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Continuation Funds and the Hybrid Solution

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By Samantha Hutchinson
Partner | Fund Finance

By Brian Foster
Partner | Fund Finance

By Patrick Calves
Partner | Fund Finance

It has been a common refrain in the fund finance industry that “hybrid” loan facilities (*i.e.*, loans underwritten on the basis of both a fund’s investor capital commitments and its investment portfolio) are constantly talked about, but are (at least in the PE buy-out space) seldom seen. An internet search returns a bounty of articles citing such facilities as a “cradle to grave” financing solution. Marketing teams crank out glossy presentations touting capabilities to execute such facilities. And conference agendas schedule panels to discuss the nuances of hybrid collateral structures. But the market consensus year after year has been that the number of hybrid deals actually executed has been . . . underwhelming.

The reasons cited for this vary, including fund organizational documents not permitting asset-based debt, the need for LPAC approval and the general difficulty in finding lenders that are able to underwrite both investor commitments and asset portfolios within a single trade. In the buy-out space, the main obstacle to the use of hybrid facilities has been the difficulty in underwriting asset portfolios that are not yet invested (for early-stage funds) and the insufficiency of remaining uncalled capital commitments (for later-stage funds). Certainly, buy-out managers have executed “hybrid” trades but they typically are heavily weighted against either the LP commitments or the underlying assets, not both. Primary buy-out funds, no matter where they are in their life cycle, do not lend themselves easily to a hybrid facility. Traditional subscription facilities and NAV facilities have thus far largely been used to meet sponsors’ fund-level financing needs, depending on the stage in the life cycle of a fund. Perhaps, due to the evolution of the fund finance market, however, and in particular the notable increase in the prevalence of continuation funds in the buy-out space, hybrid facilities will finally have their day in the sun.

A continuation fund is an entity formed for the sole purpose of buying one or more assets from an existing fund, typically near the end of its term, and that is managed by the same fund sponsor, sometimes alongside another sponsor. Investors in the existing fund may elect to redeem their interests in that fund or may elect to continue their investment by rolling their interests in the existing fund into the continuation fund. The rise of continuation funds under current market conditions has been much discussed, and the current challenging conditions look set to continue pushing managers to find alternative ways to create liquidity in the absence of viable traditional exit options. In 2022, GP-led volume was estimated between $43bn-53bn and the continuation-funds range made up at least ¾ of this volume. Of this, single-asset deals were estimated to comprise at least 40% of this number. Once considered the playground for "problem" assets, continuation funds are increasingly being used by sponsors to retain well-performing assets to sell at a later time in a more optimal market while still providing an exit option for investors in need of liquidity.

In order to effect a continuation fund's acquisition of assets and payout of existing investors, the continuation fund needs to raise additional capital. This additional capital typically comes in the form of new equity commitments, either by new investors or by rollover investors from the existing fund making additional commitments. Nevertheless, additional equity capital may not be sufficient. In these circumstances, debt financing is an obvious solution to bridge the gap.

While debt financing may be an ideal solution to fill any capital shortfalls, continuation funds present unique challenges for traditional subscription and NAV fund finance structures. New investors for continuation funds tend to consist of other alternative investment funds, most commonly, secondaries funds. These investors often don't have ratings and will have a different risk profile compared to the rated institutional investors that often form the core of the borrowing base for traditional subscription facilities. It is also common for a majority of the investors in the existing fund to elect to redeem their interests (rather than roll into the continuation fund), and rollover investors may be reluctant to provide new capital commitments to the continuation fund given the amount and duration of capital previously committed. As a result, continuation funds tend to have less diversified pools of uncalled investor capital commitments to form the core of the borrowing base than is typical for subscription facilities.

NAV facilities are also difficult to implement for continuation funds. NAV facilities are often underwritten on the basis of the number of assets (and the diversity thereof) in the underlying asset pool and based on cash flow expectations from realizations of such assets. By their nature, continuation funds have concentrated investment portfolios – a single or a small number of investments. Moreover, the driver of launching a continuation fund is to extend the exit timeline for certain investments until market conditions change for the better, making the timing of realization difficult to predict, albeit significantly shorter relative to primary assets. Finally, the cost of financing for concentrated asset exposures may be prohibitively high, and the subset of lenders able to lend solely against such concentrated exposures is very limited.

Enter the hybrid facility. In instances where sponsors and their lenders find it difficult to implement a standalone subscription or NAV facility for a continuation fund, hybrid facilities that look to both the uncalled investor capital commitments and investment portfolios of continuation funds on a combined basis have proven to be a valuable solution. On a blended basis, the capital commitments and the assets of a continuation fund have very desirable characteristics.

In the case of a continuation fund's investor base, investors in continuation funds will often have funded a material portion of their capital commitments at the outset of the fund, either because (i) they have rolled over a significant portion of their capital commitment from the existing fund or (ii) they are new investors that are funding a portion of their commitments upfront to pay for the acquisition of the continuation fund's portfolio. As a result, continuation-fund investors have immediate "skin in the game," creating a significant economic incentive to satisfy further capital calls. Additionally, because continuation fund investor bases tend to be made up of a smaller group of sophisticated investment funds, it is easier for lenders to obtain investor documents that provide lenders with additional comfort lending against these commitments (*e.g.*, investor comfort letters, financial statements, etc.). In the case of a continuation fund's investment portfolio, these investments are often premium assets that have a robust track record of performance with the same sponsor and have a shorter remaining holding period relative to primary assets. So, while neither source of credit support may stand on its own, each diversifies the risk of the other, and together they form a compelling source of credit support for lenders to underwrite.

With the spike in use of continuation funds, there seems to finally be a compelling need for hybrid facilities from private-market managers and a great opportunity for lenders – the cost of borrowing in the leveraged finance market has gone up significantly but this has not yet fed fully into "NAV" financing. These products provide an attractive risk-adjusted return for lenders who can provide these facilities, benefiting not just from recourse to well-performing assets but also recourse to the investors. No doubt managers are also looking at this as a cheaper form of financing compared with pure asset-based leverage. And financing will have to be a necessary part of these trades. Secondary dry powder at the end of 2022 was estimated at approximately $131bn. If you assume around half of that will be available for GP-leds and the majority of that number for continuation funds, you arrive at a capacity level which isn't sufficient to finance anywhere near the number of primary funds that are likely to need to consider continuation funds as an alternative liquidity solution in the near-term. It is time for marketing teams to dust off those glossy presentations and for hybrid facilities once again to feature in conference agendas. It's time for reality to finally meet the hype.