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FINANCING FACILITIES

Alternative Financing Facilities: Streamlined Borrowings and Longer Loan Durations With Hybrid Facilities

By Rorie A. Norton, *Private Equity Law Report*

Streamlining is a hallmark of the PE industry: sponsors constantly pursue it to maximize the value of portfolio companies, as well as to optimize their own compliance and investment management efforts. Therefore, it makes sense for PE sponsors to look to consolidate the various financing facilities they use for fund- or management-level borrowings. A hybrid facility is a logical outgrowth of that effort as a single credit agreement combining the benefits of both subscription facilities and net asset value (NAV) facilities.

To better understand hybrid facilities, the Private Equity Law Report recently interviewed Haynes and Boone partner Ellen Gibson McGinnis for her insights on unique traits and trends in this area. Specifically, this article outlines the mechanics of a hybrid facility's borrowing base; explores some of the pros and cons for sponsors to consider pre-adoption; and explains why hybrid facilities have never achieved widespread adoption as sources of fund financing.

For more on NAV and subscription facilities, see "Characteristics and Benefits of NAV Facilities for Secondary Funds" (Sep. 10, 2019); and "Trends in the Use of Subscription Credit Facilities: Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions (Part Two of Two)" (Feb. 7, 2019).

PELR: Please provide a summary of hybrid facilities and where they fall on the spectrum of financing options available to PE sponsors.

McGinnis: A PE fund usually has a subscription facility when it is formed, with a borrowing base composed of the unfunded capital commitments of its creditworthy investors. That subscription line gets drawn during the fund's investment period. At the end of that investment period, when unfunded capital commitments have been exhausted, many PE funds terminate their subscription facilities and replace them with separate NAV facilities that use qualifying fund assets as the borrowing base.

Alternatively, a hybrid facility basically combines a subscription facility and a NAV facility in the same documentation. General partners (GPs) benefit by having a single financing facility with a longer duration because the assets acquired under a subscription line support the borrowings under the NAV portion of the facility. Putting a single hybrid facility in place – instead of separate subscription and NAV facilities (which may, at times, be with different lenders) – should result in reduced costs (*e.g.*, bank fees, legal fees, etc.) for the GP.

In addition, GPs benefit from having the hybrid line in place upon forming the fund, both by ensuring access to borrowings over the fund's term and by locking in pricing of the loans. It also allows a GP to avoid a potentially tenuous transition period, during which it is simultaneously winding down a subscription facility and negotiating a separate NAV facility. There is a benefit to the lenders in that they are locking in their customer for two different kinds of facilities upfront.

[For more on other types of financing facilities, see "Alternative Financing Facilities: How GP and Co-Investment Facilities Increase Sponsors' 'Skin in the Game'" (Feb. 11, 2020); and "Financing Facilities Offer Private Funds and Managers Greater Flexibility (Part Two of Three)" (Jun. 9, 2016).]

PELR: What are the mechanics between the subscription and NAV portions of a hybrid facility?

McGinnis: The mechanics are mostly similar to standalone subscription and NAV facilities, although there are some nuances that need to be worked out when determining the relationship between the facilities and their respective borrowing bases in the loan documentation.

One approach used in hybrid facilities functionally treats the subscription and NAV facilities as separate items in a single set of documents. In that instance, the GP would borrow under the subscription facility before deciding at what point – typically based on the PE fund's remaining amount of uncalled capital commitments – it has sufficient assets to support the NAV facility. Upon pulling that trigger on the NAV facility, the subscription facility essentially goes away, and the GP just relies on the NAV facility for the borrowing base going forward.

The more common approach, however, is for hybrid facilities to be set up for a more gradual transition between the borrowing bases of the subscription and NAV facilities, where the two functionally overlap. In this scenario, once the borrowing base under a subscription facility has decreased to a certain point, then either an option is exercised by the GP or a switch is automatically triggered in the fund documents. At that point, the borrowing base supporting the outstanding loans changes to include the PE fund's assets, and reliance on the subscription borrowing base is phased out as unfunded commitments decrease or the ability to call them terminates.

It is worth noting that a key feature of both approaches is the GP's option to trigger the NAV portion of the hybrid facility. Bear in mind, the interest rate for the NAV portion is often higher than for the subscription line and is negotiated years before it's actually deployed. Therefore, if the terms or pricing of the NAV portion are off-market by the trigger date, or if the GP simply does not want to continue working with the lender, then it can simply choose not to exercise the option. There is no cost or penalty to the GP if that looks advantageous.

If the GP chooses not to exercise the NAV option, the borrower can pay off the subscription portion and terminate the hybrid facility. With that said, it is uncommon for a GP to actually go all the way down the path to terminate the entire hybrid facility. Instead, GPs tend to use the option as a form of leverage to bring the lenders back to the table to negotiate amendments to the terms or interest rates of the NAV facility to match the market.

PELR: In light of this issue, how is the borrowing base for a hybrid facility generally determined?

McGinnis: The borrowing base for the subscription portion doesn't really get altered by being part of a hybrid facility, as it's still derived from the unfunded capital commitments of the PE fund's investors. The advance rate (*i.e.*, the percentage of the value of the underlying collateral used to determine the size of loans available to be drawn under the facility) is based on either X percent loaned against all included investors or varying concentration limits based on the credit level of each investor. It remains pretty simple.

[See "How Can Private Fund Managers Use Subscription Credit Facilities to Enhance Fund Liquidity?" (Apr. 4, 2013).]

Conversely, there is a lot of negotiation about the parameters of collateral to be included in the borrowing base for the NAV portion of the hybrid facility, although that is really no different than for a standalone NAV facility. It begins by defining the eligible investments that constitute the borrowing base. That involves the lender understanding the types of investments – *e.g.*, debt, real estate, portfolio companies, etc. – to be made by the fund; how to assess their value; and how to build parameters around eligibility going forward.

In particular, the eligibility parameters for assets to be included in the borrowing base will consist of various restrictions imposed by the lender. For example, there is often a limit on how much of the portfolio can be concentrated in X geography (*e.g.*, property for a real estate fund, borrowers in a private credit fund, etc.). Another typical requirement is that assets must be assignable (*e.g.*, no contractual limits, existing liens, consent requirements, etc.) in the event the lender needs to exercise its rights upon a default under the hybrid facility by the PE fund.

There is a lot of diligence around these issues, which is how you derive the eligibility parameters for bringing fund assets into the borrowing base in the first place. Those parameters also prescribe the terms for maintaining assets and determining whether they stay eligible to remain in the borrowing base.

Further, there tends to be more negotiation and analysis around the advance rate for the NAV portion than the subscription portion. Lenders with sufficient experience and expertise in an asset class can perform their own evaluations about what percentage of the asset to include. Sometimes it is straightforward (*e.g.*, obtaining an appraisal for real property), or the lender can reference the secondary market for valuation purposes (*e.g.*, certain types of debt).

In most instances, however, lenders need to rely in some part on how a GP assesses the value of its fund's assets when setting the advance rate for the borrowing base of the NAV portion. This relative complexity and difficulty is at least part of the reason why the advance rates on the NAV side tend to be much lower than for the subscription portion of the hybrid facility.

PELR: How widely adopted are these financing facilities relative to the other types of facilities available to fund managers (*e.g.*, GP facilities, co-investment facilities, etc.)?

McGinnis: That's the interesting thing. There has always been a lot of buzz in the industry about hybrid facilities. Every time you go to a conference, someone wants to do a panel on hybrid facilities, and everyone's talking about them as if they're the next big thing.

At least in my world, however – and I've been doing hybrid facilities for probably around a decade – they just haven't really taken off. I primarily see them with successor funds where each iterative fund (*e.g.*, Fund 10, Fund 11, etc.) of a sponsor's strategy will have the facility. This makes some of the diligence on both sides of the transaction easier because of the track record, overlap in investors, consistent strategy, etc., in addition to being able to use the existing hybrid financing documents as a form for later launches.

Outside of the successor-fund context, we probably only work on a few new hybrid facilities each year. Even globally, we'll consult as U.S. counsel on some European deals, and I've only seen a couple hybrid facilities there. That amount has stayed consistent in recent years despite all the buzz in the industry, and I just don't see it increasing.

It's a shame they haven't become more widespread, as I think they can be quite useful. I think the reason they haven't caught on involves everything we have talked about – it's really putting two things together under one piece of documentation, which has some advantages and also some negatives associated. Rather than dealing with that, most sponsors continue to adopt separate subscription and NAV facilities over their funds' lives.

PELR: Building on your observation, what are some of the downsides or difficulties that PE sponsors can face with hybrid financing facilities – both in terms of arranging the facilities and having them in place?

McGinnis: For sponsors, the downside is that the upfront cost is higher because you're basically negotiating two facilities at once – it's complicated, it takes longer and you're sometimes dealing with different parts of a single bank. Also, drafting, negotiating and structuring a hybrid facility often requires starting from scratch, which requires more high-cost attorney efforts. Comparatively, while subscription lines are by no means a commodity, there is a form you start with, and it's easier to get the documentation in place.

[See "Operational Challenges for Private Fund Managers Considering Subscription Credit and Other Financing Facilities (Part Three of Three)" (Jun. 16, 2016).]

From the lender's perspective, a difficulty is having to agree on pricing for the NAV portion far in advance of it being used. Instead of the facility having a three- or four-year term, a hybrid facility may have a minimum five- or six-year duration. That can make it tricky for lenders to anticipate on the closing date what the rate should be at that end of the term of the loan. Those facilities do not typically give lenders the option to negotiate a different rate when the NAV portion is triggered, so they are pretty much locked-in from the beginning. Institutionally, there are a lot of lenders that just aren't interested in figuring that out.

Further, there are a limited number of banks that are actually capable of doing the subscription line work and also handling whatever assets the fund is acquiring, both in terms of valuing those assets and managing them in an event of default. There aren't many banks that have been willing or able to bring those resources together to provide the lines.

Of course, it also may be that there isn't sufficient demand from funds for hybrid facilities, and the banks' pipeline is sufficiently filled with the separate facilities.

PELR: How common is it for PE sponsors, relatively speaking, to have a hybrid facility compared to other closed-end fund strategies (*e.g.*, real estate and private credit)?

McGinnis: There were tax reasons why subscription facilities and, by extension, hybrid facilities, were initially more popular with real estate funds. That has changed, however, and now there are probably more hybrid facilities in the PE space than in other asset classes.

I suspect the primary reason is that it's harder for some subscription lenders to perform diligence on a real estate fund's portfolio of assets for the NAV portion of the hybrid facility than for a PE fund. Real estate funds require looking at a particular asset and putting in a lot of work to vet it on the lender side before it comes into the borrowing base. So, it's easier for a lender accustomed to providing NAV facilities with real estate assets to put a subscription line in place on the frontend than it might be for a typical subscription lender to take on real estate assets in a NAV facility on the back-end.

[For more on real estate funds, see "PE Real Estate Funds: Structuring by Investor Type and Distinct Statutory Considerations (Part One of Three)" (Aug. 13, 2019); and "Dechert Global Alternative Funds Symposium Highlights Portfolio Management and Global Trends for Private Equity and Real Estate Funds" (Jul. 2, 2015).]

PELR: What features of PE sponsors, if any, position them better or worse for putting hybrid facilities in place for their PE funds?

McGinnis: Because hybrid facilities can be quite tricky, lenders really need to have a good relationship with, and understanding of, the sponsor supporting the fund. That is why lenders typically pursue hybrid facilities with well-established, sophisticated PE sponsors that have strong track records and good relationships with the banks.

With that said, there are obviously "younger" PE sponsors that have done NAV financings for their funds. It's just a bit harder and less common than for well-established PE sponsors.

PELR: What are the most important things for an in-house general counsel or chief compliance officer at a PE sponsor to think about if he or she were considering putting a hybrid facility in place?

McGinnis: Certainly, the aforementioned pros and cons should be considered. Given the complexities, it will take a little longer to put a hybrid facility in place than a subscription facility – 10-12 weeks is realistic, but that can vary depending on a number of factors.

Really, a sponsor needs to think about issues associated with hybrid facilities early in the process, pick the right lender and ensure it has appropriate legal counsel negotiating on its behalf before entering into a term sheet. That is the key. Make sure you are talking with your lender long before you form the fund in question so you can really think through what the issues would be based on the fund's assets and see if it makes sense.

[See "Subscription Facilities Provide Funds With Needed Liquidity But Require Advance Planning by Managers (Part One of Three)" (Jun. 2, 2016).]