The Banking Law Journal

Established 1889

An A.S. Pratt™ PUBLICATION

November-December 2023

LexisNexis

THE BANKING LAW JOURNAL

VOLUME 140 NUMBER 10 November-December 2023

LexisNexis®

QUESTIONS ABOUT THIS PUBLICATION?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please call or email:

Matthew T. Burke at .... (800) 252-9257
Email: .... matthew.t.burke@lexisnexis.com

For assistance with replacement pages, shipments, billing or other customer service matters, please call or email:

Customer Services Department at . . . . (800) 833-9844
Outside the United States and Canada, please call . . . . (518) 487-3385
Fax Number . . . . (800) 828-8341
Customer Service Website . . . . http://www.lexisnexis.com/custserv/

For information on other Matthew Bender publications, please call
Your account manager or . . . . (800) 223-1940
Outside the United States and Canada, please call . . . . (937) 247-0293

ISBN: 978-0-7698-7878-2 (print)
ISSN: 0005-5506 (Print)

Cite this publication as:

The Banking Law Journal (LexisNexis A.S. Pratt)

Because the section you are citing may be revised in a later release, you may wish to photocopy or print out the section for convenient future reference.

Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

MATTHEW BENDER

(2023–Pub.4815)

Editor-in-Chief, Editor & Board of Editors

THE BANKING LAW JOURNAL (ISBN 978-0-76987-878-2) (USPS 003-160) is published ten times a year by Matthew Bender & Company, Inc. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices. For customer support, please contact LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204 or e-mail Customer.Support@lexisnexis.com. Direct any editorial inquiries and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway, #18R, Floral Park, NY 11005, smeyerowitz@meyerowitzcommunications.com, 631.291.5541. Material for publication is welcomed—articles, decisions, or other items of interest to bankers, officers of financial institutions, and their attorneys.

POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, LexisNexis Matthew Bender, 230 Park Ave, 7th Floor, New York, NY 10169.

POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, A.S. Pratt & Sons, 805 Fifteenth Street, NW, Third Floor, Washington, DC 20005-2207.

NAV Facilities: A Potential Liquidity Solution?

By Jennifer M. Morgan, Jeffrey Misher, Rachel Shepardson and Olivia Stewart*

A net asset value-based facility (NAV Facility) can provide significant utility to fund clients by expanding the tenor and availability of their leverage options. The authors of this article discuss key issues surrounding NAV Facilities and expect the types of fund clients utilizing, and the number of lenders offering, NAV Facilities to broaden.

WHAT IS IT?

In its most simple form, a net asset value-based facility (NAV Facility) is a credit facility, whereby availability under the facility is based on the net asset value of the portfolio investments of the borrower, often a private fund, and the facility is secured by the assets of the fund. The collateral package in a NAV Facility varies depending on the strategy of the fund, but it most often includes the distribution and liquidation streams from the fund's investments, pledges of equity in underlying holding vehicles where the fund may hold investments, and accounts into which the distribution and liquidation proceeds flow.

The fund finance market is more than familiar with credit facilities to funds (generally private equity, real estate or secondaries funds), secured by the unfunded capital commitments of the fund's investors (Subscription Facilities). For the past decade or so, the Subscription Facility market has been bustling, as lenders seek to bolster their books with a comfortable and well-developed product, and fund managers enjoy quick access to cash with certainty, the availability of letters of credit and the ease of managing currency risk. However, in recent months, we have observed a decline in availability and attractiveness of Subscription Facilities due to lack of supply, increased regulation, rising interest rates, higher underwriting standards for underlying investors and other market factors. This is where NAV Facilities may come in as a useful alternative.

Because a NAV Facility focuses on the underlying assets as its repayment source (as opposed to unfunded capital commitments), they are very useful for later-stage funds that do not have a sufficient amount of unfunded capital commitments left to support a traditional Subscription Facility or funds that are otherwise facing challenges in obtaining a Subscription Facility. Additionally, the shifted focus away from unfunded capital commitments to underlying assets (the value of which tends to outlive the availability of unfunded capital commitments) results in NAV facilities having longer tenors (typically 3-5

* The authors, attorneys at King & Spalding LLP, may be contacted at jmorgan@kslaw.com, jmisher@kslaw.com, rshepardson@kslaw.com and ostewart@kslaw.com, respectively.

years) than their Subscription Facility counterparts (typically 1-3 years), therefore making NAV Facilities a great tool for fund sponsors after they use up a majority of their unfunded commitments.

KEY ISSUES

Valuation Considerations

The borrowing base in a NAV Facility is typically structured based on a "loan-to-value" ratio (the LTV Ratio), that is, the ratio of loans made to the fund to the fair market value or "net asset value" of the eligible assets. The LTV Ratio brings to the surface two of the most heavily negotiated concepts in a NAV Facility: (1) defining an "eligible asset," and (2) valuation methodologies.

For "eligible assets," lenders tend to be focused on including diverse, high-quality investments that are sufficiently insulated from adverse credit events (which differ depending on the particular asset class of the investments in question), while funds seek to obtain credit for as many assets as possible. This creates a natural divergence of interests which often leads to intensive negotiation early on in the term sheet phases.

A similar tension is seen around the valuation of the assets, with questions focused on: (1) what is the fund's valuation methodology (and is the lender comfortable with it), (2) how often will valuations be required in the normal course (and what triggers will be included in the credit documentation for intra-normal course valuations), and (3) what rights will the lender have to challenge the fund's valuations (and perhaps more importantly, what happens if the valuations differ in a material manner)? While these concerns can be mitigated by a fund's performance record and robust valuation methodologies being clearly outlined in the partnership agreement or other governing agreement (the LPA) for the lender to understand at the initial diligence phases, the topic remains a hot button issue for parties involved in NAV Facilities.

Asset-Level Financing

A more bespoke issue arises in the context of how a NAV Facility interplays with asset-level financing. As discussed, the security in a NAV Facility typically covers distributions from investments, the bank accounts where the distributions flow and, depending on the strategy of the fund, shares in the holding companies that hold the underlying investments (a Holdco). One consideration is that the underlying assets may have third-party leverage in place at the asset level, which will be senior to the NAV lender in an enforcement scenario. Given this, in NAV Facilities where the shares in the Holdco are pledged, the NAV lender will need to diligence the underlying asset-level financing documents to understand the potential impact that such pledge to the NAV Lender may have under the asset-level financing documents. In particular, the NAV lender will be focused on determining whether the pledge itself (or more likely, whether the enforcement of the pledge following a default under the NAV Facility) will trigger a mandatory prepayment or other cross-default under the asset-level financing.

Depending on the answer to these questions, the NAV lender will need to consider whether the value of the asset is in reality limited given subordination considerations. To address such concerns around subordination, certain NAV Lenders may require a guarantee of the NAV borrower's obligations under the NAV Facility from the Holdco, secured by a pledge of the Holdco's deposit and securities accounts into which distributions from the underlying investments are paid.

Covenants and Events of Default

In addition to the standard covenants we are all used to seeing in Subscription Facilities, NAV Facilities also tend to contain covenants that are "par for the course" in a typical leveraged finance transaction. This includes:

(1) Cash sweep requirements;

(2) The prepayment of outstanding loans under the NAV Facility if the LTV Ratio exceeds an agreed upon maximum loan-to-value (the Maximum LTV) – which such prepayment may take the form of the lender requiring a certain percentage of net distributions to be applied to the outstanding loans until the desired LTV Ratio is achieved;

(3) Restrictions around access to cash in the collateral accounts upon the occurrence of certain events (for example, restrictions around withdrawing from the collateral accounts if an event of default has occurred or if the LTV Ratio exceeds the Maximum LTV before or after giving pro forma effect to such withdrawal); and

(4) Limitations on the disposition of assets (which typically includes a flat restriction on the disposition of investments without the consent of the lender, subject to oftentimes heavily negotiated carveouts, such as allowing the disposition of investments without the consent of the lender if there is no material event of default and such disposition would not otherwise result in a mandatory prepayment under the NAV Facility).

Governing Agreement Language

Similar to what we saw 15+ years ago in the Subscription Facility market, when there was tremendous focus by lenders on borrowing and pledge language in the LPA, the same attention is being placed on the terms of the LPA to ensure the NAV Facility is appropriately contemplated and authorized. In particular, there is focus on the borrowing and pledge language to confirm the fund's ability to enter in to the NAV Facility, understanding "change of control" provisions and how such provisions operate in lieu of the NAV Facility, and what consents, if any, are required for transferring assets (in particular, consents in connection with the pledge of the investments, the transfer of an investment in a foreclosure proceeding, the redirection of investment proceeds to a secured collateral account, etc.).

CONCLUSION

NAV Facilities can provide significant utility to fund clients by expanding the tenor and availability of their leverage options. As interest in NAV Facilities continues to peak in the United States fund financing market, we expect to see the types of fund clients utilizing, and the number of lenders offering, NAV Facilities to broaden.