Continuation Funds and the Hybrid Solution

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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.

Let’s Get “Real”

October 13, 2023

By Chris van Heerden
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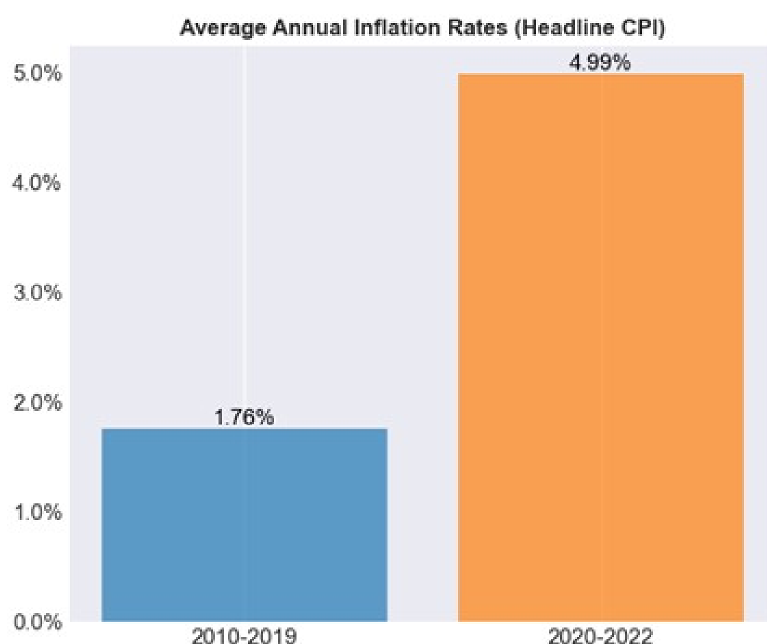
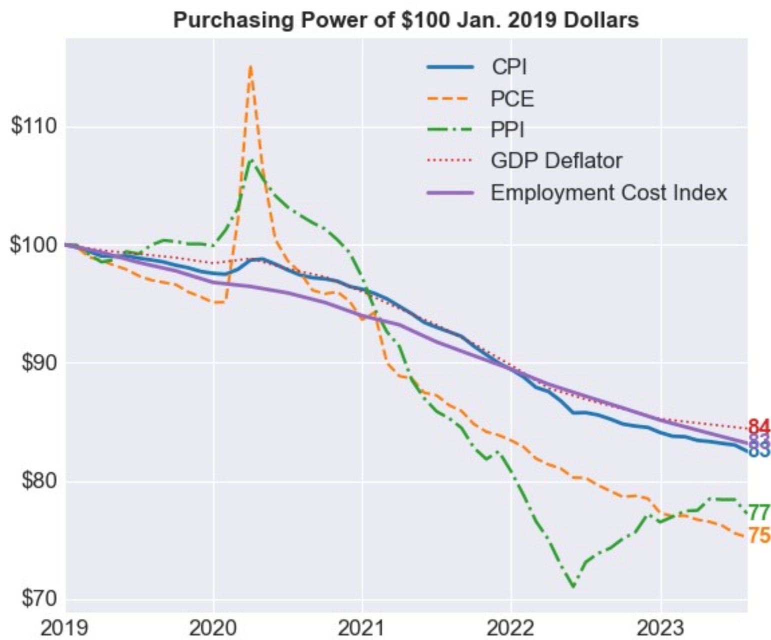
Old habits die hard. For the decade leading up to Covid, inflation averaged a very comfortable 1.5%-2.0%. Stable, low inflation meant no one could be blamed for letting “real,” inflation-adjusted thinking fall by the wayside. In 2023, however, clear differentiations between real and nominal trends probably need to stage a comeback.



Source: Bureau of Labor Statistics and Cadwalader, Wickersham & Taft LLP

Since inflation measures the overall level of prices, and by extension the purchasing power of a fixed sum of money, it matters to pretty much everything financial. At home the impact on inflation is fairly obvious in the grocery store bill or at the daycare, but that’s a relatively narrow view. Over the past three years, inflation has been a pervasive component of everything from corporate earnings, investment returns, asset price appreciation, to debt growth.

In fund finance, as in any other business in 2023, we would be well served to get more specific about how much of our business trends are explained by inflation. Failure to differentiate nominal (gross) trends from real (inflation adjusted) trends means we risk getting a false sense of growth or accomplishment from results that are simply attributable to dollars becoming worth less. It could also delay us in recognizing underperforming fundamentals when nominal numbers are marginally in the black.



Source: Bureau of Labor Statistics and Cadwalader, Wickersham & Taft LLP

Inflation reporting does us a disservice, with the emphasis most often falling on the change in the rate of change — not exactly an intuitive framing. When inflation numbers “come down” month over month, it means that price levels are still increasing and purchasing power is still diminishing (as long as the inflation rate is positive). It may just not be happening as fast as it did the prior month. Going one step further, slowing inflation does not mean that the purchasing power of a fixed hourly wage job or the spending power of a retirement savings that were lost in prior months is in any way restored.

Thinking in real terms will help us make sense of things that are happening around us. Since 2020, the supply of money in the economy has increased by 43% while average hourly earnings grew by 30% over the same period. This means a significant share of the expansion in the monetary base wasn’t passed through to workers, which is, not surprisingly, creating tensions in certain places.

Paid experts expect the rate of inflation to moderate, and they’ll keep rolling the forecast forward until it proves correct. I’m not equipped to make a forecast, but I think we should prepare for more than one possible scenario. The Philly Fed survey shows a 2.5% consensus headline CPI forecast for 2024. Given events from the past week, it may be fair to question whether a 2.5% forecast adequately reflects the inflation upside probabilities given (1) the unwinding of globalization, which is progressively looking less and less gradual, (2) the wage imbalances highlighted above, (3) materially higher uncertainty in global energy supply, (4) the potential that the mountain of Federal debt and its short tenor could influence the Fed’s wherewithal to raise rates, (5) historical examples of geopolitical conflict driving inflation higher by rerouting supply chains, raising commodity demand, and amping-up deficit spending.

Bringing it back to fund finance, I’m simply making the case that bringing “nominal” and “real” back into the lexicon may help us better understand our market growth, our revenue outcomes, and perhaps can help refine forward expectations.

Why so Seri(e)ous? Cayman Series Partnerships in Fund Finance Transactions

October 13, 2023

By Georgina Pullinger
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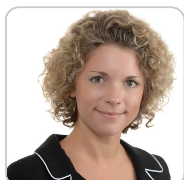

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Funds make use of series partnerships across jurisdictions to allow for segregation of partnership interests, assets, distributions and operations into separate series or classes[1]. A particular quirk of Cayman series partnerships ("CSP"), however, is that they are not statutory entities[2] and instead exist solely as a matter of contract. It is therefore important for lenders to understand how this structure differs from statutory series vehicles and how this might impact a financing.

An overview of Cayman Series Partnerships

The purely contractual arrangement of a CSP means that the segregation of assets and/or liabilities of different series of interests arises solely pursuant to the terms of the limited partnership agreement ("LPA"). As the series structure is contractual, it is effective as between the partners. It is not, however, effective in relation to third parties (such as creditors) in the absence of limited recourse language limiting the recourse of such third parties to the assets relevant to a particular series.

As with all series or segregated portfolio vehicles, the separation of the series interests can be fairly limited (*e.g.,* relating only to how distributions are calculated as between series), or can impact a much wider range of the financials and day-to-day operations of the CSP (*e.g.,* where only certain series are permitted to borrow or grant security) and this will ultimately be dictated by the commercial rationale for establishing the fund as a CSP. It follows that CSPs in finance transactions can be very straightforward and make minimal difference to the usual financing approaches or, at the other extreme, they can be fairly complicated and nuanced, requiring certain bespoke amendments to the facility documentation that needs to be approached on a case-by-case basis.

Lender considerations in in relation to CSPs as obligors

A lender will need to confirm the following points when entering into a financing involving a CSP obligor:

- whether the CSP is entering into the transaction (i) for the general account of the CSP, which will usually make the analysis fairly straightforward, or (ii) on behalf of specific series, in

which case it can get more complicated;

- where the transaction is being entered into on behalf of individual series, whether every series is participating in the transaction (*i.e.*, borrowing and/or granting security), or only certain series; and
- whether it is anticipated that the CSP will have different third-party creditors at a later date, potentially to other series of the CSP.

If there will be subsequent creditors to different series, secured parties will need to be focused on steps relating to perfection and priority, to minimize any risk of issues arising if a subsequent lender does not have adequate notice of the series structure and ring-fencing of assets. It is worth noting that under Cayman Islands law, a secured creditor can generally enforce security without the need for court involvement (even if the security provider is subject to insolvency proceedings) so assuming that security has been properly taken and perfected, enforcement against the assets of specific series of a CSP should not present an issue for a lender.

Lenders will also need to consider the recourse arrangements outside of the strict security package analysis. In a subscription facility, for example, although the capital commitments are looked to as the primary source of repayment, the loans are generally still fully recourse to the assets of the fund generally, so lenders will need to consider how recourse to a series and general CSP assets is to be dealt with beyond the capital commitments analysis.

Additional lender protections for CSP financings

In connection with documenting a facility with a CSP, secured parties should consider whether series-specific restrictions are appropriate. It is not unusual to include ongoing representations as to various statements of fact relating to the operating of the series to address additional lender risks related to a CSP. We often see a representation confirming that the general partner has taken all actions necessary to create and maintain the applicable series, and that any creditor in respect of liabilities attributable to any other series shall not have recourse in respect of those debts to the assets of the current series.

Additional covenants are often included as well, for example, a requirement for the general partner to ensure that (i) assets and liabilities are not transferred between different series, and (ii) any creditor in respect of liabilities attributable either to any other series or to the general account of the CSP shall be on notice that they do not have recourse in respect of those debts to the assets of the current series. There may also be restrictions in relation to the creation of new series.

LPA diligence involving CSPs

Lenders will need to closely review the LPA to confirm how the CSP's series structure works to ensure that the LPA actually segregates assets and accounts in a way that is consistent with (i) the commercial intention of the parties, and (ii) the proposed financing and security arrangements. Some LPAs may include limitations as to whether a CSP can only borrow on a series-by-series basis, or prohibit borrowing on a joint and several bases as between series, which can impact how the borrowing base is established and how the financing is structured.

Winding up considerations

The LPA for a CSP may include a process for winding up a specific series, and such provisions are often included for consistency with the U.S.-fund documents. As CSPs are not creatures of statute, parties should properly consider the consequences of a proposed winding up of a particular series. Care needs to be taken in drafting and consideration given to whether these provisions would be recognized by Cayman courts, given the lack of statutory segregation, particularly when these terms are to align provisions of a wider fund structure.

Lender considerations in relation to CSPs as pledged entities

Additional considerations arise again when the CSP itself is the pledged entity. Given that there is no statutory segregation of assets for a CSP, in the event of insolvency, the assets of a specific series will not be ring-fenced and will form part of the CSP's general assets. This is an important factor to consider when a lender has taken security over an LP interest that is assigned to a particular series, as ultimately the value assigned to such a series could be significantly adjusted if the contractual series structure collapses.

Conclusion

The use of a CSP can offer benefits to investors, but lenders and secured creditors need to be conscious of the limitations of these structures as a matter of Cayman law, given the lack of statutory recognition.

[1] Referred to as "series" for the purpose of this article.

[2] Unlike, for example, a Delaware series LLC or series partnership, or a Cayman segregated portfolio company.

See You Next Week: Cadwalader Finance Forum – October 19

October 13, 2023

See you next week!

The 2023 Cadwalader Finance Forum is just one week away – on Thursday, October 19 at the Ritz-Carlton in Charlotte. We are looking forward to this engaging event, which will give you up-close interactions with industry thought leaders via intimate fireside chats and panel discussions exploring the latest market trends.

Following an in-depth conversation with Michael Dryden, Partner, Sixth Street, a who's who of finance executives will share their insights, including leaders from:

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- **ATLAS SP Partners**
- **Bank of America**
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- **Barings**
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- **Blue Owl**
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- **Citizens**
- **DBRS Morningstar**
- **Eastdil Secured**
- **EverBank**
- **First Eagle Investment Management**
- **Goldman Sachs**
- **Golub Capital**

- **Huntington Bank**
- **Iron Hound**
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- **KKR & Co.**
- **Kuvare Insurance Services**
- **Limekiln Real Estate**
- **MassMutual**
- **Morgan Stanley**
- **Mudrick Capital Management**
- **Neuberger Berman Private Equity**
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- **Petros PACE Finance**
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For the latest full list of panels, speakers and other details, visit our event's **website**.