KEYNOTE INTERVIEW

Portfolio finance: Untapped value?

Portfolio finance can offer additional investment firepower or a source of liquidity, both of which are in high demand in the fallout from the pandemic, explains 17Capital's Augustin Duhamel

Portfolio finance – capital advanced based on the value of a fund's portfolio – has grown rapidly in the years since the global financial crisis. While this trend has strengthened in benign times, it could well be that in today's more crisis-driven market when demand for capital and liquidity are high, the market really comes into its own.

We caught up with Augustin Duhamel, managing partner at 17Capital, to discuss the future of portfolio financing and how it is currently being used by LPs and GPs.

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Q How has portfolio financing developed in recent years?

It's a market that has evolved over the past few years and grown tremendously since 2008 when we first made an investment of preferred equity against a portfolio of assets. Yet it is still nascent relative to other forms of finance. Clearly, at the portfolio company level, there are a plethora of financing options, from senior debt, to mezzanine, unitranche, second lien, etc. At the fund level, there is now a very well-developed subscription lines of credit (SLC) market through which firms can bridge capital calls.

However, we see significant growth potential for portfolio finance as it is becoming an increasingly understood and accepted source of finance in private equity. It also offers LPs and GPs solutions in what have become challenging market conditions caused by covid-19.

Q How can this form of financing help in today's challenging market?

Portfolio finance is a very effective tool to support portfolio companies and/or help with liquidity. It can be used by GPs to send capital down the chain to fund follow-on investment or for more defensive reasons, as a substitute for equity injections. GPs can also send capital up the chain to LPs by using the finance as a cash advance on future cashflows.

In both cases, this enables GPs to help grow the assets' value and benefit from future upside – without having to

sell the assets to generate liquidity – this is especially useful at a time when the market has paused and there is uncertainty around valuations.

Q And what about finance directly for LPs?

It's likely that exits are going to be put on hold for some time, which will obviously lower distributions. At the same time, capital calls may continue even if GPs are not investing because there will be a need to repay SLC facilities. This means some LPs are likely to find themselves liquidity constrained. Traditionally, they would have had to sell assets on the secondary market, but this is currently challenging because net asset values have not yet adjusted for today's – or tomorrow's – market.

Instead, LPs can look to NAV-based lending or preferred equity finance on their portfolios – both avoid the need for discussions around NAV value, they avoid selling at a discount and the LP gets to keep the upside. For those that can't borrow, preferred equity is appropriate because it doesn't count as a liability on their balance sheet; it also helps LPs manage the denominator effect as it effectively reduces an LP's exposure to the fund portfolios against which the preferred equity is taken out.

Q What activity are you seeing in the market following the covid-19 outbreak?

The crisis we're living through is new in many ways, including because there is no visibility as to how long it will take for life to resume as normal, yet some of the effects of the crisis we have seen before as both LPs and GPs seek increased liquidity.

There are currently a variety of situations. For example, some GPs are seeking out funding to support and stabilise their portfolio companies – they're looking to inject further equity, while others are seeking capital and capacity to make further investments and follow-ons. We are also seeing some GPs for whom imminent exits have frozen and they are seeking capital either to recycle into investments or to distribute to investors. We are talking to LPs who are looking to fund future capital calls and ensure they are not caught by short-term liquidity issues. It's clear that there are now options available to the market at times when everything comes to a hard stop – these are options that were only just emerging during the last crisis.

Q How are you evaluating investments given the current situation?

Now is the time to stick to the basics. The key criteria for us have always been the quality of the GP and the quality of the portfolio we finance. We want to be invested with GPs with the resources and experience to support their portfolio companies. The underlying companies also need to have resilient business models. The current cash position of portfolio companies is obviously key right now and we are also looking at the terms of the underlying debt and its maturity. We're doing a lot at the moment with repeat clients because we know them already; we are also engaging with a high number of new clients, hoping we can resume on-site due diligence in a reasonable time frame.

> *"It's clear that there are now options available to the market at times when everything comes to a hard stop"*

Q How will the portfolio finance market evolve in the next few years?

It's going to continue to grow strongly. I think it will be similar to what we've seen in the SLC market, where initially the facilities were subject to significant debate between supporters and detractors. Ultimately, SLCs became normalised because of the impact they have on fund performance – funds not using them are at a disadvantage.

Portfolio finance is a useful tool to manage liquidity and make effective use of the portfolio's value – the difference between those using it and those not will show. As a result, portfolio finance will eventually become a standard feature of the market. ■

What portfolio finance options are available?

There are two main types: NAV-based lending and preferred equity. The former has a repayment date and offers lenders security over assets at a relatively low cost. The latter is much more flexible in that the finance is offered without a maturity date and the lender has security over the cashflows as opposed to the assets, but at a higher cost than NAV-based lending.

They would be used under different circumstances. NAV-based lending would be appropriate for LPs and GPs looking for lower loan-to-value on a diversified portfolio, especially if they have some visibility on exit. Preferred equity is more suited to a higher LTV – it can go above 50 percent of NAV – and higher concentration within the portfolio. However, given they are both forms of finance that leverage the portfolio, there are two prerequisites for them: first, that the finance will benefit the portfolio and the returns of the fund; second, that the GP has a strong and resilient relationship with its investors.