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FINANCING FACILITIES

Characteristics and Benefits of NAV Facilities for Secondary Funds

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The growth of the fund finance market has historically been attributed to the rise of credit facilities secured by the unfunded capital commitments of a fund's investors (Subscription Facilities). Subscription Facilities have traditionally been used by funds as sources of short-term capital by delaying the need to call capital from investors or to bridge the time between capital call issuances and the actual capital contributions.

A fund's ability to borrow under a Subscription Facility is subject to a borrowing base calculated based on a percentage of the unfunded commitments of certain included investors in the fund (Borrowing Base) and often subject to certain advance rates and concentration limits. Because the borrowing capacity is driven by investor commitments, Subscription Facilities are most useful to newer funds with significant unfunded capital commitments.

The well-documented rise of the Subscription Facility market over the last decade has created a competitive marketplace, driving many lenders to expand their fund financing offerings to provide fund sponsors with the ability to borrow throughout the lives of their funds. One example is the development of net-asset-value facilities (NAV Facilities), which are credit facilities backed by the equity value of a fund's investment portfolio. This article examines the typical structure of NAV Facilities for secondary funds (Secondary Funds), the collateral that Secondary Funds use to secure those loans (*i.e.*, limited partnership (LP) and other equity interests in PE funds) and the benefits to funds of using NAV Facilities.

See our two-part series on trends in the use of Subscription Facilities: "Advantages for PE Investors and Sponsors Have Led to Adoption by Some Hedge Funds and Credit Funds" (Jan. 24, 2019); and "Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions" (Feb. 7, 2019).

Benefits and Uses of NAV Facilities

Funds realize several benefits from using NAV Facilities. First, NAV Facility proceeds may provide liquidity to a fund at a time when commitments are fully drawn but distributions from underlying investments have not been received. This scenario, which prevents access to a traditional Subscription Facility,[1] typically applies to funds in the late-investment stages or that have matured beyond their investment periods. It can also commonly apply to a fund sponsor that finds

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itself with the "high-class problem" of having deploying capital in its fund much faster than it anticipated and not having completed, or having been unable to complete, its next fund.[2]

Access to a NAV Facility bridges these time gaps and provides a fund with needed liquidity to pay various costs and expenses; to fund dividend recapitalizations; or to fund follow-on investments. In each case, the fund can perform these tasks without exiting any investments at times that might not otherwise be optimal for that fund's investment thesis.

Finally, NAV Facilities can help equal the playing field for certain types of funds, such as Secondary Funds, debt funds and, to a certain extent, real estate funds, that, generally speaking, could not achieve traditional PE-style leverage on their assets. NAV Facilities allow these types of funds to generate higher rates of return that approach those of traditional PE funds by financing the purchase of the funds' underlying assets in the same way a PE fund leverages an operating company in a traditional leveraged buyout.[3]

Relatedly, in the case of a Secondary Fund, the opportunity to access increased leverage via the use of a NAV Facility allows the Secondary Fund to offer higher prices, thereby enabling it to compete in more competitive situations and auctions.

See our two-part series on selling minority stakes in PE firms: "Recent Trends and Structural Considerations" (Apr. 2, 2019); and "The Appeal of Stable and Early Income Streams" (Apr. 9, 2019).

Structure, Collateral and the Issue of Consent

Historical Evolution of NAV Facilities

When NAV Facilities were first introduced to the market, lenders expected to take direct security over the underlying investment portfolios based on their experience in the leveraged acquisition finance market. For example, a Secondary Fund would prepare for a NAV Facility by forming a single special purpose vehicle (SPV) to serve as the borrower (NAV Facility Borrower) and provide a direct pledge of the underlying LP interests.[4]

The issue with this approach, however, was that the terms of the underlying fund documentation governing the LP interests often stipulated that taking direct security in the LP interests, as well as any future transfer of the LP interests to the lender in an enforcement scenario, required the consent of the underlying general partner or fund manager (GP) for each LP interest.

Where a NAV Facility was backed by a single LP interest, consent of the underlying GP (GP Consent) was sometimes easier to obtain and thus more likely to be requested, or even required, by the lender. Nevertheless, obtaining GP Consent was often quite challenging because GPs are rightfully wary of permitting lenders or their transferees to become limited partners in the underlying funds, especially if there are ongoing funding obligations for the capital commitments. Additionally, many LPs were not thrilled with needing to go to their GPs for essentially two requests – to permit the transfer of the LP interest to the Secondary Fund and to permit

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that Secondary Fund to (potentially) assign to a lender.

PE sponsors have questioned the need for GP Consent as the number of Secondary Funds entering into NAV Facilities has grown significantly in recent years, along with the advent of "bulk" sales of LP interests.[5] This is particularly the case as NAV Facilities are increasingly backed by large and diverse portfolios of investments that occasionally span multiple jurisdictions. This factor can make it unrealistic or impractical for a lender to obtain GP Consent to the pledge of the LP interests, as well as to the transfer of the underlying LP interests to a lender in an enforcement scenario.

Modern Approach: Two-SPV Structure

The issues surrounding GP Consent have caused Secondary Funds and lenders to agree on an alternative NAV Facility structure that often involves having the Secondary Fund establish two SPVs.[6] The first SPV serves as the NAV Facility Borrower and holds the equity interests of the second SPV (Holdco), which directly owns the underlying LP interests included in the Borrowing Base. This enables the NAV Facility lender to potentially foreclose on the shares of the Holdco in a default scenario without disrupting or triggering any GP Consent rights of the underlying LP interests.

For more on the use of SPVs in another context, see "Investment Vehicles, Investor Rights and Restrictive Covenants in PE Co-Investments (Part One of Two)" (Jun. 18, 2019).

Of course, even this two-SPV structure may still be prohibited if the underlying fund documentation requires GP Consent for indirect pledges. Moreover, the mere transfer of the underlying LP interests from the Secondary Fund to the SPV may be deemed an assignment subject to GP Consent under the underlying fund documents. Careful planning when entering into a secondary transaction can enable a Secondary Fund to transfer the underlying LP interests to its affiliates, thereby obviating the need for GP Consent to transfer to an SPV.

Ultimately, whether a lender will require GP Consent – and the proximity of the equity pledge to the underlying LP interests – will vary across lenders. This will often depend on the GP Consent provisions; the structure and investment strategy of the Secondary Fund; and the quantity and quality of LP interests that are servicing the debt under a NAV Facility.

Collateral

In the two-SPV approach, the NAV Facility Borrower generally provides an "all assets" pledge to the lender to secure its obligations under the NAV Facility, including a pledge of 100 percent of the equity interests of the Holdco (Equity Interest Collateral). If the NAV Facility Borrower is a limited partnership, lenders will generally require the GP to pledge its interests in the NAV Facility Borrower (GP Interests). The Holdco will typically guarantee the NAV Facility Borrower's obligations under the NAV Facility and secure that guarantee with a pledge of the deposit and securities accounts into which distributions of the underlying LP interests are paid.

While many lenders will insist on a collateral package that includes a direct or indirect equity pledge of the underlying LP's interests, the cleanest approach from the borrower's perspective is to limit the collateral grant to a

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pledge of the account into which distributions on the underlying LP interests are paid. Since it may be difficult for a lender to take comfort in this approach, this article is limited to NAV Facilities that include an equity pledge.

To perfect the collateral granted by the NAV Facility Borrower and, if applicable, the Holdco, UCC financing statements are filed against both entities. Any deposit or securities accounts of the parties are also required to be subject to control agreements in favor of the lender. Lenders may require an additional source of collateral if a NAV Facility is backed by a single LP interest, such as a guarantee from the Secondary Fund or a pledge by the Secondary Fund of any remaining capital commitments to the NAV Facility Borrower.

In an event-of-default scenario, NAV Facilities provide lenders with the right to foreclose upon – or exercise other secured creditor remedies with respect to – the Equity Interest Collateral and, where applicable, the GP Interest (or the underlying LP interests, as the case may be). This gives a lender the ability to manage an orderly disposition of the underlying LP interests. In the two-SPV structure, the bank may foreclose on the equity of the SPV upon a default and then control the management or disposition of the LP interests without any change in record ownership. Nevertheless, depending on the terms of the underlying fund documentation, the transfer of an LP interest from the SPV to a third party may still require GP Consent.

For more on pledging equity interests in another context, see "How Can an Investor Pledge Its Private Fund Interest as Collateral for a Loan Without Obtaining the Consent of the Fund's Manager or General Partner?" (Jun. 25, 2010).

Borrowing Base and Mandatory Prepayments

Availability under NAV Facilities, like availability under Subscription Facilities, is subject to a Borrowing Base. For NAV Facilities, the Borrowing Base is calculated by reference to the net asset value of "eligible" underlying LP interests satisfying specific investment criteria (*e.g.*, the absence of certain adverse investment events such as bankruptcy events, insolvency events and breaches of material investment contracts) and is often adjusted for manager, industry and other concentration limits.

Also, if the ratio of loans outstanding under a NAV Facility to the Borrowing Base (the LTV Ratio) exceeds a specified threshold at any time, the NAV Facility will require the borrower to prepay a sufficient amount of loans to bring the facility into compliance with the maximum LTV Ratio.

Finally, NAV Facilities typically require mandatory prepayments with proceeds of distributions received from the underlying LP interests. These prepayments may range – depending on the LTV Ratio – from 25 percent to 100 percent of distributions, and they may be subject to prepayment penalties or no-call periods. Well-advised Secondary Funds will work to limit the application of prepayment penalties to truly voluntary prepayments.

See our three-part series: "Subscription Facilities Provide Funds With Needed Liquidity But Require Advance Planning by Managers" (Jun. 2, 2016); "Financing Facilities Offer Private Funds and Managers Greater Flexibility" (Jun. 9, 2016); and "Operational Challenges for Private Fund Managers Considering

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Subscription Credit and Other Financing Facilities" (Jun. 16, 2016).

Conclusion

The authors expect to see a continued rise in the number of NAV Facilities, as well as in the various uses employed by funds seeking to raise these facilities. This growth will likely be driven by later-stage funds seeking liquidity without calling capital from investors or waiting for distributions from underlying investments, and as Secondary Funds and other similarly situated funds pursue opportunities to bolster their ability to invest in assets that have traditionally been difficult to leverage.

As the NAV Facilities market continues to grow – funds, including Secondary Funds, have raised record amounts of capital in recent years – the authors also expect continued discussion and streamlining among NAV Facility Borrowers and lenders over the scope of collateral and requisite consents to these facilities.

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[1] Of course, a fund's organizational documents may also limit its ability to enter into a Subscription Facility or may not permit a fund to call capital to repay indebtedness once the fund's investment period has ended, although well-drafted organizational documents should afford a fund this flexibility.

[2] Fundraising time horizons for funds can often take six months or more. Also, newer funds that deploy capital faster than anticipated may need to wait to harvest some transactions so they can build a successful track record for the next fund.

[3] A traditional PE fund will often leverage a portfolio company – operating companies with predictable and, presumably, growing revenues – up to 6.5x its earnings before interest, tax, depreciation and amortization.

[4] Importantly, as long as a Secondary Fund's organizational documents and the applicable credit documentation permit, NAV Facilities and Subscription Facilities can exist in parallel without creating intercreditor issues. This is because the NAV Facility will always sit at an SPV below the Secondary Fund, which is the borrower under the Subscription Facility. It is worth noting, however, that although

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it is rare, NAV Facilities can be structured at the Secondary Fund level. This can only occur if, among other things, the Secondary Fund's organizational documents permit, the Secondary Fund is comfortable with unrelated business taxable interest risk and the Secondary Fund has no Subscription Facility (or there is appetite among the parties to enter into an intercreditor agreement).

[5] As the secondary market for LP interests has matured, many LPs have sought to sell their entire portfolios of LP interests, whether as part of a "rebalancing" of their exposures to certain asset classes, a new investment focus or a desire for consolidation. For example, an LP may seek to decrease its exposure in real estate LP interests or to focus only on LP interests in a particular geography. Secondary Funds have responded by acquiring an LP's entire portfolio or type of interest in a single bulk purchase.

[6] Regardless of structure, any SPV providing credit support for a NAV Facility will have an extremely limited scope of permitted activities to ensure it is, in fact, free from competing creditors. In addition, many lenders will take steps to ensure it is a "bankruptcy remote" entity.

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