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Summary of BVCA engagement with the Bank of England on financial stability considerations in private capital

June 2024

1. Context

The BVCA has engaged with the Bank of England in the context of speeches by senior Bank officials (Nathanaël Benjamin and Rebecca Jackson) and in the run up to the Bank's upcoming Financial Stability Report. This is scheduled for publication on 27 June will include commentary and analysis on the potential for the private equity industry to pose risks to the financial system.

In addition to facilitating meetings between the Bank and senior executives from BVCA member firms, the BVCA has provided the Bank with written evidence relating to aspects of the industry that the Bank has asked questions about. Our aim is to support the Bank in its work on identifying financial stability risks by sharing insights from experienced industry practitioners.

The BVCA anticipates further engagement with the Bank over the summer. This note sets out some of the key points included in a longer paper shared with the Bank and summarises some of the evidence that the BVCA has provided to the Bank so far. Please do not hesitate to contact Tom Taylor (ttaylor@bvca.co.uk) and Nick Chipperfield (nchipperfield@bvca.co.uk) for further information or to discuss the BVCA's broader engagement with the Bank of England in more detail.

2. Key points raised by the BVCA

Impacts on portfolio companies

Private equity-backed portfolio companies tend to be more resilient: There is clear evidence that private equity firms continue to offer strong support to portfolio companies during periods of economic stress. The two best known studies on this topic analyse private equity-backed companies' performance during the financial crisis and the COVID-19 pandemic, and point to a correlation between private equity ownership and resilience, despite sometimes higher debt levels. We believe this is a result of a number of features of the private equity model, including: (i) practical support, including expertise in capital markets, financing, treasury, operational improvement, talent sourcing; (ii) access to liquidity that private equity owners offer as part of their business model; and (iii) governance: private equity's long-dated funds facilitate an active ownership model that combines a long-term investment horizon with significant influence or control, leading to governance advantages that promote growth and resilience.

Valuations

There are clear regulatory requirements and drivers for robust valuations in private equity. Valuations serve a different purpose to market pricing of listed equities. Typically, private equity valuations are carried out quarterly and are subject to detailed process and governance requirements under AIFMD, with methodology set by the IPEV Guidelines, typically involving numerous steps facilitating challenge, with internal portfolio and risk committees, third-party independent review, investor oversight through limited partner advisory committees, and submission to fund auditors (generally 'Big-Four' or equivalent). Private equity firms need to operate a robust valuations process to ensure they can operate effectively, providing transparency for their investors, allowing sound decision-making for portfolio management, and enabling effective functioning secondary markets. Investors in private equity funds (limited partners or LPs) are generally large, highly reputable, and often international institutions. They are typically amongst the most sophisticated and demanding investors in global finance. This is the audience to which private equity firms report on their funds' performance, and accordingly there is a considerable level of scrutiny and challenge applied.

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Risk management and transparency

At both firm level, and for the funds raised by a private equity firm, there are comprehensive risk management frameworks applied. At firm level, AIFMD and/or IFPR require careful risk and capital adequacy assessments. Many firms have firm-level operating committees or equivalent that typically combine the expertise of functional heads of IT, human resources, legal compliance, finance, cyber and information security, tax and ESG, with oversight across of the firm's key internal risks. These committees will typically engage proven, high quality, professional services firms for additional technical support on key risk topics, known and emerging as and when necessary. At fund level, private equity investment teams and the fund managers conduct in-depth due diligence on investee companies before making any investments (which is often refreshed during the period of ownership) and will use investment and valuation committees to ensure that investments are carefully considered, and downside risks thoroughly assessed. It is standard for most private equity firms to use in-depth conventional financial modelling to flex risk variables and build downside cases. The inputs for these flexed cases are often linked to the due diligence deep-dive reports typically commissioned with expert external advisory firms ahead of new investments. Investment committees, normally comprising the most senior and experienced investment professionals and typically not including members of the "deal team" sponsoring the proposed investment, scrutinize these reports and the models and papers produced by the deal team. This high level of scrutiny that is applied ahead of investment continues with regular investment committee reviews of portfolio companies throughout their investment life-cycle, review cadence being typically adjusted based on any risks or issues identified by the investment team. Risk management within the portfolio is another area in which private equity firms have resources and governance frameworks to support both value creation and risk management during the fund's period of ownership of its portfolio companies. In addition to all this, **there is a considerable level of scrutiny and high expectations from investors on the operation of this committee process, its application, governance and rigour.**

There are extensive transparency requirements for large private equity-backed companies: Larger private equity-backed UK companies have been subject to ever higher levels of public scrutiny over the last decade. This is reflected in the inclusion of large private companies within transparency and reporting frameworks applicable to large listed companies (such as the UK's TCFD-based Climate-related Financial Disclosure rules). Large portfolio companies also fall within the scope of the Walker Guidelines. Adherence to this framework requires in-scope UK companies to report publicly in a manner similar to that required of FTSE 250 companies. Large private equity-backed companies' adherence to the Walker Guidelines is independently championed, monitored and reported on annually by the Private Equity Reporting Group.

Worst case scenarios are limited even in challenging market conditions. The risk of loss of capital in a closed-ended private equity fund structure is **capped at the total amount committed by investors** (known as "LPs") to the fund at the outset. Whilst the loss of a private equity fund investment in such a scenario would evidently be harmful to the fund and its investors, typically sophisticated investors will have their own risk management and diversification strategies to mitigate the impact on their overall investment performance. Therefore, the risk of contagion or correlated losses elsewhere in the financial system from under-performance seems limited from the BVCA's perspective. It is also perhaps worth noting here that the same considerations apply to secondaries funds or continuation funds, which use fundamentally the same closed-ended commitment model.

Development of the market

Continuation funds are a positive feature of a more flexible and maturing market: Continuation funds have developed over several years in part to accommodate both: (i) investors' desire to extend their investments in strongly performing investee companies beyond the end of the agreed term of the existing fund because they wish to benefit from further upside expected from the fund's investments; and (ii) liquidity for any investors in an existing fund who elect not to invest in the continuation vehicle. This

flexibility of private equity investment structures, which is driven by institutional investor requirements and with their close involvement/agreement, is a strength of the model and a sign of a maturing market. It complements long-existing technology for extending private capital fund terms that operate successfully, including extending fund maturities with limited partner consent and/or transferring one or more fund investments into a trust. Continuation funds can only be formed if new and existing investors choose to invest in them: there is no unilateral scope for a private equity manager to form a continuation vehicle, for example as a mode of exit for an existing fund investment. For that reason, any new vehicle would entail the same kind of deep due diligence, modelling and risk management assessments for investors described for new fund investments above.

NAV financing has evolved with a maturing market but remains a niche and relatively low risk form of lending: NAV facilities are generally only offered to managers of larger funds with lower-risk portfolios, and for a limited number of "use cases". These include: funding portfolio company growth; extending hold periods where a future exit will drive higher returns (in this sense, they are an alternative tool to continuation vehicles and other secondary transactions); supporting portfolio companies' liquidity needs; and funding distributions to LPs seeking liquidity due to their own portfolio management and/or macro motivations. Importantly, NAV facilities do not affect portfolio company valuations, so seemingly cannot cause a "doom loop" or self-reinforcing negative cycle. Whatever the rationale behind any particular NAV financing facility, the risk profile of NAV lending has been and remains relatively low:

- LTV ratios are relatively conservative: NAV facilities' maximum LTVs permitted usually sit at 20-25% of the aggregate value of the portfolio companies against which a provider has agreed to lend, with opening LTVs usually closer to 10-15% (sometimes as low as 5%).
- Lenders are well protected: Typical agreements include LTV based triggers, for example such that if NAV declines by 33-50%, then the lender will be able either to take ownership of the private equity fund's interests, or to mandate that the firm run an orderly monetisation process (fire sales are not viewed as in lenders' best interests). The interests of fund investors, including the private equity firm, are subordinated to the lender.
- Collateral is typically diversified across mature companies: Collateral consists of a diversified pool of investments, often in ten or more individual large portfolio companies. The diversification protects the lender against idiosyncratic, market specific and temporary shocks to portfolio companies, and can lead to pricing benefits for the firm and fund investors, relative to financing over a single portfolio company. The size of the companies typically subject to NAV facilities means they are mature, well-established, well-run and thus present less risk as collateral. This is not typically offered by lenders in relation to a portfolio of SMEs.
- The market is and is likely to remain relatively small: The current size of the NAV lending market globally is estimated to be less than $100Bn (Fund Finance Association, 2022), which represents under 1% of the estimated value of private equity investments globally. NAV lending seems likely to remain a small percentage of the market, even accounting for further growth.
- Firms and investors have incentives to focus on downside risk: Both the private equity firm's own fund interests (as an investor alongside LPs) and those of its investors are typically subordinated to the NAV lender in priority of payment. Given the cross-collateralised nature of the security, private equity firms and LPs alike are keenly focused on any potential downside scenarios, at what point covenanted LTV levels would be tripped, and what the related cure rights and steps would entail (to protect the fund's residual equity value in the portfolio). NAV lenders are sensitive to this point too and there are typically cure rights embedded in the loan documentation, as well as scope for consensual discussions between the parties in the event of a breach of the loan terms, particularly given NAV loans on not generally widely syndicated. We

are not aware of any situation where a NAV lender has enforced and taken position of its collateral under such an arrangement.

The larger end of the private equity industry is globally interconnected: Private equity investment is very much a cross-border industry. For example, it is not uncommon for a firm to have its headquarters in the US, a European base in the UK, funds domiciled in the EU, investors from around the world and a global portfolio of investments. It is common for firms active in the UK to be supervised by financial services regulatory authorities and subject to regulation in the UK, EU and US simultaneously. This means strong alignment with overseas regulatory authorities on data and monitoring is essential because UK-based aspects[1] of large-scale private equity businesses are entwined with operations in other jurisdictions as part of a global industry. Any consideration of the UK private equity industry's impact on financial stability would therefore benefit from close cooperation with overseas authorities that have access to the relevant data, particularly in the US and EU.

3. Further information, data and evidence

The BVCA has provided more information, data and evidence to the Bank of England on the following areas:

- Impact of the current economic context on the private capital industry
- Private equity valuation methodology, process and governance
- Risk management regulation, practice and reporting frameworks
- Continuation and secondaries funds
- NAV financing facilities

We would welcome further evidence that BVCA members or others feel might be valuable for the Bank to receive in relation to any of these topics. Please do not hesitate to contact Tom Taylor (ttaylor@bvca.co.uk) and Nick Chipperfield (nchipperfield@bvca.co.uk) for further information or to discuss the BVCA's broader engagement with the Bank of England in more detail.