The continuing evolution of NAV facilities

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Background

In recent years, credit facilities provided to private equity funds have been dominated by two forms: "Subscription Facilities" and "NAV Facilities". Subscription Facilities – sometimes referred to as "capital call" credit facilities – have become increasingly common for newer funds with significant unfunded capital commitments, with the loans thereunder secured by the fund's right to call such capital commitments from its investors.

Availability under Subscription Facilities is subject to a "borrowing base", calculated as an agreed advance percentage of unfunded commitments of certain "included" investors in the fund (with the inclusion and "advance rates" dependent on the creditworthiness of each such investor). Subscription Facilities are generally intended to serve a fund borrower's short-term capital needs by bridging the time between the issuance of capital calls to investors and the time such capital is actually contributed.

For many funds, however, Subscription Facilities are not a viable option, either because the fund's organisational documents do not permit such facilities or, in the case of a mature fund, the fund has already called a significant portion of its commitments, leaving it with minimal unfunded commitments against which to borrow. These private equity funds have sought instead to raise capital through "asset backed" or net asset value facilities: "NAV Facilities".

NAV Facilities are credit facilities backed by the fund's investment portfolio. For a "fund-of-funds", these assets will typically be the limited partnership and other equity interests in hedge funds and private equity funds, consisting of both primary investments as well as those purchased in the secondary market. Availability under NAV Facilities is also subject to a borrowing base, in this case calculated by reference to the net asset value of "eligible" fund interests satisfying specific investment criteria (e.g., the absence of certain adverse investment events) and often adjusted for manager, industry and other concentration limits. In the event that, at any time, the ratio of loans outstanding under NAV Facilities to the borrowing base (the "LTV Ratio") exceeds a specified threshold, NAV Facilities will require the borrower to prepay loans in order to bring the facility into compliance with such maximum LTV Ratio.

In this chapter, we examine the typical structure of, and collateral securing, NAV Facilities. In addition, we focus on recent developments with respect to NAV Facilities, including: (i) the use of escrow arrangements to fund acquisitions of fund interests; (ii) the increasing use of "hybrid" facilities, or facilities with features of both Subscription Facilities and NAV Facilities; and (iii) the use of NAV Facility technology by fund employees and insiders to obtain leverage on existing investments.

Structure and collateral: NAV Facilities

Unlike Subscription Facilities, which "look up" to the capital commitments of investors for collateral, NAV Facilities "look down" to the underlying fund interests for credit support. In a typical NAV Facility for a fund of private equity funds, the fund establishes two special purpose vehicles ("SPVs"). The first SPV, the borrower (the "NAV Facility Borrower"), is created for the sole purpose of obtaining the financing under the NAV Facility and holding the equity interests of the second SPV ("Holdco") which directly (or, less frequently, indirectly) owns the underlying fund interests included in the borrowing base.

The NAV Facility Borrower generally provides an "all assets" pledge to the lender to secure its obligations under the facility, including a pledge of 100% of the equity interests of Holdco (the "Equity Interest Collateral"). If the NAV Facility Borrower is a limited partnership, lenders will generally require that its general partner (the "General Partner") provide a pledge of the general partner interests in the NAV Facility Borrower (the "GP Interest"). Holdco most typically guarantees the NAV Facility Borrower's obligations under the NAV Facility and secures such guarantee with a pledge of the deposit and securities accounts into which distributions on and proceeds of the underlying fund interests are paid.[1]

This double-SPV structure and pledge of Holdco equity and, where applicable, the GP Interest, provides lenders upon a default with the right to foreclose upon (or exercise other secured creditor remedies with respect to) the Equity Interest Collateral, thereby obtaining the ability to manage an orderly disposition of the underlying fund interests. To perfect the collateral granted by the NAV Facility Borrower and Holdco, UCC financing statements are filed against both entities, and any such deposit or securities accounts are required to be subject to control agreements in favour of the lender.

In contrast, if the NAV Facility is for a fund of hedge funds rather than private equity funds, the lender will typically require the NAV Facility Borrower to credit its underlying hedge fund investments to a securities account held at a securities intermediary. The securities intermediary becomes the legal owner of the underlying hedge fund investments (with beneficial ownership remaining with the fund borrower), thereby creating a "securities entitlement" in favour of the borrower.

The borrower then pledges this securities entitlement, as well as the securities account (but not the underlying hedge fund investments), to the lender to secure its obligations under the NAV Facility. To ensure perfection of the lender's security interest in the securities entitlement, the securities account is subject to a control agreement in favour of the lender and a UCC financing statement is often filed against the fund borrower. The pledge of the securities entitlement, and protections under the control agreement, provide the lender, upon an event of default, with the right to instruct the securities intermediary to redeem the underlying hedge fund interests pursuant to the terms of the underlying fund documentation.

Recent developments in NAV Facilities

Escrow funding structures

In one recent development, funds utilising NAV Facilities to finance the acquisition of underlying fund interests have made use of customary escrow arrangements pending the closing of the related acquisition. Under such arrangements, loans made under the NAV Facility are deposited directly into an escrow account, which account, along with the funds deposited therein, are subject to the control of the lender and pledged to the lender to secure the NAV Facility obligations.

Utilising this escrow approach satisfies both the operational needs of the borrower, as buyer of the fund interests, as well as the credit concerns of the lender. From the borrower/buyer's perspective, loan proceeds under the NAV Facility are readily available, with minimal prior notice, to be released by the escrow agent to the seller to consummate the acquisition. Lenders, on the other hand, are comfortable that the approach creates little practical risk since, once funded, the loan proceeds are held in an account subject to a lien in favour of the lenders, and either released to the buyer (upon the closing of the acquisition) or repaid directly to the lender (if the acquisition is terminated or does not close by an agreed outside date).

Given the relative novelty of escrow arrangements in the NAV Facility context, several considerations are worth noting. First, for purposes of calculating the LTV Ratio during the escrow period (and especially where other loans are already outstanding under the NAV Facility), the parties should ensure that the calculation excludes both: (i) the escrowed loans (prior to release from the escrow account) from the calculation of "loan"; and (ii) the cash and other investments on deposit in the escrow account from the calculation of "value". If either the loans or cash/investments were included in the LTV Ratio calculation, such ratio would be either artificially low (if only such cash/investments were included in the denominator) or artificially high (if, e.g., only such loans were included in the numerator).

A second issue to consider in the escrow funding context is payment of any agreed upfront fees. Upfront fees are generally payable by a borrower to a lender upon the funding of a loan, and calculated based on the principal amount of the loan. While often styled as "original issue discount" on the funded loan or documented as a separate fee payable by the borrower, in practice, such fees are most typically paid through a "net-funding" mechanism, in which the lender reduces the aggregate amount actually advanced to the borrower by the amount of the applicable upfront fee. In either case, the borrower continues to owe the full stated principal amount of the loan to the lender.

In the case of an escrow funding, it is usually the case that the loans are net-funded into escrow, with the lender retaining the upfront fee. Assuming the acquisition closes and the escrow proceeds are released to the borrower, the usual rules apply and the borrower remains liable for the full stated principal amount of the loan. In contrast, where the escrow terminates and the escrow proceeds are instead repaid directly to the lender, practice is mixed with respect to whether repayment of the net-funded escrow proceeds (plus accrued interest) to the lender is treated as repayment of the loan in full. In addition, in certain circumstances, the parties may negotiate a premium (e.g., 1–3% of the stated amount of the loan) payable to the lender in the event the loans are prepaid upon escrow termination, in order to compensate the lender for the opportunity costs of funding into escrow in anticipation of the failed acquisition.

Satisfaction of closing conditions and transfer of fund interests

Another issue for parties to an NAV Facility is how to evidence satisfaction of the conditions to the making of the loan. Lenders will most typically require that, as a condition precedent to making loans to finance acquisitions of fund interests, the borrower provide satisfactory evidence of ownership of the fund interests. Recent NAV Facilities have specified that this condition is to be satisfied by the borrower's counsel certifying that: (i) all conditions precedent set forth in the applicable purchase and sale agreement ("PSA") have been satisfied; and (ii) the underlying fund interests have, in fact, been acquired by the fund.

If, as is often the case, the formal transfer of legal title to the buyer of the underlying fund interest is subject to the consent of the general partner, managing member or other applicable entity (a "GP Consent"), this process is often bifurcated such that the borrower's counsel initially certifies, at closing, that all conditions precedent to the closing of the PSA have occurred (other than the payment of the purchase price and release of executed GP Consents) and, following payment of the purchase price and release of applicable GP Consents (usually one-to-three days thereafter), further certifies that the formal transfer of the underlying fund interests to the buyer has occurred.

In contrast, in the escrow context, no such certification is necessary in connection with the initial funding of the loans into escrow. Rather, the initial certification from borrower's counsel should be specified as a condition precedent to the release of funds from the escrow account, with any additional certification being provided once the purchase price is paid, and any GP Consents are obtained thereafter.

New categories of borrowers under NAV Facilities

A further market development has been the increasing use of NAV Facilities by non-fund-of funds borrowers. While historically, NAV Facilities have been used by fund-of-funds to borrow against the value of limited partnership and other equity interests in private equity and hedge funds, recently, some private equity funds have been using the NAV Facility technology to borrow against the equity value of their investments in operating/portfolio companies.[2] Given the illiquidity of these assets, these facilities will likely take the form of "Hybrid Facilities", secured not only by interests in the underlying portfolio investments but also by fund investors' capital commitments.

Typical features of Hybrid Facilities – consistent with other forms of fund financings – include: (i) posting additional collateral or prepaying in the event the LTV Ratio (calculated on the basis of the value of the underlying portfolio investments) exceeds a certain threshold; and (ii) a mandatory prepayment upon the loan amount exceeding a certain percentage of unfunded capital commitments. Hybrid Facilities are particularly useful for a fund looking for long-term financing that is available from the fund's inception (when it has significant uncalled capital commitments, but few (if any) investments) until the time the fund is fully invested (when all such commitments have been utilised to finance such investments).

Moreover, funds have recently started to use NAV Facility technology to permit fund management, and other insiders, to leverage their existing investments in the funds they manage. Given that, in these cases, the collateral consists of internally controlled underlying funds, lenders are often permitted to take a direct pledge of the underlying fund interests and, thus, advance against a higher percentage of the value of the underlying fund interests.

Conclusion

As funds continue to realise the benefits of using NAV Facilities, we expect to see the types of funds and other non-fund borrowers using such facilities, as well as the purposes for which such facilities are used, continue to broaden. Further, as NAV Facilities continue to be used to fund acquisitions of fund interests, we expect to see an increase in the use of escrow arrangements, as well as a rise in other issues implicated by such arrangements.

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Endnotes

1. We note that in certain NAV Facilities, the Holdco entity acts as borrower, with the top-level SPV providing a downstream guaranty of the borrower's obligations, secured by a pledge of the Equity Interest Collateral. While for purposes of this article, there is no difference between the two structures, we have referred to the more typical approach throughout.
2. We note that lenders providing these facilities to private equity funds are almost always structurally subordinated to lenders providing financing secured directly by the assets of the underlying portfolio companies.

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