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Article

Unencumbered Asset Pool Credit Facilities: An Alternative to Subscription, NAV and Hybrid Products

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Introduction

As the fund finance market continues to expand, we have seen a growing interest among real estate and other private equity funds (each, a "Fund") in unleashing the value of their assets to optimize investment returns. In order to meet the financing needs of these Funds, a growing number of banks and other credit institutions (each, a "Lender") are providing credit facility products supported by a pool of the Fund's unencumbered assets (each a "UAP Facility"). While loan availability under UAP Facilities is most often based on the value of a Fund's unencumbered real properties, recently we have seen unencumbered private equity assets serve as a basis of loan availability in an increasing number of transactions. In light of this trend, this article will discuss common features of UAP Facilities and compare UAP Facilities to subscription-backed credit facilities (also known as "capital call" or "capital commitment" facilities, and each a "Subscription Facility"), net asset value credit facilities (each a "NAV Facility") and hybrid credit facilities (each a "Hybrid Facility").

Common Features of Subscription Facilities, NAV Facilities and Hybrid Facilities

Loan availability under a Subscription Facility is subject to a borrowing base, which is typically tied to the value of the pledged uncalled capital commitments of investors satisfying certain eligibility requirements, multiplied by an advance rate. Subscription facilities commonly outline certain events (e.g., investor bankruptcy, failure to fund capital contributions, withdrawal or excuse rights) that exclude investors from the borrowing base calculation. In connection with a Subscription Facility, a Lender will customarily receive a pledge by the Fund and its general partner of their respective rights: (1) in and to unfunded capital commitments of the investors in the Fund; (2) to make capital calls and enforce the obligations of the investors to contribute capital; and (3) to the deposit accounts into which the investors are required to fund their capital contributions.

In contrast to Subscription Credit Facilities (which look "up" to capital commitments of investors to determine loan amount availability), NAV Facilities look "down" to the net asset value of the underlying portfolio investments of the Fund in determining borrowing availability. Consequently, NAV Facilities may be particularly useful for mature Funds in which the investors have already funded a majority of their capital commitments and the Fund has deployed this equity for purposes of assembling a portfolio of investments. Loan availability under a NAV Facility is customarily limited to the net asset value of the "Eligible Investments," multiplied by an advance rate, subject to certain adjustments and limitations. Similar to Subscription Facilities, Lenders under a NAV

Facility will typically impose certain eligibility criteria when determining which Eligible Investments to include in the borrowing base (including considerations based upon investment strategy, liquidity and diversification of investments), and ongoing inclusion is subject to the absence of specified adverse credit/exclusion events (e.g., liens, 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.). Although some Lenders will consider NAV Facilities on an unsecured basis in the case of high-quality asset classes, most Lenders will require a pledge of collateral that typically includes: (1) distributions and liquidation proceeds from the Fund's portfolio investments; (2) equity interests of holding companies through which the Fund holds such investments; and (3) in certain cases, equity interests relating to the investments themselves.[2]

Hybrid Facilities represent a combination of the collateral characteristics supporting Subscription Facilities and NAV Facilities an approach that allows Funds and Lenders maximum flexibility in structuring the credit facility. And although Hybrid Facilities were originally utilized by Funds nearing the end of their investment period (and following the accumulation of portfolio investments), they are now also being put in place at the time of the initial investor closing to provide seamless funding throughout a Fund's lifecycle. In determining loan availability under a Hybrid Facility, Lenders will typically look down to the net asset value of the underlying portfolio investments of the Fund, as they would in a NAV Facility; however, unlike a NAV Facility, Hybrid Facilities almost always include a borrowing base component tied to undrawn investor commitments and covenants that ensure there is a sufficient surplus of uncalled capital commitments. As a result, hybrid facility Lenders typically coordinate between product groups and share institutional knowledge in order to provide bespoke collateral support solutions in the form of uncalled capital commitments and a pool of known and potentially unknown portfolio assets (as proceeds from the Hybrid Facility may be used to purchase these assets). And because support for a Hybrid Facility is typically made up of some combination of the collateral pledged under Subscription Facilities and NAV Facilities, both Lenders and Funds are able to craft customized liquidity solutions based on the availability and suitability of such collateral.

Common Features of UAP Facilities

Unlike Subscription Facilities (which look to the uncalled capital commitments of certain investors) or NAV Facilities and Hybrid Facilities (which primarily look to the net asset value of Eligible Investments), UAP Facilities look to the value of a subset or pool of the Fund's and/or its affiliates unencumbered assets to determine loan availability and are unsecured. Lenders will only give borrowing base credit with respect to assets that are unencumbered, meaning the assets are free and clear of all secured indebtedness and liens and encumbrances, and the value of such assets is typically multiplied by an advance rate and subject to certain deal-specific adjustments. Similar to Subscription Credit Facilities, NAV Facilities and Hybrid Facilities, Lenders will often impose additional borrowing base eligibility requirements when determining loan availability under a UAP Facility. For example, in a UAP Facility where the unencumbered asset pool is real estate, common eligibility criteria include requirements that: (1) the owner of the property has no secured or unsecured indebtedness with respect to the property, subject to certain carve-outs; (2) the owner of the property has the rights to create liens on the property to secure its indebtedness and to sell, transfer or otherwise dispose of the property; (3) the property is fully developed and the improvements thereon are completed; (4) the property is wholly owned by the Fund or an affiliate thereof; (5) the property is located within a specific geographic area; and (6) the property is in compliance with laws and regulations and is free from major architectural deficiencies, title defects, environmental conditions or other adverse matters. Likewise, UAP Facilities typically provide mechanics for removal of unencumbered assets that may cease to satisfy the eligibility criteria and addition of unencumbered assets that meet the eligibility requirements after the closing of the facility.

The ability to add and remove assets from the availability pool provides the Fund with tremendous flexibility relating to its financing options for such assets. In many cases, a Fund may utilize a UAP Facility during the process of acquiring a portfolio of investments due to the efficiency of adding assets to the line. Thereafter, a Fund may optimize individual asset pricing and liquidity by negotiating secured financing terms (and simply removing the asset from the UAP Facility pool). And although UAP Facilities are commonly comprised of unencumbered real estate assets, in recent years we have also seen Lenders extend credit to Funds and their affiliates based on the net asset value of unencumbered private equity assets. The borrowing base for these UAP Facilities have included pools of equity interests in a Fund or portfolio company, portfolio company indebtedness and equity securities issued by an entity in connection with collateralized loan obligations.

In terms of UAP Facility covenants, perhaps the most prominent provision is the negative pledge with respect to the unencumbered assets (meaning that the Fund and the other loan parties agree not to pledge the unencumbered assets receiving borrowing base credit to secure indebtedness). And unlike a NAV Facility, which will typically prohibit liens on all assets of the Fund and its affiliates (subject to specific carve-outs), the negative pledge featured in a UAP facility is customarily limited to the unencumbered assets receiving borrowing base credit and the equity of the entities holding such assets, thus affording the Fund and its affiliates the flexibility to encumber properties that are excluded from the borrowing base to meet ongoing business needs. UAP Facilities typically also include financial covenants applicable to the Fund and/or its affiliates, such as maximum leverage ratios, maximum indebtedness levels, minimum net worth, interest coverage, fixed charge coverage, etc. These covenants serve to give the Lender comfort as to the financial health of the applicable loan parties.

While the nature and extent of the collateral is a distinguishing feature of Subscription Credit Facilities, NAV Facilities and Hybrid Facilities, UAP Facilities, by contrast, are typically unsecured. As such, Lenders will often require each owner of the unencumbered assets included in the borrowing base to fully guaranty the obligations under the UAP Facility to the extent that such owner is not a direct borrower under the facility. UAP Facilities also often include specific financial covenants addressing the unencumbered assets used to support the borrowing base, such as minimum asset value, minimum number of assets and concentration limits with respect to such assets (e.g., no more than a certain percentage of the aggregate value of unencumbered assets is attributable to any single unencumbered asset or no more than a certain percentage of assets are located in a single jurisdiction). Some UAP Facilities include a covenant that the Fund will grant a security interest in some or all of the unencumbered assets included in the borrowing base if certain performance metrics are not satisfied. Further, UAP Facilities may also be structured without a borrowing base, in which case the Lenders rely on financial and other covenants to monitor the asset pool and financial condition of the Fund.

Conclusion

As the fund finance market matures, Lenders and Funds continue to explore new and innovative ways to finance investments and otherwise obtain liquidity from existing pools of assets. Alongside the rise in NAV Facilities and Hybrid Facilities, we have seen a number of Funds in recent years seek out financing under UAP Facilities for a growing number of asset classes. Because UAP Facilities provide Funds with an alternative method for satisfying financing needs and optimizing returns for Fund Investors, we expect to see continued growth of these facilities in the coming years.

Endnotes

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[2] For further discussion of NAV and Hybrid Facilities, see "Net Asset Value Credit Facilities" in the *Mayer Brown Fund Finance Market Review (Summer 2013),* available at www.mayerbrown.com/files/Publication/5fd578e0-4b3c-44ca-9be1-067497f87f8b/Presentation/PublicationAttachment/f7a7e13d-58af-4d95-9b92-271daf64e4f7/Mayer%20Brown_Fund-Finance-Market-Review-Summer-2013.pdf, and "Hybrid Credit Facilities" in the *Mayer Brown Fund Finance Market Review (Fall 2017),* available at www.mayerbrown.com/files/Publication/5d762917-53ee-4b79-abba-8628bdbe46a0/Presentation/PublicationAttachment/5f040404-e76e-4bfa-8e07-a1e6528bebb3/Fund-Finance_Review_Fall_2017.pdf.