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Article

Benefits of Fund-Level Debt in Acquisition Finance

Frederick C. Fisher IV, Christopher M. Chubb and Anastasia N. Kaup [1]

Introduction

Private equity and other investment funds have traditionally utilized portfolio company-level financing to finance acquisitions. These types of financings have focused on the portfolio company for both the debt underwriting and collateral package. The categories of these loans include asset-based loans ("ABL"), cash flow financings and real property mortgages, among other traditional lending products.

In our practice, we are seeing increased and opportunistic use of fund-level debt as an alternative or complement to secured financing at the portfolio company level. Fund-level debt can include net asset value ("NAV") credit facilities, subscription credit facilities and facilities combining characteristics of both NAV and subscription credit facilities ("hybrid facilities"). This article focuses on the relative benefits of using fund-level credit facilities to finance acquisitions of portfolio companies and/or assets thereof as compared to traditional acquisition finance.

Overview of NAV, Subscription and Hybrid Credit Facilities

NAV credit facilities are fund-level facilities that look to investments of the fund as the primary source of repayment. Although a lender may consider the strength of a fund in its underwriting process (e.g., compare the credit evaluation for providing financing to a successful $1 billion Fund VI versus an untested $50 million Fund I), the assets of the fund are typically the primary basis for a lender's underwriting and, in the case of a secured facility, the sole collateral. In a secured NAV facility, the lender can obtain liens on, among other things, (a) the equity interests in portfolio companies (or holding companies that ultimately own the portfolio companies), (b) distributions and liquidation proceeds from the portfolio companies or other investments, (c) in the case of debt funds, loans extended by the debt fund to its borrowers and (d) fund-level collection accounts. In other cases, borrowers with creditworthy assets are able to access credit based on borrowing base formulas but without granting liens on their assets.

Loan availability under an NAV credit facility is typically limited to a sum equal to (a) an agreed advance rate for a given category of assets (potentially subject to concentration limitations for each category) multiplied by (b) the NAV of certain agreed "Eligible Investments." NAV credit facilities are often subject to unique covenants and other terms in financing agreements (e.g., the requirement to maintain a minimum NAV or loan-to-value ratio, or rights with respect to asset replacement).

Whereas NAV credit facilities look downward to the underlying portfolio investments or other assets of the fund and their value as collateral and/or source for repayment, subscription credit facilities look upward to the unfunded capital commitments of the investors in the fund.

Subscription (also known as "capital call" or "capital commitment") credit facilities are now well known and utilized by private equity funds of all stripes. For years, such credit facilities have offered funds with numerous benefits including: (a) quick access to capital to bridge timing gaps in and "smooth out" the timing and receipt of capital calls from investors; (b) flexibility and nimbleness to rapidly access and deploy capital to take advantage of time-sensitive and opportunistic investments; (c) the means to borrow smaller amounts as needed and later call capital in larger amounts to reduce administrative burdens, maximize efficiency and bolster positive investor relations; (d) access to letters of credit and the ability to borrow in multiple currencies; (e) the ability to secure hedges, swaps and other derivatives transactions and (f) the means to bridge capital needs in connection with an asset-level financing.2

Hybrid credit facilities are a blend of NAV credit facilities and subscription credit facilities. Collateral for hybrid credit facilities is negotiated on a deal-by-deal basis, but it can provide lenders with recourse to the underlying investment assets that typically support an NAV credit facility, as well as the uncalled capital commitments of investors that typically support a subscription credit facility.[3] For hybrid credit facilities with a blended borrowing base, the proportion of the borrowing base made up of capital commitments versus NAV assets often changes over time; as capital commitments are called and those funds are deployed to make investments, the value of those investments builds up the borrowing base through the NAV asset prong. The blended borrowing base of the hybrid credit facility helps fulfill the financing needs of the fund at multiple stages in its life cycle and obviates the need to refinance as capital commitments are called.

Relative Benefits of Fund-Level Financing

Funds and lenders alike can enjoy benefits of fund-level financing, particularly to facilitate acquisitions, including:

- Decreased transaction costs due to having only one credit facility per fund (rather than multiple asset-level or portfolio company-level credit facilities), resulting in lower overall costs and low to no commitment or broken deal costs.
- Timing benefits due to not having to arrange, structure, coordinate and close multiple asset-level or portfolio company-level credit facilities contemporaneously with, or in order to, facilitate acquisitions.
- The ability to focus fund financial and personnel resources on acquisitions, without the need to run a simultaneous process to secure asset-level or portfolio company-level financing.
- Lower relative cost of debt and increased fund profitability, for reasons including (a) lenders' greater comfort in the fund's overall performance, as opposed to performance on an asset-level or portfolio company-level basis; (b) multiple income streams from multiple portfolio companies and assets to support repayment; (c) reputational risk of non-repayment; (d) decreased diligence costs and (e) better pricing on fund-level debt secured across a diversified pool of collateral, compared to stand-alone portfolio company-level debt.
- Multiple high-quality sources of repayment supporting a single-credit facility.
- Potentially increased deal flow for lenders who are positioned to provide financing for the fund through its investment cycle across various platforms.
- A single, top-level credit facility lends to high levels of cooperation between funds and their lenders, increasing transparency

into a fund's ultimate business goals and strategy and promoting partnerships.

- Lenders at the fund-level facility have a larger hold percentage of the fund's overall debt, with greater diversity of assets.
- Potential pricing breaks and beneficial borrowing base adjustments depending on the assets and concentrations thereof comprising the borrowing base.

Though beyond the scope of this article, we recognize that fund-level financing is not an ideal fit for every fund and situation. Potential challenges to be addressed include: (a) accounting and tax issues, e.g., how to allocate expenses at the asset or portfolio company level or otherwise as desired, and international tax

implications for funds that have diverse investments in multiple jurisdictions; (b) the risk of insolvency at the portfolio company level (although this risk is likely limited for well-diversified and properly structured funds)4 and (c) unique portfolio goals and challenges, e.g., whether advance rates and eligibility criteria offered by lenders will permit funds to achieve preferred leverage levels and returns.

We have addressed these issues in a variety of ways for a diverse array of funds and can suggest solutions based on individual fund characteristics and transaction dynamics. In many cases, these concerns can be mitigated or resolved by consulting experienced counsel early on in the fund formation and/or financing processes, or with other creative approaches (e.g., placing what would otherwise be mezzanine or junior-level debt in a senior position at the portfolio company level, which may be obtained at a much lower all-in rate than usual given its then senior position in the capital structure).

Depending on the type, goals and characteristics of the fund, it is possible to employ each of the aforementioned types of financing and to call on uncalled capital commitments, as well as underlying assets and investments, to fulfill varying capital and liquidity needs throughout the entire life cycle of a fund.

Market Trajectory and Conclusion

Given the relative benefits of fund-level credit facilities over traditional asset-level and portfolio company-level financing, as well as the overlap in collateral and sources of repayment, we see funds enjoying numerous benefits in obtaining fund-level facilities on a stand-alone basis, and/or as a jumping-off point to financing at multiple levels of the capital structure over the life of the fund. As a fund's capital demands, needs and goals evolve, fund-level facilities can provide unique advantages in terms of flexibility. As funds continue to mature and lenders shift their underwriting focus from individual investments to the strengths of funds themselves, we expect funds will utilize (and lenders will offer) additional fund-level facilities and financing options.

Endnotes

[1] Frederick C. Fisher is a partner in Mayer Brown's Chicago office and a member of the Banking & Finance practice. Christopher M. Chubb ("Chris") is a partner in Mayer Brown's Chicago office and a member of the Banking & Finance practice. Anastasia Kaup is a member of Mayer Brown's Banking & Finance practice and represents lenders, investors, funds, sponsors, portfolio companies, investment management firms, corporate borrowers and other parties in complex banking and financing transactions.

[2] For more information on subscription credit facilities, see https://www.mayerbrown.com/files/Publication/96e93616-8f87-407c-ac3c-c0d151b512b3/Presentation/PublicationAttachment/b3947934-6123-45f9-9c2f-ce336d07be75/Subscription-Credit.pdf.

[3] For more information on hybrid credit facilities, see *Hybrid Credit Facilities*.

[4] This risk can be further mitigated by negotiating a cross-default provision to only certain investments. Funds can also negotiate the ability to substitute non-performing assets for better-performing assets in the borrowing base.