EXPERT COMMENTARY

With every offering having unique strategic advantages, fund sponsors should consider all the options available to them, writes Anastasia Kaup, a partner at Fund Finance Partners

Fund financing vs portfolio company financing

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Funds primarily use one or more of the following financing products: subscription credit facilities; net asset value or asset-based loan credit facilities; or hybrid credit facilities combining SCF and NAV terms. These products are distinguished by their respective collateral packages, with SCFs 'looking up' towards investors, NAV credit facilities 'looking down' toward investments and hybrids looking both ways.

SCFs are customarily collateralised by investors' uncalled capital commitments, the right to enforce related remedies and the bank account into which capital contributions are paid. They are usually revolving credit lines with a borrowing base derived from the uncalled capital commitments of eligible investors, subject to advance rates (based on investor credit quality) and investor concentration limits.

Secured NAV lines, meanwhile, are customarily collateralised by the fund's investment portfolio (including proceeds) and an equity pledge in entities owning those investments. The fund may also guarantee the obligations – something that is especially important when an affiliate (eg, a portfolio company) is the borrower. NAV lines may be secured or unsecured and can be revolving or term loans. Credit availability is based on the NAV of eligible investments and subject to similar restrictions and modifiers as SCFs.

Lastly, hybrids combine characteristics of SCFs and NAV lines, and are typically secured by the collateral that would be pledged for both.

Strategic considerations

Fund sponsors usually pursue a particular fund financing solution based on whether the fund is ramping, mature or harvesting. In any case, the capital provider and terms of each solution are driven by practical, purpose-driven considerations.

Fund sponsors typically turn to SCFs to meet various objectives, as they provide liquidity and leverage for investments. Sponsors can access cash quickly (often within one business day) to take advantage of time-sensitive investments and beat out competitors. SCFs are a bridge between capital calls, portfolio-level financing (which can potentially take months to establish) and additional fundraising. They can also finance portfolio companies until they have established performance and can obtain their own capital.

SCFs increase certainty of deal execution and ease of fund administration (eg, to avoid making anticipatory capital calls or return capital, or to strengthen a bid with evidence of financial wherewithal). SCFs also facilitate derivatives transactions. Additionally, SCFs enable sponsors to fund distributions prior to liquidation of investments – particularly valuable where the fund owns rapidly appreciating, illiquid assets. By procuring liquidity, SCFs facilitate capital true-ups with future closings and honour investor redemptions, while also financing payment of management fees and expenses. SCFs provide access to letters of credit and alternative currencies at a low cost, without posting cash or additional collateral with counterparties.

SCFs are an ideal product earlier in the fund's life, when it still has uncalled capital commitments to support the facility. At this early stage, they can be used as a balance sheet builder, to establish a track record and to provide prospective investors with a picture of what the portfolio will look like. Borrowing against the uncalled capital of a modest pool of initial investors can finance foundational investments and get additional investors to subscribe.

Finally, SCFs are an accelerant for fund growth, when the fund otherwise might not be able to achieve such growth or the cost of doing so would be substantially greater without the use of fund financing.

Assessing the options

Funds use NAV lines to meet a variety of objectives, typically in the middle to later stages of life. This will happen after the fund has acquired investments that generate sufficient NAV, against which the fund can borrow. In addition to the reasons funds use SCFs, fund sponsors seek NAV lines as a financing alternative if capital commitments are mostly or fully called (therefore the fund has minimal to no availability under any SCF).

Fund sponsors also use NAV lines to obtain liquidity to cover expenses for defensive (principal-protecting) or offensive (capitalising on dislocated asset prices) purposes, in between distributions, and to acquire additional investments. Credit funds specifically will often utilise NAV lines as a key component of the capital structure, to enhance yields and return on invested capital, and to achieve liquidity objectives.

Lastly, funds use hybrids in several circumstances: when the sum of the collateral value of uncalled capital commitments and the investment portfolio is superior to that which could be achieved with co-existing SCF and NAV credit facilities; if the fund might not otherwise obtain one of the two; and/or for long-term flexibility.

Early in life, the fund can borrow against uncalled capital commitments. As capital is drawn to fund investments, and those investments gain value, the fund can borrow (potentially even after the end of its investment period) against NAV.

Counting benefits

Funds often use fund-level leverage, because it is typically more advantageous to the fund, its portfolio companies and investors, than portfolio-level leverage. There are four primary reasons why fund-level leverage stands on its own as a replacement or complement to a typical portfolio company-level leveraged buyout financing: firstly, for speed and consistency.

Fund-level leverage can be established much faster than portfolio-level financing (eg, three to four weeks) and likely requires less negotiation prior to closing.

Secondly, utility for bridging and backstop financing. Fund-level leverage enables the fund to support its portfolio companies until they can obtain their own financing, or until they can obtain improved terms, and can facilitate the acquisition of portfolio companies or growth capital expenditures by assuring the seller/counterparty that backstop financing is there.

Thirdly, fund-level leverage involves limited diligence and, with the right structure and partner, limited time and effort by the fund sponsor. Portfolio-level financing often requires extensive operational, managerial and industry due diligence, plus significant time and effort due to the concentration of repayment risk in a single business.

Lastly, fund-level leverage can offer improved returns. The sponsor can increase the pace at which it originates, manages and monetises investments, and can therefore support a more robust portfolio.

Fund-level leverage during the portfolio ramp-up period has other important benefits. Accelerated portfolio growth demonstrates to prospective investors the sponsor's ability to deploy capital and manage investments early on, while the fund is still seeking capital commitments. Fund-level leverage also provides unmatched flexibility to fulfil fund and portfolio company needs and objectives, as well as permitted strategy shifts, throughout the fund's life.

There are numerous financing products available to meet the needs and objectives of funds and their portfolio companies, with those outlined here being the most common. Each product has unique benefits suited to different times and reasons. In addition, funds should consider using fund-level leverage as a complement to prospective portfolio-level leverage. Overall, because fund-level leverage can result in potentially significant time and cost savings for the fund, as well as improved returns, it is a compelling choice for fund sponsors and investors alike. ■