

FUND FINANCE FRIDAY

NAV Acquisition Finance for Secondaries Facilities

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In the private equity secondaries market, financing is often used to facilitate the purchase of portfolios of interests in private equity funds. These transactions require lenders to underwrite the value of assets that the borrower does not yet own, which gives rise to a specific set of challenges for the lenders. Below we discuss some of those challenges and the steps lenders can take to get comfortable making such loans.

Which entity is acquiring the portfolio? Financings of portfolios of interests in private equity funds are structured around the vehicle that owns the portfolios of funds (the “AssetCo”). Typically, the AssetCo acts as the borrower or as a guarantor of the financing and pledges its account to which proceeds of the fund interests are directed. The investor(s) in AssetCo pledge 100% of the equity of AssetCo as well as the equity of the general partner of AssetCo. In documenting an acquisition financing, lenders will review the details of the purchase and sale arrangement to confirm that the financing has been properly structured around the vehicle that will hold the portfolio of fund interests after consummation of the underlying purchase and sale transaction.

Conditions to closing the purchase transaction. The underlying purchase and sale transaction will be subject to specified conditions precedent that have been agreed between the purchaser and the seller. Since lenders are providing financing in advance of the closing of the purchase and sale transactions, they will want to ensure that when they fund the amount of the initial advance to the borrower, the only open condition precedent to the effectiveness of the purchase and sale transaction is payment of purchase price to the seller of the fund interests. To do this, the lender will need to check the conditions precedent listed in the purchase and sale agreement. These generally include delivery of pre-closing notices, officer’s certificates,

authorizing resolutions and legal opinions, in addition to the payment of the purchase price, but may also include other transaction-specific conditions and deliverables. In order to gain sufficient comfort that all conditions precedent have been satisfied (other than payment of the purchase price), lenders can (1) review the finalized closing deliverables provided in escrow, (2) talk to purchaser's and/or seller's counsel prior to funding and (3) join a pre-closing call with all relevant parties to the acquisition.

Payment of the purchase price. In most cases, the amount of the loan will be insufficient to cover the entire purchase price for the portfolio fund interests, and as a result, the borrower will need an equity contribution from its investors in order to have sufficient cash on hand to meet its payment obligation. Prior to funding, lenders often want to receive evidence that sufficient equity capital has been contributed in order to top up the debt financing in an amount at least equal to the purchase price. To ensure that payment is effectively made to the seller of the portfolio fund interests, the lender may choose to advance the amount of the loan (1) directly to seller itself, (2) to a "blocked" deposit account of the borrower where the lender has to approve the subsequent payment transfer to the seller or (3) to a deposit account of the borrower subject to a standing instruction with the applicable account bank to transfer the deposited loan amount to the account of the seller by a specified time.

Conditions to transfer the underlying assets. Separate and apart from the conditions to the closing of the purchase and sale transaction as between seller and borrower, steps will need to be taken to transfer ownership of the underlying private equity fund interests from seller to borrower. Some of the more common conditions to a valid and effective transfer of a private equity fund interest are: (1) the execution of the transfer agreement by the borrower, the seller and the general partner of each underlying fund, (2) delivery of the borrower's subscription documentation, (3) execution by the borrower and the general partner of each underlying fund of a side letter (if any), (4) the execution of any required third-party consents, such as the GP's consent to the transfer of the ownership interest (which may be included in the executed transfer agreement or a separate side letter) and (5) an updated register of owners on file with the fund's administrator. Although final executed copies of such documents may not be available until after the closing of the purchase and sale transaction, lenders will want to have comfort that the general partners of the underlying funds have agreed to the transfers and will process the transfers promptly following closing. Lenders may ask to review executed documents in escrow, or at least review final and agreed versions of the documents if escrowed deliverables are not otherwise available. Lenders may also seek assurances from purchaser's counsel and/or counsel for the underlying fund general partners that documents are in final and agreed form and will be executed promptly following closing of the purchase and sale transaction. For some loans, law firm letters are issued providing assurances as to the foregoing.

Dealing with failed transfers of underlying fund interests. Given the inherent risk to the lenders in advancing funds to an entity that does not yet own any of the portfolio fund interests that will ultimately support the loan obligations, the credit agreement will include a repayment mechanic and other protective measures if for any reason some or all of the fund interests do not effectively transfer to the purchaser promptly after such loan amounts have been advanced. In the event that any portion of the fund interests failed to transfer over to the borrower, those assets would then be excluded from the borrowing base. If the aggregate value of the fund interests that did transfer over is insufficient to support the outstanding loan obligations, a

mandatory prepayment of a portion of the loan amount will be required. Until such mandatory prepayment is made, additional protective measures may be implemented – the borrower will be restricted from using any cash on hand for other purposes, including distributions to equity holders and payment of management fees, and the accounts pledged to the lenders may also be subjected to lender control.

While the specific risks and requirements for loans used to finance acquisitions of secondaries interests vary on a deal-by-deal basis, this article highlights the importance of the investment diligence process and proper structuring of the loan documentation to align with the terms of the underlying purchase and sale transaction.