KEY POINTS
- NAV or asset backed facilities are secured against the underlying cashflow and distributions that flow up from the underlying portfolio investments.
- There is no reason why these NAV or asset backed facilities cannot be provided to any type of closed ended fund.
- There has also been a substantial increase in "hybrid" facilities.

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NAV, asset-backed and hybrid funds finance facilities

In this article, Leon Stephenson explains the significant growth in the market of NAV or asset backed facilities over recent years.

There has been substantial growth in the funds finance market over recent years with more and more funds seeking subscription line or capital call facilities from lenders. These are debt facilities provided by lenders to funds where the recourse of the lender is to the uncalled commitments of the fund. With the rapid growth of these facilities there have been substantial pressures on pricing as lenders compete between each other for this business.

More recently, there has been a significant growth in the market of NAV or asset backed facilities. These are funds finance facilities provided by lenders to the fund or to a special purpose vehicle owned by the fund, that are not secured against the undrawn investor commitments, but rather the underlying cashflow and distributions that flow up from the underlying portfolio investments. Therefore, lenders under these facilities are "looking down" for recourse against the underlying investments rather than "looking up" to the investor commitments.

For secondary funds, lenders will typically take security over the limited partnership interests that the secondary fund holds in different fund assets it owns or is about to acquire. For direct lending funds, the lenders will take security over the benefit of the underlying loan portfolio (not too dissimilar to the security that may be granted to a lender under a CLO warehousing facility). For PE funds, the lenders would typically take security over the shares in the relevant holding companies of the PE fund that acquired the underlying investments. Quite often the lenders providing these facilities to PE Funds may be structurally subordinated to other lenders that have provided finance that is secured directly against the underlying portfolio companies.

In some instances lenders that are lending to a special purpose vehicle owned by the fund will require a guarantee to be provided by the fund. However, lenders need to be careful and ensure that if this is the proposed structure, no borrowing limits of the fund are exceeded.

In principle there is no reason why these NAV or asset backed facilities cannot be provided to any type of closed ended fund that holds assets for a given period.

There are an increasing number of new lenders that are entering into this market as the returns are generally higher than the returns available for subscription line and asset backed facilities. These new entrants into the market are not only the existing banks that provide funds finance facilities, but also credit and special situations funds that are searching for sufficient yields. A perfect example of where this product can prove highly desirable to a PE fund, is when there is some sort of urgent liquidity required at the fund level but there are no imminent distributions from portfolio investments foreseeable. A fund may need to make distributions to its investors to for example ensure such investors can make new investments into the fund managers' new fund. Therefore, having access to this liquidity can ensure fund managers continue to fund raise successfully.

On the direct lending side, it is important that leverage is applied to the fund by way of NAV or asset backed facilities to ensure that the fund is producing the rates of return promised to its investors. The challenge then becomes making sure these facilities are provided at sufficiently low margins to ensure that they can enhance the IRR of the direct lending fund.

Finally, there has been a substantial increase in "hybrid" facilities. These are facilities provided by lenders, where the lenders' recourse is to both the underlying assets and also the undrawn commitments of the fund. Different lenders design different types of hybrid products for their fund clients, but in almost all cases, there will be covenants that ensure that there is sufficient headroom of undrawn investor commitments, as well as ensuring that the net asset value of the fund remains above a minimum level. These facilities are particularly useful to funds that are looking for long term financing facilities that are available from the funds first close, until the end of the life of the fund when all of its commitments have been fully drawn down and the fund is fully invested.

We expect further significant growth in these types of facilities as the demand from funds increases and the lenders' search for yield becomes more challenging. ■

Further Reading:
- Trends in funds finance: co-investment, general partner and manager support facilities [2015] 7 JIBFL 440.
- Differences between subscription line and corporate facilities [2014] 1 JIBFL 58.
- Another seat at the table? Ways to adapt loan documentation to accommodate credit fund lenders [2015] 3 JIBFL 152.

Biog box
Leon Stephenson is a partner at Reed Smith and is Head of its European Funds Finance Practice. Leon specialises in funds finance transactions including capital call and subscription line facilities, NAV and Asset-Backed facilities, Hybrid facilities, GP support, manager support and co-investment facilities to private equity, direct lending and other types of funds.
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