Private Funds CFO

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NEWS & ANALYSIS

Alternative fund financers ride to the rescue, but is it enough?

Concentrated NAV lenders and preferred equity financers are seeing historic dealflow. But only a handful of alternative lenders exist, and banks active in concentrated NAV are scarce and rarely transact. With potentially thousands of funds looking for liquidity for their portfolio companies, will this rare source of fund liquidity be able to sate demand?

There are only a handful of players in the concentrated net asset value (NAV) lending and preferred equity financing markets, but since early and mid-March they've seen a tremendous boost in dealflow.

At Crestline Investors, managing director and senior portfolio manager Dave Philipp says dealflow is up some five to ten times historical levels. At Investec in London, banker Matt Hansford says he's looking at more than one new concentrated NAV deal a day. One banker in New York, who declined to be identified because he didn't have permission to speak to the press, says his team was seeing "multiples" on usual dealflow, adding that "we expect it to go up from here." Pierre-Antoine de Selancy, managing partner at preferred equity financer 17Capital in London, told sister title Secondaries Investor last week that the firm saw $2.5 billion in dealflow – a quarter of 2019's total – in two and half weeks. A week later that number hit $3.5 billion, he tells Private Funds CFO: "It's not slowing down. If anything, it's increasing."

"It's really just a ton of stuff we're looking at," says Doug Cruikshank, head of fund financing at Hark Capital, which primarily lends to mid-market sponsors (though it has lent to other asset classes), with a target investment size of $5 million-$80 million and target coupon of around 10 percent, according to its site.

Who, what, when, why?

With the turmoil in markets caused by the covid-19 pandemic, GPs and LPs alike are facing strains on liquidity. GPs are propping up their portfolio companies, many of which have seen their cashflows freeze up, with injections of cash from wherever they can get it – existing fund equity, capital call lines, LP commitments. But with the GP-led secondaries market all but closed – and likely doing so for months as market multiples and EBITDAs become clearer. Banks are reportedly becoming more cautious in how much they lend and to whom, and with no end yet in sight for the confusion thrown upon economic activity, firms are looking more closely at rarer forms of fund financing.

Both concentrated NAV lending and preferred equity are considered niche forms of fund financing. While the latter has been around since before the crisis, concentrated NAV is relatively new. Traditional NAV lending tends to focus on funds with diverse portfolios (often large secondaries purchases, for example). In concentrated NAV, lenders make a loan to funds that are usually somewhere mid-way through their lifecycle, with generally 10 or fewer assets left in the portfolio, and most equity already deployed. Structures differ and maturities are flexible, but loans generally come in the one to five-year range, with bullet payments, often structured as payment-in-kind (allowing the borrower to preserve cash on hand, while being expensive enough to incentivize borrowers to have a goal and a timeline for the capital, and to stick to it). Lenders often have payment priority to LPs, or get seniority to all distributions if the loan defaults. Loans can be cross-collateralized with some flexibility to pull assets out of the pool, or not – it's a highly bespoke market.

Borrowers are usually funds that need to make capital injections to portfolio companies, make distributions to investors in the case a realization event has been delayed, boost portfolio company growth or make additional acquisitions, among other things. They're more expensive than most bank financing, which is most

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often on diversified portfolios. That said, a handful of banks other than Investec are or have been active – if infrequently and with varying risk appetites – and concentrated NAV lending tends be done by a different business line than diversified, like the leveraged finance or special situations desks. Keeping in mind significant differences in lending styles, multiple market sources say the odd bunch of banks that have been active in the market include: Goldman Sachs, JPMorgan, UBS, Nomura, Macquarie, National Australia Bank, Commonwealth Bank of Australia, and Silicone Valley Bank. (As for Investec, it generally looks at loans with anywhere from 5-35 percent LTV, with a pricing of Libor plus 500-1000bps, in sizes from $20 million-$250 million, though it can arrange much larger deals.)

Non-bank players are fewer, but more active. They include the firms mentioned above, as well as Origami Capital Partners in Chicago. Concentrated NAV loans can have interest percentages that run anywhere from the middle single digits into the teens.

Because of those potentially high rates, many funds tend to exhaust their other liquidity options first: capital calls, qualified borrower joinders within credit agreements (subscription line clauses that allow a portfolio company to become the effective borrower), hybrid lines, among them. But the sector is attracting new interest under the circumstances.

Jocelyn Hirsch, partner at Kirkland & Ellis in Chicago, says interest in NAV loans, both diversified and concentrated, has rallied. "We are seeing funds that weren't always interested in NAV lending becoming interested, because they have liquidity issues and don't necessarily want to call capital because they think this is short-term, or maybe the fund is at the end of its life," she says. Banks tend to be more active in diversified NAV (for example, loans made to purchasers of secondary interests), but fund finance professionals say banks have been 'pencils

Doug Cruikshank

Zachary Barnett

down' on many of those transactions. Indeed, two sources said in March that a large secondaries purchaser was rejected for by their relationship diversified NAV lender, putting up 100 percent of the equity for the buy (that report could not be verified, but secondaries deals are sometimes done with high LTVs of more than 50 percent, making them less attractive in times of uncertainty).

Banks reign it in

Banks – infrequently and (apparently) quietly active in concentrated NAV – are largely busy assessing their current exposures and prioritizing their best relationships, even in areas where they highly active, like in subscription credit lines, diversified NAV and hybrid credit line lending.

"We're seeing increased pricing, funds are becoming more lender friendly, tenors are shortening; but banks are prioritizing resources and being very selective," says one sub-line lender whose bank also provides diverse NAV facilities and, on occasion, concentrated NAV loans. (GPs speaking to Private Funds CFO have so far reported that their sub line lending banks are still being accommodating.)

"The thing that we're running into is that these banks are understandably busy with their existing trades and existing relationships. There are new deals getting done, but it's certainly not as fast as many of our clients would like," says Zachary Barnett, managing partner at Fund Finance Partners in Chicago.

Indeed most of the deals lenders, speaking with Private Funds CFO, were looking at were from existing clients inquiring about tapping them again for rescue capital, curing covenant breaches, buying out LP interests in their own funds to facilitate their liquidity needs, or for working capital (in some cases also for 'accretive', growth capital). In mid-March, Hark's Cruikshank told Private Funds CFO that many of the sponsors were being proactive, anticipating severe stress. "Sponsors know there are going to be some issues, and what they're trying to do in a very thoughtful manner – and actually I've been really impressed with how on it everyone's been – they're trying to assess potential weak spots in their portfolio, in advance of them becoming weak spots, and trying to come up with some contingency plans to try to handle what they think could be inevitable," he said. Cruikshank said later in March that Hark had closed a tack-on loan for an existing client that month, adding that the firm expected to close more deals in the coming 30 to 45 days.

New clients, new plays

But new clients are also beginning to

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make calls. "We're beginning to see the fruits of our marketing efforts," said the bank NAV lender who wished not to be identified. And two of the people speaking to Private Funds CFO indicated that they have taken calls from investors considering, or are considering themselves, taking down loans big enough to syndicate between themselves (many NAV lenders will offer direct co-investment to their own LPs and other non-traditional market players on larger loans). "I think we're going to see more of that because some of the deals are bigger in scale than the capitalization of the main NAV lenders today," said the unidentified NAV lender, who added that while smaller funds have been the traditional borrowers of concentrated NAV loans, new interest was coming from managers with as much as $10 billion in AUM.

All the lenders spoken to said they were taking calls from GPs already considering making offensive purchases, as well, though given sellers will likely sell only if severely distressed themselves, those talks were considered very early stage as of late March.

THE PLAYERS

Select terms and info of firms cited

Firm	General deal sizes	Strategy notables	Contact info
Crestline Capital	$10m-$250m	One to five year terms.Primarily to traditional industries and operating companies, but also to real estate and infrastructure. Portfolios typically have multiple remaining investments, with mature companies that are cash flow positive. Loans either to fund or directly to portfolio companies (with fund-level guaranty). Senior or preferred equity. Interest in PIK or cash. Amortizing or contingent on exit of the portfolio.	+1 (817) 339-7600 (General)
Hark Capital	$5m-$80m	One to five year terms. Holdco, senior and subordinated loans to funds and portfolio companies. Loans have a target coupon of circa 10 percent, no amortization and with no portfolio company financial covenants. Negative EBITDA permitted. Any industry.	+1 (646) 829 3623 (Doug Cruikshank)
Investec	$10m-$50m	€/£/$ 10-200m, at LIBOR + 5%-10% (cash/PIK), 5-30% LTV (concentrated portfolios), secured or unsecured and ranking behind underlying asset debt. Loans made to fund or portfolio asset level, to the GP or manager vehicle. Repayments/cash sweep: repaid from exits or other distributions from underlying portfolio. Ability to share some distributions with LPs or reinvest to optimize returns	+44 (0) 2075 973 914 (Matt Hansford)
Origami Capital Partners	$10m-$200m	Typical investments include: Real estate and PE fund interests and restructurings, hard-to-sell assets owned by funds, 'off-the-run' NPLs; private JVs or other vehicles, minority interests in operating alternative management firms; other illiquid investments with no apparent exit strategy. Target equity investment size $10m-$50m	+1 (312) 263 7800 (General)
17 Capital	Up to $500m ($1bn with syndication)	Up to $500m ($1Bn with syndication), NAV-based financing, typically preferred equity, for private equity funds or limited partners. Capital available for investments in existing companies, equity or debt, or to fund capital calls.	+44 (0) 20 7493 2462 (General); +1 (646) 392 9401 (General)

Source: Firms' websites, publicly available materials

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"We've… seen sponsors come to us trying to provide new capital to their portfolio companies to pursue a variety of market driven opportunities," says Crestline's Philipp. "Several funds are looking to deliver some equity gap financing in order to close an acquisition as the underlying debt capital market has pulled back or seized up, right now," he adds. Crestline aims for $25 million-$100 million loans (with flexibility on either side) for lower-middle and mid-market funds, as well as growth equity, real estate and infrastructure funds.

Investec's Hansford says others have their eyes out for "bolt-ons and tuck-ins for the portfolio to be really value-creative and maybe differentiate themselves versus their peers, who they think will be more focused on defending value." He adds that many of the conversations he's having regard funds from 2015-2017 vintages.

Many funds, unable to do much in the way of new transactions while pricing is so unclear, are taking closer looks at their portfolio companies' debt, and considering buying it out – yet another arena where concentrated NAV lenders are eager to play. Hark has entertained interest from potential borrowers on this front, Cruikshank says. Crestline's Philipp says his firm is also active on this front: "We have done several deals where we are extinguishing portfolio company debt with equity or buying the debt itself or issuing new debt."

"Getting leverage for debt purchases is very much top of the list for many firms given the current environment," says Kirkland & Ellis' Hirsch. Funds are looking to buy the debt of their own portfolio companies, or even that of companies that they have previously done due diligence on, but didn't close. "Even PE shops that haven't looked at purchasing debt as an asset class before are getting interested. Some firms are setting up special situations funds or annex funds on an emergency basis to enable them to purchase debt."

Demand surge, but supply is the question

Alternative lenders like those active in concentrated NAV and preferred equity are highly selective. Due diligence on these deals is not a quick and easy task, for any player. Concentrated NAV deals are bespoke, and approaches to assessing the borrowers vary, from the amount of emphasis placed on the residual value of the underlying, to the amount laid on the history and performance of the GP, to the accessibility of the assets in the case of a default in cases where the loans are secured.

At the start of April, Investec's Hansford had said the bank hadn't yet closed concentrated NAV deals since the intensification of the pandemic

began. Over in the preferred equity space, 17Capital's de Selancy says the firm only transacts on about 5 percent of dealflow, and this year it's more likely to be around 2 percent. Demand is also causing increased pricing – in 17Capital's case by around 500 basis points, Selancy says (17Capital primarily provides preferred financing, but also does some NAV lending, depending on customer requirements). "It's a moving environment, but the scarcity of capital is driven by the fact that demand has gone through the roof."

Hark lists eight NAV deals done in 2019 on its website, and Crestline has done more than 20 since it began playing in the sector, according to Philipp. The bank NAV lender who declined to be identified said that while he had about a dozen deals on his desk in late March, he and his team had been busy in recent weeks talking to their current borrowers and assessing their portfolio. "We haven't been making a lot of outbound calls; shame on us," he said.

Dave Philipp

With the pandemic causing almost ubiquitous stress on business' cash flows, demand is likely to far outpace supply.

"These alternative lenders are providing much-needed financing to the market," says Fund Finance Partners' Barnett. "But to be honest, there's not going to be enough of that to plug the gap for many of the 4,000 private fund sponsors that are going to be in search of liquidity, some for accretive and others for protective purposes."

"If there were more of them now, we'd all be better off, because they are providing the types of liquidity, rescue financing and short-term gap financing that banks aren't likely to be able to execute on over next 6 to 12 months," he continues. "This is the type of efficient deployment of capital the market needs right now." ■

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