CADWALADER

FUND FINANCE FRIDAY

NAV Financing – What Was Old Is New Again

January 6, 2023 | Issue No. 205

By Bryan Barreras
Counsel | Fund Finance

Happy New Year! As we begin the new year and look back at the developments in the fund finance market in 2022, and look forward to what 2023 has in store for us, one common theme is the continued increase in the use of NAV financing products, both in the U.S. and European markets. Several market participants noted (in our **European market predictions** article last month) the rise of the use of NAV facilities in 2022 and their expectations that this will continue in 2023 as funds look to manage their liquidity in the current environment and as funds, sponsors and lenders become more comfortable with these products.

For purposes of the above, NAV financing products are primarily loans to private equity (PE) funds where the value of the portfolio companies comprising the investment assets of the PE fund provide support for the borrower's loan obligations. Whether the security interest provided to the lenders is directly over the borrower's investment assets or merely supported by those assets (*e.g.*, by taking a pledge over the accounts into which proceeds from those assets are paid, or by obtaining some other indirect support provided by the investment assets) depends on a number of factors, and requires an analysis and understanding of the PE fund's holding structure for those assets and sometimes diligence of the assets themselves. See our more detailed discussion of these products and the potential pitfalls that lenders in this space need to be aware of **here.** One factor supporting the increased use of NAV financing products that was seen in 2021 and 2022, and that is expected to continue in 2023, is the ability to customize these products for the particular holdings and to meet the specific investment strategy of a PE fund – see **here** for a discussion of the varied uses of NAV facilities.

For those of us who cut our teeth in the hedge fund financing space, NAV financing is nothing new. Similar to PE funds' use of subscription credit facilities, funds of hedge funds (FoHFs) have been using NAV financing for more than two decades. NAV facilities in the context of FoHF borrowers refer to loans that are secured by the pledge of a portfolio of hedge funds owned (directly or indirectly) by the borrower. In addition to FoHFs, borrowers under these facilities often include family offices, pension funds and mutual funds, but the collateral structure and primary legal considerations are similar regardless of borrower type. These

facilities appear in various forms − loans, note purchase transactions and derivatives transactions − though the primary structuring considerations are common across these products.

Bare necessity is the primary driver for the use of NAV facilities by FoHFs. Unlike PE funds, which have investor commitments that provide a liquid form of collateral that can be pledged as security for loans, most FoHFs require commitments from investors to be fully funded at the time of subscription, and those subscription proceeds are used by a FoHF to simultaneously acquire its underlying portfolio of hedge funds. As a result, a FoHF has no meaningful assets to pledge as security other than its underlying portfolio of hedge funds in which it invests, necessitating the use of NAV financing products. (Note that while some FoHFs have adopted a hybrid investment model in the past several years, taking some subscriptions as investor commitments, this is still not common in the hedge fund market.)

Because both types of facilities are ultimately looking to the borrower's investments as the source of repayment, there is significant overlap in the key issues facing both PE NAV facilities and FoHF NAV facilities, although, as discussed below, these are often addressed in different ways:

- The collateral structure, and the ability to control and ultimately dispose of the investment portfolio, ideally without recourse to the court system and without interference from or the need for action by any third parties, is key for each type of facility, though the means for achieving this are substantively different. The collateral structure for PE NAV financings typically either looks to force distributions from those investments into a deposit account that is pledged to the lenders or requires entity-level direct or indirect pledges and consents that will allow the lenders to transfer or dispose of the investments or the entity that holds the investments as part of their enforcement. (See **here** for a discussion of some issues that arise from such collateral structures.) FoHF NAV financings structures typically require the pledged hedge fund portfolio to be held in a securities custody account that is pledged to the lenders, as discussed below.
- The borrowing power and/or loan-to-value maintenance requirements in each are based on the value of the underlying investment portfolios, so the ability to obtain regular valuations from an independent source (*e.g.*, the managers of the underlying investments for FoHF NAV and PE NAV secondary financings, or the administrator of the fund borrower), and to potentially discount or dispute those valuations, are critical elements of the reporting and covenant provisions, as is the ability to deem certain investments as ineligible (*i.e.*, give them a value of zero for purposes of determining borrowing power and to calculate collateral coverage ratios). The importance of these provisions was highlighted during the Financial Crisis – when many hedge funds suspended publication of NAVs and/or gated redemptions, resulting in discounts being applied by lenders and loan-to-value breaches in FoHF NAV facilities – and during the early days of COVID-19, when concerns about the timeliness and accuracy of fund valuations led to a slowdown in PE NAV financings until the next cycle of valuation reports.
- Because the collateral value in each is tied to the borrower fund's investment portfolio, the negative covenants and other restrictions limit the ability of the borrower to dispose of these assets and/or make distributions to equity holders. The life cycle, and the withdrawal rights of their investors, of the two different types of funds becomes relevant

here. Whereas a PE fund will ultimately dispose of its investment portfolio and make a final distribution to its investors (even if just to roll them into the next fund), FoHFs have no natural "end" and therefore FoHF NAV financings can remain outstanding indefinitely, and their investors can choose to remain in the fund (or exercise their regular redemption rights to exit the FoHF). One result of this is that amortization provisions, requiring that distributions and sale proceeds from underlying investments be used, at least in part, to pay down the loan well in advance of the loan's maturity, are a common feature of PE NAV financings, while they are rare in FoHF NAV financings.

- And because the pledged assets in both cases are subject to market risks and fluctuations, diversity of investments (or, said another way, lack of concentration) is typically factored into the borrowing power calculations. This mitigates somewhat the risk of gating and NAV suspensions that is inherent in FoHF NAV financing structures.

Possibly the single biggest difference between PE NAV financings and FoHF NAV financings, at least from a structural perspective, is the central role played by the custodian in FoHF NAV financing transactions. PE funds infrequently hold their investments in a custodial account (for structural reasons and due to the nature of the underlying investments). FoHF NAV financings, conversely, almost uniformly require the borrower's portfolio of hedge funds to be held in a securities custody account that is pledged to the lenders and that is subject to a control agreement in favor of the lenders. This allows the lenders to enforce against the portfolio of hedge funds by directing the custodian, who is the registered owner of the hedge funds and who has contractually agreed to follow the instructions of the lenders upon the occurrence of certain events, to submit redemption requests (or transfer requests, if desired) to the underlying hedge funds, with the redemption or sale proceeds paid to the pledged account. A discussion of the indirect holding system (*i.e.*, holding assets through a securities intermediary) is beyond the scope of this article, but note that it is generally accepted in the FoHF NAV financing space that pledge and/or transfer restrictions at the level of the underlying hedge funds are not implicated by the pledge by a borrower of its custodial account to which such hedge fund interests are credited. Note additionally, however, that the involvement of a custodian implicates the Hague Securities Convention and requires legal analysis on that front.

While there are substantive differences between PE NAV and FoHF NAV financings, there are enough similarities that the 20-plus years of existence of the FoHF NAV financing market, including in particular the experience gained working out defaulted transactions during the Financial Crisis, can inform the continued development of the PE NAV financing market. Prior to the Financial Crisis, FoHF NAV facilities were primarily used to provide leverage on the borrower's portfolio of hedge funds, so FoHFs that did not use leverage as part of their investment strategy would often not have a facility in place. However, during and coming out of the Financial Crisis, these products were increasingly seen as a needed source of liquidity, both to bridge expected liquidity requirements and during times of market distress, and even FoHFs with no intention to deploy leverage began to put FoHF NAV liquidity facilities in place. With the focus on liquidity in the PE space in the current market environment, it's no surprise that PE funds are also increasingly looking to NAV facilities to similarly manage their own liquidity needs.