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The continuing evolution of private equity net asset value facilities

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Background

Loans provided to private equity funds come in two general forms: Subscription Facilities and NAV Facilities. Subscription Facilities, also referred to as "sub-line" or "capital call" credit facilities, have become standard features of newly formed funds with significant unfunded capital commitments. These loans are secured by the fund's and its general partner's rights with respect to the capital commitments from limited partners or other investors in the fund. Borrowing capacity under a Subscription Facility is determined by a "borrowing base" calculated as a percentage of the unfunded capital commitments of eligible investors in the fund. Traditionally used to finance the fund's short-term working capital needs, Subscription Facilities are increasingly utilised by private equity funds for medium- and longer-term financing needs, including funding for multiple investments and making loans directly to portfolio companies.

Many private equity funds are unable or find it impractical to use Subscription Facilities as a source of long-term financing, either because the fund's limited partnership agreement ("LPA") prohibits or materially limits these facilities or, in the case of a later-stage fund, the fund has already called a material portion of its unfunded commitments. These private equity funds often seek to satisfy their financing needs through a "net asset value" – or "NAV" – Facility. NAV Facilities are financings backed by the fund's investment portfolio. Unlike Subscription Facilities, which look "up" to the capital commitments of investors in the fund for the borrowing base and collateral and are in some sense an advance against future capital calls on investors, NAV Facilities look "down" to the underlying portfolio investments for credit support.

NAV Facilities have long been utilised by "secondaries" private equity funds to finance or refinance the purchase of limited partnership and similar equity interests in other private equity funds in the secondary market (a "Secondaries NAV Facility"). More recently, buyout and other "primary" private equity funds have adopted Secondaries NAV Facility technology to leverage the equity value of their portfolio operating companies. These "primary" or "portfolio company" net asset value facilities (a "Primary NAV Facility") incorporate key structural elements from Secondaries NAV Facilities but reference a borrowing base consisting of a pool of operating company – rather than private equity fund – investments. In this chapter, we discuss the rise of Primary NAV Facilities and examine several important considerations when structuring these facilities.[1]

What is a Primary NAV Facility?

In contrast to the traditional Secondaries NAV Facilities, which are typically backed by a diversified pool of tens or hundreds of relatively small private equity fund interests, even the largest Primary NAV Facilities reference a much smaller and more concentrated pool of equity or debt investments in portfolio companies. As a result, while there are many similarities, Primary NAV Facilities deviate from Secondaries NAV Facilities in a number of important ways, including with respect to structure, collateral support and valuation of assets.

Uses of Primary NAV Facilities

Primary NAV Facilities are used by private equity funds to support the financing needs of the fund's existing portfolio companies, finance new and tack-on acquisitions and, in certain circumstances, provide liquidity for the fund's investors. These facilities are especially important in periods of challenging market conditions during which other forms of financing for these activities may be impaired or no longer available. As an example, during the early months of the COVID-19 pandemic in the spring of 2020, many (especially highly leveraged) portfolio companies were unable to obtain additional funding from their existing lenders to meet their (increasing) liquidity needs. More recently, the rising interest rate environment and increased cost of acquisition financing has dampened mergers and acquisitions activity and, consequently, funds' ability to monetise unrealised gains on their private equity investments. In response, private equity funds have sought to leverage their operating company investments to obtain the additional required liquidity.

Structure

The fund typically establishes one or more special purpose vehicles ("SPVs") to hold the underlying portfolio investments subject to the Primary NAV Facility. These SPVs, often created for the specific purpose of effecting the financing, serve as the borrowers under the Primary NAV Facility. As direct subsidiaries of the fund, the borrowers are often located several levels above the underlying operating company,[2] the equity value of which the lenders rely upon for repayment. As such, the Primary NAV Facility lenders are structurally subordinated to both lenders providing financing directly to the portfolio company as well as providers of any "holdco" (including any preferred equity) or back-leverage financing at an entity between the borrower and the portfolio company.

Borrowing base

As in Secondaries NAV Facilities, borrowing capacity under Primary NAV Facilities is subject to a borrowing base calculated by reference to the fair market value or "net asset value" of eligible portfolio investments. To be eligible for inclusion in the borrowing base, each portfolio company will need to satisfy specific investment criteria, including the absence of material adverse investment events. There are notable differences in the material investment event criteria between Secondaries NAV Facilities and Primary NAV Facilities, reflecting the nature of the underlying borrowing base assets. While Secondaries NAV Facilities focus on adverse events relating to the private equity sponsor or issuer of the applicable limited partnership interest, Primary NAV Facility ineligibility is triggered by events relating to the operating companies themselves. Events such as the bankruptcy of an operating company, defaults by an operating company in respect of its material debt or adverse changes in leverage ratios or other applicable financial metrics of the operating company may result in the exclusion of such assets from the Primary NAV Facility borrowing base.[3] In addition, given the structural subordination of Primary NAV Facilities to debt or other obligations at holding vehicles below the borrower, many facilities either completely prohibit or deem ineligible any portfolio investment subject to such priming debt.

Valuation

The quantum of a Primary NAV Facility is typically determined based upon an initial "LTV Ratio" equal to (i) the principal amount of loans outstanding under the facility, often including accrued and unpaid interest, divided by (ii) the borrowing base. Initial LTV Ratios for Primary NAV Facilities are, in general, far lower than those applicable to Secondaries NAV Facilities primarily due to the more limited diversification, lesser liquidity of the underlying investments and, in certain cases, the expected realisation process.[4]

The fair market value of portfolio companies included in the borrowing base is initially determined based upon quarterly valuations provided by the borrower. To ensure the accuracy of these valuations, lenders seek that each quarterly valuation – or at least one annually – is conducted by a third-party valuation firm. This approach differs from Secondaries NAV Facilities, in which lenders are more willing to rely upon valuations of the secondaries investments as reported by the (third-party) sponsors. Lenders also typically require dispute rights in Primary NAV Facilities, enabling them to challenge and adjust borrower-provided valuations (whether or not conducted by a third party) where they believe such valuations to be inaccurate or not reflective of the current market value of the portfolio companies. In such cases, the lenders engage a third-party appraiser to provide an alternative valuation to be utilised for borrowing base purposes. The timing, number, cost allocation and consequences of these dispute rights are heavily negotiated in Primary NAV Facilities, and the resolution is often specific to the nature of the underlying portfolio.

Similar to Secondaries NAV Facilities, Primary NAV Facilities often (but not always) include margin call mechanics requiring the borrower to maintain an LTV Ratio within maximum leverage levels. To the extent that the LTV Ratio at any time exceeds the specified maximum threshold (whether on account of newly delivered borrower valuations, lender disputes or material investment events), the Primary NAV Facility borrower is obligated to take corrective actions to ensure compliance with an agreed maximum LTV threshold. These actions may include (i) a mandatory prepayment of loans, or (ii) a call on the fund (and its investors) for capital contributions to the borrower's collateral account, in each case in an amount necessary to reduce the LTV Ratio to an agreed "cure" level below the maximum threshold.

Collateral and credit support

Collateral

Secondaries NAV Facilities have traditionally been structured as non-recourse to the fund, with the collateral support limited to the portfolio investments. The collateral package is typically focused on a pledge by the borrower of the deposit and securities accounts into which cash and non-cash distributions and proceeds from sales of underlying portfolio companies are deposited. In Secondaries NAV Facilities, obtaining direct pledges of the portfolio investment interests is often challenging and impractical due to the various restrictions commonly included in the underlying LPAs of such portfolio investments, including on pledging or transferring limited partnership interest without the consent of the general partner of the portfolio investment. Given the large number of portfolio investments in a Secondaries NAV Facility, obtaining consents from each of the numerous general partners within a reasonable time period is logistically challenging. To address these issues, lenders typically rely on a "holdings" pledge structure, pursuant to which the borrower pledges the equity interests of an intermediate holding company that directly owns the portfolio investments. In a foreclosure scenario following default, this arrangement provides lenders with a "single point of enforcement" by exercising remedies with respect to the pledged equity interests in the holding company.

In contrast, the smaller number of borrowing base assets in a Primary NAV Facility reduces some of the challenges associated with obtaining required consents to pledges and post-foreclosure sales or transfers. Consequently, lenders are more likely to seek (more) direct pledges of the equity interests in the operating companies, which would provide the lenders, in a foreclosure scenario, greater flexibility to exercise remedies with respect to equity interests in individual operating companies. In practice, however, given the complex arrangements amongst the various parties to any portfolio company investment – the company, its management and other existing and new shareholders – borrowers often encounter similar constraints in obtaining all necessary consents in Primary NAV Facilities. Even where obtained, these consents may be granted by only certain of the required parties and restricted in scope to, e.g., the initial pledge of the portfolio company equity, but not a transfer in connection with an exercise of remedies, and may expressly subject any exercise of remedies to rights of first offer, rights of first refusal or tag-along rights.[5] In such cases, lenders may seek to obtain the same holdings equity pledge structure used in Secondaries NAV Facilities, but even this may present contractual issues for the borrower under both shareholder and other investment agreements as well as the underlying debt documentation of the portfolio company.[6] Where the parties agree that no direct or holdings equity pledge is feasible, the collateral package may be limited to a pledge of the borrower's collateral accounts together with all rights of the borrower to receive dividends and distributions on and sale proceeds of the underlying portfolio company investments.

Similar to Secondaries NAV Facilities, Primary NAV Facilities are generally non-recourse to the fund, other than for customary "bad boy" events. In certain circumstances, however, Primary NAV Facility lenders also benefit from additional credit support in the form of fund-level guarantees or, where guarantees cannot be provided by funds due to limitations in the fund's LPA or tax or other regulatory restrictions, equity commitment letters from the fund to the borrower to which the lenders are express third-party beneficiaries.[7] This fund-level credit support is most appropriate in Primary NAV Facilities with more highly concentrated investment portfolios, higher initial LTV levels, an absence of a margin call mechanism and a limited collateral package.[8]

<u>Financial covenants</u>

Where a Primary NAV Facility is either directly recourse to the fund or credit support is provided in the form of fund guarantees or equity commitment letters, lenders may require ongoing financial maintenance covenants to assess and assure the creditworthiness of the fund providing the support. These covenants may include (i) restrictions on indebtedness that the fund may incur (in addition to a Subscription Facilities and other pre-agreed debt), (ii) a minimum liquidity requirement – calculated as the ratio of available fund liquidity in the form of cash and uncalled capital commitments to the debt and other material obligations of the fund, or (iii) an asset coverage test that tests the ratio of the net asset value of the fund to its debt and other obligations.

<u>Enforcement considerations</u>

Primary NAV Facilities will include a pledge of the deposit and securities accounts into which proceeds of and distributions on the portfolio investments are deposited as collateral, which are subject to the exclusive control of the lender. In the event of a default and subsequent acceleration of the loan, the lender's primary remedy will be to direct the depository to apply any funds or other assets in the accounts toward repayment. Where a direct (or holdings) equity pledge of portfolio investments has been provided, the lender may exercise its rights to foreclose or sell the pledged equity interests through customary UCC public or private sales.

Where pledges of equity interests in the underlying portfolio investments or any holding company are not provided, the repayment of the facility following an event of default is dependent upon the timing of sales and other monetisation of the underlying portfolio by the sponsor. In such circumstances, lenders may seek to protect themselves against both extended delays in portfolio realisations and adverse (from the lenders' perspective) corporate actions with respect to the investments during such period. An evolving method to address these concerns is to include, at transaction closing, both negative consent rights and affirmative direction rights in the borrower's LPA or other applicable constituent documents, with the lenders designated as express third-party beneficiaries. The negative consent rights – providing the lenders with customary "minority investor" protections – may prohibit the borrower (sponsor and general partners) from taking specified actions, such as incurring priming debt or liens, entering into transactions with affiliates or selling the portfolio investments, without obtaining prior consent from the lenders. The affirmative direction rights may include the ability of the lenders to direct the borrower to initiate a sales process with respect to one or more underlying portfolio investments. To provide lenders with the ability to enforce these rights, the parties may expressly agree and acknowledge in the LPA that, with respect to a breach of any such provisions, monetary damages are inadequate, the lenders would suffer irreparable harm and, as such, "specific performance" is the appropriate remedy. The intended outcome of this approach is that, upon any such breach, courts would grant injunctive relief to the lenders mandating that the borrower, sponsor or general partner take the directed action (and refrain from taking any prohibited action), resulting in the realisation of proceeds and repayment of the Primary NAV Facility.[9]

Conclusion

As private equity funds continue to realise the benefits of using Primary NAV Facilities, we expect to see an expansion in the types of funds using such facilities and the purposes for which such facilities are used. Lenders are also likely to continue exploring various structuring options and protective measures to balance the contractual and structural complexities of portfolio company investments with the growth and evolution of such financings.

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Endnotes

1. In the alternative, primary private equity funds have sought to leverage investments in single portfolio companies via a "back-leverage" financing referencing solely the single investment. These financings have many similarities with Primary NAV Facilities, but also important differences. This chapter will also compare and contrast these two forms of financing.
2. In particular, funds often form tax blockers and investor aggregator vehicles below the borrower to directly hold the portfolio investments.
3. Single asset back-leverage financings include many features of "public" margin loans, including the occurrence of an exclusion event – and, consequently, a mandatory prepayment or event of default – upon a material decline (e.g., of 50% or more) in the asset's fair market valuation since closing.
4. The initial LTV in single asset back-leverage transactions tends to be higher than Primary NAV Facilities on account of the stronger collateral protections and enforcement rights and additional fund credit support discussed below.
5. In single asset back-leverage financings, lenders frequently require the borrower to obtain any and all required consents for a direct pledge and post-foreclosure transfer of the asset. This includes obtaining waivers of any rights of first offer, rights of first refusal or tag-along and other similar rights to which issuers of such equity interests or other shareholders may be entitled.

6. Lenders may seek a pledge of the economic interests (e.g., limited partnership interests) but not the general partner or similar control interests of the holding company as an alternative to avoid any control or other restrictions in the underlying investment agreements or debt agreements.
7. In contrast, single asset back-leverage financings nearly always benefit from fund-level guarantees or equity commitment letters to address the increased "gap" risk of lending against a single illiquid private equity (or debt) investment.
8. It is important to note that the structure of the collateral package and associated credit enhancements in Primary NAV Facilities varies from deal to deal based on the applicable facts and circumstances and continues to evolve with the maturation of the market.
9. Alternatively, these rights may be included in a side letter with the sponsor, borrower and applicable general partners for each portfolio investment, pursuant to which the parties include the applicable "specific performance" agreement and acknowledgments.

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