NAV facility puts finance underneath the fund.
- The NAV facility is repaid out of proceeds coming out of the portfolio and takes priority on distributions before any remaining amounts go up to the fund for distribution to investors under the fund waterfall.
- Whereas the bridge facility requires diligence on the underlying investors, a NAV facility provider will need to run a detailed analysis on the portfolio and that can be more or less extensive depending on the type of NAV facility provider.
- NAV facilities are provided by banks, institutional investors and credit funds. There is therefore a significant breadth of offering and terms available (although the providers remain a less diverse group than providers of bridge facilities).

Pros	Cons
Increased funding for the portfolio without having to call on LPs.	Lenders will need time to analyse the portfolio.
Credit funds and other non-bank lenders can be creative and flexible in their offering, potentially providing lending against assets that would otherwise be difficult to finance.	Limited number of providers offer this type of facility, which may impact pricing and availability.

Preferred equity



- Preferred equity sits between the investor's capital commitments and debt put in by a lender. It sits behind any existing debt but ahead of the investors in the fund. Typically, it is invested into a vehicle underneath the fund, and then used to inject capital where required in the portfolio, or finance distributions back up to fund investors.
- It is a limited recourse investment: it is only repaid out of the proceeds of the portfolio (or a specific sub-set, depending on the negotiated terms).
- Preferred equity investors typically take a fixed return on their investment (often structured as a waterfall with differing sharing percentages depending on target IRR hurdles). Once their original investment and return is paid, they withdraw from the portfolio and returns flow up to the fund investors as before. Preferred equity can, if required for tax or regulatory reasons, also be structured as a loan instrument into a portfolio.
- Preferred equity can be very flexible and quick to implement. However, there are only a few providers who can handle larger scale transactions.
- Structuring the portfolio so that the preferred equity can slot in between the portfolio and the fund will require transferability analysis and may in some cases require significant work to move assets. If third party consents are required, this may be a stumbling block for a preferred equity investment.
- It is not shown on the diagram, but it is equally possible, with requisite LP consents, to "open up" an existing fund and create a new partnership class of preferred equity which is subscribed for by existing investors (and potentially new investors). This does away with a need for a subsidiary vehicle but will normally only work where there are a smaller group of LPs to co-ordinate and a larger cornerstone who is prepared to underwrite the transaction.

Pros	Cons
Investment has a limited upside; the fund takes back the portfolio once the preferred equity investor has been paid out.	Moving of assets around into subsidiary structures may require extensive pre-planning and transferability analysis.
Very flexible and can be done quickly.	Limited number of providers offer this type of investment, which may impact pricing and availability.

Get in touch

Macfarlanes has specialist teams who have worked on a number of structured funding transactions of the type set out in this note and your usual Macfarlanes contact would be happy to arrange a conversation to discuss the technical and commercial aspects of any one of these particular transactions.

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