



Fund Finance 2026

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The continuing use of preferred equity in private equity net asset value facilities

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Background

Credit facilities provided to private equity funds come in two general forms: Subscription Facilities and NAV Facilities. Subscription Facilities – often referred to as “capital call” or “sub-line” facilities – are a feature of most newly formed funds with significant unfunded capital commitments. These loans are secured by the funds’ rights to call the capital commitments (and related assets). Availability under a Subscription Facility is subject to a “borrowing base” determined as a percentage of the unfunded capital commitments of eligible investors to the fund. Subscription Facilities were traditionally used to service a fund’s short-term, working capital needs, but are increasingly used by private equity funds for longer-term financings, including funding for multiple, smaller investments and providing loans and other credit support to their portfolio companies.

Many private equity funds are unable or find it impractical to use Subscription Facilities as a source of permanent financing, either because the fund’s limited partnership agreement (“LPA”) prohibits or materially limits these facilities or, in the case of a later-stage fund, the fund has already called a material portion of its unfunded commitments. These private equity funds may seek to satisfy their financing needs through a “net asset value” – or “NAV” – Facility. NAV Facilities are financings backed by the fund’s investment portfolio. Unlike Subscription Facilities, which look “up” to the capital commitments of investors in the fund for the borrowing base and collateral, NAV Facilities look “down” to the underlying portfolio investments for credit support.

NAV Facilities have long been utilised by “secondaries” private equity funds to finance (or refinance) the purchase of portfolios of limited partnership and similar investments in other private equity funds in the secondary market (a “Secondaries NAV Facility”). More recently, buyout funds have adopted Secondaries NAV Facility technology for purposes of financing private equity acquisitions and “follow-on” investments as well as (back-)leveraging existing portfolio company investments. These private equity “portfolio company” NAV facilities (a “Private Equity NAV Facility”) incorporate key structural elements from Secondaries NAV Facilities but reference a borrowing base consisting of a pool of (primary) portfolio company – rather than (secondary) private equity fund – investments. In this chapter, we examine several important considerations and recent developments with respect to Private Equity NAV Facilities, especially the continuing use of preferred equity structures.

What is a Private Equity NAV Facility?

In contrast to traditional Secondaries NAV Facilities, which are backed by a diversified pool of tens (or even hundreds) of fund interests, Private Equity NAV Facilities reference a much smaller and more concentrated pool of portfolio company investments. As a result, Private Equity NAV Facilities differ from Secondaries NAV Facilities in a number of important ways, including with respect to structure, collateral support and valuation of assets.

Uses of Private Equity NAV Facilities

Private Equity NAV Facilities are used by private equity funds for a range of purposes, including to support the financing needs of existing portfolio companies, finance new and tack-on acquisitions and provide liquidity for investors. These facilities have become more common in recent years to address challenging market conditions, such as the unavailability or impairment of portfolio company-level financings during times of market dislocation and, more recently, the increased financing costs that materially reduced mergers and acquisitions activity and, thereby, funds' ability to monetise their private equity investments. This increased demand has resulted in a corresponding increase in competition (and differentiation) amongst potential Private Equity NAV Facility providers, and led to important developments in Private Equity NAV Facility structures and terms.

Structure

A private equity fund typically establishes one or more special purpose vehicles ("SPVs") to hold the underlying portfolio investments and serve as the borrower under the Private Equity NAV Facility. As a direct subsidiary of the fund, the borrower is often situated several levels above the underlying portfolio company, the equity value of which the lenders rely upon as credit support.¹ Private Equity NAV Facility lenders are, as a result, structurally subordinated to both lenders providing financing directly to the portfolio company as well as providers of any "holdco" or "back-leverage" financing at an entity between the Private Equity NAV Facility borrower and the portfolio company.

There are, however, often provisions in fund organisation and investor offering documents that limit or prohibit entry into traditional Private Equity NAV Facilities. These provisions may include contractual restrictions on the incurrence of debt at the fund level or the pledge or transfer of portfolio company interests or commercial understandings with (tax-sensitive) investors adversely impacted by debt at (or below) the fund. To address these limitations, private equity funds and their lenders are increasingly adopting alternative structures to achieve their financing goals, including the use of preferred equity instruments.

Preferred equity

Preferred equity has become a useful approach for private equity funds seeking an alternative to Private Equity NAV Facilities. Since preferred equity is generally treated as equity, not debt, it permits the funds to satisfy their organisational, contractual or investor concerns while, at the same time, ensuring the necessary seniority for the NAV providers, i.e., higher payment priority than existing, ordinary limited partner interests. However, as a result of this equity treatment, many financing providers are unable to purchase and hold such instruments directly without violating regulatory or other restrictions.

In a preferred equity structure, the private equity fund forms an SPV (the "Preferred Issuer") that issues preferred equity interests to an affiliated (often "orphan") SPV (the "Preferred Holder").² The Preferred Holder serves as the borrower under the Private Equity NAV Facility and pledges the preferred equity interests it owns in the Preferred Issuer as collateral to the lenders. The proceeds of this Private Equity NAV Facility are used by the Preferred Holder to purchase the preferred equity from the Preferred Issuer, and the Preferred Issuer, in turn, applies the proceeds to their intended use.

This structure effectively addresses pledge and transfer limitations commonly imposed by organisational and other governing agreements of the portfolio investments because preferred equity represents only the economic rights of the underlying assets and does not confer control over the underlying portfolio investments. A primary consequence of this structure is that, in contrast to the traditional structure, the Preferred Holder borrower does not own the underlying portfolio investments at a level structurally senior to the fund. Rather, the borrower has a senior and prior contractual claim over the investment return relative to the fund.

It is critical that the terms of the preferred equity, which are typically set forth in the organisational documents of the Preferred Issuer, reflect the requirements of the Private Equity NAV Facility, most fundamentally to provide the Preferred Holder with meaningful control rights following a foreclosure or other exercise of remedies under the facility, as discussed below.

Alternatively, certain (primarily institutional) financing providers have been willing to purchase and hold the preferred equity investments directly, in which case the terms of the preferred equity instrument itself – including stated dividends and mandatory redemption events – need to precisely mirror those of a Private Equity NAV Facility. The payment waterfall relative to other equity in the Preferred Issuer should be carefully drafted to ensure the priority of the preferred equity at all times, and anti-layering covenants need to be included to protect this payment priority and liquidation preference. In many cases, the preferred equity documents will include debt-like covenants similar to those in a Private Equity NAV Facility, which trigger a mandatory redemption and dividend rate step-up after a period of non-compliance.

Collateral and credit support

Collateral

Secondaries NAV Facilities have traditionally been structured as non-recourse to the fund, with the credit support limited to the underlying portfolio investments. Obtaining direct pledges of the secondaries portfolio investment interests in a Secondaries NAV Facility is often impractical because underlying LPAs of such portfolio investments may include restrictions on pledging or transferring limited partnership interests without the consent of the applicable general partner, and the large number of portfolio investments in a Secondaries NAV Facility makes obtaining such required consents within a reasonable time period logistically difficult. Lenders, therefore, typically rely on a “holdings” pledge structure, pursuant to which the borrower pledges equity interests in a subsidiary holding company that directly owns the portfolio investments. This arrangement provides lenders with a “single point of enforcement” following default via exercising remedies with respect to the pledged equity interests in the subsidiary holding company.

In contrast, the smaller number of borrowing base assets in a Private Equity NAV Facility reduces some of the challenges associated with obtaining required consents. Consequently, lenders are more likely to seek pledges of the portfolio company investments, which would provide lenders with more direct and greater flexibility in exercising remedies with respect to individual interests in portfolio investments. In practice, however, given the highly negotiated and complex contractual arrangements amongst the various parties to any private equity investment – the company, its management and other existing and future shareholders – Private Equity NAV Facility lenders often encounter similar constraints in obtaining consents with respect to the investments. And, even where obtained, these consents may be granted by only certain of the required parties or restricted in scope to, e.g., the pledge of the portfolio company equity (but not a subsequent transfer in connection with an exercise of remedies) or may expressly subject any exercise of remedies to rights of first offer, rights of first refusal or tag-along rights. Even if lenders seek the same subsidiary holdings equity pledge structure used in Secondaries NAV Facilities, this may

still present contractual issues for the Private Equity NAV Facility borrower under shareholder and other investment agreements as well as the underlying debt documentation of the portfolio companies. Where the parties agree that no direct or subsidiary holdings equity pledge is feasible, the collateral package of a Private Equity NAV Facility may be limited to a pledge of the collateral accounts (together with, usually, all rights of the borrower to receive dividends and distributions on and sale proceeds of the underlying portfolio company investments).³

While Private Equity NAV Facilities are also generally non-recourse to the fund, other than for customary “bad boy” events, in certain circumstances Private Equity NAV Facility lenders may also benefit from additional fund credit support. The recourse often takes the form of fund-level guarantees or, where guarantees cannot be provided by funds due to organisational limitations or tax or other regulatory restrictions, equity commitment letters in favour of the borrower to which the lenders are express third-party beneficiaries. This fund-level credit support is most appropriate in Private Equity NAV Facilities with more highly concentrated investment portfolios, higher initial LTV levels, an absence of a margin call mechanism and/or an otherwise limited collateral package.⁴

In Private Equity NAV Facility structures utilising preferred equity, the collateral is typically limited to a pledge of the preferred equity and the deposit and securities accounts of the Preferred Holder.⁵ Accordingly, in these structures, following a default, lenders may foreclose on the preferred equity instrument, but will not have the ability to directly exercise remedies on the underlying portfolio investments (or the subsidiary SPV holding the portfolio companies) or the accounts – at the Preferred Issuer – into which distributions on and proceeds of the investments are made. The terms of the preferred equity must, therefore, grant the lenders some ability to direct the monetisation of the Preferred Issuer’s assets following an event of default and ensure that all such payments on and with respect to the underlying portfolio companies flow to a collateral account at the Preferred Holder prior to any payments on the common equity interests held by the fund.

Enforcement considerations

Private Equity NAV Facilities will include a pledge of the deposit and securities accounts into which proceeds of and distributions on portfolio investments are deposited. Upon an event of default, the lender’s primary remedy will be to direct the depository to apply any funds or other assets on deposit in those accounts toward repayment of the loans. In Private Equity NAV Facilities secured by preferred equity and the accounts of the Preferred Holder, lenders will rely on the terms of the preferred equity to ensure that all distributions received by the Preferred Holder are deposited into the collateral accounts subject to the control of the lenders.

To the extent a direct (or holdings) equity pledge of portfolio investments is included in the collateral package, the lender may also exercise its secured creditor rights and remedies under the Uniform Commercial Code (“UCC”) to foreclose on or sell the pledged equity interests. Where such pledges are not provided – including in Private Equity NAV Facilities structured with preferred equity – repayment of the facility following default will depend primarily on the timing of sales and other monetisation of the underlying portfolio. In such circumstances, lenders may seek to protect themselves against both extended delays in portfolio realisations and adverse (from the lenders’ perspective) corporate actions with respect to the investments during such period. An evolving method to address these concerns is to include, at transaction closing, both negative consent rights and affirmative direction rights in the borrower’s LPA or other applicable constituent documents, with the lenders designated as express third-party beneficiaries.

Similarly, in the case of preferred equity investments, the terms of the preferred equity itself may contain customary “minority investor” protections, e.g., prohibiting the Preferred Issuer from incurring priming debt or liens, entering into (off-market) transactions with affiliates or selling portfolio investments, in each case without obtaining prior consent from the lenders (including, post-enforcement, as the holder

of the preferred equity). Such terms may include the right of the lenders to direct the Preferred Issuer to initiate a sales process with respect to one or more underlying portfolio investments or even grant the lenders a board designation right or power of attorney to act on behalf of the Preferred Issuer to monetise underlying portfolio investments.⁶ In certain preferred equity instruments, we have also seen general partner or managing member replacement rights in the event that the Preferred Issuer and its general partner or manager are not cooperating in the monetisation of the underlying portfolio investments after a mandatory redemption. This mirrors a foreclosure right that the lender under a Private Equity NAV Facility may have to the extent it has the benefit of a direct or indirect equity pledge, and gives the Preferred Holder control over the underlying portfolio investments.

Borrowing base

Borrowing capacity under Private Equity NAV Facilities is subject to a borrowing base calculated by reference to the fair market value or “net asset value” of eligible underlying portfolio investments. For portfolio companies to be eligible for inclusion in the borrowing base, each portfolio company will be required to satisfy specific investment criteria, including the absence of material adverse investment events, such as the bankruptcy of a portfolio company, defaults by the portfolio company in respect of its material debt or adverse changes in leverage ratios or other applicable financial metrics of the portfolio company. Given the structural subordination of Private Equity NAV Facilities to debt or other obligations at holding vehicles below the borrower, many facilities either completely prohibit or deem ineligible any portfolio investment subject to such priming holdco or back-leverage financings (or, to the extent holdco or back-leverage financings are permitted, such financings are required to be structured as single-asset back-leverage facilities, and such Private Equity NAV Facilities are subject to leverage limitations that account for such permitted financings).

Conclusion

As private equity funds continue to realise the benefits of using Private Equity NAV Facilities and the lender market for such facilities continues to expand, we expect to see an expansion in the types of funds using such facilities and the purposes for which such facilities are used. Lenders will also continue exploring various structuring options and protective measures to balance the contractual and structural complexities of portfolio company investments with the growth and evolution of such financings.



Endnotes

- 1 In particular, funds often form tax blockers and investor aggregator vehicles below the borrower to directly hold the portfolio investments.
- 2 Preferred equity is a class of equity interests of the SPV that is “senior” to the common equity interests held by the private equity sponsor, with a right to payment of dividends from the SPV’s income (pre-liquidation) and a “liquidation preference” upon liquidation of the SPV prior to any payments on the common equity interest.
- 3 Lenders may seek a pledge of the economic interests (e.g., limited partnership interests) but not the general partner or similar control interests of the holding company as an alternative to avoid any control or other restrictions in the underlying investment agreements or debt agreements.
- 4 The structure of the collateral package and associated credit enhancements in Private Equity NAV Facilities vary widely from deal to deal based upon the applicable facts and circumstances and continue to evolve with the maturation of the market.

- 5 In some Private Equity NAV Facility structures utilising preferred equity, a pledge of the Preferred Issuer's deposit and securities accounts is also obtained, but the feasibility of this hinges on whether such a pledge is permitted under the fund's LPA and other offering documents.
- 6 Alternatively, these rights may be included in a side letter with the sponsor, borrower and applicable general partners for each portfolio investment, pursuant to which the parties agree and acknowledge that "specific performance" is the appropriate remedy, such that, upon any breach of these agreements, courts will grant injunctive relief to the lenders mandating that the borrower, sponsor or general partner take the directed action (and refrain from taking any prohibited action).

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- Enforcement
- Secondaries
- Ratings
- Collateralised fund obligations

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