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NAV and hybrid fund finance facilities

Leon Stephenson
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Overview

Historically, there were many years of rapid growth in subscription line or capital call facilities from lenders.

Capital call or subscription line facilities are debt facilities provided by lenders to funds where the recourse of the lender is to the uncalled investor commitments of the fund. The bank will generally provide a short-term facility to the fund to effectively bridge the commitments of the investors of the fund. Therefore, the bank's credit risk is on the investors of the fund and their obligations to provide monies to the fund when called upon to do so. This requires detailed credit analysis by the bank on the creditworthiness of the investors they are effectively lending against, usually carried out by assigning each investor a rating together with an advance rate against each investor. Many banks have been and are still entering this market.

However, the most significant growth in recent years in the fund finance market has been the net asset value (NAV) or asset-backed facilities. These are fund finance facilities provided by lenders to the fund, or to a special purpose vehicle (SPV) 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. The credit analysis that is required to be undertaken by the banks for these types of facilities is very different from that needed for subscription line facilities. For pure asset-backed and NAV facilities, the creditworthiness of the investors of the fund is much less important than the value of the underlying assets.

Nevertheless, these asset-backed facilities are still provided to the same fund managers who are also looking for subscription line facilities, and a number of banks that have traditionally only provided subscription line facilities have now widened the products they currently provide and are making available NAV facilities. Providing asset-backed facilities can allow lenders to continue to provide liquidity lines to their clients, even when the investment period of a fund has terminated and there are no uncalled capital commitments remaining. Very often, the pricing a lender can obtain for these NAV facilities is higher than for subscription line facilities, and a slowdown in fundraising during 2023 has stimulated high demand for NAV facilities. We now also see many non-bank lenders providing these facilities to sponsors.

Types of fund utilising NAV and asset-backed fund finance facilities

Introduction

There is a wide range of different funds focusing on different types of investments that may benefit from utilising such facilities. Secondary funds that acquire and hold limited

partnership and other equity interests in funds can borrow from banks secured against the limited partnership interests that the secondary fund holds or is about to acquire.

Direct lending funds, and credit funds that acquire and hold loans and other debt instruments, may enter into such facilities and provide security over the benefit of the underlying loan portfolio.

Private equity firms that have a more illiquid portfolio of assets (perhaps only 10–20 investments in the portfolio) may also borrow from lenders, secured against the shares of the various holding companies that hold each investment and/or bank accounts in which distributions of income or sale proceeds of underlying assets are transferred. This provides liquidity to such funds outside the ring fence of the investment itself that may have been provided as collateral for senior debt provided at the portfolio investment level.

There has also been a recent growth in NAV facilities being provided to real estate and infrastructure-focused funds. This usually involves teams at banks, who have traditionally been focused on financing against individual assets, now looking to provide financing against a portfolio of assets. In the real estate finance context, financing would take the form of a loan secured by a mortgage over the property and, in the infrastructure context, this would often be a project finance structure with security against the project cashflows and direct agreements in place at the asset level. If lenders already have a good understanding of the underlying assets, whether infrastructure or real estate, and can get their heads around lending higher up in the fund or corporate structure of the borrower, then there are real opportunities for these teams to provide portfolio-wide NAV financing against multiple real estate or infrastructure assets.

Although very different types of funds may utilise these facilities and for different purposes, the key characteristics of these facilities are that they are generally provided at the fund level or directly below the fund level, and the primary source of repayment will be from the underlying assets. The other difference between these NAV fund financing facilities and mezzanine or other holdco facilities is that the NAV fund finance facilities usually have recourse against the cashflows of all or a multitude of the underlying assets, whereas mezzanine facilities are often only provided to one underlying investment.

The type of security a lender will take will depend on the structure of the relevant fund and the nature of its underlying investments. However, unless a hybrid structure, it is unlikely that the principal security given will be over uncalled capital commitments. It is much more likely to be security that allows the lender to control the underlying assets or distributions paid on such assets.

Secondary funds

For secondary funds, it is important for a bank to ensure that it has direct rights to any distributions that are payable to the secondary fund from the limited partnership interest it holds. It may be commercially and legally difficult to get direct security over these limited partnership interests, so often security is just taken by the lender over the shares of an SPV entity that will be set up to hold all of the limited partnership interests the lender is lending against.

The typical structure would involve the secondary fund first establishing an SPV vehicle. If the limited partnership interests have not yet been acquired by the secondary fund, then this SPV vehicle would directly acquire the various limited partnership interests. If the limited partnership interests are already held directly by the secondary fund, then the secondary

fund will attempt to transfer all of the limited partnership interests to be financed into a new SPV vehicle. The lender will then lend directly to the SPV and take security over the shares of the SPV, and over any bank accounts of the SPV into which distributions from the underlying limited partnership interests are paid. On enforcement, the lender will take control of the SPV and enforce over the SPV's bank accounts so that it will be the sole beneficiary of any distributions that are paid up to the SPV.

Direct lending and credit funds

For direct lending funds and other credit funds, the lenders will usually 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 collateralised loan obligation (CLO) warehousing facility). The lenders will analyse the underlying loan portfolio of the fund to establish what level of loan-to-value (LTV) ratio it can provide. There will be eligibility criteria that will need to be met for a particular loan to be included in the asset pool that the lender is lending against. The eligibility criteria may require that the underlying loan is senior-secured, not subject to any default, and is provided to an underlying borrower that has a minimum EBITDA located in a particular jurisdiction or geography.

Furthermore, there may be certain borrower concentration limits applied to the collateral assets, so that no group of loans with the same borrower (or affiliate of borrowers) can exceed a certain percentage of the whole portfolio of collateral assets. Often the lender will also want to limit the proportion of underlying borrowers of the loans that are in a particular industry. Some lenders structure these facilities as a loan facility; others as a note purchase facility not too dissimilar from a securitisation structure.

A lender may structure such facilities as a note purchase facility in order to facilitate its ability to sell down a portion of the debt to other noteholders who would like to participate. Certain lenders may not insist on security directly over the loans themselves, but rely on NAV covenants alone and blocked accounts into which the proceeds of such loans are paid. For these facilities, it is important to have strong undertakings on group entities to pay all proceeds into these accounts over which the lender has control. Other lenders will want direct asset security over the loans, which often is provided by way of a general floating charge or single security agreement over all of the assets.

Another important factor for LTV ratio is the diversification of the underlying loan portfolio. Typically, the more diversified the loan portfolio, the more favourable the LTV terms the borrower can expect to apply. Some lenders are able to provide facilities to a direct lending fund or one of its SPVs, secured against a single loan asset. In this instance, from an economic risk perspective, the credit fund is essentially sub-participating the relevant loan to the bank that is providing the fund finance. However, the LTV ratios in these instances are likely to be very low, and may be around the 5–15% range. A deeper due diligence analysis is normally required by the bank when lending against single loans, and the security package may need to be extensive to allow the bank to benefit directly from the security on the underlying loan if there is a default. This may require local security to be granted if there is security for the underlying loan, subject to different governing laws.

Most recently, there has been a significant number of special situation and dislocation credit funds set up that seek to capitalise on the low valuation of loan assets in the market and to provide capital to borrowers who have a more urgent need for it. We predict there will be an important increase in the demand for NAV facilities to these sorts of credit funds as such funds typically have a heavy leveraged strategy.

Private equity funds

The NAV facility to a private equity fund saw rapid growth during the course of 2020 and 2021. The need for this type of facility was accentuated by the spread of the COVID-19 virus, the various "lockdowns" in different jurisdictions and the consequential increased need of private equity funds for additional liquidity at portfolio level. Furthermore, with less fundraising during 2023 and private equity funds holding on to assets longer due to investor cautiousness, NAV facilities have proven to be an extremely useful source of liquidity. There have been a number of larger sponsors who have decided to take out such a facility for their more vintage funds that are heavily invested and have a large portfolio NAV. In these structures, the lenders often take security over the shares in the one or more holding companies of the private equity fund that directly or indirectly own the portfolio investments.

Usually, the lenders providing these facilities to private equity funds may be structurally subordinated to other lenders that have provided finance that is secured directly against the underlying portfolio companies. These facilities generally carry higher risk, as the portfolio of assets is not as diversified as the facilities provided to direct lending and credit funds with diversified and numerous assets. These types of facilities may also be known as "holdco" loans and essentially amount to mezzanine financing, albeit with recourse to cashflows from multiple rather than single investments. Providing financing to holdcos secured against the shares of the holdcos rather than the underlying assets of the portfolio companies means that the lender has less control over the assets of the portfolio, normally resulting in higher pricing of such loans. There is also a trend in the market for these facilities to be provided to an SPV finco of the fund. The basic structure would be a loan to the finco from the lenders and then the finco would on-lend the proceeds into the holding vehicles that sit underneath the fund. The advantage of this structure is that it may avoid issues such as change of control triggers in shareholders' agreements and leveraged finance facility agreements, or avoid the need to seek a regulatory consent in relation to regulated assets. The finco "on-lending" structure allows the lender and the fund to "cherry-pick" which assets the lenders have control over and therefore to only take "controlling" share pledges over holding vehicles where change of control issues do not exist. In some limited instances, we have seen an SPV finco borrowing but not on-lending to a holding vehicle in the equity structure, in order for such a holding vehicle to issue preference shares to the finco in return for the proceeds of the NAV facility. The lender to the finco would then take security over the preferred shares. This is a clever way of providing the private equity portfolio with capital without any debt actually being incurred by any entity within the private equity group. However, a number of lenders in the market have pushed back on this structure and it is the exception rather than the norm.

With the typical private equity fund existing for a period of 10 years, many funds are set to see most of their life dominated by this market uncertainty. This presents a number of challenges, in particular, finding the right time to sell investments – and get the right price – which has become a real concern for fund managers; and if funds are not selling investments, they need cash available to support them. The fund finance market has evolved over this period to meet this demand.

When a private equity fund makes an investment, it commonly pays for the investment through a combination of borrowing from a lender and deploying its own capital. The pattern then repeats with the fund making its next investment and arranging separate borrowing for that second investment. As the fund continues to make investments, a misalignment of interest begins to occur, as the fund manager is managing the fund's portfolio of investments, but the fund's lenders are each solely focused on the individual investments that they are lending against.

The NAV facility to private equity funds as a financing structure aligns itself with the portfolio of investments the fund has, rather than looking at the investments individually, and in doing so, is able to recognise the NAV of the fund as a whole and allow the fund manager the flexibility to deploy this borrowing where it deems best for the fund. This, amongst other things, neatly resolves any liquidity issues for investments where the lender(s) to that investment may not want to provide more debt, or the cost of doing so is prohibitively expensive.

Currently, use of NAV facilities is in addition to, rather than instead of, the traditional investment-by-investment borrowing funds utilised, and is typically put in place once the fund has acquired most of its investments.

As always, careful consideration needs to be given to the extent to which any private equity fund borrows money, and whether it will ultimately benefit its investors. NAV facilities are deliberately structured so as to ensure benefits to the fund and its investors, through:

- the borrowing always being measured against the NAV of the fund (i.e. the value of the investments after the borrowing incurred on each individual investment has been accounted for);
- lenders only being prepared to lend at a conservative level (e.g. most NAV facilities are set at around 10–20% of the NAV of the fund);
- borrowing under a NAV facility being caught by any borrowing restrictions imposed on the fund by its investors, so the fund manager cannot arrange borrowing above pre-agreed levels; and
- fund managers often discussing plans to enter into a NAV facility with investors to gauge their appetite for this kind of borrowing.

The last thing a fund manager wants to do is be forced to sell an investment when it would prefer not to. Investors do not want this either. This, combined with the continued market uncertainty, has generated another trend in the private equity market at the same time as NAV facilities: fund secondaries (where a number of investments in a fund's portfolio are grouped together and sold into another fund – a so-called "continuation fund"). Because a NAV facility is set up to look at a portfolio of investments, it is extremely well suited to finance secondaries transactions, and support value creation long term.

The key feature of NAV facilities to private equity funds is that they are flexible: flexible to recognise value where it exists in a fund's portfolio; flexible to allow the fund manager discretion to decide how best to deploy the borrowing; and flexible to enable the fund manager to sell investments at the correct time. Given such flexibility, there have now been many NAV facility transactions whose purpose is to accelerate distributions to investors of the sponsor.

Structure and terms

Unlike subscription line and capital call facilities that typically take the form of revolving credit facilities, NAV finance facilities usually take the form of term loan facilities. If the facility is being provided to allow for a certain liquidity event or to bridge a particular exit of one of the investments, then the tenor may be quite short (e.g. six to 18 months). However, if the fund is entering into the facility shortly following fund-close as part of a leverage strategy, the facility will have a longer tenor, perhaps five years or more.

The key covenant in such facilities is the LTV covenant. This is the financial ratio of the amount of the financial indebtedness of the borrower against the NAV of the portfolio that will be securing the facility. For credit funds and secondary funds, LTV ratios range from 10% to as high as 60%, depending on the diversification of the underlying assets. Such

facilities may contain an "LTV grid" that allows the borrower to benefit from higher LTV ratios, and therefore a higher facility amount provided by the lender in the event that more assets are placed into the portfolio. Likewise, the interest rate payable on the facility may decrease, the more diversified the portfolio.

The eligibility criteria of the portfolio (i.e. the list of conditions that need to apply to the underlying assets for them to be eligible for the purposes of lending against them) will often be listed in a schedule to the facility agreement. The lender may also require a veto right on the acquisition of the assets, although there is usually strong push-back from the fund on this. The fund will argue that it alone should decide which assets can be purchased and, as long as such assets comply with the eligibility criteria, the fund should be allowed to select which assets will serve as collateral assets. The existence of veto rights will be much more prevalent in NAV facilities to private equity funds where the number and concentration of investments is likely to be much higher than a credit fund. If there were a clear and precise set of eligibility criteria for a financing to a credit fund, the fund would not expect the lender to then have a separate veto right on whether each new asset can be treated as eligible collateral.

These term loans often have cash-sweep and amortisation features, so that all or a portion of any distributions that are paid up to the borrower from the underlying investments go first to repay outstanding utilisations under the facility. The amount of such cash-sweep may vary depending on the LTV that exists at the point in time that such distribution is paid. There may be a specific obligation to sweep all available cash, or the lender may just rely on the LTV covenant compliance, so that a prepayment would only be needed if failure to do so would cause an LTV covenant breach.

The security package is often negotiated quite hard between the lender and the borrower. It is likely that the underlying assets are located in or subject to different governing laws and jurisdictions. The lender will certainly need an overriding security document (often governed by English or New York/Delaware law) that seeks to take security over all of the underlying assets. The lender may then require local security to be granted and local perfection of security to be undertaken. There will be a cost-benefit analysis at the start of the transaction to determine whether a full security package can be provided, and also a discussion about whether there are any contractual or legal restrictions on providing such security.

As discussed previously, for NAV facilities to credit funds, it is quite usual for just one overriding single security document taking security over all of the loan portfolio (notwithstanding different governing laws of the underlying loan agreements) to be entered into. However, if there is a high proportion of the NAV allocated to loans in a particular jurisdiction, it is then worth the borrower and lender discussing whether separate asset security should be taken in that local jurisdiction as well, to ensure valid and locally perfected security.

For facilities provided to secondary funds against their limited partnership interests, taking security over the underlying limited partnership interests usually requires the general partner of the underlying fund to provide its consent. As discussed previously in this chapter, the lender and the borrower may need to devise structures to avoid seeking this consent, or to make it more likely that consent will be given by general partners of the underlying funds. Generally, when seeking consent from general partners for security to be given for NAV facilities to secondary funds, four consents are required:

- consent to transfer the limited partnership interests from the secondary fund (if held directly by the secondary fund) into a wholly owned SPV located under the secondary fund;

- consent to the secondary fund granting security to the lender over the shares/interest it has in the SPV;
- consent to the lender enforcing its security over the shares/interest it holds; and
- consent to the lender selling the shares it owns post-enforcement to a third party.

In our experience, some of these consents, if given by the general partners of the underlying funds, are likely to be conditional on items such as no adverse tax or regulatory consequences to the underlying fund, and also restrictions on the lender's ability to transfer its interest in the underlying fund to one of its competitors.

For facilities provided to direct lending and credit funds, the terms of the underlying loan agreements will need to be diligenced very carefully. The provisions relating to transfers and assignments of the loans (typically entitled "Changes to the Lenders") must be reviewed to see whether the underlying borrower has any consent or consultation rights prior to the fund transferring its loan to the lender on enforcement. In relation to facilities provided to private equity funds, if security has been granted over shares in a holding company that owns the underlying assets, it is important that no change-of-control provisions are triggered in senior facilities agreements or under material contracts entered into by the portfolio companies.

Even if the lender and borrower take the view that there are too many loan documents to be diligenced prior to entering into the facility, we would still strongly recommend that copies of all of the loan documents be made available to the lender prior to the putting in place of the NAV facility. If there is ever a default on the NAV facility in the future, the lender needs to be sure that it has the underlying documents, so that it knows where and how to enforce without breaching terms of the underlying loan agreements.

Furthermore, if the private equity fund does not own 100% of all of the assets but has joint venture arrangements with other third-party equity investors, then it is very important for the lenders to due diligence any joint venture or shareholders' agreements that have been entered into. There may be restrictions on the ability of the joint venture shareholders (i.e. the private equity fund or one of its holding companies) to transfer its shareholding in the joint venture entity. Sometimes this can be worked around by inserting a wholly owned topco above the joint venture shareholder, and giving security to the lender over the shares in the newly formed topco. In any event, the provisions of these shareholders' agreements need to be looked at very carefully.

There may also be confidentiality restrictions in the shareholders' agreements that prevent disclosure by the private equity fund to the lenders without the other joint venture parties' consent. If the private equity fund also has asset-level senior loan financing, then a NAV lender would also want to understand whether these senior loans contain change-of-control provisions that would require the underlying borrower to repay the senior facility in full. This is important because it may not be in the best interests of the NAV lender to enforce its share security and trigger a mandatory prepayment of any senior loan if the underlying portfolio company does not have available cash to repay it.

The lender will want to make sure there is tight security over the bank accounts into which the distributions from the underlying assets flow. More often than not, the lender will require a new account to be opened with it, and require the borrower to direct that all distributions be paid into this account. The lender needs to understand how distributions flow from the underlying operating companies up to the holding vehicles, and to ensure that cash is moved into an account secured in favour of the lender as soon as possible.

In some instances, lenders that are lending to an SPV owned by the fund will require a guarantee or other shareholder support to be provided by the fund to further enhance the

security for the asset-backed facility. However, lenders need to be careful and ensure that if this is the proposed structure, no borrowing limits of the fund are exceeded. Furthermore, if the fund has a subscription line facility, the terms of the subscription line finance documents will need to be reviewed to ensure there are no restrictions on other financial indebtedness and that there are no negative pledges included.

If there are borrowing and guaranteeing limits at the fund level, it may be that an equity commitment letter (ECL) is provided to the NAV lender instead of a guarantee. An ECL is a letter that is addressed by the fund to the SPV borrower, pursuant to which the fund agrees that it will capitalise or provide funds to the SPV borrower as and when needed by the SPV borrower. Depending on the jurisdiction of the entities concerned and the way in which the ECL is drafted, this may not amount to a guarantee and so avoid breaching any guarantee limitations in the fund's limited partnership agreement.

There has been a recent trend for some NAV lenders requiring second-ranking security/recourse to the undrawn commitments of investors. If the fund has, or is intending to also have, a subscription line lender provide financing to the fund, this can give rise to detailed discussions on intercreditor arrangements, with the subscription line provider and asset-backed lender negotiating to get the strongest position possible with respect to the fund's assets.

These intercreditor discussions focus on important issues, such as: cross-defaults between the NAV facility and the subscription line facility; restrictions on payments going to and from the fund when there is a default under the NAV facility or the subscription line facility; and standstill periods during which one lender must wait until the other lender has decided whether to enforce. A more detailed discussion about so-called "hybrid" facilities is provided towards the end of this chapter.

Information

There should be rigorous information requirements in the facility agreement so that the lender is made aware at any time of potential issues connected with the value of the underlying assets. The borrower may provide regular certificates confirming that financial covenants such as LTV ratios, leverage ratios and portfolio interest coverage ratios are met. There may be scheduled quarterly portfolio telephone calls between the borrower and the lender to discuss the performance of the collateral assets. Some lenders go further and require copies of management presentations, any rating agency reports delivered, and financial information provided to the borrower in relation to the underlying assets.

Valuations

These facilities typically have detailed provisions in relation to valuation of the underlying assets. An independent valuation agent may need to be appointed by the borrower (in agreement with the lender). The lender will usually want to make sure that the valuation agent owes a contractual duty to the lender (on a reliance basis) and this may be documented through a specific engagement letter with the valuation agent that is addressed to both the borrower and the lender, or through a separate reliance letter. The valuation agent will be required to provide periodic valuations (e.g. every quarter or, in some circumstances, every month) to the lender. There will also be times when the latest valuation will need to be used to determine a particular course of action under the facility agreement. For example, an LTV ratio may need to be determined prior to any acquisition or sale of an asset. Only if the LTV exceeds a given threshold will the relevant acquisition or sale of the collateral asset be permitted.

In addition, there will usually be provisions in the facility agreement that allow the lender to seek an alternative valuation if the lender does not agree with the valuation provided by the valuation agent or the fund. The amount of deviation needed between the lender's calculation of the value of the portfolio and that of the valuation agent may be negotiated between the borrower and the lender before the lender has the right to instruct a separate valuation. Sometimes the valuation methodology is set out in a schedule to the facility agreement so that the borrower and the lender agree the principles and terms on which the underlying assets are valued. There will be further discussions between the lender and the borrower about who should bear the cost of the valuation, and in what circumstances.

Some lenders do not wish for an independent valuation agent to be appointed, but instead prefer to value the assets themselves internally. If a lender has the experience and resources to do this, then it is clearly to the benefit of the lender. However, borrowers may have concerns about this and wish to provide for some objectivity on the lender's calculation. This may be resisted strongly by the lender, and lead to negotiations between the borrower and the lender to find a compromise position. The fund's starting point in relation to valuations will usually be that the lender should rely on the valuations that the fund provides to its investors. This may be fine for the lender, provided that it has a right to have the investments separately valued if it believes that the fund's valuation is inaccurate. As there has been a significant slowdown in exits of private equity funds' investments, it has become more difficult for lenders to rely on the valuations provided by funds. This has meant that there is now a lot of focus from lenders on what the correct valuations of assets should be and who should be valuing them for the purpose of the NAV facility.

Hedge funds and funds holding highly liquid assets

NAV facilities to hedge funds are structured very differently from those asset-backed funds facilities provided to closed-ended funds such as secondary, direct lending and private equity funds. The hedge fund often segregates the investments it wishes to use as collateral into separate securities accounts with a bank. The securities intermediary that holds the investments becomes the legal owner of the investments by signing the relevant subscription agreements of the hedge fund. However, the hedge fund remains the beneficial owner of the investments.

The hedge fund then provides security over its entitlement or rights to the hedge fund investments, while the owner of the assets remains the same. This security can take the form of an account charge (if the account is in the UK) or a security agreement and control agreement (if the account is located in the US). This structure can avoid any restrictions on transfer that exist in respect of the underlying assets. If there is then a default under the facility agreement and the lender wants to be repaid, it can direct the account bank (as the case may be, in accordance with the control agreement or acknowledgment of the account charge signed by the account bank) to redeem the hedge fund interests, and for the proceeds once received to be paid over to the lender.

Some lenders are providing NAV facilities to debt funds that hold various debt instruments as portfolio assets. We have worked with lenders on structures that involve no direct security over the underlying assets but simply security over the bank account, into which income or disposal proceeds from the underlying debt instruments are paid. The borrower then has an obligation to post cash margin, depending on the level of the NAV of the existing portfolio, to make sure there is a minimum level of cash available in the account over which the lender has security. This NAV facility structure is particularly helpful to funds that are regularly trading their debt instruments.

Securitisation regime

The European Securitisation Regulation, Regulation 2017/2402/EU (ESR), came into force from 1 January 2019. The ESR sets out certain obligations with respect to transactions that amount to a securitisation. There is a risk that some NAV facilities that are provided by lenders against loan assets could amount to securitisation transactions and therefore have the ESR applied to them. An analysis should be undertaken by the lender's and borrower's lawyers when commencing a NAV loan-on-loan transaction to establish at the outset whether the ESR applies.

The ESR is only intended to apply to entities established in the European Union, so borrowers established in Luxembourg and Ireland (two of the most popular jurisdictions for credit funds) could fall within the regulation. Part of the analysis will be to determine whether the repayments to the NAV lender are reliant only on the underlying cashflows from the loan assets, or whether it has recourse to other cashflows/assets (such as undrawn commitments of a fund).

If it is determined that the transaction does amount to a securitisation, then the NAV lender needs to ensure that there is a 5% interest (risk retention) retained by an entity referred to as an "original lender", "originator" or "sponsor" for the life of the securitisation. Furthermore, there are certain disclosure requirements that the NAV borrower will need to fulfil to the NAV lender and the regulator, including the submission of a transaction summary prior to closing of the transaction and ongoing reporting using the applicable reporting templates. There are severe penalties on both the fund borrower and the NAV lender if they do not comply with the requirements of the ESR.

Key developments

There is an increasing number of new lenders entering this market, as the returns are generally higher than the returns available for subscription line and asset-backed facilities. These new entrants to the market are not only the existing banks that provide fund finance facilities, but also credit and special situations funds and insurance companies that are searching for sufficient yields.

A perfect example of where this product can prove highly desirable to a private equity 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. The lenders of these facilities (which are often established as funds themselves) may provide interesting financing structures that allow them to provide capital by obtaining preferred priority distribution rights in the waterfall set out in the limited partnership agreement of funds. This allows financing to be made available other than by way of debt at the fund level. Obtaining capital by way of preferred stock means that the finance provider effectively sits as preferred limited partner in the fund.

There has been some recent growth in the provision of these preferred share facilities and, as discussed previously in this chapter, facilities to a finco that takes a preferred share interest in the PE fund portfolio. They are most helpful at the end of the life of the fund, where borrowing limits in the partnership agreements prohibit additional debt at the fund level, and such facilities may be a tax-efficient way of getting additional capital to the end-of-life fund.

There have been a number of direct lending funds and other credit funds who themselves are focusing on providing NAV facilities to private equity funds rather than the traditional unitranche product. This is a further indication that the market for these facilities is likely

to grow significantly over the coming year. These facilities may be provided against the fund's assets or to the manager or co-investment vehicle controlled by the employers/ partners secured against the co-invest stake in the fund.

Therefore, having access to this liquidity can ensure that fund managers continue to fundraise successfully. Alternatively, a follow-on expense or investment may need to be made by the fund. If its investor commitments are fully drawn, the fund may have an urgent and pressing need for short-term liquidity until distributions come up from the investment portfolio.

Traditionally, NAV facilities were put in place during the later stages of the life funds, as a sort of "after care" liquidity line. This is due to the fact that these facilities generally lend themselves more to funds that have been fully or nearly fully invested and have assets to lend against. However, we are seeing some funds looking to put in place NAV and asset-backed facilities at the start of the life of the fund, so that such facilities can be utilised as and when investments are brought into the portfolio. This trend is consistent with the general trend in the fund finance market for funds to be much more aware of the uses and benefits of fund finance facilities, and the desire to have the relevant financing structures in place from inception as part of the funds strategy.

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 internal rate of return (IRR) of the direct lending fund. The quality of the underlying loan assets and the security provided against such underlying loans is clearly an important factor in a financial institution, determining what sort of pricing is offered for a NAV or asset-backed facility. Diversification is also very important, and so competitive pricing appears to be more available to larger senior-secured direct lending and credit funds that have a large portfolio of loan assets.

There has also been some syndication of these NAV and asset-backed facilities. Pension funds and other non-bank investors, who would typically invest in a fund as a limited partner, are also considering providing capital by way of fixed income by participating in these facilities. Typically, a large investment bank would arrange the transaction, then go out to these non-bank lenders to sell down their participation in the loan. Investment banks are often keen on a distribution strategy that allows them to reduce their exposure, but at the same time continue to hold a majority portion of the loan and run the facility agency and security agency function. This allows the investment bank to continue to develop the relationship with the underlying fund while not being fully exposed to the facility. It may be that the investment bank arranging the NAV facility needs to rate the debt in order to facilitate distribution to these non-bank lenders. This can lead to a change in the structure of the NAV facility itself, so that it takes the form of a note.

There are other types of users of these facilities that seem to be active in the market, including large limited partner investors such as sovereign wealth funds, family offices and funds of funds. These investors have a diversified pool of assets they hold (usually limited partnership interests in other funds) that can be used as collateral to secure financings provided by lenders. This provides such borrowers with liquidity if they need it, without having to liquidate any of their underlying investments. Private wealth arms of investment banks, in particular, are looking to grow this business as it allows them to develop close relationships with key principals that are their current or potential clients.

The increase in interest rates SOFR, SONIA and EURIBOR has resulted in non-bank lenders becoming increasingly competitive, and the market is now seeing banks and non-banks sometimes competing for the same mandate on a NAV transaction.

Hybrid facilities

There is still the use of "hybrid" facilities on certain transactions. These are facilities provided by lenders that look down to the value of the underlying assets, but in almost all cases, there will be covenants that ensure there is sufficient headroom of undrawn investor commitments. These facilities are particularly useful to funds that are looking for long-term financing facilities that are available from the fund's 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. A lot of banks have found it challenging to make such facilities available. This is mainly because different parts of banks will have expertise with respect to analysis of investor commitments and the value of the underlying assets, respectively. However, some banks have been very successful in having their CLO teams and fund finance/financial institutions teams collaborate closely together to allow this offering to be put forward to their fund clients.

A hybrid facility provided by one lender might be very different to that provided by another. Some banks refer to a hybrid facility when actually it is just a capital call or subscription line facility with a NAV covenant inserted and a looser financial covenant ratio of undrawn investor commitments to financial indebtedness. These facility agreements will be drafted as classic subscription line facilities but will have a NAV ratio that needs to be satisfied once the ratio of undrawn commitments to financial indebtedness reaches a certain level.

Other institutions have provided hybrid facilities when there is some sort of issue obtaining clean security over all of the relevant undrawn commitments of investors into the fund. For example, there are situations when a group of certain investors, for tax or other reasons, will invest in a fund through a separate feeder fund vehicle. In some instances, the manager of the fund has not set up this feeder fund vehicle, and so the fund is not able to provide security over the rights of the feeder fund to draw down from the ultimate investors. To mitigate this imperfect security structure, lenders may, in addition to taking security over the rights of the fund to draw down from the feeder fund, take security over any shares in holding companies of the fund that own the assets. The lender may also take security over any intercompany loans or other receivables owed by the holding companies to the fund. This ensures that the lender can have the first right over any distributions or cashflows coming up from the underlying assets if there is a default by the fund.

We have seen the growth of hybrid facilities that are put in place when the fund is heavily invested but there are still some undrawn investor commitments remaining. The bank will provide financing against the underlying assets of the fund by way of term debt, but the fund may also need a working capital facility to finance fund expenses and follow-on investment.

One of the structures we have put together involves a tranche A facility that is a revolving credit facility of a modest amount to finance the fund expenses, and a tranche B facility that is a term loan facility of longer duration. If the fund already has an existing subscription provider who provides a facility of a relatively small amount (due to a limited number of undrawn investor commitments remaining), then it may make sense to "take out" this subscription facility and replace it with the tranche A facility made available by a lender under the hybrid facility. This means that the fund only needs to deal with one fund finance provider, which may have cost and execution benefits to the fund. Many funds have the ability to recall capital distributed to the investors after the investment period. Some lenders are able to lend against this recallable capital and to treat it in the same way as undrawn commitments. In end-of-life hybrids, it is quite common for a lender to include this recallable capital in its borrowing base or LTV covenants.

There are lenders in the market who have the ability to execute both a subscription line facility and a separate asset-backed facility at the start of the life of the fund, but to only make available the commitments of the subscription line facility, so that no non-utilisation fee is payable on the asset-backed line. After a certain amount of time, the borrower can then give notice to the lender to "switch" the commitments from the subscription line facility to the asset-backed facility. This is a clever way of ensuring the fund has cradle to grave financing, without incurring additional fees for this.

Certain lenders are able to lend against a blended financial covenant that consists of a ratio of the total debt of the borrowers as against the aggregate value of: (i) the undrawn investor commitments; (ii) the NAV of the fund; and (iii) the total amount of cash held in accounts secured in favour of the lender. This provides a neat solution to a fund, which is able to utilise the facility at the start of the life of the fund when the investor commitments are large, but then continue to utilise it as investments are made and the NAV increases.

The year ahead

The range of these types of facilities will continue to grow as different funds with different strategies begin to realise the benefits of fund finance facilities that do not look just to the undrawn commitments of the funds. As exits are delayed and funds need to accelerate distributions to investors, NAV facilities are continuing to grow quickly. A lack of fund-raising is also leading to sponsors resorting to NAV facility lines for liquidity. ILPA, the Institutional Limited Partners Association, has warned that investors may not be aware of the use of NAV facilities in certain of the funds they have invested in. However, the vast majority of fund managers now disclose clearly in their fund documentations the power for such managers to take out such facilities and, in many circumstances, it is the investors themselves who are requesting the NAV facility line in order to assist with acceleration of distributions to them. The universe of NAV facilities will continue to expand and 2024 should be an exciting year for their growth.

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Leon is co-head of the Reed Smith fund finance team, based in London. Leon and the team work with banks, other financial institutional lenders, managers, general partners and limited partners of funds on specialist fund financing transactions with private equity, secondaries, real estate, direct lending and infrastructure funds.

Leon has particular specialist knowledge of NAV/asset-backed and hybrid facilities, secondary funds facilities, capital call facilities, co-investment and GP/manager support facilities and other types of liquidity facilities provided to funds.

Leon is recognised as a Leading Individual in Fund Finance by *The Legal 500 UK* 2023 and the team was awarded Band 1 in Fund Finance by *The Legal 500 UK* 2023. Leon was recognised as "Partner of the Year for Banking" at the Client Choice Awards 2017. Leon represents a large proportion of lenders that provide fund financing as well as a number of private equity and other funds on complex fund finance transactions.

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Global Legal Insights – Fund Finance provides in-depth analysis of laws and regulations across 21 jurisdictions, covering fund formation and finance, key market developments and the year ahead.

This year's edition also has 27 expert analysis chapters covering subscription, NAV and hybrid facilities, diligence, derivatives, U.S. lender remedies, comparison of European, U.S. and Asian markets, umbrella facilities, side letters, assessing lender risk, securitisation, rated subscription lines, ESG, single asset back-levering transactions, rated note structures and insurance investments, financing secondary fund acquisitions, preferred equity, fund manager M&A, leverage at the fund level in Europe, and collateralised fund obligations.

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