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Article

Fund of Funds Financing: Secondary Facilities for PE Funds and Hedge Funds

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Real estate, buyout, infrastructure, debt, secondary, energy and other closed-end funds (each, a "Fund") frequently seek to obtain the benefits of a subscription credit facility (a "Subscription Facility"). However, to the extent that uncalled capital commitments may not be available to support a Subscription Facility (for example, following expiration of the applicable investment or commitment period, a Fund's organizational documentation does not contemplate a Subscription Facility) or a Subscription Facility already exists, alternative fund-level financing solutions may be available to Funds based on the inherent value of their investment portfolios (each, an "Investment"). As Fund finance continues to grow in popularity, banks (each a "Lender") have been working with their private equity and hedge fund clients in particular to assist them with unlocking the value of their Investments. The appetite for liquidity among these Funds dictates facilities that share similar characteristics, although hedge fund financing includes unique issues to address in this expanding market.

One solution for providing liquidity to a Fund is to structure borrowing availability based on the net asset value ("NAV") of a Fund's Investments. Although lending against a Fund's Investments is a far different credit underwrite than a traditional Subscription Facility, we have seen a steady increase in NAV-based credit facilities (a "NAV Facility"), particularly in the context of Funds which invest in other Funds ("PE Secondary Funds"). In a typical structure, the PE Secondary Fund arranges for a credit facility to be provided to a subsidiary of the Fund (the "Vehicle") as the borrower that is established for purposes of holding/ acquiring Investments on behalf of the PE Secondary Fund, and such Vehicle is restricted from having any indebtedness other than the NAV Facility. As security for this type of NAV Facility, 100 percent of such Vehicle's equity is pledged in favor of the Lender (along with its bank accounts receiving both capital contributions from the parent Fund(s) and distributions from the Investments). Additionally, in many transactions, guarantees from the PE Secondary Fund are provided in support of such Vehicle's obligations under the NAV Facility and/or support the payment of any unfunded commitments relating to the Investments. Certain contractual rights may also be provided to permit the Lender to require or direct the disposition of Investments held by the Vehicle after a default of the NAV Facility. This general structure is often used to secure a NAV Facility, such that a PE Secondary Fund is able to pledge the equity of the entity holding the Investments as collateral. We note that as with any NAV-based credit facility, due diligence with respect to the Investments may be required to confirm that transfer restrictions[2] in the underlying subscription documents and partnership agreements relating to such private equity Investments would not be violated by the pledge of such equity, and if necessary, appropriate consents to such pledges can be obtained. Hedge funds investing in other hedge funds (each, a "Hedge Fund of Funds" or "Master Funds") are increasingly seeking to utilize a similar structure to obtain the benefit of Fund-level financing for purposes of portfolio management (access to liquidity without the necessity of exiting illiquid positions in an untimely manner), facilitating redemptions and/or to enhance returns through leverage. Recently we have noted an uptick in Lenders providing financings for Hedge Funds of Funds based primarily on the NAV of its Investment portfolio, i.e., the limited partnership interests in other funds (hereinafter, a "Secondary Facility"). In this article, we set out the basic structure and likely issues that may be presented in the context of a Secondary Facility for Hedge Fund of Funds.

Basic Structure

Secondary Facilities for Hedge Funds of Funds are a highly specialized type of NAV facility and can take multiple formats, including that of a straightforward credit facility, a note purchase agreement or a pre-paid forward sale under an ISDA master agreement used in over-the-counter derivatives transactions. Regardless of form, these facilities contain common components. Traditionally, availability under a Secondary Facility is limited to an amount equal to the "Eligible NAV" of the "Eligible Investments," multiplied by an advance rate. The "Eligible NAV" typically equals the NAV of the Eligible Investments, less any concentration limit excesses deemed appropriate by the Lender under the circumstances. "Eligible Investments" will typically be a subset of Investments that are not subject to certain exclusion events or other limitations as described in further detail below.

While a common approach to collateralizing NAV Facilities for PE Secondary Funds is for a Lender to obtain an equity pledge of the Vehicle in order to address potential transfer restrictions applicable to the Investments, in the context of Secondary Facilities for a Hedge Fund of Funds, the applicable Master Fund segregates the Investments serving as collateral into a "securities account" under Article 8 of the UCC which is subject to a control agreement executed by a securities intermediary ("Securities Intermediary") in favor of the Lender. By segregating these assets into a separate securities account, the Securities Intermediary becomes the legal owner of each hedge fund Investment in which the Master Fund invests by executing the applicable subscription documents of the underlying hedge fund Investment (while the beneficial ownership of such Investment remains with the Master Fund). This structure thereby enables the Master Fund borrower to pledge its "security entitlement" (described below) in the underlying hedge fund assets in the securities account to the Lender while the direct owner of such Investment remains unchanged without violating certain transfer restrictions which may otherwise be applicable (similar to the PE Secondary Fund structure described above). However, the right to foreclose on any applicable Investments will remain subject to any applicable transfer restrictions, so the Lender's primary remedy is redemption (where the Lender instructs the Securities Intermediary to redeem the hedge fund interests credited to the securities account pursuant to the terms of the control agreement). And although such redemption also remains subject to any timing constraints set forth in the hedge fund subscription documents, transfer restrictions should not preclude a practical realization on the underlying collateral.

It should also be noted that feeder funds (each, a "Feeder Fund") can obtain similar financing by establishing a securities account with respect to its Investment in the Master Fund (thereby enabling the Investment in the Master Fund to serve as the "Eligible Investment" for the Secondary Facility). In this scenario, the portfolio requirements established by the Lender in order to determine the suitability of the collateral supporting the Secondary Facility (described below) are typically tied to the Master Fund's portfolio of underlying investments.

Portfolio Requirements

In many cases Borrowers that enter into Secondary Facilities will have a mature portfolio of Investments, so a Lender may assess at the outset which Investments should be included as "Eligible Investments" for the NAV of the Secondary Facility (otherwise Lenders may look to the investment guidelines provided for in the Master Fund Private Placement Memorandum to establish eligibility criteria for the proposed Secondary Facility). Regardless, Lenders will ordinarily be sensitive to the composition of such portfolio of Eligible Investments, and as a result, will set forth requirements with respect to diversification of the portfolio, investment strategy and minimum liquidity. Common diversification requirements include the following: limitations on the NAV of the largest Investments, sponsor diversification, minimum number of Investments, limitations on the particular types of Investments involved (infrastructure vs. buyout, growth, venture and special situation funds, etc.), geographical limitations and strategy diversification (long vs. short equity Investments, arbitrage and global macro, etc.) and particular investments underlying the limited partnership interests. Nonetheless, it is a typical requirement that there be no change in the investment policy of the Hedge Fund of Funds, sponsor or other creditworthy entity guaranteeing the Secondary Facility without Lender consent.

Exclusion events related to Eligible Investments are also established at the outset of a Secondary Facility and can include: the existence of liens, bankruptcy or insolvency events of the Investment issuer or sponsor, failure by the Master Fund to pay capital contribution obligations as they become due, a write-off or a material write-down by the Master Fund of an Investment, redemption gates or other matters impacting the general partner of an underlying Fund (such as general partner "bad boy" acts or replacement of the general partner). Appropriate exclusion events and diversification requirements are key elements for any Lender providing a NAV-based credit facility as Investments failing to satisfy these criteria will not be included in the borrowing base (while these requirements must also be balanced with the need of the Master Fund to retain appropriate flexibility for purposes of maximizing portfolio value). In any event, ongoing portfolio monitoring and reporting requirements will be imposed on the applicable borrower throughout the term of the Secondary Facility as further described below.

Advance Rate and Financial Covenants

In connection with Secondary Facilities for Hedge Funds of Funds, Lenders establish an "Advance Rate" with respect to the NAV of the Eligible Investments to be acquired and/or refinanced with the proceeds of the Secondary Facility, as may be adjusted to reflect a "haircut" specified by the applicable Lender. Such a "haircut" (or discount) methodology is Lender specific and will often be set forth on an appendix to the initial term sheet for the Secondary Facility and is concerned with addressing risks and exposure the applicable Lender has with respect to the Investment portfolio (including specific Eligible Investments) securing the Secondary Facility (incorporating above-mentioned factors such as the diversification of the Eligible Investments and the Investment style/strategy of the particular borrower and/or Fund of Funds). Considering these "haircuts" are Lender specific, it is not uncommon for a Secondary Facility for Hedge Fund of Funds to be structured as a bilateral lending arrangement (and not syndicated due to difficulties associated with attempting to synchronize these proprietary formulas in the context of a multi-lender credit facility as discussed below).

In order to give Lenders assurance of the continued performance of a borrower and/or related guarantor on its obligations under a Secondary Facility, such facilities are often structured by setting forth a maximum "Loan-to-Value" ratio of the outstanding facility amount to the NAV of the Eligible Investments included in the securities account. Loan-to-Value calculations are commonly determined by taking the lowest of (a) the aggregate NAV of Eligible Investments as calculated by the sponsor of the underlying Investment in the most recently provided valuation; (b) the borrower and/or related Hedge Fund of Funds' valuation in good faith and in accordance with its investment policy or applicable governing documents; and (c) acquisition costs minus NAV adjustments attributable to (i) distributions with respect to such Investments, (ii) other customary to exclusion events or write-downs and/or (iii) any portion of NAV of eligible investments in excess of concentration limits. Such Loan-to-Value calculations may also take into consideration cash distributions maintained in the collateral account.

Another common and important financial covenant to ensure performance of the Secondary Facility focuses on share drop percentage thresholds on a monthly, quarterly and yearly basis. For each such calculation it is important to specify at the outset whether NAV will be pegged on the closing date of the Secondary Facility (or whether the NAV value can increase over the life of the borrower and/or Hedge Fund of Funds), and whether impacts to NAV resulting from third-party redemptions will be included in such calculations. Other financial covenants include limitations on debt or liens incurred by the applicable borrower and that all Investments are made through the account held by a securities intermediary and pledged to the Lender as security, as described in further detail below. A change of the securities intermediary or a change of control of the Investment manager can also lead to a default of the Secondary Facility. Finally, Lenders may require prohibitions on Investments other than the Investments in the initial portfolio and investments relating to the initial portfolio Investments.

Custody Matters

Lenders should also be aware of the prominent role a Securities Intermediary plays with respect to the custody of, and reporting requirements associated with, the Investments serving as collateral for the Secondary Facility. As previously mentioned, assets such as limited partnership interests, limited liability company interests, shares of closely-held corporations and life insurance policies are commonly subject to broad transfer restrictions which impact grants of security interests over such collateral. To secure the obligations to a creditor under a Secondary Facility, a Hedge Fund of Funds commonly pledges an investment account, managed by a Securities Intermediary as collateral.[3] A security interest in such account is typically perfected through a control agreement executed by the Securities Intermediary, and in contrast to a direct pledge of a Fund of Fund's rights in the underlying Funds (which may be viewed as breaching such transfer restrictions), the rights at issue under the control agreement are directly traceable to a Securities Intermediary and are viewed under the Uniform Commercial Code as a "security entitlement" (which is both a package of personal rights against a securities intermediary and a property interest in the assets held by the Securities Intermediary). And in addition to other remedies available under the loan documentation, the creditor's avenue of enforcement of its security interest in the Investments pledged as collateral may be through redemption, whereby the creditor instructs the Securities Intermediary to redeem the Hedge Fund of Funds' interests from the underlying Funds which have been credited to the securities account, which the Securities Intermediary will be obligated to request pursuant to the relevant control agreement.

Lenders typically require reporting with respect to the Investments pledged as collateral, including monthly reporting of the Investments maintained by the Securities Intermediary and redemption information. Lenders may also seek from the applicable borrower month-to-date estimated NAV, monthly estimated NAV and monthly official NAV reporting with respect to each Investment pledged as collateral. Furthermore, periodic reporting relating to a Hedge Fund of Funds' balance sheet showing aggregate assets, liabilities and net assets, as well as ongoing reporting requirements such as a management letter, audited financial statements, schedules of Investments (detailing all of the Hedge Fund of Funds' Investments) and other financial assets may be requested by the applicable Lender. Other reporting requirements may involve disclosure of any changes to liquidity, currency or other significant terms of the Hedge Fund of Funds' Investments, or even relate to the Securities Intermediary and involve weekly reporting of aggregate assets and detailed positions at the Securities Intermediary, as well as access to the positions electronically or via email reports with required consent for any movements of cash or securities into and out of the account. And to the extent the information provided by the Securities Intermediary to the Master Fund (which may include weekly reporting of aggregate assets and monthly fair market value information (net of liabilities) and similar information) is consistent with the reporting requirements of the applicable Lender, this may simplify implementation of a Secondary Facility.

Other Issues

One of the primary challenges in a Secondary Facility is the Lender's comfort around the calculation of the NAV of Investments, as Hedge Funds of Funds are often invested in illiquid positions with no readily available mark. To further complicate such issue, in a multi-Lender facility, each Lender will have different ways of calculating the advance rate applicable to a given portfolio of Investments and thus issues might arise as to which Lender decides what the value of the collateral is and/or what NAV of the Investments shall be for purposes of covenant compliance under the Secondary Facility. Additionally, in the context of Secondary Facilities provided to a Feeder Fund, issues may arise as to whether the Feeder Fund can have more beneficial rights than other limited partners invested in the Master Fund. For instance, a Lender may request that the Feeder Fund acting as borrower be able to redeem its interest in the Master Fund notwithstanding any other gates imposed on redemption (and applicable to the remaining limited partners), and despite the fact that such Master Fund will always be subject to the redemption provisions of the underlying Investments. Nevertheless, the Lender will argue that it should be entitled to more favorable provisions on the basis that it is a debt provider, instead of equity. And while a detailed examination of these issues is beyond the scope of this article, we note that Lenders and Master Funds alike have successfully navigated around these issues in connection with establishing Secondary Facilities.

Conclusion

While the underwriting process of Secondary Facilities is materially different from that of Subscription Facilities and other Fund financing alternatives, when structured properly, Secondary Facilities can offer an attractive risk-adjusted return for a Lender while providing Funds and Hedge Funds of Funds needed liquidity and flexibility. As more Funds and particularly Hedge Funds of Funds seek to maximize the value of their underlying Investments, we expect additional growth in the market for Secondary Facilities.

Endnotes

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[2] In many circumstances, General Partner consent may be required to address indirect transfer limitations contained in the underlying Investment documentation. We note that General Partners will generally provide consents to such pledges, and the foregoing are more easily obtained than a lien on the Investment itself.

[3] The Master Fund also typically provides a security interest in the financial assets pledged as collateral, and a Uniform Commercial Code financing statement is filed in connection therewith.