FUND FINANCE FRIDAY

# Shining a Light on European "Security-Lite" Financings

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NAV facilities come in all shapes and sizes and, unlike subscription facilities, there is no standardised collateral package for these kinds of transactions. In the European market, many lenders - particularly investment banks - are focused on ensuring that they have recourse to the underlying assets of the fund via their security documents. This might take the form of direct security over: (i) each of the topcos through which a fund (indirectly) owns the relevant underlying portfolio company; (ii) any aggregator vehicle through which the fund (indirectly) owns all or a large number of the underlying portfolio companies; or (iii) a combination of (i) and (ii). Recently, we have seen an uptick in the number of financings in Europe that are structured as what are commonly referred to as "security-lite" transactions: these transactions involve no security being granted over the underlying assets of the fund, with lenders (often non-bank in this context) only given secured recourse to the bank accounts into which distributions from the fund's investments are paid. In this article, we shine a light on some of the key factors to take into account for these kinds of transactions.

**Financial Covenants and Cash Sweep Mechanics**

One of the key ways in which lenders look to get comfortable with a more limited security package is through the financial covenants and the interplay between those covenants and the cash sweep and pricing provisions. Ultimately, Lenders will be looking for repayment from the distributions and sale proceeds derived from the underlying assets of the fund and so they will want to limit the circumstances in which those amounts flow out of the group structure without being caught by the cash sweep. Typically, a borrower may be entitled to pay amounts out of the secured accounts (in the form of distributions to investors, for example) where the fund's LTV ratio does not, and will not, exceed an agreed threshold (the "Relevant LTV Threshold") as

a result of that distribution. Where the LTV ratio exceeds the Relevant LTV Threshold (or an Event of Default has occurred), the facility agreement will usually require that 100% of net distributions and sale proceeds be applied in prepayment of amounts outstanding under the facility. In addition, the facility may include margin ratchet provisions which provide for incremental increases in pricing where the LTV exceeds certain pre-agreed thresholds. Equally, if the borrower exercises any option to capitalise (or PIK) interest payments, this may also attract a higher margin for the relevant loan.

**Diversity of Assets**

The diversity of the fund's investment portfolio is often a key factor (and risk mitigant) for a NAV lender, particularly in the context of security-lite transactions. For this reason, a lender will typically look to include various covenants in the facility that seek to preserve the benefit of a diverse asset portfolio. These may restrict any cross-collateralisation or cross-guarantees between portfolio companies and their respective holding companies. Equally, a borrower may be restricted from reinvesting any distributions received in respect of a particular investment other than in follow-on investments in that same asset (with reinvestment across different assets being seen as a form of cross-contamination). Lenders may also require that the 100% cash sweep applies in circumstances where the fund ceases to own a pre-agreed number of "eligible" or "cornerstone" investments.

**Unsecured Recourse**:

Whilst lenders in a security-lite transaction will have direct recourse to monies in the secured bank accounts in an enforcement scenario, they will also want to understand what additional rights may be available to them as an unsecured creditor. This could be important in circumstances where the lender is not willing or able to "sit on its hands" and wait for repayment proceeds to flow up to the secured accounts. The lender (or a third party purchaser of its rights under finance documents) may need to understand the process by which it can obtain a judgment against the borrower and enforce that judgment in the relevant jurisdiction(s) where the fund's asset are located. It will also want to know the relevant timeframes involved. Moreover, lenders may need to take additional measures in order to preserve the value of the assets pending the outcome of any legal proceedings (via an injunction or freezing order for example). Clearly, this can involve detailed analysis from legal counsel (both in terms of the relevant insolvency regimes and the litigation steps involved in bringing an unsecured claim) and the process will differ depending on the relevant jurisdiction(s) involved.

There are various ways in which these considerations may influence the finance documents with some lenders looking to ensure that the borrower (and any other relevant obligors against which they may have unsecured recourse) is an "insolvency-remote" entity (or as close to one as possible) so as to limit third-party creditor risk and ensure that they will have as much control over any enforcement process as possible. If a lender can ensure that it is the sole unsecured creditor, it will be the only instructing creditor of any insolvency practitioner that is appointed by the courts to enforce a claim and therefore have great degree of control over that process. For this reason, it is common to restrict to the borrower from incurring additional financial indebtedness and/or granting any additional security over its assets. Where it is the case that distributions and capital call proceeds are funnelled through the group structure via intra-group loans, lenders may also require that the relevant group entities enter into a subordination

agreement pursuant to which they agree that any intra-group claims will be subordinated to those of the lender.

**Due Diligence**

The nature of the due diligence conducted in the context of security-lite transactions is necessarily less extensive than what would typically be required in the context of a traditional NAV facility secured against the underlying assets of the fund. Since security will not be taken over the assets, lenders will be less focused as to whether the granting and/or enforcement of the security will be restricted in the fund's constitutional documents/any shareholder agreements or whether a "Change of Control" could arise under any senior financings at portfolio company level. That notwithstanding, lenders will clearly be focused on whether the borrower has legal title to the assets and whether there are any arrangements which might dilute the value of the asset or result in cash leakage. As such, lenders will need visibility of the whole fund structure and the way in which distributions are paid up to the secured accounts. The facility agreement will typically require the borrower (and potentially any relevant holding companies that are controlled by the borrower or fund) to procure that all distributions derived from the underlying portfolio companies are paid to the secured accounts and that they will not decline, delay or frustrate the receipt of any distributions proceeds to which they are entitled. Lenders may also look to impose restrictions on the ability of the fund (and its subsidiaries) to alter the group structure by imposing anti-layering provisions in the facility agreement which restrict members of the fund group from creating any additional holding companies which might incur additional debt and reduce the NAV available to the lender.

**Final Thoughts**

Clearly, the abovementioned points are not exhaustive and there are a wide range of issues that lenders will take into account when putting in place a security-lite structure. The agreed collateral package for any NAV transaction will be driven by a range of factors, including the creditworthiness of the borrower (and its relationship with the lender), the nature of the fund's assets and the specific underwriting requirements of the lender. However, given the increased prominence of security-lite financings in the European market, we are confident that the issues noted above will continue to influence the way in which these transactions are documented.