

ANNEX: Private equity and its tools to manage liquidity

In this Annex we would like to describe some situations where private equity funds may be deemed leverage. As flagged in our answer to Question 47, none of these tools lead to high levels of leverage - but given the interest of the European Commission on the topic of leverage, we felt a description could be found useful.

Subscription credit lines (SCLs)

The use of subscription credit lines (SCLs) by private equity funds can have an impact on the performance of the fund as it shortens the effective investment period, particularly when measuring performance with metrics like the Internal Rate of Return (IRR).

However, this is not the reason why SCL are widely used and the impact on IRR is nuanced as it depends on several factors. It is also important to underline here that the performance of a fund cannot be reduced to a single metric, such as IRR.

Subscription line facilities are backed by uncalled commitments made by the fund and are therefore not as such leverage, because they do not increase the exposure of the fund.

Use of SCLs

- Subscription credit lines are intended to **ensure that the fund has immediate access to capital or liquidity without the need to make a commitment call.**

This flexibility allows fund to move quickly when investment opportunities arise without the need to wait for the capital contributions or avoid making pre-emptive capital calls with a risk that the investment is ultimately not made. Shortly following an investment financed with a SCL, the capital commitments are drawn and used to pay off the outstanding under the SCL. Therefore, given the short period of a capital call delay, the impact on the IRR would be negligible.

- Likewise, SCLs are also used to **cover the day-to-day operating costs of the fund** (or sometimes smaller add-on investment) without the need to make intermittent small-size commitment calls

Their purpose is to create less administrative work for the investors and the fund. In such a case, the capital commitments may be delayed for a longer period but the effect on the IRR will be marginal as the nominal amount of delayed capital contributions is in any case relatively small.

Conclusion

SCLs serve to enhance the efficiency of fund operations and are generally regarded as a convenient tool that benefits both managers and investors. As such, their usage is widely adopted by market participants.

In essence, the SCL can be seen as a tool to mitigate certain inconveniences intrinsic to the operational nature capital calls, but not one to replace or add to capital contributions. This

is also why SCLs are *short-term* facilities that are *backed by the capital commitments* of the fund. Thus, SCLs are intended as a source of liquidity and portfolio management tool that simplifies the operations of both the fund manager and its investors, rather than a source of leverage or instrument to boost IRR.

Overall, SCLs pose very little risk as they effectively bridge to the eventual contractual contribution of capital by a diversified group of investors, all of which are strong counterparties.

It is worth using this occasion to remind that, despite all recent crises, it is extremely rare, if not unheard of, for an investor to default on a fund capital call, given the consequences would be forfeiting their entire claim in that fund.

NAV Facilities

NAV Facilities and CFOs are two financial instruments used in the private equity sector to manage liquidity of the fund. However, these instruments do not inherently lead to new risks. Private equity firms often employ risk management practices to mitigate potential risks. These methods are designed to ensure that funds can use leverage, when they use leverage, effectively and responsibly.

These typically refer to a term loan (or, to a lesser extent, a revolving credit facility) secured by the fund's underlying portfolio of investments, and, as such, the size of the facility is linked to the net value of the portfolio (i.e., the value after deducting debt on the level of the portfolio companies).

Current use of NAV facilities

They remain a niche product in Europe and most managers are not using them. Market practice at the moment, especially in Europe, is for managers only to establish these after explicit consent or consultation with their investors. Where investors indicate approval, it will be on the basis the financial risk profile of the facilities is low. Investors ask their managers to report performance with granularity which generally allows them to split out any benefit from NAV financing, so there is transparency when it comes to the impact on returns.

- NAV facilities should generally be seen as **alternative way of (re-)financing** where traditional bank facilities are hard to obtain or costly, rather than a layer of leverage.

NAV Facilities indeed provide flexible and efficient access to liquidity to finance capital expenditures and/or add-on investments for portfolio companies.

- They are commonly used by **(near) end-of-life funds that have deployed (almost) all capital commitments to make investments and can no longer rely** (or at least only to a limited extent) **on capital commitments** to meet their liquidity needs or borrow under a subscription-backed credit facility (due to the lack of uncalled commitment).

In such circumstances, the NAV facility offers a compelling source of liquidity as the fund may use its investment portfolio to obtain commercially better credit terms in exchange for granting security.

- Funds may also use NAV facilities to **refinance close-to-maturity credit facilities of their portfolio companies.**

This reduces borrowing costs as high yield leveraged loans are more expensive to service.

- NAV facilities are also used to **support and extend the holding period of portfolio companies during an economic downturn** to wait for the market to rebound to exit at a higher valuation.

This allows them to operate counter-cyclical and thereby increasing financial stability.

How they are used

The borrowing base of the NAV facility is calculated on the basis of the net value of eligible portfolio investments satisfying certain inclusion/exclusion criteria and often subject to concentration/sector limitations, typically resulting in a conservative Loan-to-Value (LTV) ratio.

Consequently, the potential additional leverage is limited, particularly when portfolio-level leverage is already high. Furthermore, the high LTV of NAV Facilities, combined with the diversified nature of the underlying portfolio, offers robust security, shielding lenders from idiosyncratic asset risks. As such, the collateral securing the NAV Facility constitutes a strong buffer against a contagion of credit risk in the event of default.

Alignment of interest between fund managers and investors & impact on financial stability

The fund manager and investors - limited partners (LPs) - are both subordinated to NAV lenders, who have top priority for distributions. For private equity managers, defaulting on a NAV facility would have severe consequences (i.e.: the (complete) loss of investment) and impact their ability to secure future capital commitments. Therefore, the NAV facility is highly unlikely to be a source of conflict of interest.

In essence, NAV Facilities do not increase risk but rather enhance financial stability. They provide private equity funds with an alternative liquidity source to support and maintain their portfolio (especially in times where credit is scarce) while lenders benefit from strong security rights linked to high LTV ratios. This enables private equity funds to generate liquidity without the necessity of exiting investments during unfavourable market conditions, allowing them to operate counter-cyclical. Therefore, we disagree with the statement that NAV facilities would constitute a new 'source of risk' but argue instead that they may provide a source of financial stability. Moreover, these remain transparent in the sense they are disclosed to investors and ultimately approved by them - and where they lead to fund leverage, this is captured by leverage metrics as defined in EU law.

Finally, NAVs are conservatively structured with low opening LTVs and wide covenant levels to allow for a substantial drop in NAV before triggering distress - typically 50% or more. This drop in NAV is well in excess of that seen by the vast majority of European private equity managers during the financial crisis.

Collateralised Fund Obligations (CFOs)

CFOs are a form of securitisation involving the acquisition of a pool of private equity fund interests by a special purpose vehicle (SPV). The SPV's financing of the acquisition is achieved through the issuance of (tranches of) debt and equity notes to investors.

CFOs are a development driven by investors in private equity, given the need for these to have a diversified pool of private equity interests, rather than being driven by individual managers themselves. It therefore is inaccurate to refer to CFOs as a level of leverage within private equity.

Overall, CFOs **remain a niche area**, and whilst the liquidity they represent is welcome, they are not expected to constitute a meaningful portion of underlying investor demand.

Structure

Chiefly, a CFO is a fund-of-fund but structured as a securitisation vehicle with different tranches of debt and equity. The anticipated cash flows from the underlying private equity funds are used to make payment under the notes. To ensure a consistent dividend stream for CFO noteholders, the underlying fund interests are often of different vintages, with payments flowing first from older vintages and then from younger ones. The debt tranches have priority in terms of cash flows, whereas the equity tranche is the most junior and absorbs first losses (in return for potentially higher returns).

Therefore, CFOs are well structured instruments that reduce risk through diversification of both their inbound as outbound cash flow combined with a pre-emptive allocation of risk, which enables more robust risk management by its investors.

Other relevant elements

CFOs will be **rated**, and the rating agencies will investigate the underlying structures in some detail.

CFOs offer **dual-layer diversification**: they hold interests in various funds, and these funds, in turn, invest in a range of portfolio companies. In addition, CFOs are in principle over-collateralised as a result of eligibility and concentration limits. The CFO generally receives a higher credit rating than the underlying individual investments.

In any case, the credit risk is spread among the different noteholders among different tranches, which allows for a more granular allocation of risk depending on the investors' risk appetite and loss-absorption capacity. In other words, the underlying fund interests indirectly provide robust credit support to noteholders, while the tranche division offers structural credit enhancement to senior noteholders.

Senior notes are often rated investment grade, making CFOs an attractive choice for institutional investors like pension funds and banks subject to risk-weighted capital requirements, as they may prefer investing in CFOs over direct investments in the underlying funds. Therefore, the senior tranches of CFOs are considered investment-grade instruments that allow regulated financial institutions to provide the requisite liquidity to the market thereby increasing market stability.

Role

CFOs allow funds to unlock capital from some or all of the fund's assets to return to investors in situations where a full exit may not be possible or desirable due to commercial, macroeconomic or geopolitical reasons.

They provide liquidity and can enhance returns for the equity tranche of the CFO. Indeed, through the utilisation of a CFO, fund investors can strategically adjust their portfolios. This includes unlocking capital for further investments with preferred managers and rebalancing

their portfolios to align with preferred investment styles, industries, or vintages. A fund manager can pool diverse fund interests and secure capital by using them as collateral.

Additionally, investors find CFOs appealing because this structure offers access to a diversified pool of investments featuring an improved credit rating. Furthermore, it serves as a tool for investors to navigate market volatility within their existing portfolios of private equity investments. Therefore, both on the fund manager as investor side, CFOs are a boon to portfolio risk management.

Conclusion

In conclusion, **CFOs do not add a layer of leverage**, but instead transform private equity interests in a more resilient instrument that unlocks liquidity in the market for their managers.

As such, it adds flexibility to the private equity landscape by making fund interests more liquid, which enables investors to better navigate market volatility and reposition their investment portfolio in line with their risk policies while mitigating risk through diversification.