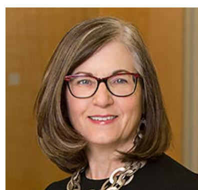
NAV Facilities and Hybrid Facilities

A Lexis Practice Advisor® Practice Note by Ellen Gibson McGinnis and Deborah Low, Haynes and Boone, LLP



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This practice note describes net-asset-value (NAV) and hybrid forms of subscription facilities. These facilities are distinguished in part by their different collateral packages, with the hybrid being secured by uncalled capital commitments and portfolio assets, and the NAV secured by portfolio assets only. This note describes how these facilities differ from each other and from subscription facilities, and how that impacts the timing and availability of borrowings, the due diligence process, and the drafting of covenants, remedies, and other provisions of the loan documents.

Introduction: What Are NAV and Hybrid Facilities?

As an increasing number of funds look to enter into subscription-secured credit facilities, the fund finance market has expanded rapidly. This has given rise to an increase in the prevalence of traditional subscription-secured credit facilities, where the primary collateral securing the credit facility is the contractual obligations of the fund's investors to make capital contributions to the fund and the bank account into which such capital contributions are made.

As funds increasingly utilize subscription facilities, they are also looking for additional ways to leverage their assets for increased borrowing capacity throughout the life of the fund. Often the result is the fund entering into a NAV facility or a hybrid facility, in which the loans issued under the credit facility are secured by a pledge of the investments made to acquire a portfolio of assets by the fund (referred to as the portfolio assets), the related distributions and cash flows from such assets, and equity in each entity that owns the assets. In a NAV facility, the collateral will be solely the portfolio assets of the fund or its holding entity, whereas in a hybrid facility, the collateral could be both the portfolio assets and the uncalled capital commitments and capital contributions of investors in the fund, resulting in a hybrid between a traditional subscription-secured credit facility and an asset-backed collateral structure. In both a NAV facility and a hybrid facility, the value of the underlying portfolio assets is determined by the NAV of the portfolio assets, the calculation of which is discussed in further detail below.

A NAV facility or hybrid facility may also be structured such that the holding company that is entering into investments in portfolio assets is the borrower under the facility and the fund through which investors contribute capital is either a co-borrower or a guarantor. Loans made under a NAV facility or a hybrid facility may be used to acquire portfolio assets or to provide leverage for an existing investment portfolio.

For guidance on subscription facilities, see Subscription-Secured Financings: Enforcement vs. Perfection, Subscription Facility Exclusion Events, and Subscription Facilities.

Benefits of a Hybrid or NAV Facility

A hybrid facility or NAV facility enables a fund to receive borrowing value against the portfolio assets of the fund, thereby maximizing its overall borrowing capacity. Borrowing availability under a traditional subscription-secured financing will decrease throughout the life of the fund as capital gets called. Under a NAV or hybrid facility, however, borrowing availability is determined in whole or in part by the NAV of the fund's portfolio assets, permitting borrowings after the expiration of the fund's investment period (which is the point at which the fund is no longer permitted to call capital for the purpose of acquiring new investments), and after all capital has been called. Therefore, a hybrid facility or NAV facility will allow the fund to obtain a longer-term facility than would otherwise be available under a traditional subscription-secured credit facility. This optionality can be valuable to a fund, particularly if it needs short-term liquidity to pay expenses in between distributions from portfolio assets or towards the end of the life of the fund.

A hybrid facility or a NAV facility may also enable a fund to be opportunistic about its investment opportunities if it has exhausted a large portion of its uncalled capital commitments but expects additional subscriptions to come in through later closings. A NAV facility or hybrid facility can also allow a fund to look towards future fundraising opportunities: if the lender permits it, the fund can use proceeds of loans under a credit facility to make distributions to its investors (prior to the actual realization of proceeds from portfolio assets) with the expectation that all or a portion of such distributions will be reinvested in a sponsor's successor fund.

Hybrid facilities and NAV facilities also provide the opportunity for lenders to deepen their relationships with funds and sponsors by becoming more invested in the fund's business and supporting anticipated growth opportunities of the fund and successor funds.

Comparison of Hybrid Facilities vs. NAV Facilities

The decision to enter into a hybrid facility as opposed to a NAV facility (or a subscription-secured facility and a separate NAV facility) will often depend on the fund's immediate needs and its banking relationships. At the outset of the fund's life, before the fund has acquired significant portfolio assets, the NAV of the fund's portfolio assets will not be sufficient to support borrowing under a NAV facility. For this reason, initially, funds will often elect to utilize a traditional subscription-secured facility that permits borrowings as soon as the fund has closed a significant amount of capital commitments. However, if a fund is certain of its investment strategy and has a good relationship with its bank, it may be able to lock in favorable pricing and terms for a hybrid facility at the outset of the fund's existence. This can be beneficial for aggressive funds as it enables the fund to start borrowing against its portfolio assets as soon as it begins acquiring investments. For other funds, it may be preferable to wait until a significant number of portfolio assets have been acquired to permit the fund to negotiate for more favorable terms under a hybrid Facility or NAV facility or take advantage of favorable pricing conditions in the market.

A fund may also elect to have separate banks administer its subscription-secured facility and its NAV facility. This may be determined by a fund's individual relationships with its banks or pricing that is available to the fund in the market. Banks may also have difficulty offering a NAV facility or a hybrid facility, either because of the bank's inability to underwrite portfolio assets or to price a longer-term facility, or as a result of the bank needing cooperation from multiple internal divisions.

Due Diligence and Documentary Considerations for Lenders

Due Diligence on the Underlying Portfolio Assets

In order for a bank to underwrite a NAV facility or hybrid facility, significant diligence on the portfolio assets of the fund is necessary, both at the outset of the credit facility and on an ongoing basis as new portfolio assets are acquired. The lender or its counsel will typically need to review the documentation governing the underlying portfolio assets to verify that the fund (or its special purpose entity or holding company) is the owner of the assets. See Due Diligence and Legal Issues in Lending Transactions and Due Diligence for Financing Resource Kit.

Additionally, particularly where the underlying portfolio assets constitute secondary market assets such as debt or equity, a lender and its counsel will need to pay attention to the terms of the underlying documentation governing transferability of such portfolio assets. It is not unusual for the documentation governing an underlying debt or equity investment to prohibit the owner of the investment from pledging a security interest in its rights in the portfolio assets. Depending on the type of investment asset, the Uniform Commercial Code (UCC) could render the anti-assignment

provision ineffective and enable the lender under the NAV facility or hybrid facility to nonetheless take a perfected security interest in the asset (see Assets Commonly Excluded from the Security Package for a description of the UCC's anti-assignment override). However, such an anti-assignment prohibition could prevent the lender from exercising customary rights and remedies in the collateral constituting portfolio assets, including the right to foreclose on the portfolio assets and become the owner of record, to liquidate or otherwise dispose of the portfolio assets, or to direct the payment of distributions or cash flows directly to the lender. If limitations on transferability exist, a lender may require the fund to obtain third-party consents, from the issuer of any equity (or from any other equity holders, if needed) or from the underlying borrower or lender in any debt investment, as applicable, approving the pledge of a security interest in the portfolio asset and confirming that such third party will approve the transfer of the asset or any economic rights in the portfolio assets to the lender.

Obtaining third-party consents for the transfer of portfolio assets often can be burdensome or commercially impractical for funds. For this reason, in order to provide comfort to lenders, funds will often form special purpose entities or holding companies (an SPE) through which portfolio assets may be acquired or to which they may be transferred after acquisition. The SPE will be a borrower under the NAV facility or hybrid facility and the fund will pledge its equity in the SPE as collateral under the credit facility. This pledge of equity will enable a lender to compel the disposition of the portfolio assets by enabling it to foreclose on ownership in the SPE. For added security, the fund may also serve as a co-borrower or guarantor under the facility. See "Remedies" below for more on how the security documentation should address the lender's right to foreclose on equity interests of the SPE or on the portfolio assets.

Maintaining the portfolio assets in a separate entity from the capital commitments may also facilitate a fund's ability to enter into separate capital call and NAV facilities. This could enable the fund to keep its assets separate for covenant purposes and prevent an issue (e.g., an investor default) from hindering the fund's entire borrowing ability.

In certain situations, a lender may be comfortable relying on representations and warranties as to the transferability of the portfolio assets without performing its own diligence. However, such a situation may require significant overcollateralization of the fund's indebtedness to the lender (thereby requiring more portfolio assets to back the same amount of loans) or depend on the overall creditworthiness of the fund's sponsor. Additionally, a fund may enter into a hybrid facility, where the primary collateral is the capital commitments but the portfolio assets provide additional collateral. Though not common, a fund may enter into such a capital call facility with NAV components for purposes of getting higher advance rates against the capital commitments and capital contributions.

The lender will also need to obtain information on the portfolio assets and the fund's investment strategy to determine appropriate advance rates, concentration limits, and eligibility of assets under the credit facility. Lenders will typically require that portfolio assets meet certain criteria for eligibility as borrowing base assets, such as the portfolio asset being senior secured, transferable, or governed by the laws of particular jurisdictions. The lender may also apply certain concentration limits to the borrowing base, to promote diversification and limit exposure to specific borrowers (where the underlying assets constitute debt), classes of portfolio assets, or geographic locations. Therefore, substantial diligence is needed during the underwriting process.

NAV Covenants

In order to measure borrowing availability under a NAV facility, the credit agreement will need to include provisions for the reporting on the NAV of the portfolio assets. NAV will typically be calculated by third-party valuation agent or administrator approved by the lender and should be reported at least quarterly throughout the life of the facility. Lenders will also often require that funds maintain certain covenant levels, which can take the form of a required minimum NAV or a maximum loan-to-value ratio (the LTV ratio). The LTV ratio is a critical measurement under a NAV based facility, as it will provide the ratio of the borrower's total NAV to the total indebtedness incurred by the fund. If the LTV ratio exceeds a minimum threshold, the terms of the credit agreement will often require a mandatory prepayment to pay down indebtedness and reduce the LTV ratio.

In order to track NAV measurements and financial covenants, the borrower will be required at least on a quarterly basis to deliver a compliance certificate, which will provide a list of portfolio assets and information on projected distributions or cash flows of the portfolio assets.

Repayment Provisions

The credit agreement will also need to address how the portfolio assets are utilized for repayment of loans made under the credit agreement. Specifically, if a portfolio asset consists of debt or equity in the secondary market, then the distributions from the asset could be a source

of repayment for the loans. In such a situation the lender may want to capture all or a portion of the distributions from the portfolio asset for prepayment and typically will require all distributions be applied to repay the facility obligations during the occurrence of an event of default. Consequently, for NAV facilities and hybrid facilities, the lender will need to have a security interest in the bank account into which distributions are made and the ability to take exclusive control of payments out of the account in a default or mandatory prepayment situation. See Repayment and Voluntary Prepayment Provisions in Credit Agreements, Mandatory Prepayment Provisions in Credit Agreements, and Deposit Accounts and Investment Property Resource Kit.

Conversely if the portfolio asset is of a type that does not yield regular distributions, the cash flow used to repay the facility will derive from the proceeds of the sale or other transfer of the portfolio asset. Given that the time line for a sale or transfer of the portfolio asset is unpredictable, the lender may require cash flow or liquidity covenants to ensure that the borrower will be able to make payments in the ordinary course of interest, fees, or expenses as they come due. The lender will also commonly require that proceeds of the disposition of any portfolio asset be paid into the borrower's collateral account and applied towards prepayment of the loans.

Remedies

The nature of the portfolio assets as an easily saleable asset may also provide an opportunity for the borrower to quickly cure an event of default arising from a deficiency in borrowing base value. In a situation where the outstanding credit extensions exceed the value of the borrowing base, or the minimum required LTV ratio is not met, the credit agreement may provide a short cure period prior to the declaration of an event of default, if during such period the borrower has identified portfolio assets that can be sold for the purpose of regaining compliance with the provisions of the credit agreement (which determination may be subject to lender approval) and is diligently pursuing such sale. Following such sale, the proceeds will be used for the repayment of loans in an amount necessary to eliminate the borrowing base deficiency or LTV ratio noncompliance.

Additionally, security documents executed for a hybrid facility or NAV facility will need to provide adequate remedies for the lender to realize on its pledge of the equity in the special purpose vehicle (SPV) or the underlying portfolio assets, to extent the lender can enforce on such assets directly. Under a traditional capital call facility, the lender will typically exercise its remedies by issuing a capital call to repay outstanding indebtedness under the credit facility. However, in a NAV facility or hybrid facility, the lender needs to be prepared to hold equity in the SPV or the underlying portfolio assets and likely needs to have appropriate internal protocols that will enable it to hold and dispose of such assets. Therefore, the lender needs to ensure that the security documentation includes appropriate provisions regarding voting rights in underlying portfolio assets constituting equity and provisions enabling the lender to dispose of the portfolio assets. See Remedies Provisions in Security Agreements, Covenants in Security Agreements, and LLC and LP Security Interest Resource Kit.

Finally, depending on the structure of the credit facility, the lender, in consultation with its counsel, will need to ensure that it has received adequate consents or issuer acknowledgments to take title to the fund's portfolio assets or the equity in the SPE. The consents and acknowledgments required will depend on the underlying corporate documentation governing the portfolio assets and should be determined in the due diligence phase (see "Due Diligence on the Underlying Portfolio Assets" above).

Conclusion

A NAV facility or hybrid facility can provide significant benefits to funds by enabling them to expand their borrowing capacity. Likewise, NAV facilities and hybrid facilities can be beneficial to lenders by providing opportunities to increase their returns and deepen their relationships with funds as sponsors. As more and more lenders and funds seek to enter into the fund finance market, NAV facilities and hybrid facilities can be attractive options, provided that lenders are able to appropriately service the collateral and the borrowing needs of the fund.

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Ellen McGinnis is a partner at Haynes and Boone, LLP, Washington, DC, and Co-Chair of the firm's Fund Finance practice group, for which Haynes and Boone is trusted counsel for U.S. and foreign commercial and investment banks as lenders to private equity funds. Ellen provides critical thinking and practical advice to a wide-range of clients in financing transactions, focused in particular on subscription-secured credit facilities, having worked on the product since its initial development in the late 1980's. Ellen has recently represented a number of clients in hybrid collateral facilities, leads many of the practice's international and multi-currency transactions, and represents lenders making loans to private equity firm partners.

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