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Valuation adjustment rights in NAV Facilities

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Background

In recent years, financings provided to private equity funds have taken two primary forms: "Subscription Facilities" and "NAV Facilities". Subscription Facilities – often referred to as "capital call" or "sub-line" facilities – have become standard features of newly formed funds, with the loans thereunder secured by the fund's (and its general partner's) rights with respect to the unfunded capital commitments of its investors.

The availability under Subscription Facilities is subject to a customary "borrowing base", equal to an agreed advance rate against the unfunded commitments of all or, in many cases, only certain "included" investors (with advance rates and inclusionary criteria often dependent on the creditworthiness of each such investor). Subscription Facilities historically financed the fund's short-term working capital needs, primarily bridging the time between the issuance of capital calls to investors and the actual capital contribution by such investors to the fund. More recently, certain funds have used Subscription Facilities for their medium-term financing needs as well; e.g., financing multiple smaller investments so that capital calls on investors are made only on a periodic basis and in a material amount.

For many funds, however, Subscription Facilities are not viable financing options, either because the fund's organisational documents prohibit or materially limit such facilities (including with respect to desired tenor or quantum) or, in the case of an older vintage fund, because the fund has already called a significant portion of its commitments to consummate such investments, leaving it with only minimal unfunded commitments. Private equity funds in these situations have sought instead to obtain financing through "asset-backed" or net asset value facilities: "NAV Facilities".

NAV Facilities are financings backed by the fund's investment portfolio. For a "secondaries" fund, these assets will typically be limited partnership and other equity interests in private equity funds, consisting of both primary investments as well as those purchased in the secondary market. Availability under NAV Facilities is similarly subject to a borrowing base, in this case calculated by reference to the fair market value or "net asset value" of eligible 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. In the event that, at any time, the ratio of loans outstanding under a NAV Facility (together with, often, accrued and unpaid interest thereon and fees with respect thereto) to the borrowing base (the "LTV Ratio") exceeds a specified threshold, the borrower will be required to prepay loans (or, in certain cases, take other actions) in order to bring the NAV Facility back into compliance with such maximum LTV Ratio.

For purposes of calculating the NAV Facility borrowing base, the fair market value of the fund's investment portfolio is most typically based on the net asset value of the underlying investments as most recently reported by the applicable sponsor, typically on a quarterly basis. To ensure that these reported valuations – and, consequently, the borrowing base – are and remain accurate, NAV Facilities customarily include a mechanism for lenders to object to and adjust such reported valuations. While this adjustment right is always important for valuations of relatively illiquid assets, not readily measurable against publicly available benchmarks, it is critical during periods of financial market turbulence, during which such asset values may be subject to sudden and significant fluctuations putting heightened focus on the reliability of valuation reports delivered 90 days or more before their initial use in the borrowing base.

In this chapter, we examine the typical structure of NAV Facilities and focus on the triggers, timing and mechanics of valuation adjustments to the portfolio investments underlying the NAV Facilities.

Structure and collateral: NAV Facilities

Unlike Subscription Facilities, which look "up" to the capital commitments of investors in the borrower for collateral, NAV Facilities look "down" to the underlying portfolio investments for credit support. In a typical NAV Facility for a secondaries private equity fund, the fund establishes one or more special purpose vehicles ("SPVs"). The SPV serves as the borrower under the NAV Facility (the "NAV Facility Borrower") and is created for the sole purpose of obtaining the financing and holding the underlying portfolio investments included in the borrowing base.[1]

The fund, which, depending on the terms of the NAV Facility, may also guarantee the NAV Facility obligations, pledges 100% of the equity interests of the NAV Facility Borrower to the lenders to secure the loans under the NAV Facility (the "Equity Interest Collateral"). 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 NAV Facility Borrower, in turn, secures its obligations under the NAV Facility with a pledge of the deposit and securities accounts into which distributions on and proceeds of the underlying portfolio investments are paid.[2]

The pledge of 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, thereby obtaining the ability to realise on the interests, either directly (a foreclosure on the Equity Interest Collateral and orderly disposition of such fund interests) or indirectly (a sale of the Equity Interest Collateral to a third party on a portfolio basis). To perfect the collateral, UCC financing statements are filed against all entities, and any such deposit or securities accounts are made subject to control agreements in favour of the lender.

Where the portfolio investments underlying the NAV Facility are hedge fund interests rather than private equity funds, the lender will typically require the NAV Facility Borrower to credit the underlying hedge fund investments to a securities account held at a securities intermediary. The securities intermediary thereby becomes the legal owner of such investments (with beneficial ownership remaining with the borrower), creating a "securities entitlement" in favour of the borrower. The borrower then pledges this securities entitlement, as well as the securities account (but <u>not</u> the underlying hedge fund investments themselves), to the lender to secure the obligations under the NAV Facility. To ensure perfection of the lender's security interest in the securities entitlement, the securities account is subject to a control agreement in favour of the lender, and a UCC financing statement is often filed against the borrower. The pledge of the securities entitlement, and protections under the control agreement, provide the lender with the right, upon an event of default, to instruct the securities intermediary to redeem the underlying hedge fund interests pursuant to the terms of the underlying fund documentation, with the redemption proceeds deposited into the account subject to the control of the lender.

Adjustments to portfolio investment valuations

Adjustment trigger

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, so long as the lender (or administrative agent) reasonably determines that such valuation is incorrect, incomplete or unreliable. Certain NAV Facilities limit this discretion by requiring, as a condition to any such adjustment, that (a) such adjustment be requested within a specified period following delivery of the sponsor-reported valuation, (b) certain material "investment events" (e.g., resignation of the sponsor or audit qualification) have occurred with respect to the applicable portfolio investment, and/or (c) the reported valuation deviates materially (often formulated as exceeding a "*de minimis*" threshold) from the lender's (or administrative agent's) then current fair market valuation and may limit the frequency of such adjustment requests.[3]

Valuation adjustment

Once triggered, most NAV Facilities provide the lender (or administrative agent) with broad rights to adjust the fair market value of any portfolio investment for purposes of the NAV Facility borrowing base in its reasonable discretion. Certain NAV Facilities, as above, limit this right by, amongst others, (a) requiring that any such adjustment be made by an agreed independent third-party appraiser, (b) applying any such third-party appraised valuation to the borrowing base solely to the extent that it deviates materially (often, again, formulated as exceeding a "*de minimis*" threshold) from the sponsor-reported valuation, and/or (c) permitting the borrower to dispute the lender (or, in limited cases, third-party appraiser) adjustment, with such dispute resolved, most typically, through a formal negotiation process and/or a further appraisal.

Valuation timing

As noted above, NAV Facility borrowing bases are initially determined by reference to the quarterly (or other periodically) reported valuations of the underlying investment portfolio. These periodic reports, most typically prepared "as of" the fiscal quarter end of the portfolio investment, are often not delivered to the lender – and, as a result, the borrowing base is not updated – until 45 to 90 (or more) days after the end of the applicable fiscal quarter. NAV Facility borrowing bases are, therefore, necessarily "historical" in nature. While lenders agree to rely on such latest available valuations in the ordinary course, their right to dispute and adjust such valuations is necessary to ensure that the borrowing base reflects the "real time" fair market value of the applicable portfolio investments. As such, it is imperative that the valuation triggers referred to above permit adjustments both where the reported valuations were "incorrect, incomplete or unreliable" *as of* the date prepared by the sponsor as well as *on any subsequent date* of determination following delivery of such historical report. This feature is of heightened importance during a period of significant financial instability and uncertainty, as was true for many portfolio investments in the spring of 2020 due to the systemic shocks resulting from the COVID-19 pandemic. As an example, the definition of "fair market value" may provide the lender or administrative agent the right to adjust the value of the portfolio investment intra-quarter to the extent the lender or administrative agent:

> reasonably determines that the sponsor-reported valuation is incorrect, incomplete, unreliable *or otherwise does not reflect then applicable value of the portfolio investment as of such time*.

Adjustment methodologies

Especially where a third-party appraisal is required (but even, as best practice, in the many NAV Facilities where the lender (or administrative agent) is granted broad discretion), lenders and borrowers should consider pre-agreeing the permitted methodologies for any valuation adjustment. Clearly documenting these methodologies will provide clarity to – and reduce uncertainty and disputes between – lenders and borrowers at the time a valuation adjustment is triggered and the borrowing base is to be adjusted. The most appropriate valuation methodologies for adjusting the borrowing bases in NAV Facilities include:

- *Comparable Transaction Method*: A determination based upon publicly disclosed valuation multiples from sales of private equity fund interests similar to the applicable portfolio investment (e.g., of the same issuer, sponsor, strategy, industry and/or maturity profile), as adjusted to reflect the differences between such comparable fund interests and the applicable portfolio investment.
- *Public Company Method*: A determination using valuation multiples of public companies similar to the portfolio investments (e.g., of the same industry and geography) and comparing to the borrowing base valuations of those portfolio investments.[4]
- *Discounted Cash Flow Method*: A determination based upon the present value of projected cash flows of the applicable portfolio investment over a discrete projection period *plus* a terminal value representing the prospective value of such portfolio investment at the final year of such projection period.[5] This methodology requires the sponsor to prepare and provide such financial projections (on a portfolio company basis), so any failure to so provide or any determination by the lender (or administrative agent) or appraiser that such projections are incorrect, incomplete or unreliable will preclude use of this metric.
- *Agreed Appraisal Methodology*: A determination based upon the average of the values calculated using the Comparable Transaction Method, the Public Company Method and the Discounted Cash Flow Method.
- *Liquidation/Cost Approach*: A determination based on the underlying assets and liabilities of the portfolio investment (again on a portfolio company basis), rather than on the expected earnings such investment would generate as a going concern.

Conclusion

With the sharp and sudden volatility brought on by the COVID-19 pandemic, lenders and administrative agents under NAV Facilities were forced to evaluate and consider utilising their right to adjust reported net asset values for portfolio investment to ensure adequate collateral coverage. Documents that did not clearly delineate the triggers, timing and mechanics of those valuation adjustments made the discussions with borrowers (and their sponsors) – already fraught with the challenging financial environment – more difficult than they might have been. With clearer language outlining these fundamental points in the NAV Facility documentation, much of the uncertainty and resulting disagreement that arose from the exercise of this adjustment right may well have been avoided.

Endnotes

1. In other structures, the NAV Facility Borrower is created to hold the equity interests of a second SPV ("Holdco") which, in turn, directly holds the underlying portfolio investments included in the borrowing base. In such structures, the NAV Facility Borrower will generally provide an "all assets" pledge to the lender, including a pledge of the equity interests of Holdco.
2. In a second variant of NAV Facilities, Holdco acts as borrower, with the top-level SPV providing a downstream guaranty of the borrower's obligations, secured by a pledge of the Equity Interest Collateral. While for purposes of this chapter there is no difference between the two structures, we have referred to the more typical approach throughout.
3. The inclusion of any of these limitations is necessarily dictated by the facts and circumstances of the particular NAV Facility, including the number, form, concentration and other characteristics of the underlying investment portfolio.
4. Given that portfolio investments underlying a NAV Facility most typically comprise multiple portfolio companies, this valuation may also involve a risk analysis taking into account the size, diversity of operations and products, financial strength, profitability and growth of each such portfolio company to better compare the "aggregate" metrics of the portfolio investment relative to such public companies in order to reach the appropriate valuation multiples.
5. To address the inherent uncertainty associated with such projections (especially since, as noted above, they are derived from multiple portfolio companies), parties may consider using the weighted average of numbers under different projected scenarios.

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