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Why Hybrid Credit Facilities Are Trending

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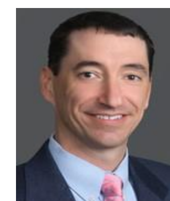
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Real estate, buyout, debt, secondary and other closed-end funds have often used subscription-backed credit facilities — also known as “capital call” or “capital commitment” facilities (each a “subscription facility”) — to access cash quickly, or as a bridge to capital calls or other permanent asset-level financing. Under these facilities, lenders look to a fund’s uncalled capital commitments and rights to call capital as security for the loans and for purposes of calculating borrowing base availability. However, as funds mature beyond their investment or commitment periods and most or all of the investor capital commitments have been funded, some funds turn to net asset value (NAV) credit facilities with availability based on the underlying portfolio investments of the fund (each a “NAV facility”) for financing needs on account of the diminished borrowing availability under a subscription facility. While both subscription facilities and NAV facilities continue to grow in number and use, funds are also exploring other financing options,[1] including hybrid facilities, which provide lenders with recourse to both the uncalled capital commitments (the typical collateral under subscription facilities) and the underlying investment assets (the traditional credit support under NAV facilities). These hybrid facilities offer both funds and lenders added flexibility in tailoring a financing package that works for all parties.

Subscription Credit Facilities

Traditionally, subscription facilities have helped funds (among other things) harmonize capital calls, both in terms of size and frequency. A fund’s governing documents typically require that its investors be provided at least 10 to 15 business days’ notice prior to funding a capital contribution. Subscription facilities, however, permit funds to receive borrowings on short notice (often within one business day), permitting them to move quickly on time-sensitive investments and avoid the lead time required in calling capital from investors. Subscription facilities also help funds avoid the need to make frequent capital calls in small amounts for working capital and similar expenses, potentially including management fee payments.

Borrowing Base and Collateral

Loan availability under a subscription facility is subject to a borrowing base, which is

customarily based on the value of the pledged uncalled capital commitments of investors satisfying certain eligibility requirements, with advance rates based on the credit quality of the relevant investors. Lenders will also often impose concentration limits that specify the aggregate amount of capital commitments from a single investor or category of investors that may be included in the borrowing base. Subscription facilities may also outline certain events (i.e., investor bankruptcy, failure to fund capital contributions, material adverse changes, withdrawal or excuse rights) that exclude investors from the borrowing base calculation. Lender diligence with respect to subscription facilities, therefore, will likely focus on the obligations and capacity of the individual investors to fund their respective capital commitments.

Subscription facilities will also have events of default tied to the investors (e.g., if a specified percentage of investors default on capital contributions).

The chief characteristic of a subscription facility is the collateral package, which consists of the unfunded commitments of the limited partners in the fund to make capital contributions, and not of the underlying portfolio investments themselves. Subscription facilities typically involve a pledge by the fund and its general partner of the following as collateral: (1) rights in and to unfunded capital commitments of the investors in the fund; (2) rights to make capital calls and enforce the obligations of the investors to contribute capital; and (3) the deposit accounts into which the investors are required to fund their capital contributions.

The pledge of rights in the unfunded capital commitments and rights to make capital calls enable lenders in a foreclosure situation to step in and make capital calls to the investors directly in the event the general partner fails to do so. Lenders can then use the incoming capital contributions to repay the debt under the facility. And with respect to the pledged deposit accounts, the fund covenants that all the capital contributions will be funded to the collateral account (which is typically held by the lender or otherwise subject to its control pursuant to an account control agreement).

NAV Credit Facilities

As funds mature beyond their investment or commitment periods, they have greatly diminished borrowing availability under traditional subscription facilities because investors have funded a majority of their capital commitments. NAV facilities help fill financing gaps by looking down to the net asset value of the underlying portfolio investments of the fund instead of looking up to the investor capital commitments in determining borrowing availability. These facilities are particularly desirable to funds that may have immediate liquidity requirements but no imminent distributions from portfolio investments.

Borrowing Base and Collateral

NAV facilities require a significantly different credit underwrite than subscription facilities, and lenders have historically taken a cautious approach. Loan availability under a NAV facility is traditionally limited to the "eligible NAV" of the "eligible investments," multiplied by an advance rate (which tends to be lower than other asset-based credit lines due to the lack of immediate liquidity of the portfolio investments). Eligible NAV is generally defined as the net asset value of the eligible investments, but this value may be adjusted for any concentration limitations. For example, there may be limits on how much value is attributable to any one portfolio investment or type of investment. Lenders will also set forth requirements regarding diversification of the underlying portfolio investments, minimum liquidity and investment strategies. Lender diligence will often focus on the historical performance of each portfolio

asset and any issues that may be related to the pledge and foreclosure on the collateral (discussed below). The eligible-NAV calculation can be tailored so that it (a) excludes the fair-market value attributable to investments subject to exclusion events, write-downs or concentration limits and (b) provides adjustments and recalculations based on financial reporting delivered to the lender. The eligible investments must satisfy enumerated underwriting criteria (evidence of ownership, no liens, etc.), and ongoing inclusion is subject to no specified adverse credit/exclusion events (bankruptcy or insolvency events with respect to the investments, failure by the fund or portfolio company to pay obligations, breaches of material contracts with respect to the investments, etc.).

One of the primary challenges of NAV facilities is the lender's comfort with respect to the NAV calculations of the underlying portfolio investments. A fund's organization documents, however, may contain robust valuation procedures that help mitigate these risks, and a lender may request the right to have a third-party valuation process if the valuations provided by the fund seem inaccurate and/or require interim reporting covenants related to adverse credit events.

One of the chief characteristics of NAV facilities is the inclusion of certain covenants related to the underlying portfolio investments. A common covenant is that the fund maintain a certain minimum net asset value. Lenders may also insist on mandatory prepayment provisions tied to investment performance, including following payments or other proceeds distributed from the underlying investments to the fund. Other covenants may include prohibitions on transfers of investments during default or if an overadvance results, negative pledges, separate financial covenants beyond eligible NAV, and providing copies of all investment-related documents and compliance certificates.

In certain instances, lenders will consider NAV facilities on an unsecured basis in the case of high-quality asset classes. However, there is still a strong preference toward a secured facility, even if complete security over the portfolio investments can be a difficult commercial request by lenders. While the collateral varies on a case-by-case basis, lenders will typically look to the following collateral to secure their loans: (a) distributions and liquidation proceeds from the fund's portfolio investments; (b) equity interests of holding companies through which the fund may hold such investments; and (c) equity interests relating to the investments themselves.

The method of obtaining a security interest in the cash distributions and liquidation proceeds is similar to subscription facilities — the fund pledges its rights in collection accounts into which such proceeds are deposited and covenants that all cash from its portfolio investments will be directed into these accounts. Typically, the fund is prohibited from making withdrawals unless the borrowing base is satisfied on a pro forma basis.

Equity pledges under NAV facilities look very similar to those in the leveraged loan market.A lender will be able to foreclose on the equity interest collateral and either take ownership control of the interests in the holding companies or sell such equity interests and apply the foreclosure sale proceeds to its debt. However, lenders must also be aware of any transfer restrictions or consent requirements that may compromise a valid equity pledge (particularly in the context of an equity interest in individual portfolio investments), and obtaining any necessary general partner consents to such pledge may require considerable lead time. Lenders should also be sensitive to various perfection issues, especially when non-U.S. law may apply.

Hybrid Facilities

Hybrid facilities represent a combination of the collateral characteristics supporting subscription

facilities and NAV facilities and provide both lenders and funds with maximum flexibility in terms of satisfying liquidity needs throughout the life cycle of a fund. Hybrid facilities, like NAV facilities, have been used by funds that are nearing maturity of (or have matured beyond) their investment or commitment periods and have significant investment portfolio equity value. For example, some facilities take an aftercare approach, extending the life of an existing subscription facility by (a) modifying the borrowing base to set the advance rate for included investors to 100 percent, eliminating concentration limits or advancing 100 percent against all investors (not just certain eligible investors) and (b) adding a covenant that the fund must maintain a minimum net asset value or comply with a debt coverage ratio. At the same time, a significant market trend has been for funds to turn to longer-term hybrid facilities in their early stages — beginning with the first closing of investors into a fund and extending until all of the investor capital commitments have been fully drawn down and the funds are fully invested.

Borrowing Base and Collateral

Hybrid facilities provide covenants that ensure there is a sufficient surplus of undrawn investor commitments (echoing subscription facilities), as well as ensuring the net asset value of the fund remains above a minimum level (a NAV facility concept). And borrowing availability unrelated to investor commitments, like under NAV facilities, is based on the "eligible NAV" of the "eligible investments."

Consequently, one difficulty for hybrid facility lenders is the need to underwrite both investors providing collateral support in the form of uncalled capital commitments and a pool of known and potentially unknown portfolio assets (as the loans under the facility may in fact be used to purchase these assets). This means more due diligence may be required, including, in respect of the NAV collateral support, determining if there may be transfer restrictions in respect of any portfolio company assets. Lenders are addressing these concerns by relying on substantial amounts of existing data on investors (in respect of uncalled commitment collateral) and pre-agreed investment eligibility criteria, mandating a tailored investment strategy or limiting expansion of the borrowing base beyond capital commitments until sufficient assets have been acquired by the fund in connection with NAV collateral support of the hybrid facility.

Collateral under hybrid facilities is determined on a case-by-case basis, but lenders can provide a tailor-made solution to any fund based on the availability and suitability of the typical collateral under both subscription facilities and NAV facilities. Lenders and funds typically cooperate in establishing a collateral package containing all or some form of the following as part of negotiating appropriate risk-adjusted pricing:

1. A pledge by the fund and/or its general partner of its rights in and to the unfunded capital commitments of the fund's investors, as well as rights to make capital calls and enforce the obligations of the investors to contribute capital;

2. A pledge by the fund of deposit accounts into which (a) the fund's investors are required to fund their contributions and/or (b) the distributions and liquidation proceeds from the fund's portfolio investments are deposited;

3. A pledge of equity interests in the holding companies through which the fund holds its underlying investments (particularly in circumstances where underlying portfolio investment documentation prohibits a lien being placed on the asset); and

4. A pledge of the equity interests relating to the investments themselves to the extent not otherwise prohibited as noted above.

The clear advantage of hybrid facilities is that lenders and funds alike can benefit from continuous funding under a single credit facility (and without the costs and inconvenience of multiple refinancings) by drawing upon the collateral packages that have historically and successfully supported both subscription facilities and NAV facilities.

Conclusion

As both subscription facilities and NAV facilities continue to mature, lenders and funds are pushing toward even more flexible financing solutions. This includes relying on the traditional subscription-backed collateral pool while also looking to the value of portfolio investments and structuring practical financing around both. This "one-stop shopping" benefits both lenders and funds by providing seamless liquidity without duplicating costs (both in terms of dollars and allocation of human resources) associated with refinancing or restructuring credit facilities instead of focusing energy on new opportunities.

While the atmospherics are ripe for continued growth in the subscription credit facility and NAV facility markets, it is clear that the future is trending in the direction of hybrid facilities; they combine the positive attributes of both products and can be tailored to service a particular fund's needs while maximizing the efficiency of lender and fund resources.

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[1] For information on fund-level debt facilities, see Benefits of Fund- Level Debt in Acquisition Finance.

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