The use of net asset value facilities for portfolio acquisitions

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Background – NAV Facilities and the fund finance market

In recent years, secured credit facilities provided to funds have been dominated by two forms: the "Subscription Facility" and the "NAV Facility". The Subscription Facility – sometimes referred to as a "capital call" credit facility – has become increasingly common lately for newer funds with significant unfunded capital commitments, with the loans secured by the fund's right to call those capital commitments from its investors. Subscription Facilities are generally intended to serve a fund borrower's short-term capital needs by bridging the time between the time of the issuance of the call on investors and the time of performance. For many funds, Subscription Facilities are not a viable option, however, either because the fund's organisational documents do not permit such facility (or do not permit certain essential features – e.g., the pledge of capital commitments to a third party lender) or, in the case of a mature fund, the fund has already called a significant portion of such commitments.

In these cases, funds have sought to raise capital through a net asset value, or "asset backed" facility: a "<u>NAV Facility</u>". NAV Facilities are credit facilities backed by the assets included in the fund's investment portfolio. In the case of a "fund-of-funds", the principal focus of this article, such assets will typically be limited partnership and other equity interests in (mature) hedge funds and private equity funds, often purchased by the fund-of-funds borrower in the secondary market. Availability under a NAV Facility is subject to a "borrowing base" determined by reference to the net asset value of "eligible" portfolio investments 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 the NAV Facility to the then applicable borrowing base (the "<u>LTV Ratio</u>") exceeds a specified threshold (usually in the 30–60% range), the NAV Facility will require the borrower to make a mandatory prepayment to bring the facility into compliance with that maximum LTV Ratio.

NAV Facilities have often been used by funds to effect "dividend recaps" by paying investors a distribution with loan proceeds during the mid to later stages of the fund's term (in advance of a full runoff of the underlying portfolio). In this article, however, we focus on issues that may arise from the increasing use of NAV Facilities to finance (or refinance) the acquisition of portfolio investments, including the use of separate subsidiaries to effect such acquisitions.

Structure and collateral

In a typical NAV Facility, the fund establishes two special purpose vehicles ("SPVs"). The first SPV, the borrower (the "Borrower"), is created by the fund for the sole purpose of obtaining the financing under the NAV Facility and holding the equity interests of the second SPV ("Holdco"), which directly owns the portfolio investments included in the borrowing base. The Borrower generally provides an "all assets" pledge to the NAV Facility lender to secure its repayment obligations, including a pledge of 100% of the equity interests of Holdco (the "Equity Interest Collateral"). If the Borrower is a limited partnership, lenders will require that the general partner of the Borrower (the "General Partner") also provide a pledge of its general partner interests in the Borrower (the "GP Interest"). Holdco most typically guarantees the Borrower's obligations under the NAV Facility and secures such guarantee with a pledge of its deposit and securities accounts into which distributions on and proceeds of the portfolio investments are paid.[1]

This SPV structure, especially the pledge by the Borrower of the Equity Interest Collateral and, if applicable, the pledge by the General Partner of its 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 right to manage the wind-down of the underlying portfolio investments. To ensure the perfection of the collateral granted by the Borrower and Holdco, UCC financing statements are filed against the Borrower and Holdco, and any such deposit or securities accounts are required to be subject to account control agreements in favour of the lender.

NAV Facilities and acquisition financings

Purchase and sale agreements

The acquisition of hedge fund and private equity fund interests in the secondary market is generally documented pursuant to a purchase and sale agreement ("PSA") between the buyer and seller of the applicable interests (the "Fund Interests"). The PSA will contain the purchase price for each Fund Interest as well as the various conditions precedent to the transfer, or closing, of such Fund Interest. One fundamental condition to each such closing is that the general partner, managing member or other applicable entity controlling the Fund Interest consent to such transfer (the "GP Consent"), as required by the organisational documents of the Fund Interest being acquired. Typically, once an agreement to sell a portfolio of Fund Interests has been reached, the seller (or, in certain cases, the buyer) will approach the general partner, managing member or other applicable entity controlling each Fund Interest to obtain the GP Consent with respect to such Fund Interest. Depending on the number of Fund Interests being purchased under a single PSA – and the number of general partners, managing members or other applicable entities controlling such Fund Interests – a PSA may provide for several closings, with the first closing occurring at the end of the quarter during which the PSA is executed, at which time GP Consents with respect to a material portion of the Fund Interests have been obtained.

Issues to consider in NAV Credit Facilities

As noted above, NAV Facilities are increasingly being used by funds to finance the acquisition of underlying hedge fund and private equity fund investments in connection with the closing of a PSA. Several issues may arise in this context that are important to consider. First, a fundamental condition precedent to funding under a NAV Facility is provision by the Borrower of satisfactory evidence of ownership of the portfolio investments to be included in the borrowing base and LTV Ratio calculations. In the case of a NAV Facility utilised to made a "dividend recap", such evidence often takes the form of an accountants' certification as to the fund's (or, more precisely, Holdco's) ownership of such investments in connection with the most recent audited/reviewed financial statements of the fund.

In the acquisition context, by contrast, even assuming that all conditions to the closing have been satisfied, such statements will generally not be available as of the closing date. In addition, given the nature of the underlying interests in the NAV Facility, such evidence is significantly more difficult to obtain than for other types of acquisition financings, where the purchase of an asset may be evidenced by a stock or merger certificate (in the case of the purchase of, or merger with, another company) or the crediting of (listed) equity or debt interests to the Borrower's brokerage accounts (in the case of a margin or similar loan). To address this concern, recent NAV Facilities have required that as a condition precedent to funding, the fund's counsel (or its trustee) certify to the lender that all conditions to the PSA have been satisfied and all such underlying portfolio investments have, in fact, been acquired by the fund.

A second, related issue that arises in this context results from the fact that, as mentioned above, the formal transfer of legal title to the buyer of Fund Interests will almost certainly be subject to applicable GP Consents. Unless obtained in advance, there are no guarantees that such consent will be provided; even if provided, a GP Consent often will not be granted until after the purchase price is required to be paid by the buyer under the PSA.[2] However, if the purchase price under the PSA is being financed (in whole or in part) by a NAV Facility and the funding under such facility is subject to the purchase of such investment (which purchase is, in turn, subject to GP Consent), what results is a "chicken and egg" problem whereby the fund will be unable to consummate the PSA until the financing is provided under the NAV Facility, but absent consummation of the PSA and transfer of the underlying Fund Interests to the buyer, the lender will not be willing to provide such financing.

Possible solutions

There are a few potential solutions to this problem. Most conservatively, a lender may exclude from the borrowing base any portfolio investments the transfer of which remains subject to GP Consent. Once GP Consent is obtained with respect to such investment, the Borrower would be permitted to access the remaining financing under the NAV Facility on a delayed draw basis. One problem with this solution is that the PSA almost always requires that the entire purchase price attributable to a Fund Interest be provided upfront at the closing of such Fund Interest. As such, depending on the maximum LTV Ratio under the NAV Facility and its other available sources of capital, a Borrower may not have sufficient funds available to pay the full purchase price if investments subject to outstanding GP Consent are excluded at the outset.

A more tailored solution, most effective where GP Consents with respect to all investments are expected soon after the closing date, is to include as a condition precedent to the funding of the NAV Facility a certification from the Borrower's counsel 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. Once the purchase price has been paid (with the proceeds of the NAV Facility) and the GP Consents are released, the lender may require an additional certification from such counsel that formal transfer of the underlying investments to Holdco has occurred. Under this structure, in the event that the GP Consents are not provided within a specified time period (e.g., three business days after funding), the lender may require the Borrower to prepay the outstanding loans in amount sufficient to reduce the LTV Ratio to a maximum specified rate.

Holdco subsidiaries

For various legal, regulatory, tax and accounting reasons, it may be required or beneficial to a fund to purchase and hold one or more Fund Interests through subsidiaries domiciled in jurisdictions other than that of Holdco ("Holdco Subsidiaries"). Given that any debt of Holdco Subsidiaries would be structurally senior to the debt of Holdco and the Borrower, prior to including any investments held by Holdco Subsidiaries in the borrowing base and LTV Ratio calculation, it is critical to ensure that the lender maintains its secured creditor rights with respect to such investments. As described above, the key rationale for the two-SPV structure of NAV Facilities is for lenders to be in a position to control the wind-down of the underlying portfolio investments following a default under the facility. Absent additional structuring, however, a subsidiary of Holdco would fall outside of the Equity Interest Collateral, negating the desired control. To address this gap, and to avoid being structurally subordinated to the holders of any Holdco Subsidiary debt, certain lenders have permitted the formation of Holdco Subsidiaries to hold portfolio investments included in the borrowing base, subject to such subsidiary providing a guarantee of the borrower's obligations under the NAV Facility (secured by a pledge of its deposit and securities accounts), and to Holdco pledging the equity interests of such subsidiary.[3] Taken together, and assuming UCC financing statements are filed against both the Borrower and Holdco and account control agreements with respect to the accounts of the Holdco Subsidiaries are entered into, lenders are put in the identical position they would have been had such portfolio investment been held by Holdco, rather than its subsidiary.

Conclusion

As the frequency and size of sales of Fund Interest portfolios in the secondary market continues to rise, we expect to see a concurrent increase in the use of NAV Facilities as a means of funds obtaining capital to finance the purchase of such portfolios. To ensure that lenders retain the customary protections around the borrower's ownership of the underlying Fund Interests, we expect to see further developments in the conditions evidencing that the individual Fund Interests have been validly purchased, and in the scope of entities permitted to own such interests.

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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 guarantee of the borrower's obligations secured by a pledge of the Equity Interest Collateral. While for the 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, in certain transactions, the General Partner agrees to automatically release the GP Consent upon payment of the purchase price for the Fund Interests. This article addresses those cases in which the GP Consent to the transfer of the Fund Interests is not automatically released with respect to all, or part, of those Fund Interests.

3. We note that there may be instances in which Holdco cannot pledge the equity interest of certain Holdco Subsidiaries. In such cases, lenders have been able to get comfortable without a pledge of the equity interest of the Holdco Subsidiaries on the basis that the lenders can still control the wind-down of the underlying portfolio investments, albeit indirectly, via their Equity Interest Collateral and, if applicable, the General Partner's pledge of its GP Interests in the Borrower.