Hogan Lovells

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Private fund preferred equity and NAV financing opportunities and risks

Sovereign investors in private funds will be hearing increasingly of preferred equity and Net Asset Value (NAV) financing, especially as a response to the market slowdown caused by the COVID-19 pandemic.

In this *Sovereign Investor Insights* article, we look at what this alternative financing trend involves and why it is happening, and we examine some of the issues relevant to sovereign investors considering these opportunities.

A variety of approaches exist and not all will have been tested through a full market cycle. It is, therefore, important to consider new opportunities carefully, understanding rewards and risks from first principles and looking for parallels from outside the private funds industry for guidance.

Preferred equity – the basics

Preferred equity itself is not new – preference shares have existed in private and public company finance for many years. A preference share typically provides the holder with a fixed coupon return (if there are profits available for distribution) and a priority ranking on a return of capital event such as a solvent liquidation or on a sale of a business. In contrast, ordinary (in the U.S., more often known as "common") equity typically only pays dividends after any preference shareholders have been paid their preference dividends, and ordinary equity holders only receive any capital returns after preference shareholders have received the "preferred" return on their preference shares.

Although preference shares sit at the top of the equity "stack", they are subordinated to their issuer's debt, such as bank or bond finance. Preference shares, accordingly, sit somewhere between debt and ordinary equity in the risk and reward profile, carrying more risk and reward than debt and less risk and reward than ordinary equity.

What is new is the application of preferred equity financing in the secondary private funds market. Preferred equity can be injected into a fund itself, into a special purpose vehicle (SPV) below the fund and above one or more portfolio companies or can be provided to an investor (typically a limited partner) in a private fund.

If provided to a fund or to an SPV formed below the fund, the preferred equity investment can be used for a variety of purposes, including to provide cash for growth opportunities, to refinance existing debt or equity funding, or simply to provide cash to keep distributions going to fund investors.

If provided to a fund investor (typically in an SPV formed to hold one or more interests in private funds), cash from the issue of preferred equity can be used for investment into the underlying fund (for example to meet capital calls). Alternatively, the cash can be used to enable the fund investor to monetize its investment and deploy its cash elsewhere, whether into other investments or to make payments to its own investors, without giving up all of its existing ownership interests.

Private fund investors can, therefore, use preferred equity as an alternative to a secondary sale, particularly where investors are concerned that a secondary sale valuation may not give sufficient recognition to potential future increases in fund value, perhaps following a post-pandemic economic recovery.

In these instances, preferred equity can be used to craft a bespoke economic arrangement that effectively involves the sale of all or a portion of the interests in a fund at an agreed current valuation (using cash from an injection of preferred equity to make a distribution to one or more existing investors) in exchange for priority payment terms in favor of the preferred equity investor and yet still enabling one or more existing investors to share in some or all of the future upside of the fund's investment portfolio.

NAV financing – the basics

A NAV loan is typically a loan to a fund in order to enable the fund to meet cash needs. The size of the loan is geared to the net asset value of the fund, hence the term "NAV financing."

NAV loan uses vary and include, among others, the provision of cash (i) to avoid structural debt covenant breaches, (ii) to provide short-term finance near the end of the life of a fund when limited partner commitments have all been exhausted, and (iii) to provide one or more limited partners with a full or partial exit. NAV loans can also be made to funds of funds – that is, funds that themselves invest in other funds.

NAV loans typically rank behind senior debt, but ahead of preferred and ordinary equity, in terms of risk and reward.

The attractions of preferred equity and NAV financing in a post-COVID-19 world

Most sectors of the Western (and, indeed, global) economies have suffered and are continuing to suffer from the economic pressures caused by the COVID-19 pandemic. The crisis has affected operating businesses' turnover, costs, and profitability generally (with a few exceptions including among suppliers of personal protective equipment and home delivery services). This is especially so for consumer-facing businesses typically favored by private equity and that are dependent on cash flow to service acquisition debt.

Private equity portfolio companies are in many cases generating less cash than previously. This is creating demand by portfolio companies for investor cash (whether to grow or simply to meet working capital needs or service existing debt and equity investor expectations) and, coupled with the unpredictable duration of the crisis and ever-changing government responses to it making it harder to price assets, delaying exits and new fund investment opportunities for investors.

For fund general partners and managers, preferred equity and NAV financing offer a means to bring cash into portfolio companies and also to offer limited partner investors a means of realizing some cash from their investments, but without triggering a "fire sale" or foregoing all ordinary equity future upside. This may free up money for investment in new ventures, for example to take advantage of new, lower asset prices, or to move into different, more attractive asset classes.

There are investors who still need to deploy cash into alternative assets such as private equity (typically as limited partners in private limited partnerships), but given the market turmoil and uncertainty, they may be reluctant to invest via traditional "alternative investment" approaches. For some of them (including sovereign investors), NAV financing and preferred equity investment in funds may be an attractive new "alternative alternative" asset class offering exposure to private equity but with some of the uncertainties associated with pure ordinary equity removed.

Which is best – NAV financing or preferred equity?

Which new secondary fund investment instrument is best will depend on the circumstances of the funding and fund-raising parties in each case. Generally speaking, NAV financing is similar to term debt and there may be an amortisation profile, with repayments of principal falling due on set dates and there may be a requirement for some current cash to pay interest. Preferred equity instruments tend to be more open-ended, with redemptions not due for a longer period or possibly until a fund matures (rather like the payment-in-kind (PIK) notes used by private equity funds themselves in acquiring portfolio companies).

Preferred equity is generally a more expensive means of raising finance than NAV financing, but an advantage of preferred equity can be that it allows those raising finance more "breathing space" to pay investors and its terms can be easier to customize flexibly to the unique circumstances of each transaction.

The possible downsides of NAV financing and preferred equity structures

In both cases, the advantages of the new financing options come at a price – NAV financing and preferred equity are more expensive than senior debt and the NAV financing interest coupon or fixed price preferred equity returns will eat into future returns from any retained ordinary equity.

NAV financing interest rates depend on a variety of factors, including loan to value ratios and the nature and range of investments held by a fund, but are typically lower than the cost of preferred equity finance. Loan to value covenants are typically tested quarterly, with lenders able to call in loans if covenant breaches occur and are not remedied. Preferred equity returns are often seen in the range of 10-15 percent.

In addition, for the providers of NAV financing and preferred equity the returns offered are unsecured and subordinated and preferred equity does carry equity risk (albeit ranking ahead of ordinary equity.

If NAV financing debt and preferred equity (which is arguably quasi-debt) result in investee entities becoming over-leveraged and unable to meet their commitments, investors in the new instruments could lose money.

How should sovereign investors expect to participate?

Sovereign investors could expect to participate in these new funding structures either as existing fund investors, seeking the returns to be made from obtaining NAV financing and preferred equity to release value in portfolios of fund investments, or, potentially, as providers of NAV financing and preferred equity (perhaps alongside specialist arrangers).

Specialist arrangers, who were pioneering these new financing techniques before the pandemic, are now seen as increasingly higher-profile conduits for a new class of investment capital, providing general partners and fund managers much-needed alternative financing, providing fund limited partners liquidity for existing interests and providing a new means of deploying investment capital, including through the raising of preferred equity funds to rival secondary private equity funds.

Even if sovereign investors do not intend to obtain or provide NAV financing or preferred equity, they may still wish to be knowledgeable about these techniques in order to understand the implications for their investment returns if funds in which they are directly or indirectly invested are using NAV financing or preferred equity.

How can legal input help sovereign investors and how can sovereign investors help the market?

The success of NAV financing and preferred equity investments will, as with all investments, depend on a variety of factors, especially the strength of the economy, the accuracy of financial modelling of the instruments and the alignment of interests of the investors and issuers (i.e. is there a 'win-win?'). The importance of tax and legal input should not, however, be underestimated.

Anticipating taxable events, including on the issuance, transfer, and redemption of instruments and on the payment of income and capital gains can make a material difference to investment gains and losses and financing costs, as can planning for and managing change of tax law risk.

Terms and conditions should provide as much certainty as possible in a world where change is constant – for example, as it pertains to the calculation and variation of interest rates (e.g. the advent of negative interest rates and the changing of benchmarks from LIBOR to SOFR (U.S.) SONIA (UK), €STR (EU)) and political change (e.g. Brexit, trade wars, new trade treaties, evolving sanctions regimes), a risk that can be heightened for sovereign investors especially.

It is also important to understand existing fund arrangements and how NAV financing and preferred equity structures may fit within these (noting that existing arrangements probably did not specifically anticipate the new instruments being created). As well as requiring a deep understanding of existing fund documents, good legal advice will anticipate the discussions that may take place in LPACs (limited partner advisory committees) that will be asked to review and consider new financing transactions and, ultimately, the range of outcomes that could occur in litigation and how to advocate for a sovereign investor's preferred investment proposals.

The production of NAV financing and preferred equity documentation can draw on a rich heritage of detailed structuring, documentation, dispute resolution and insolvency, and reconstruction experience in the bond, bank finance, convertible, hybrid debt-equity and derivatives markets. It is something of a crossover discipline, where knowledge of a variety of different financial instrument product-types and related issues is invaluable – breadth of knowledge is important when operating in more novel product territory, especially on a cross-border basis.

Tax, legal, and other risks cannot be entirely mitigated, but being prepared to stand back and consider the opportunities and risks presented by new instruments critically will help to maximize the opportunities and minimize the risks. As large players in an emerging asset class, and who may participate as both investors and issuers, sovereign investors can potentially drive the creation of norms that create an efficient, predictable and fair market for all users, increasing investment opportunities and the ability of portfolio companies to play their role in economic recovery and growth.

In the meantime, however, sovereign investors will need to recognize that a market consensus will take time to emerge and there is probably no "one size fits all" approach to this topic that suits all investors and investee entities – indeed, part of the appeal of these structures is their ability to flex to meet the specific needs of a given situation, and so sovereign investors should feel empowered to be creative in finding solutions that offer "win-win" outcomes for all parties involved.

If you have any questions about how NAV financing and preferred equity in private funds could be relevant to you, please contact one of our team members on the right hand side of the page.

This Sovereign Investor Insights is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed to the right.

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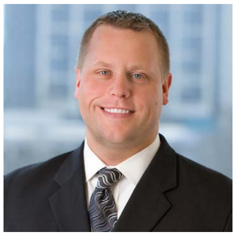

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