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VC *vs* PE: Comparing the venture capital and private equity fund financing markets

Cindy Lovering & Corinne Musa
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Overview

Market trends in the fund finance space have been well documented over the years. Following the collapse of Dubai-based Abraaj in 2019 and the JES Global Capital fraud in 2021, lenders have bolstered their diligence and compliance processes to ensure that their collateral in the historically safe subscription facility product – the rights to capital contributions from investors – is well vetted and secure. More recently, (i) pricing for capital call facilities has trended up in line with interest rate hikes by the Federal Reserve, (ii) banks are re-evaluating their portfolios in response to market conditions, internal depository requirements and regulatory mandates, (iii) new lenders continue to enter the market, (iv) alternative lenders are edging into the market as well, particularly looking for the higher returns associated with asset-backed leverage, including net asset value ("NAV") facilities backed by a fund's underlying investments, and (v) demand for debt facilities from general partners ("GPs") and their principals, to fund GP commitments or for personal capital, continues to be on the rise. As trends in the fund financing market continue to evolve, it is also important to consider key differences in how private equity funds and venture capital funds use the variety of available financing products. This chapter explores some of those differences and analyzes the benefits and challenges from both the fund and lender perspectives.

Fund-level financings

At the fund level, capital call facilities or subscription credit facilities are a standard product used by both private equity and venture capital funds primarily as a bridge loan to receipt of capital contributions. There is a huge competitive advantage for a fund in having a capital call facility, because it can boost its internal rate of return by borrowing and investing prior to an investor having to part with any cash or make its investment. The benefits for a private equity fund can be significant, given that there is sometimes no requirement to repay borrowings within a specified time frame in the underlying fund documentation, or any such requirement can be fairly lengthy (usually, up to 12 months, since that time frame helps mitigate risks of generating unrelated business income tax for certain tax-exempt investors). This allows the private equity fund to generate returns for an extended period of time before an investor pays a dime of its investment. Venture capital funds, however, frequently rely on an exemption to the U.S. Investment Advisers Act of 1940 (the "Advisers Act"), which significantly limits this benefit. The Advisers Act, which requires investment advisers to register with the Securities and Exchange Commission, provides for exemptions, including a venture capital exemption. The analysis of the venture capital exemption can be complex, but one prong of the analysis requires that a venture capital

fund does not borrow or incur leverage in excess of 15% of the fund's aggregate capital commitments and any such borrowing is for a "non-renewable term of no longer than 120 calendar days." Thus, some of the instinctive benefits frequently touted as relevant metrics for funds using subscription facilities are less relevant for venture capital funds, and may not be a significant part of the value proposition for the fund in using a subscription facility. That being said, subscription facilities remain attractive to venture capital funds for other reasons, such as the administrative convenience of making multiple investments and paying expenses without troubling investors with multiple capital calls.

Relatedly, a useful feature of most fund-level credit facilities is the ability of the fund to add holding company or portfolio company entities as borrowers on the facility, backed by a secured guarantee from the fund. This feature usually labels the holding company or portfolio company borrower as a "qualified borrower," which is generally subject to limited covenants given that the lender's source of repayment is the underlying commitments from the fund investors and not the assets of the qualified borrower itself (although the scope of covenants/representations applicable to qualified borrowers is often a point of negotiation between the lender and fund). While the qualified borrower feature has gained substantial traction in the private equity market, where funds frequently add holding companies or operating companies that have had difficulty getting third-party financing on attractive terms, the feature is rarely used in the venture capital market. Venture capital funds usually only take minority positions (i.e., less than 50% ownership) in emerging companies, and qualified borrowers are often required to be wholly owned subsidiaries of the applicable fund for the lender to provide financing to the entity on the subscription facility. For this reason, the trend of adding qualified borrowers on capital call credit facilities appears to be limited to private equity financings.

Another development in subscription facilities is that lenders are more frequently requesting investor letters for anchor investors (usually, investors with capital commitments in the 25–35% range). Investor letters add another layer of comfort for lenders with respect to their ability to obtain capital contributions from investors upon a forced capital call. Such investor letter requirements seem to affect both private equity and venture capital funds in a similar vein. Whether investor letters become a sticking point in negotiations depends primarily on the investor make-up and/or any underlying concerns with the partnership agreement/side letters not sufficiently protecting the lender's interests. Either type of fund may have a narrowly concentrated investor base where the request for an investor letter may come into play. However, funds should equip their partnership agreements with (arguably) standardized lender protections (e.g., express authority of the fund to enter into subscription facilities and the GP's right to pledge capital commitments and the right to call capital, waiver of investor defenses, lender exclusion from the no-third-party beneficiary clause, etc.) to best position themselves in a negotiation to limit or waive investor letters. Funds may also benefit from having their draft partnership agreement borrowing language reviewed by potential lenders prior to execution to help streamline the financing process, and limit, to the extent possible, the likelihood of requiring separate investor letters.

GP-level financings

An investment fund's GP may need to access liquidity for purposes of supporting its own commitment to the related fund. These facilities often take the form of a term loan credit facility amortizing over time, to align with the fund's investment period. A GP facility will almost always also involve a pledge of collateral from the GP, which can range from an

"all assets" pledge to the economic (not management) rights in the related fund. Creative approaches to financing the GP position for large sponsors can involve notes offering and securitization structures. Large private equity sponsors often have easier access to these types of structures, and GP financing generally, because of their established track records and deep relationships with lenders. Venture capital firms, in contrast, may be looking to fund individual founder positions, and therefore generally confront more challenges in finding lenders that are comfortable with the GP collateral and/or are willing to accommodate a structure that does not fit easily into their credit underwriting regime. Despite some reluctance, however, lenders to venture capital funds may accommodate GP financings despite credit concerns in order to strengthen ties with established clients or as an investment in new client relationships. Thus, in the venture capital space, a GP-level financing may bear similarities to an LP-level financing (discussed further below). GP financings can raise a number of key issues relating to the collateral, including that a pledge of collateral needs to be narrow so as not to conflict with any pledge by the GP to a subscription line lender, and the scope of collateral *vis-à-vis* the GP's interest in a particular fund needs to account for any conflicts in those fund-level limited partnership agreements. Both GPs and lenders should take heed of such collateral issues and address them in the loan documentation early on to obviate unintended consequences and costs down the line. Another common feature of GP-level financings is financial covenants, either loan-to-value or liquidity requirements. Similar to limited partner ("LP") financings, GP financings can sometimes require firm guarantees from the fund's management company, and/or personal guarantees from individual members of the GP. Whether these features are included in GP financings in a private equity or venture capital context can depend on the overall strength of the firm and practical considerations in terms of near-term future facilities with the particular proposed lender.

Management line of credit

Management companies can also play an important role in a fund's overall financing structure, and lenders frequently provide liquidity options to assist management companies, primarily for working capital to help a management company manage payments for expenses between the receipt of management fees from the funds. Occasionally, management company lines are also used to warehouse investments prior to an anticipated fundraise, but in the ordinary course, these facilities are meant to assist a firm with "keeping the lights on" in between fee payments. Strong sponsor borrowers often have management facilities that are unsecured, with just financial covenants relating to assets under management or the amount of expected management fees received. For newer or less established fund managers (and generally, in the current economic environment), these management facilities will be secured by all assets of the management company, including the rights to management fees and any related bank accounts. Diligence for management company facilities requires review of any management company agreements, investment advisory agreements and the partnership agreements of the relevant funds to ensure that a pledge of the rights thereunder is permitted, and to determine potential offsets that may reduce anticipated management fees.[1] Complications may arise if the management company and GP are the same entity, which occurs more frequently in the Asia market. In this circumstance, an all-asset lien over the management company/GP would conflict with subscription facilities under which the manger/GP has pledged its right to call capital from fund investors. Differences in the use of management company facilities in the venture capital and private equity space are minimal, as the primary driver of terms is ultimately the size of the sponsor (venture capital

or private equity), whether it has an established track record and how comfortable the lender is with the relevant fee streams. The less comfortable a lender is, the more likely it will be to look for additional credit support, including by way of guarantees from the founders of the particular firm at issue.

LP financings

In both private equity and venture capital funds, the LPs in the fund frequently seek various forms of third-party financing to help the LPs of the fund or GP to fund their capital commitments. The most typical form of these is usually a partner loan program, where the fund manager will arrange for a loan program for certain affiliated LPs with a bank lender. The bank offers loans directly to the LPs, and the management firm assists by providing regular information to the bank, and, occasionally guaranteeing the individual partner borrowings (allowing the partners to secure advantageous pricing with minimal ongoing obligations). The collateral for an individual borrower's loan is usually its individual LP interest in the particular fund, which the fund acknowledges as part of the loan documentation and initial set-up. The individual borrower's loan may also be secured solely by the management fees of the management company in the case of partner programs that are linked to a management company facility. A potential drawback to this type of facility when utilized by partners of the GP, however, is the possible tax ramifications. A partner's capital interest in the GP that is funded with the proceeds of a loan made or guaranteed, directly or indirectly, by the underlying partnership, a partner or any related person may be treated as carried interest, and would therefore be ineligible for the capital interest exception set forth in Section 1061 of the Internal Revenue Code. This means that any allocation to a partner that is attributable to a contribution funded by such loan would be subject to the longer, three-year holding period applicable to carried interest rather than the one-year holding period that would apply if the allocation were subject to the 1061 exception and treated as capital interest. Care should be taken to ensure that the financing of a partner's capital commitment to the GP is structured in a manner that considers any negative tax consequences that may result if the facility is made or guaranteed by a fund-related party (e.g., in some cases, if the partner of the GP is "personally liable" for the loan, these adverse rules may not apply). While these programs are popular, they can be burdensome on a new manager, and if they are not otherwise available, LPs will occasionally enter into bespoke negotiations with a private bank to fund their positions. These loans can be used either for general liquidity (in an attempt to monetize their otherwise illiquid fund interests) or to allow for funding of capital commitments. LP financings of this type often involve negotiations between the LP and the fund or GP itself, in order to address any transfer restrictions set forth in the related fund limited partnership agreement. Because the collateral for these financings is by its nature illiquid, advance rates against the LP interest collateral can be quite low and lenders may require additional financial covenants and minimum cash liquidity amounts for their borrowers.

There are other debt financing options available to LPs based on their fund positions. LPs sometimes obtain loans from the applicable GP or management company for the related fund. These can be easier to obtain since the affiliated entity is familiar with the collateral (i.e., the LP's interest in the fund) and has a deep understanding of the valuation of the interest. That said, in the venture capital space in particular, there are frequently limitations in the fund documents about loans among affiliated parties where conflicts of interest or other disclosure issues may be in play. Some of these restrictions may pertain in the private equity market as well, and it is important to check the underlying fund documents and to consider any tax implications from any related party loans when pursuing these transactions.

Another financing option for LPs that seems to be gaining more traction lately with third-party financiers is restructuring an LP investment to allow a preferred equity provider to provide liquidity to the LP. The preferred equity would then receive distributions from the fund until a negotiated hurdle rate is achieved. This arrangement provides some of the benefits of both debt and equity treatment.

LP borrowers in both the venture capital and private equity spaces continue to look into creative ways to monetize the value of their portfolios by relying on banks and non-bank lenders to provide liquidity solutions. In doing so, fund LPs are acting similarly to the investment funds themselves, looking to lever their portfolio company assets in pursuing a NAV or other asset-based facility.

Understanding the different objectives, limitations and credit underwriting considerations of private equity and venture capital funds and appreciating perspectives on both sides of the negotiating table will help counsel negotiate meaningful terms that are relevant for their clients, and thought should be given to these considerations at every level of the fund structure.

* * *

Endnote

1. Notably, notwithstanding any anti-assignment provisions in the applicable management agreement, terms that restrict assignment of payment obligations (i.e., management fees) are unenforceable under Section 9-406 of the Uniform Commercial Code.

* * *

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