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Fund Finance

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Considerations in the use of Aggregator Vehicles 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 "sub-line" or "capital call" facilities – have become standard features of newly formed funds with significant unfunded capital commitments from investors, in which loans are secured by the fund's (and its general partner's) rights with respect to these capital commitments. Historically, Subscription Facilities were 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 to investors and the receipt of the related capital contributions by the fund. Increasingly, however, private equity funds are using Subscription Facilities for their medium- and longer-term financing needs, such as financing multiple (smaller) investments and providing letters of credit and alternative currency borrowings to portfolio companies, such that capital calls on investors may be less frequent but larger. Borrowing capacity under Subscription Facilities is subject to a customary "borrowing base" equal to an agreed advance rate against the unfunded capital commitments of all or, in many cases, specified "included" investors, with advance rates and inclusionary criteria typically dependent on the creditworthiness of each applicable investor.

Many private equity funds are unable or find it impractical to use a Subscription Facility as a source of financing, either because the fund's constituent documents do not permit or materially limit such facilities (including with respect to desired tenor and quantum) or because the fund is closer to full investment and therefore has only limited unfunded commitments to borrow against. These funds have generally sought instead to obtain leverage through "asset-backed" or net asset value facilities – "NAV Facilities" – to meet their ongoing financing needs.

NAV Facilities are financings backed by the fund's investment portfolio. Unlike Subscription Facilities, which "look up" to the capital commitments of investors for the "borrowing base" and collateral, NAV Facilities "look down" to the underlying portfolio investments for credit support. For a "secondaries" private equity fund, these assets will typically include limited partnership and similar equity interests in other private equity funds. In a typical NAV Facility for a secondaries fund, the fund establishes one or more special purpose vehicles ("SPVs") wholly owned by the fund. The SPV, often created for the sole purpose of obtaining the financing and holding the underlying portfolio investments included in the borrowing base, is the borrower under the NAV Facility (the "NAV Facility Borrower"). In other structures, the NAV Facility Borrower is created solely to own the equity interests in a second SPV ("Holdco"), which, in turn, directly holds the underlying

portfolio investments included in the borrowing base, with the NAV Facility Borrower providing an "all assets" pledge to the lender, including a pledge of the equity interests in Holdco, and Holdco providing a limited pledge of its deposit and securities accounts.

Private equity sponsors increasingly create and utilise 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. The primary benefit of this structure is that it permits a private equity sponsor to provide exposure to the entire investment pool to multiple affiliated funds without the administrative burden of dividing the pool into numerous sub-pools for each fund. 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). A financing arrangement of this type introduces a number of complexities to structuring NAV Facilities. In this chapter, we examine several issues to consider when structuring a NAV Facility in which the credit support is based – in whole or in part – on the fund's proportionate interest in portfolio investments held by one or more Aggregator Vehicles.

Structure and borrowing base

As noted, Aggregator Vehicles are created by sponsors to serve as pooled investment vehicles to allow two or more funds (and/or other investors) to invest in a single investment or pool of investments.[1] Where an Aggregator Vehicle is structured as a limited partnership, it will have two or more limited partners and a general partner that manages the Aggregator Vehicle and makes investment decisions on its behalf.[2] Limited partners in an Aggregator Vehicle are most typically affiliated fund entities formed and managed by the sponsor, although, not infrequently, third-party investors (usually "friends and family" of the sponsor) are also permitted to invest in the Aggregator Vehicle. Investments made by the Aggregator Vehicle are consummated by the limited partners calling and contributing capital from their third-party investors to the Aggregator Vehicle, which the Aggregator Vehicle, in turn, uses to make investments in the underlying portfolio investments.

Borrowing capacity under NAV Facilities is subject to a borrowing base calculated by reference to 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. If, at any time, the ratio of (i) the principal amount of loans outstanding under a NAV Facility (often together with accrued and unpaid interest) to (ii) the borrowing base (the "LTV Ratio") exceeds a specified maximum threshold, the borrower will be required to prepay loans (or take other actions) in order to bring the NAV Facility back into compliance with this maximum level. Where the underlying portfolio investments in a NAV Facility are owned by an Aggregator Vehicle into which the SPV borrower invests – as opposed to direct ownership of the portfolio investments by the borrower or a wholly owned Holdco – it is imperative that borrowing base credit is given solely to the borrower's proportionate share of the Aggregator Vehicle's holdings. Put otherwise, the borrowing base value of these investments must be limited to the portion of the net asset value of underlying portfolio investments held by the Aggregator Vehicle attributable to the economic interest of the borrower in the Aggregator Vehicle, as the borrower is entitled to receive only its portion of proceeds of and distributions from the Aggregator Vehicle and, upon a foreclosure, able to sell such portion of the Aggregator Vehicle.

Equity Interest Collateral and collateral accounts

The collateral package under NAV Facilities typically includes the following: (a) a pledge of the equity interests (the "Equity Interest Collateral") in Holdco held by the NAV Facility Borrower (or, in situations where the NAV Facility Borrower directly holds the underlying portfolio investments, a pledge of the equity interest in the NAV Facility Borrower by its direct parent entity); and (b) a pledge of the deposit and securities accounts into which distributions on and proceeds of underlying portfolio investments are paid. If the NAV Facility Borrower is a limited partnership, lenders may also require that its general partner similarly pledge the general partnership interests in the NAV Facility Borrower (the "GP Interest").

The pledge of Holdco or NAV Facility Borrower equity and, where applicable, the GP Interest, provides lenders with the right to foreclose upon (or exercise other secured creditor remedies with respect to) the Equity Interest Collateral following a default under the NAV Facility. This, in turn, provides lenders with the ability to realise upon the underlying portfolio interests, either directly (via a foreclosure on the Equity Interest Collateral and orderly disposition of the portfolio interests) or indirectly (through a sale of the Equity Interest Collateral to a third party on a portfolio basis). To perfect the security interest in the collateral, Uniform Commercial Code ("UCC") financing statements are filed against all loan parties, and any such deposit or securities accounts are subject to control agreements in favour of the lender.

Equity pledge

Where portfolio investments are owned by Aggregator Vehicles, the Equity Interest Collateral is limited to the NAV Facility Borrower's (less than 100%) equity interest in the Aggregator Vehicle. Following an event of default, lenders (or, in a syndicated facility, the collateral agent) will have the right to exercise remedies with respect to the pledged Aggregator Vehicle equity pursuant to a customary UCC public or private sale process. As the NAV Facility Borrower does not own all of the Aggregator Vehicle's equity, any such sale will necessarily be of a partial interest in the Aggregator Vehicle. A consequence of this is that the lender (or other purchaser) will, following such foreclosure, be subject to the existing terms and conditions of the Aggregator Vehicle's constituent documents, under which it is unlikely to have any meaningful control over the management of the Aggregator Vehicle and/or disposition of the underlying investments. To ensure a smooth foreclosure process, it is critical that the Aggregator Vehicle and, where applicable, its general partner or other managing entity pre-consent to both the pledge of the Equity Interest Collateral by the NAV Facility Borrower as well as a UCC sale by the lender (or collateral agent) following an event of default. As any such enforcement will result in a transfer of the Aggregator Vehicle's equity interests, the pre-consent should also include an agreement by the Aggregator Vehicle (or the managing entity) to admit the lender or other transferee as an investor in the Aggregator Vehicle.

Given that an Equity Interest Collateral package consisting of Aggregator Vehicle interests is limited to non-controlling equity interests representing the NAV Facility Borrower's proportionate share of the underlying portfolio investments, lenders may, in such circumstances, seek to enhance their credit support by requiring the NAV Facility Borrower to also pledge uncalled capital commitments from its investors. These pledged commitments may come from true third parties (where the borrower or its direct parent pledgor is an "external-facing" fund) or, more typically, internal (but separately creditworthy) parent funds.[3] Where the pledge is of commitments from affiliated entities, the contribution

obligations of the parent may be supported by a "bad boy" guarantee from the sponsor or other creditworthy affiliate of the NAV Facility Borrower (the "Parent Guarantee") that is triggered by a failure of the parent fund to satisfy required capital calls to the NAV Facility Borrower.[4]

Account pledge

Where portfolio investments are owned directly by the NAV Facility Borrower (or indirectly through its wholly owned subsidiary, Holdco), the deposit and security accounts into which proceeds of and distributions from portfolio investments are paid will typically be pledged to the lenders and subject to account control agreements. As proceeds and distributions received by Aggregator Vehicles are, effectively, held on account for both the NAV Facility Borrower as well as its other equity holders, lenders are most typically unable to obtain a pledge of these accounts. To ensure ready access to these funds, however, lenders often require that the Aggregator Vehicle promptly (within an agreed short period of time) distribute the NAV Facility Borrower's proportionate share of these funds to an account of the NAV Facility Borrower (or other loan party entity) that is pledged to the lenders. Lenders also typically require that the Aggregator Vehicle accounts in which the co-mingled distributions and proceeds are held are not pledged to any other third party, so as not to prime the lenders' interests in these funds.

To the extent the Aggregator Vehicles are not party to the NAV Facility credit agreement, lenders will require the Aggregator Vehicles (and their managing entities) to enter into a side letter or similar agreement formally documenting the pre-consents to pledge, foreclosure and admission and the distribution requirements. Any failure by the Aggregator Vehicle to comply with the terms of the side letter, including to distribute funds within the required period, results in a "material investment event" under which either the Aggregator Vehicle is excluded from the borrowing base or an event of default occurs under the NAV Facility, as described in more detail below.

Covenants

As is typical in financings, NAV Facility Borrowers and any related obligors are required to comply with various affirmative and negative covenants, the breach of which results in an event of default under the NAV Facility and provides lenders with the right to exercise secured creditor remedies. In addition to customary financing covenants, in order to ensure the integrity of the structure described herein (especially the absence of a direct lien on the portfolio investments underlying the borrowing base), NAV Facilities restrict the borrower from incurring debt and liens with respect to the portfolio investments and selling or otherwise disposing of portfolio investments, in each case subject to extremely limited exceptions. Where the portfolio investments are held by Aggregator Vehicles, there is often tension between the limitations sought by the lenders on the activities in which the Aggregator Vehicles may engage (e.g., the near prohibition on other debt, liens and portfolio investment sales) and the sponsor's desire to maintain maximum flexibility with respect to the operation of the Aggregator Vehicles.[5]

To address this tension and afford sponsors reasonable flexibility with respect to the Aggregator Vehicles, lenders may agree to permit Aggregator Vehicles to incur third-party debt (and associated liens) in certain situations. Lenders, in turn, seek to ensure appropriate protection by either imposing individual Aggregator Vehicle and aggregate caps on the amount of such debt, or excluding the portfolio investments of Aggregator Vehicles that incur debt from the borrowing base entirely. An emerging and more tailored compromise,

which serves to ameliorate both parties' concerns, is to permit Aggregator Vehicles to incur unlimited debt in the form of deferred purchase price with respect to portfolio investments acquired by the Aggregator Vehicle, but correspondingly reduce the borrowing base by an amount equal to the NAV Facility Borrower's proportionate share of the deferral. Especially where lenders are unwilling to provide much flexibility on the activities of the Aggregator Vehicles, NAV Facility Borrowers may seek the right to unilaterally remove Aggregator Vehicles from the borrowing base in order to engage in activities otherwise prohibited by the negative covenants in the NAV Facility.

NAV Facilities generally permit the disposal of the NAV Facility Borrower's equity interests in Aggregator Vehicles subject to several conditions, including that the disposition is at fair market value and the disposition does not result in a breach of the maximum LTV Ratio. NAV Facilities may similarly permit the NAV Facility Borrower to add Aggregator Vehicles to the borrowing base, subject to the consent of the administrative agent and/or lenders and satisfaction of other conditions, including the Aggregator Vehicle joining any side letter or agreement with respect to the consents and obligations described above. These conditions and limitations on the NAV Facility Borrower's ability to add or remove Aggregator Vehicles from the borrowing base are important from the lenders' perspective to ensure that NAV Facility Borrowers are not able to restructure the underlying credit support to the detriment of the lenders (e.g., by removing more creditworthy portfolio investments and leaving the lenders with an overall weaker collateral package).

Borrowing base exclusion *vs* event of default

A common point of negotiation in NAV Facilities is whether a breach by an Aggregator Vehicle of its obligations under any side letter or agreement should result in an event of default with respect to the entire NAV Facility (as is the case for a breach by the NAV Facility Borrower or any other loan party) or, more simply, that the particular Aggregator Vehicle – and its portfolio investments – be excluded from the borrowing base. NAV Facility Borrowers are of the strong view that a breach by a single Aggregator Vehicle should not result in an event of default, as portfolio investments held by other Aggregator Vehicles (and/or the NAV Facility Borrower and Holdco) may provide sufficient borrowing base coverage and collateral support for the NAV Facility. This argument is strongest in NAV Facilities containing a maximum LTV Ratio "financial" covenant, in which a breach by and exclusion of one or more Aggregator Vehicles may lead to a breach of this covenant and a default under the NAV Facility. Lenders still argue, however, that awaiting multiple defaults is too risky and, instead, seek to impose materiality thresholds for Aggregator Vehicles, such that a breach by material Aggregator Vehicles immediately results in an event of default.

Valuation disputes

NAV Facilities generally provide the lender (or, in a syndicated deal, the administrative agent) with broad discretion to seek an adjustment to sponsor-reported net asset valuations of the portfolio investments, so long as the lender (or administrative agent) reasonably determines that such valuation is incorrect, incomplete or unreliable. Such valuation adjustments are typically made by the lender (or, if applicable, the administrative agent) or an agreed independent third-party appraiser. Where the portfolio investments are held by Aggregator Vehicles, it is possible that the borrower's share of the sponsor-reported net asset value of the portfolio investments held by an Aggregator Vehicle exceeds the actual

fair market value of the borrower's interest in such Aggregator Vehicle (i.e., the amount the lender (or administrative agent) may realise upon a liquidation or sale of such Aggregator Vehicle). To address any such potential discrepancy, the lender (or administrative agent) may seek discretion to adjust the borrowing base value of assets held by an Aggregator Vehicle – either directly or through a third-party appraisal – to the extent the lender (or administrative agent) reasonably believes that there is such a difference in the valuations.

Conclusion

As private equity funds increasingly invest in underlying portfolio investments through Aggregator Vehicles and seek NAV Facilities based on the borrower's proportionate interest in the Aggregator Vehicles, it is critical that lenders understand the structural concerns to ensure that appropriate protections are included in such financings. We expect to see further developments in the use of Aggregator Vehicles in NAV Facilities, including and especially in those managed by third parties, and in the protections sought by lenders to address the growth and evolution of such financings.

* * *

Endnotes

1. For purposes of this chapter, we assume that a borrower, along with other entities that are not party to the financing, owns equity interests in several Aggregator Vehicles, and the borrower's proportionate share of the interests in the underlying portfolio investments held by such Aggregator Vehicles serves as the borrowing base and collateral support for the financing provided by lenders.
2. In certain limited partnerships, an investment advisor or manager may make investment decisions on behalf of the partnership.
3. This enhanced credit support package does not, however, convert the NAV Facility into a "hybrid" facility, as the borrowing base generally remains calculated solely by reference to the underlying portfolio investments (but not the pledged capital commitments).
4. A Parent Guarantee may also provide protection to lenders for other structural features, including (i) a breach by the borrower of its representation that there are no change of control provisions in the underlying portfolio investment documents with respect to a foreclosure or other transfer rights, or (ii) a breach by the managing entity of an Aggregator Vehicle of its obligation to, e.g., admit the lender or other assignee as a limited partner following an exercise of remedies following an event of default.
5. This tension is even more heightened where the NAV Facility Borrower is not affiliated with the Aggregator Vehicle and its sponsor, in which case the NAV Facility Borrower may have very limited control over the activities of the Aggregator Vehicle.

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