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Approaching Secondaries Financing from All Angles: Key Considerations for Debt in LP-Led and GP-Led Secondary Transactions

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Debt finance plays a key role in all parts of the capital structure for private investment funds and their investors. In particular, the use of debt finance is an increasingly important component of secondary transactions, whether for traditional private equity secondary funds acquiring interests in underlying funds or for fund managers facilitating GP-led transactions. However, there are different considerations which apply depending on the purpose for incurring the debt and where such debt sits in the structure. This article considers how debt can be used in different types of secondary transactions and sets out some of the key considerations for fund managers and investors.

LP-led secondary transactions

An investment in a private investment fund is a long-term, illiquid investment in which the bulk of returns for investors are distributed late in the fund's lifecycle. As limited partners, investors in a private investment fund do not control the fund's decision making with respect to acquiring and disposing of investments. Instead, such decisions are the responsibility of the fund's general partner (an entity controlled by the applicable private equity firm or fund manager). An investor seeking to realise its investment earlier in the fund's life will need to coordinate and participate in a secondary transaction to sell its interest in the underlying fund, this being commonly known as an LP-led secondary transaction.

The price for a secondary transaction is typically derived from the net asset value of the underlying fund, sometimes with a discount applied. A secondary transaction may be an attractive option for an investor seeking to lock in high fund valuations, rebalance investment portfolios or generate liquidity. This is increasingly the case in the current environment, where a slowdown in exits and IPOs has resulted in underlying funds holding on to assets for longer periods than expected and in which some investors have found themselves overexposed to private markets. As such, the market for secondary transactions is anticipated to remain strong in 2024.

Private equity secondary funds ("secondary funds") are funds established to invest in other private investment funds ("underlying funds") by purchasing the interests of selling investors. Secondary funds typically invest in underlying funds which are nearing the end of the investment period, often in cases where cash flow is already being generated by underlying assets. To the extent that the seller has any remaining commitment to the underlying fund, a secondary fund purchaser will also acquire those remaining commitments. For a secondary fund, there are a number of benefits to acquiring interests on the secondary market, including access to a mature fund with assets and a track record, a purchase price which often but not always reflects a discount to the investor's share of underlying fund NAV and a shorter runway to realising its investment when compared to a primary investment.

GP-led secondary transactions

In contrast to LP-led secondary transactions, a GP-led secondary transaction is facilitated by the fund manager coordinating the sale of investors' interests in an underlying fund. GP-led secondary transactions may take various forms, from tender offers to single-asset or multi-asset continuation vehicles, and can offer benefits to fund managers, investors and secondary funds. For a fund manager, these transactions provide continued asset exposure and growth opportunities beyond typical fund term limitations and create additional liquidity for follow-ons and portfolio companies. Investors who need liquidity are given the opportunity to access it while other investors can elect to rollover their interests and benefit from further upside with a known management team. These transactions also present opportunities for secondary funds to invest in tried and tested assets with a potentially shorter holding period.

Finance in LP-led secondary transactions

Private investment funds of all strategies will typically enter into a capital call facility early in their lifecycles, and the position is no different for a secondary fund. Capital call facilities are secured on the basis of the undrawn commitments of a fund's investors and bridge the period between making an investment and calling from investors. Such facilities are a useful tool for both fund managers and investors in smoothing the timing and administration of capital calls but do not represent true leverage because the debt is short dated and the fund's liabilities are always backed by undrawn commitments.

Many secondary funds also use net asset value (NAV) facilities in order to leverage the acquisition of underlying fund interests. Debt borrowed under a NAV facility can be used by a secondary fund to satisfy a portion of the purchase price of an acquisition, thereby decreasing the size of the secondary fund's required equity contribution. Such a facility may also be used to assist the secondary fund to meet its ongoing capital call obligations to the underlying funds in which it invests. Unlike capital call facilities, NAV facilities are secured on the basis of the secondary fund's portfolio of underlying fund interests. From a structural perspective, a secondary fund's interests in underlying funds will be held by one or more special purpose vehicles (often themselves limited partnerships) sitting below fund level. Incurring the NAV facility debt at this SPV level below the fund avoids competing creditor issues with the capital call facility at the level of the fund.

Secondary fund NAV facilities are typically structured as term loan facilities with a duration of between three and five years. Depending on the proposed use of the facility, the borrowing may occur all at once at closing, or there may be delayed draw elements allowing further utilisations over the life of the facility. The amount of debt available to be utilised is determined using a borrowing base concept which applies an advance rate to the value of all eligible interests in the secondary fund's portfolio.

The standard security package for a secondary fund NAV facility consists of security granted over the interests in the special purpose vehicles which hold the interests in the underlying funds (not over the underlying fund interests themselves) together with security over the accounts into which distributions from the portfolio are paid. If a special purpose vehicle in the security structure is a limited partnership (which is often the case), security may also be granted by the general partner of the special purpose vehicle over its interests in the special purpose vehicle (or in some cases, over the equity interests in the general partner). With respect to any security granted by the secondary fund over its interests in a special purpose vehicle, consideration will need to be given to the terms of any capital call facility to ensure that negative pledges are not breached. For this reason, we often see the secondary fund's security granted on a non-recourse basis rather than supported by an unlimited fund level guarantee.

Consent to indirect pledges – a key consideration in LP-led secondary transaction financing

As noted above, the security package for a secondary fund NAV facility will typically only include indirect pledges of the underlying fund interests. However, this may still raise issues under the terms of the underlying fund partnership agreements, which often restrict not only direct security, but also indirect security, unless the consent of the underlying fund's general partner is provided. As such, it is key for both secondary fund borrowers and their lenders to diligence the terms of the underlying fund documents. Where consent to an indirect pledge is required, it should be obtained from the underlying fund's general partner before the NAV facility is put in place. Such consent may be contained in the relevant transfer agreement between the secondary fund, the seller and the general partner or in a separate side letter agreed between the secondary fund and the general partner.

Looking at this from the perspective of an underlying fund general partner, the key question is whether to grant consent and, if so, on what conditions. We typically see underlying fund general managers take a constructive approach (in order to maintain good investor relations) and grant consent to the pledge. There is more variation with respect to whether upfront consent is granted to a subsequent transfer arising as a result of enforcement action. Where a fund manager grants its consent to such a transfer on enforcement, it will typically be conditional on the transfer being undertaken in accordance with LPA requirements. Sometimes parameters are also imposed on the identity of the lender or lenders in respect of which consent is granted.

Finance in GP-led secondary transactions

For a GP-led secondary transaction, the debt is incurred not at the secondary fund/investor level but rather by the GP-managed vehicle which is established to facilitate the transaction. As GP-led secondary transactions can be structured in various ways, we will focus on two of the most common examples in this article.

Continuation vehicles

A continuation vehicle is a vehicle established by a fund manager to acquire the selling fund's interests in the transferred assets (usually only one or two). The investors in the selling fund are given the option of receiving distributions equivalent to their proportionate interest in the assets being sold or, alternatively, they can rollover their interests to the continuation vehicle. At the same time, the fund manager will seek fresh capital from secondary funds who become investors in the continuation vehicle.

Debt is typically provided directly to the continuation vehicle for the purposes of satisfying part of the purchase price of the assets being transferred. In many cases, a continuation vehicle will enter into a hybrid facility with a security package constructed with elements of both a capital call facility and a NAV facility. This is because a continuation vehicle's investor base is typically more concentrated, which may make a pure capital call facility more challenging. Further, most lenders would find it difficult to provide a NAV facility to a vehicle with only one or two underlying assets due to the lack of diversification. Lenders providing hybrid facilities will have recourse both to the undrawn commitments of the investor base (with such investors already having significant "skin in the game") as well as one or more high quality assets transferred into the continuation vehicle. Combining both a "look up" and "look down" security package reduces the lender's risk and is likely to result in better pricing and terms for the fund manager.

Tender offers of LP Interests

A tender offer is a GP-led secondary transaction in which the fund manager facilitates the sale of interests of investors who wish to exit their investment in the fund. A feeder vehicle in the main fund is established to acquire the interests of selling investors and new investors are admitted to the feeder vehicle. The purchase price will often be funded by a mix of capital contributions from the new investors and a debt facility made available to the feeder vehicle. Again, the security package is typically a hybrid covering the undrawn commitments of the investors in the feeder fund as well as the feeder fund's interest in the main fund. While the asset base of the main fund may still be diversified, the lender's security interest is one step removed and so the feeder fund will only receive borrowing base credit for its proportionate interest in the main fund's underlying assets.

Investor letters – a key consideration in GP-led secondary transaction financing

While hybrid facilities are common for GP-led secondary transactions, we typically find that lenders give more weight to the security over the undrawn commitments due to the lack of underlying asset diversification or structural impediments to enforcement of underlying asset security. However, in many cases, the investor base is also concentrated given the involvement of anchor investors. To mitigate this from a security perspective, it is not unusual to see lenders require investor letters from the anchor investors. While these are negotiated on a case-by-case basis, the primary objective is to establish a direct contractual link between the investor and the lender, pursuant to which the investor agrees with the lender that it will meet its capital call obligations. There are also likely to be provisions which restrict the ability of the investor to reduce or transfer its interests in the fund without the lender's consent.

Conclusion

We expect to see continued interest in both LP-led and GP-led secondary transactions over the next twelve months given the record-breaking pace of secondary fund fundraising and the continuing M&A market conditions. The use of debt is a well-tested way of enhancing returns on secondary transactions but it is important for investors, fund managers and lenders alike to understand the security package and other key considerations applicable to each deal.

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