GLI GLOBAL LEGAL INSIGHTS

Fund Finance 2023

Seventh Edition

Contributing Editors: **Wes Misson & Sam Hutchinson**

glg global legal group

FUND FINANCE association

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The rise of Hybrid Facilities and increasing use of capital commitments in NAV Facilities

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Background

Credit facilities provided to private equity funds generally follow one of two primary forms: Subscription Facilities and NAV Facilities. Subscription Facilities – often referred to as "capital call" facilities – have become fundamental features of newly formed funds with dedicated investor capital commitments, in which the loans are secured by the fund's (and its general partner's) rights to call the capital commitments. Availability under a Subscription Facility is subject to a "borrowing base" determined as a percentage of the unfunded commitments of investors in the fund. Subscription Facilities were traditionally utilised to finance the fund's short-term working capital needs, primarily bridging the 10–15 business-day period between the issuance of capital calls by the general partner and the required timing for the investors to make the related capital contributions to the fund. Increasingly, private equity funds use Subscription Facilities for their medium- and longer-term financing needs, including financing multiple investments and providing letters of credit and alternative currency loans to portfolio companies, with the result that related capital calls are less frequent but larger.

Many private equity funds are unable or find it impractical to use a Subscription Facility as a source of long-term financing, either because the fund's organisational documents do not permit or materially limit such facilities or, in the case of a mature fund, the fund has already called a significant portion of its investor commitments. These private equity funds often seek to raise capital through an "asset-backed" or "net asset value" facility: a "NAV Facility". NAV Facilities are financings backed by the fund's investment portfolio. Unlike Subscription Facilities, which look "up" to the capital commitments of investors in the fund for the borrowing base and collateral, NAV Facilities look "down" to the underlying portfolio investments for credit support. For a traditional private equity buy-out fund, these investments will be the direct portfolio company interests purchased by the fund, and for a "fund of funds", the NAV Facility credit support will consist of equity interests in hedge funds and private equity funds purchased by the fund of funds borrower in the secondary market.

While lenders have historically offered Subscription Facilities and NAV Facilities as separate solutions to the particular financing needs of private equity funds, more recently, funds have sought, and lenders have increasingly been willing to provide, "hybrid" facilities that combine important structural features of both Subscription Facilities and NAV Facilities ("Hybrid Facilities"). In this chapter, we discuss the rise of Hybrid Facilities and increasing inclusion of capital commitments as support in otherwise traditional NAV Facilities.

What is a Hybrid Facility?

At its core, a Hybrid Facility is a hybrid – and contains certain of the defining features – of a Subscription Facility and a NAV Facility. In particular, these facilities both look "up" to the unfunded capital commitments of investors (the defining feature of a Subscription Facility) as well as look "down" to the fund's investment portfolio (the defining feature of a NAV Facility) for collateral and credit support. There are different forms of Hybrid Facilities, especially with respect to the formulation and types of credit support included in the borrowing base.[1] References to Hybrid Facilities in this chapter, however, will focus on financings that include both uncalled capital and underlying portfolio investments in a combined or blended borrowing base.

Hybrid Facilities are most useful to private equity funds looking for a single, permanent financing available throughout the fund's life cycle, from the fund's inception – when it has significant uncalled capital commitments, but few (if any) investments – through maturity – when capital commitments have been (nearly) fully utilised to acquire underlying portfolio investments. They may also appeal to more mature, later-stage private equity funds that lack sufficient available capital commitments – due to, e.g., concentration limitations or remaining investor mix – to support a traditional Subscription Facility.

Borrowing base

Borrowing capacity under a Hybrid Facility is typically subject to a combined borrowing base calculated by reference to both an "asset borrowing base" and a "UCC borrowing base". The asset borrowing base is equal to an agreed advance rate against the fair market value or "net asset value" of eligible portfolio investments satisfying specific investment criteria (e.g., the absence of certain material adverse investment events) and adjusted for single position, sponsor, industry and other concentration limits. The UCC borrowing base, in contrast, is equal to an agreed advance rate against the uncalled capital commitments of specified "included" (or, in certain cases, all) investors, with advance rates and inclusionary criteria typically dependent on the creditworthiness of each applicable investor. Once separately calculated, the asset borrowing base and UCC borrowing base are aggregated to determine a combined borrowing base upon which the lenders will advance loans. Lenders sometimes may also include a single advance rate measured against the sum of the net asset value of the eligible portfolio investments and the uncalled capital commitments, which functions as an override or cap on the borrowing base that is calculated using the separate advance rates. Where the inclusion of uncalled capital commitments in a Hybrid Facility is intended solely to bridge the natural investment "ramp up" of a fund, the borrowing base may be structured such that, following a pre-determined date or specified condition (e.g., more than 25% of capital commitments has been called from investors), the maximum advance rate is measured solely by reference to the asset borrowing base. Put differently, once the level of available uncalled capital commitments decreases below a specified threshold, the hybrid nature of the facility falls away and effectively converts to a traditional NAV Facility.

Structure of Hybrid Facilities

Hybrid Facilities may take the form of a revolving loan facility or may be structured as separate revolving loan and term loan facilities. A revolving loan generally provides the private equity fund with the most flexible and cost-effective solution to meet its financing needs, as the revolver may be drawn to meet both short-term liquidity needs, which provides a key benefit of a Subscription Facility, as well as to fund portfolio investments, thereby achieving a key feature of a NAV Facility. Revolving facilities may be less cost efficient, however, for funds with shorter investment cycles, as such funds will be required to continue to pay a commitment fee on the unused portion of the facility even after the fund no longer has a need for a revolving line of credit.[2] As an alternative, lenders may agree to structure the Hybrid Facility as two separate facilities, consisting of a revolving facility, based on the UCC borrowing base, with a shorter maturity date for working capital purposes, and a term facility utilising the asset borrowing base, with a longer maturity to be used to finance a pool of investments (often at or soon after closing). The facilities may or may not be cross-collateralised. As the fund matures and no longer has a need for the revolving component, the fund may seek to refinance the facilities to terminate the revolving component, resulting in a NAV Facility with an expanded collateral pool of portfolio investments and remaining uncalled capital commitments.

Collateral

The collateral package for Hybrid Facilities includes support that is typically included in both Subscription Facilities and NAV Facilities. The fund, as borrower, and the general partner of the fund grant, as applicable, have a security interest in favour of the lender in: (a) the unfunded capital commitments of the investors in the fund; (b) the right to make capital calls on such investors; (c) the deposit accounts into which the resulting capital contributions are funded; (d) the equity interests in the holding vehicle that holds the underlying portfolio investments (or, in situations where the borrower directly holds the underlying portfolio investments, a pledge of the equity interest in the borrower by its direct parent entity) (the "Equity Interest Collateral");[3] and (e) a pledge of the deposit and securities accounts into which distributions on and proceeds of underlying portfolio investments are paid. To perfect the lenders' security interest in such collateral, UCC financing statements are filed against the fund and general partner and the deposit and securities accounts of the fund are subject to control agreements, with the lenders' right to block such accounts most often springing upon an event of default or borrowing base deficiency.

Considerations for lenders

As lenders become increasingly accustomed to providing Hybrid Facilities, they face a number of challenges. First, lenders will need to perform more diligence than would typically be performed for traditional, standalone Subscription Facilities or NAV Facilities, which, depending on the structure of the lending institution, may involve different internal legal and commercial teams. Second, because Hybrid Facilities are intended to span the entire life cycle of the fund borrower, lenders need to contemplate and address potential issues, however remote, applicable to both early- and late-stage funds. A primary example is a rapid decline in the net asset value of portfolio investments during a period in which the Hybrid Facility is primarily functioning as a Subscription Facility, which may result in investors questioning whether to honour their remaining capital commitments. To address and seek to mitigate such concerns, lenders may (a) provide that the UCC borrowing base falls away at a certain minimum NAV threshold, or (b) include a maximum or overriding single advance rate.

Use of capital commitments in NAV Facilities

In order to incentivise lenders to provide NAV Facilities at lower interest rates or supported by more concentrated or otherwise illiquid portfolios of investments (or to address other challenging credit or structural concerns the lenders identify), funds may agree to include elements of Subscription Facilities (other than the UCC borrowing base) in NAV Facilities.

Enhanced credit support

As noted, NAV Facilities have historically been used by funds of funds to borrow against the value of limited partnership and other equity interests in private equity and hedge funds. Recently, however, a number of private equity funds have applied NAV Facility technology to borrow against the equity value of their investments in operating portfolio companies.[4] Given the illiquidity of these assets – even as compared to secondary fund interests – lenders may insist that these facilities be secured by a pledge of investors' capital commitments to the fund in addition to the underlying portfolio investment interests.

In another application of this concept, private equity sponsors are increasingly creating and utilising pooled investment vehicles ("Aggregator Vehicles") for the purpose of aggregating the investments of a number of their managed funds in a single pool of underlying portfolio investments. As in a traditional NAV Facility, the funds investing in an Aggregator Vehicle may seek to obtain financing based on their ownership interests in the Aggregator Vehicle (and, indirectly, their proportionate share of the underlying portfolio investments held by the Aggregator Vehicle). Where portfolio investments are owned by Aggregator Vehicles, the Equity Interest Collateral is limited to the borrower's equity interest in the Aggregator Vehicle. As these non-controlling interests provide lenders with less flexibility and optionality in a post-event of default enforcement scenario, lenders may, in such circumstances, seek to enhance the credit support of the loan by requiring the borrower (and its general partner, if applicable) to also pledge uncalled capital commitments from its direct investors.

The pledged capital commitments may come from true third parties (where the borrower or its direct parent are an "external-facing" fund) or internal feeder funds. Where the pledge is of commitments of an affiliated entity (especially where such entity is a pass-through vehicle that is not separately creditworthy), the affiliate's capital contribution obligations may be supported by a "bad boy" guaranty from the sponsor (or other creditworthy affiliate) of the borrower triggered upon a failure of the pledgor fund to satisfy required capital calls to the borrower.

The enhanced credit support provides NAV Facility lenders with the comfort that, following an event of default, they will have the right to not only exercise remedies with respect to the Equity Interest Collateral pursuant to a customary UCC public or private sale process, but also rely on the pledged capital commitments to satisfy any shortfall in the liquidation value of the portfolio assets.

<u>Liquidity covenants</u>

In NAV Facilities, lenders increasingly include covenants to address liquidity concerns that may impact a borrower's ability to repay its obligations. These covenants may include (a) a requirement that the borrower maintain a specified level of unfunded capital commitments to the extent the "loan-to-value ratio" of the NAV Facility exceeds a specified threshold, (b) a mandatory prepayment event upon the NAV Facility loans exceeding an agreed percentage of unfunded capital commitments, or (c) a requirement that the borrower maintain sufficient unfunded capital commitments to satisfy the sum of the NAV Facility loan amount and the capital commitment requirements of the portfolio investments.

Conclusion

As private equity funds continue to realise the benefits of using Hybrid Facilities, and lenders become more accustomed to providing such financings, we expect to see the types of funds using such facilities, as well as the purposes for which such facilities are used, continue to broaden. We further expect to see an expansion in the use of capital commitments in NAV Facilities as funds continue to expand the scope of portfolio investments for which they employ the use of NAV Facility technology.

Endnotes

1. In certain NAV Facilities, uncalled capital of intermediate fund entities is pledged to the lenders, but does not provide lenders with claims against the ultimate third-party investors in the fund.
2. Such facilities also typically include a commitment termination premium, such that the borrower will incur a material cost (often equal to the remaining commitment fee through maturity) upon early termination of the facility commitments.
3. A fund typically establishes two special purpose vehicles ("SPVs") under a NAV Facility. The first SPV, the 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 portfolio investments included in the borrowing base. The borrower generally provides a pledge of 100% of the equity interests of Holdco.
4. 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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