

## Underwriting Secondaries Deals

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The market for financing pools of interests in private equity funds and private credit funds continues to sizzle, with new lenders joining the market and competition on pricing leading to a tightening of spreads for the most sought after deals. We are regularly having conversations with business principals, risk officers and internal lawyers at new and existing lenders looking to better understand this market. How to underwrite secondaries is a particular focus for new lenders, and is a topic we covered at yesterday's Fund Finance Association University 2.0. Below we summarize some of the key themes that arise in these discussions:

- **Cash Flow Underwriting:** Underwriting for these transactions is predicated first and foremost on cash flow projections. Secondaries sponsors often have long histories with managers of underlying funds and are in regular communication about expectations for realization events and distributions. In conducting due diligence and underwriting for these transactions, lenders focus on the timing and allocation within the portfolio of expected cash distributions.
- **Diversification is Key:** Risk assessments are based in large part on the diversity of a portfolio. Lenders can ensure a specified level of diversification is maintained by imposing concentration limits in the borrowing base. For example, limits are imposed on the percentage of a borrowing base that can be comprised of investments in a single fund, investments in a specified number of funds (e.g., top 3, 5 or 10 funds) and investments in funds with the same sponsor (or affiliates of a sponsor). Additional diversity criteria that are applied may include investment strategy (e.g., buyout, credit, real estate, infra and growth/equity), geographic focus (e.g., limits on emerging markets exposure) or vintage (e.g., limits on newer funds or older "zombie" funds). Concentration limits may also look through the funds to the underlying investments, to ensure that the portfolio is not overly exposed on an aggregate basis to particular companies, industries or geographic regions.
- **Settled Structures:** In contrast to NAV loans, secondaries market loans tend to follow a consistent structure. A borrower establishes a special purpose vehicle (SPV) to hold interests in underlying private funds. The borrower pledges 100% of the equity of the SPV (alongside a pledge of the equity of the SPV's general partner), and the SPV pledges its cash account to which proceeds of the underlying private funds are directed. This structure effectively provides a pledge of all economic and management rights with respect to the underlying portfolio.
- **Liquidity Considerations:** Borrowers need to be able to continue to meet obligations related to the underlying investment portfolio, including funding capital call obligations and satisfying deferred purchase obligations. Lenders often take comfort from borrowers having subscription facilities in place, having remaining uncalled capital commitments from investors or maintaining pockets of more liquid investments. Some facilities may include a revolving loan component that borrowers may utilize to meet such obligations.
- **Valuation:** Secondaries loan facilities don't tend to have lender dispute rights on valuations. Valuation of the private fund investments is typically the lower of the value assigned by the borrower and the value published by the relevant fund. The fact that the funds are unaffiliated with the borrower, combined with the diversity of funds (which results in a diversity of providers of such valuations), is a significant mitigant against the mis-marking of the portfolio. In addition, there is a view that underlying fund sponsors are incentivized to value investments conservatively so that realizations don't come in below the value at which investments are marked. It is important to note, though, that interests in private funds trade at a discount in the secondary market, and the size of the discount will vary based on factors including the identity of the sponsor, the vintage of the fund, the fund strategy, interest rates and general market conditions. Such discounts must be taken into account in setting LTV ratios for a loan and in mapping out exit scenarios in the event of a default.

- **Other Debt:** Generally, a lender in a secondaries facility expects to be the only creditor of the borrower and the SPV. However, other types of debt that may be permitted include debt related to deferred payment obligations on the purchase of investments, and fx hedging obligations.
- **LTV and Cash Sweep:** From a risk perspective, the two most critical features of a secondaries loan are the loan-to-value (LTV) calculation and the cash sweep.
  - The LTV calculation measures the amount of the loan (or in some cases, the amount of aggregate debt of the borrower and SPV) against the adjusted value of the investment portfolio. For purposes of the LTV calculation, the value of the investment portfolio may be reduced to reflect investments that are deemed ineligible or that have experienced adverse events (such as a bankruptcy, a failed capital contribution by the SPV or a legal or regulatory proceeding) as well as application of the concentration limits discussed above. If the maximum permitted LTV ratio specified in the loan documents is exceeded, the borrower is given a specified amount of time to call capital from investors to restore the LTV ratio below the maximum. In some transactions, a borrower may be given an opportunity to present a plan that must be approved by the lenders to restore the LTV ratio over a longer period. Elements of a cure plan may include application of expected distributions from the investment portfolio or sales of specific positions. The maximum LTV for a loan facility often steps down as the loan gets closer to maturity.
  - The cash sweep measures the cash received during a specified period, typically each calendar quarter, and specifies a portion of such cash that must be used to repay the loan. In the first instance, measurement will be taken of the gross proceeds received during the period in respect of the investment portfolio, whether as a result of dividends, interest payments, principal repayments, equity distributions, proceeds from the sale of investments or otherwise. Certain costs or other obligations will then be netted from the gross proceeds (such as capital contributions to investment funds in the portfolio, transaction expenses or operating expenses of the SPV) to determine a “net proceeds” number that is subject to the cash sweep. Cash sweep holidays at the beginning of a facility are common during which there is no requirement to apply net proceeds in repayment of the loan. The percentage of proceeds that must be swept to repay the loan is often tied to the LTV, with a higher LTV at the time of the sweep corresponding to a higher sweep percentage.
- **Enforcement of Remedies:** In the event of a facility default, lenders will seize and apply any cash distributions as they are paid into the collateral accounts. The lenders are also likely to allow the borrower to identify positions to be sold and to commence a sale process. As a practical matter, a forced sale of the equity of the SPV (which effects a sale of the entire portfolio at once), is the least likely remedy to be imposed. However, the existence of a robust market for portfolios of secondaries interests (combined with the legal right to effect such a sale under the terms of the loan documentations), provides significant comfort from a risk perspective.
- **Current Trends:**
  - One trend that we have seen in the market is an increase in the number of registered investment companies following a secondaries strategy. As sponsors focus on fundraising from high net worth investors, many are launching funds that are registered under the Investment Company Act of 1940. These funds manage dynamic portfolios of investments in private funds, and tend to have longer terms (including some evergreen funds) than their private counterparts. Such funds may make a soft commitment to buy back a portion of their shares each quarter.
  - Another trend we have seen is the use of credit facilities by private credit secondaries funds. Financing has long been used in the private equity secondaries space, but was much less common in private credit secondaries. 2024 seems to be marking a turning point, as we have seen a steady flow of such financing transactions.