CADWALADER

FUND FINANCE FRIDAY

Miami, Here We Come

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NAV Covenants and Subscription Lines

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For funds that are nearing the end of their investment period and have limited or no remaining unfunded capital commitments, the need to continue a subscription line facility for ongoing liquidity may continue to exist for these end-of-life funds to support follow-on investments, reoccurring fund operational expenses, and costs associated with maintaining and liquidating their portfolio investments. There are a number of financing options in the fund finance market for these funds to consider, including net asset value (NAV) and hybrid credit facilities, but, for many funds, the convenience and familiarity of their existing subscription line credit facility may continue to remain the most efficient and expeditious way to extend their liquidity runway. In order to prolong an existing subscription line facility to a fund after its investment period, there are a number of important threshold factors that a lender must consider, including the purpose for which the general partner may call capital − which is usually limited and excludes calling capital for new portfolio investments not already under mandate − and whether the limited partnership agreement permits the fund to incur and repay post-investment period from the proceeds of a capital call, including recallable capital if permitted by the limited partnership agreement. In addition, structural changes are often made to the subscription line loan agreement as the lender looks to the portfolio investments of the fund and the underlying cash flow from distributions from such investments to support the ongoing credit facility. These structural changes almost always include the implementation of NAV-style covenants, including a loan-to-value (LTV) ratio or a minimum net asset value, NAV to portfolio cost, and a mandatory loan repayment feature from fund distributions.

NAV-based credit facilities

We have seen an increased interest in NAV-based credit facilities over the past few years as funds look to extend and leverage the equity value of their portfolio investments. NAV credit facilities are particularly attractive to later stage funds approaching or at the end of their investment period with little to no remaining unfunded capital but intend to participate in follow-on investment strategies and have ongoing fund maintenance needs. While the collateral for a subscription credit facility is supported by the unfunded capital commitments of the fund's investors, collateral for NAV-based credit facilities are often structured to include distributions and liquidation proceeds from the fund's portfolio investments and the rights to receive such amounts, and a pledge of equity interests of the companies holding the investments. A NAV facility will look "downward" for collateral support in contrast to a subscription facility that will look "upward" for the collateral. Unlike subscription lines that have a revolving credit facility structure with short-term tenors and are financial covenant light, a NAV facility will usually consist of a term loan facility with varying tenor lengths depending on the underlying investments and at least LTV covenants that vary based on the diversification of the portfolio assets and a mandatory repayment feature that requires the fund to use all or a significant portion of distributions received from the portfolio investment to prepay outstanding obligations of the NAV credit facility. These structural features, together with more expensive pricing for NAV credit facilities, are generally less favorable terms for fund borrowers when compared to their existing subscription line credit facilities.

Hybrid credit facilities

As with NAV-based credit facilities, there has been a corresponding increase in hybrid credit facilities or subscription facilities structured with NAV covenants. Hybrid credit facilities are also particularly useful for funds that are nearing the end of their investment period and have only a small amount of uncalled capital or are dependent on recallable capital for follow-on investments and fund expenses. The collateral pledged to secure hybrid credit facilities typically includes a blend of fund assets from looking “upward” to any remaining unfunded commitments and recallable capital if permitted by the limited partnership agreement and “downward” to the value of the fund’s portfolio investments. Similarly, a hybrid credit facility will include a combination of both subscription and NAV-style covenants, making sure there is sufficient callable capital and a minimum net asset value to support the credit facility. These features increase the complexity of a lender’s underwriting to a hybrid facility and the corresponding legal diligence performed by lender’s counsel. Pricing for hybrid facilities tends to be higher than subscription facilities but lower than NAV facilities. A hybrid credit facility provides ongoing liquidity and flexibility for maturing funds under a single credit agreement. Even with this flexibility, funds may decide that it is more efficient to continue with the subscription credit facility with enhanced structural elements, such as NAV-style covenants, added by the lender to support the extension of the loan past a fund’s investment period when the value of the portfolio becomes an important secondary source of repayment.

Subscription line NAV covenants

For funds with ongoing liquidity needs after the expiration of their investment period, and if NAV or hybrid facilities are not a great fit, some lenders will agree to extend a fund’s existing subscription line facility subject to certain supplemental credit enhancements, including adjustments to the borrowing base and the implementation of NAV-style covenants. An extension of a traditional subscription facility, even with these adjustments, in some cases, may be more beneficial to a fund than restructuring into a NAV or hybrid facility. The fund is already familiar with the covenants and reporting requirements of the existing facility and has established a working relationship with a lending team over the life of the facility. The lending team knows the fund administrative team well and works closely with them and the general partners in managing all aspects of the relationship. This rapport is invaluable and not always easy to replicate.

Significant adjustments to the borrowing base are typically needed to increase availability to the fund when the remaining uncalled capital is low or the fund only has recallable capital to include in the borrowing base. A substantial increase in the borrowing base from a traditional blended advance rate of 50% up to 90% is not uncommon. In return for this increase to the borrowing base availability, lenders typically require the implementation of NAV-style covenants to mitigate against the reduced primary source of collateral and repayment in the form of uncommitted capital and look “downward” at the asset value of the portfolio investments. The NAV covenants are designed to be tight but should be manageable and customized appropriately for the fund. The typical NAV-style covenants include one or more of the following:

LTV Ratio. A minimum LTV covenant will measure the ratio of the principal amount of the credit facility to the value of the portfolio assets held by the fund. The covenant may require that the fund maintain a minimum net asset value across a select grouping of trophy investments or across the fund's entire portfolio of investments. Having a diversified mix of underlying portfolio investments is another important factor for this covenant. Generally, lenders look more favorably on a broad diversification of portfolio investments to minimize the increased risk associated with continuing to extend credit to a fund with diminished uncalled capital. A more diversified portfolio of loans may permit a fund to obtain better loan terms and less restrictive covenants when compared to funds with less diverse portfolio investment holdings. A minimum LTV multiple of at least 25% to 35% is customary for primary PE funds.

NAV-Cost. A fund may also be required to maintain and report a NAV covenant tracking the fund's aggregate cost assigned to its portfolio investments as reflected on its most recent financial statements. It is important for a lender to track the fund's ongoing cost structure and require that the fund maintain expenses at reasonable levels to protect against unanticipated depletion of the remaining uncommitted capital or recallable capital, if applicable. A typical NAV-cost covenant will require a NAV of at least 100% to 110% of the aggregate cost basis assigned by the fund to its portfolio investments.

Mandatory Repayment. The credit agreement may require the fund to prepay any outstanding obligations with the proceeds from a distribution or liquidation of a portfolio investment. In a traditional subscription line facility, distributions and proceeds received by the funds from its portfolio investments are considered a secondary source of repayment for lenders. This secondary source of repayment becomes more important as a fund's uncommitted capital is depleted over the life of the fund and the lender looks "downward" into the portfolio investments to support the ongoing liquidity needs of the fund borrower. As a result, it is not uncommon to have a lender require a mandatory repayment of the outstanding obligations under a subscription line credit facility with the cash flow from distributions received by the fund from its portfolio investments.

Even with the addition of these NAV-style covenants, the convenience, familiarity, and efficiency of continuing a subscription line credit facility may be the most beneficial and preferred approach for both the fund and the lender to support the ongoing liquidity needs of funds nearing the end of their natural investment period.

See You in Miami!

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We look forward to seeing many of you at the 11th Annual Global Fund Finance Symposium in Miami next week. Cadwalader is sponsoring the Welcome Reception on Wednesday night, and we hope you can attend. We are also in Cabana 24 by the Oasis Pool if you get a chance to drop by. Be on the lookout for event coverage in next week's *Fund Finance Friday*.

Subscription Sunrise Run in Miami Announced

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Mourant and FFA Cares, the charitable effort of the FFA, this week announced the annual Subscription Sunrise Run along the Miami Beach Boardwalk to kick-start Day 1 of the Symposium on Thursday, February 17 at 6:45 a.m.

In a new initiative under FFA Cares, all proceeds raised will directly support StreetWise Partners' innovative 12-month mentorship program for job-seeking adults. Streetwise Partners provides mentoring support to over 600 mentees, equipping them with skills for work and confidence for life. For information and to register, click **here**. To make a donation to StreetWise Partners, click **here**.

Walkers ‘We Talk Banking & Finance’ Podcast Featuring Mike Mascia

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Julia Keppe, Alice Wight and Michael Mascia

Julia Keppe and Alice Wight of Walkers’ Jersey office this week hosted Mike Mascia on their “We Talk Banking & Finance” podcast series in a lead-up to the Fund Finance Association’s Miami conference. Julia, Alice and Mike cover themes and trends in the market, what conference attendees can look forward to and fund finance forecasts for 2022. Available [here].

Ogier CAYLUX – Fund Finance: The Investor Notice

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The security package for a subscription facility will typically include security over the uncalled capital commitments of a fund's investors, including: (i) the right to make capital calls on investors in respect of their uncalled capital commitments, together with rights to enforce payment of them; and (ii) the right to receive the proceeds of such capital calls. It will generally also include security over the bank account into which investors are required to deposit their capital contributions.

Giving notice to investors is a common feature of taking security over the uncalled capital commitments of investors of Cayman and Luxembourg domiciled funds. Below we have set out 10 frequently asked questions regarding the investor notice from a Cayman and Luxembourg law perspective.

1. Why is notice required?

<u>Cayman</u>

Priority of the security is achieved by giving notice of the creation of the security interest to the investors. Generally, where there are competing security interests over uncalled capital commitments, the first security interest that has been notified to the investors will take priority regardless of when the security interests were created.

<u>Luxembourg</u>

The security interest is perfected by execution of the security agreement. Delivery of the investor notice to each of the fund's investors ensures that no investor may discharge its obligations to commit capital other than as provided in the investor notice on the basis that it had no knowledge of the security.

2. What form should the notice take?

<u>Cayman</u>

The notice should be in writing, but there are no specific requirements concerning the form of notice. All that is required is that the investors are made aware of the security. The notice should contain a description of the security document, a statement that the security comprises security over uncalled capital commitments and rights to call capital from investors and the identity of the secured party. The form of notice is typically agreed in advance of closing and is appended to the credit agreement.

<u>Luxembourg</u>

No specific form of notice is required under Luxembourg law. Similarly to the Cayman investor notice, for the Luxembourg investor notice it is advisable that the notice be in writing and contains a detailed description of the security documents and security interests created pursuant thereto. The notice is agreed by the parties prior to closing and a form thereof is included as a schedule to the Luxembourg law-governed security agreement over uncalled capital commitments.

3. When does the notice need to be given?

<u>Cayman</u>

Notice of the security can only be given once the security has been created. Notices are often delivered upon execution of the relevant security document, or within 3-5 business days, to ensure the secured party's priority is fixed.

If the general partner of the fund is a Cayman company, the security interest created should be recorded in its register of mortgages and charges. The credit agreement or security document should also contain a requirement that notice be given to any new investor that is admitted to the fund after closing of the facility.

<u>Luxembourg</u>

Lenders are taking a stricter approach with respect to delivery of the investor notice. In Luxembourg, the notice should be delivered as soon as possible following closing. Market practice and e-delivery methods have encouraged a move towards delivery of the notice on closing or within 3-5 business days.

4. Does the notice need to be executed?

<u>Cayman</u>

While there is no legal requirement for the notice to be signed by the fund or the fund's general partner, generally the fund and/or the fund general partner will sign the notice.

<u>Luxembourg</u>

For consistency with the Luxembourg pledge over uncalled capital and to avoid complications due to competing laws, it is advisable to have notices be governed by Luxembourg law and effectively executed.

5. Who should the notice be sent by?

Cayman

The notice may be sent by the security provider or the secured party, although in practice the notice is typically given by the security provider.

Luxembourg

Although there is no legal prescription on the way notices should be served, binding effect is better achieved if the terms of the notice are actually aligned with the provisions of the pledge over uncalled capital and executed by the Luxembourg fund acting through its general partner.

6. How is the notice delivered?

The notice should be delivered in accordance with the provisions of the constitutional documents of the fund that govern service of notices on the investors. Very often, notices will be sent to investors via email. However, it is increasingly common to see investor notices delivered via online portals.

7. When is the notice effective?

The notice is only effective upon receipt of the notice by the investor (not upon it being sent by the fund). This is why evidence of delivery is required to ensure the investors have been notified.

8. What evidence of delivery should be obtained?

Lenders require a fund to confirm what form of evidence of delivery of investor notices will be provided ahead of closing, and the available evidence will depend upon how the notices have been delivered. If the notices have been sent by email, a copy of the email from the fund to its investors is often provided by the fund. On some occasions, confirmation that no bounce-back emails have been received are requested by lenders.

If the notice has been uploaded onto the fund's online portal, the available evidence will depend in part on what the portal can generate to evidence delivery. We would expect the lender to receive a copy of the email or message that is sent to the investors (which can provide additional comfort to lenders where it explicitly refers to the security being granted over the uncalled capital commitments), notifying them of a posted notification, together with a screenshot of the notice uploaded to the portal. Certain online portals can now also generate reports that confirm, among other things, the date and time that the notice was posted, the identity of the investors and confirmation of when each investor last accessed the online portal. Albeit untested before the courts, the provision of such reports to lenders is generally accepted as an effective way of evidencing delivery of investor notices.

9. If the facility is being amended or amended and restated, should the fund re-issue the notice to investors?

Assuming the security package is remaining the same, it is not strictly necessary to re-issue the notice. However, a lender may wish to consider asking for the notice to be re-issued, particularly if (i) the initial notice was sent some time ago; or (ii) if the initial notice contained specific information on the amount of or term of the facility that is no longer correct. If there have been changes in the fund's investor base, re-issuing the notice would ensure that all current investors of the fund have received the notice and are aware of the security.

10. What if the notice is not sent?

Cayman

If notice is not sent and if the fund subsequently grants a competing security interest to a third party, and if notice of that competing security interest is sent to the investors, the third party's security interest will take priority. However, it is worth pointing out that in such circumstances the third party would not get priority if, at the time the third party's security interest was created, the third party had notice of the pre-existing security interest.

Luxembourg

While not strictly necessary for perfection, notice of the creation of the security interest should nevertheless be given, as under the Luxembourg civil code (and reiterated in the Financial Collateral Law), if an investor is unaware of the security interest created over its obligation to pay, such investor may validly discharge that obligation directly to the Luxembourg fund.

On the Move – Fund Finance Tidbits

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On the Move

Well-known Cayman Islands fund finance attorney Anna-Lise Wisdom joined Conyers as a partner this week where she will continue to advise lenders on the full range of fund finance transactions. Congratulations, Anna-Lise!

Fund Finance Hiring

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Fund Finance Hiring

Pacific Western Bank is hiring a VP-level Client Manager to join its Fund Finance Group. The position will be preferably based in either Denver or New York City. If interested, please visit **here**.

Webster Bank is hiring Associates for its Fund Banking group. To learn more, visit **here**.