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NAV Financing for Pref Shares

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By Brian Foster
Partner | Fund Finance

By Patrick Calves
Associate | Fund Finance

Over the past 18 months, as we have previously discussed here, here and here, use by private equity funds of both NAV loans and preferred equity solutions has increased. For our purposes, NAV loans are loans to private equity funds that are supported, either on a secured or unsecured basis, by the value of the assets of the private equity fund. The loans are senior obligations of the borrowing fund and are documented under loan agreements with robust representations, covenants and events of default. The loan covenants typically place limitations on the activities of the borrowing fund, such as the amount of overall indebtedness it may incur, its ability to pledge or dispose of investments and its use of cash received from portfolio investments. NAV loans have fixed maturities that can only be extended by agreement of the lenders and have largely fixed returns to lenders (typically in the form of a floating interest rate plus a spread).

Preferred equity solutions provide capital to a private equity fund via the issuance and sale of equity capital, or "preferred shares," which preferred shares are not secured by the assets of the private equity fund. The claims of preferred shareholders are senior to the claims of the issuing fund's ordinary equity investors, but are junior to the claims of debt creditors. Preferred shares typically impose fewer restrictions on the activities of the issuing fund and don't have fixed maturities. They also afford more flexibility to structure the return to the capital provider (*i.e.*, the purchaser of the preferred shares), often giving the preferred shareholder a priority claim to distributions from a fund's investment portfolio up to a certain multiple of the purchase price of the preferred shares (the hurdle rate of return). This threshold level, if met, provides the purchaser of the preferred shares a minimum rate of return on its investment before the right of ordinary investors to receive further distributions of capital resumes. Even after the hurdle rate of return has been achieved, though, the preferred shareholder may retain some additional (but reduced) entitlement to the residual value of the fund's investment portfolio alongside ordinary investors.

Both NAV loans and preferred shares provide capital that enables private equity funds to monetize or expand their investment portfolios, and we often encounter these two options in the context of a private equity fund determining how best to raise capital for such purposes – *i.e.*, whether the fund prefers the lower cost of a loan or the flexibility of preferred shares. Not surprisingly, though, we are increasingly seeing NAV loans and preferred equity solutions being deployed together, with investors in private equity funds (including secondaries funds) using NAV loans to finance their purchases of preferred shares.

Lending against preferred shares rather than portfolio investments raises unique issues. We highlight certain considerations for lenders for these types of facilities below:

- **Valuation**. Lenders need to make sure that the valuation of the pledged preferred shares for borrowing base and LTV calculations is tailored to the distribution and liquidation rights attributable to the preferred shares in the issuing fund's constituent documents. In addition, given that preferred shares still rank behind any debt claims, lenders need to ensure that any debt incurred by the issuing fund is accounted for in producing such valuations.
- **Cash Flows**. Once the hurdle rate of return has been met for the preferred shares, the value of the preferred shares will be significantly reduced, even if there is a significant amount of value remaining in the portfolio. Lenders should structure cash sweeps and loan amortization provisions to ensure that the loan obligations are repaid before the hurdle rate of return is met.
- **Passive Investments**. Preferred shares are commonly structured as passive investments with respect to the issuing fund and its underlying portfolio. Unlike a foreclosure on an investment portfolio under a NAV loan, lenders will not assume any active rights of management or disposition with respect to the underlying investments on foreclosure. Lenders should carefully diligence the constituent documents of the issuing fund to make sure the distribution and liquidation rights of the holders of preferred shares are sufficiently hardwired.
- **Diligence and Consent**. Although preferred shares provide economic exposure to a portfolio of investments, that exposure is provided through securities issued by a single fund. The ability of foreclosing lenders to effect a disposition of preferred shares pledged as collateral will depend on the terms of those preferred shares. Wherever possible, lenders should obtain consent from the issuing fund to both (i) the pledge of the preferred shares that are pledged to secure the loan obligations and (ii) the transfer of such preferred shares upon a foreclosure by the lenders.