Fund Finance

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Equity commitment facilities: A primer

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Introduction

Equity commitment facilities ("***ECFs***") are loans to a portfolio company ("***Portfolio Company***") of a private equity fund ("***Fund***") where the lender's ("***Lender***") primary and intended source of repayment is a contractual commitment from the Fund to contribute capital to the Portfolio Company. Somewhat akin to both a contractually committed "equity cure" in the leverage finance market and a subordinated, unsecured subscription credit facility ("***Subscription Facility***") in the fund finance market, ECFs have increased in popularity in recent years. When properly structured and documented, ECFs are fundamentally sound transactions that provide the Lender with a clear and viable path to full repayment from creditworthy sources in the ordinary course. However, there are material nuances and complexities in both the transaction structure and enforceability analysis that the Lender should fully understand to properly underwrite an ECF. This chapter summarizes the key structural features of an ECF and outlines the essential considerations for Lenders.

Transaction structure

Basic structure

While the ECF structure could in theory be applied to any Portfolio Company, the structure offers the most utility where the Portfolio Company is either an early-stage vehicle formed to undertake a development-type project or where the Portfolio Company faces some level of short-term illiquidity and requires a bridge cash infusion. In both circumstances, the Portfolio Company is likely without sufficient cash flow or tangible assets to obtain the needed credit on preferred terms. Historically, these circumstances compelled the Fund to contribute equity capital into the Portfolio Company immediately to enable the Portfolio Company to execute its business plan. However, with an ECF, the Fund only contractually commits (the "***Equity Commitment***") to fund equity into the Portfolio Company immediately, but is not obligated to actually fund the capital ("***Equity Contributions***") until receipt of a demand notice from the Portfolio Company or the Lender. The Lender, in reliance on the Equity Commitment, in turn makes the loan immediately, enabling the Portfolio Company to use the loan proceeds to execute its business plan. Ultimately, if not repaid by other means, the ECF is repaid by a capital call on the Equity Commitment. ECFs are often structured in connection with a "follow on" investment of the Fund in the Portfolio Company and not in connection with the initial acquisition or investment. We have typically seen ECFs in the infrastructure and energy areas, although they seem well-suited to other, similar contexts.

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Benefits of ECFs

ECFs have multiple benefits for Portfolio Companies, Funds and Lenders. For the Portfolio Company, ECFs offer debt capital that would otherwise be unavailable on comparable terms. ECFs are typically structured with no financial covenants tied to the performance of the Portfolio Company, thus enabling operational flexibility. The cost of an ECF is typically meaningfully lower than what the Portfolio Company could secure based on its own credit wherewithal, thus reducing cash drag and increasing EBITDA. For the Fund, in addition to improving the performance of its Portfolio Company, an ECF defers the need to contribute additional equity capital into the Portfolio Company. In fact, if the Portfolio Company is successful in executing its business plan with the loan proceeds from an ECF, it may be able to eventually refinance the ECF with new credit facilities recourse only to the Portfolio Company, thereby completely eliminating the need for the Fund to contribute the follow-on Equity Contribution. In addition, an ECF may provide a Fund a structural solution when an outright guaranty or use of the "Qualified Borrower" feature under the Fund's Subscription Facility are unavailable due to capacity limitations. For the Lender, an ECF provides an attractive, risk-adjusted return from familiar repayment sources and deepens its relationships with both the Fund sponsor and the Portfolio Company.

Collateral package

The Portfolio Company secures an ECF with a pledge of its rights in the Equity Commitment, including its right to call and enforce the funding of Equity Contributions by the Fund. The Portfolio Company also establishes a deposit account (the "***Collateral Account***") into which all Equity Contributions are required to be deposited. The Collateral Account is pledged to the Lender and the Lender has authority to take exclusive control of the Collateral Account upon the occurrence of certain triggering events, including any event of default under the ECF. This collateral package is quite familiar to Lenders. It is identical to that in a Subscription Facility, just one step removed. The Fund itself provides no collateral to secure an ECF.

Fund involvement and disclosure

ECFs are typically fully disclosed and transparent to the applicable Fund, often arranged directly by the Fund sponsor itself and not by the Portfolio Company. The Fund executes an acknowledgment letter (the "***Consent***"), acknowledging and consenting to the ECF, waiving certain defenses that may be available with respect to the funding of Equity Contributions and addressing certain funding risks and contingencies related to the Equity Commitment itself. The Consent gives the Lender comfort that the Fund is fully committed, establishes privity of contract, and gives contractual assurances that the Fund will not take actions contrary to the intent of the transaction. The Consent also includes certain reporting obligations on the Fund to enable the Lender to monitor the transaction. The actual Equity Commitment is documented in either the limited partnership agreement or other applicable constituent documents of the Portfolio Company (a "***Partnership Agreement***") or in a separate letter agreement between the two parties (an "***Equity Commitment Letter***"). The Partnership Agreement or Equity Commitment Letter, as applicable, is heavily diligenced by the Lender to ensure the funding obligation of the Fund is absolute and unconditional.

Underwriting approach

While the Portfolio Company is fully obligated to repay an ECF, most Lenders put little to no value on the financial wherewithal of the Portfolio Company. Rather, underwriting is entirely focused on the ability of the Fund to make Equity Contributions pursuant to the Equity Commitment to enable the Portfolio Company to satisfy its obligations under

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the ECF. The Fund has two sources of liquidity: the remaining capital commitments ("***Remaining Investor Commitments***") from its limited partner investors ("***Ultimate Investors***"); and the disposition proceeds (and in certain cases, cash flow) from its investments ("***Investments***"). Because the Investments are typically illiquid, most banks primarily underwrite the Remaining Investor Commitments as their primary source of repayment, with the net asset value ("***NAV***") of the Investments considered as valuable credit enhancement and a mitigant in a loss-given-default analysis. Historically, Ultimate Investor funding of Remaining Investor Commitments has been pristine; one of the lowest rates of delinquencies in unrated exposures in the credit markets. Thus, most Lenders will simply require Remaining Investor Commitment coverage sufficient to ensure the Fund will be able to honor the Equity Commitment when called. A typical ECF would require a coverage ratio (a "***Coverage Ratio***") along the lines of:

> Remaining Investor Commitments must exceed the sum of (i) the principal obligations outstanding under any Subscription Facility of the Fund, plus (ii) the Equity Commitment, plus (iii) any other indebtedness, guarantees, liabilities and other equity commitments of the Fund (which will likely be *pari passu* with the Equity Commitment), plus (iv) a buffer to over-collateralize for Ultimate Investor delinquencies and springing liabilities.

Some ECFs, particularly in the case of flagship Funds for experienced sponsors, may supplement the Remaining Investor Commitments in the Coverage Ratio with a small percentage of the Fund's NAV (or, alternatively, advance to 100% of Remaining Investor Commitments but require the Fund to maintain a minimum NAV floor at all times).

Structural observations and considerations

Like most transactions, ECFs are never perfect from the creditor's perspective. Below is a list of structural issues and nuances in ECFs the Lender should be aware of.

1. The Fund's Subscription Facility. As is standard course in the Subscription Facility market, the Subscription Facility lender to the Fund will have a first priority security interest in the Remaining Investor Commitments, any related capital contributions and the related collateral account into which such contributions are deposited. Thus, in an insolvency proceeding of the Fund, the Remaining Investor Commitments, when funded, would first be applied to the repayment of all outstandings under the Subscription Facility prior to being available to honor the Equity Commitment. Thus, to the extent the Lender is underwriting the ECF primarily on the Ultimate Investors funding their Remaining Investor Commitments to enable the Lender's ultimate repayment, the ECF is structurally subordinated to the Subscription Facility. The position is in many ways analogous to being an unsecured lender to the Fund, subordinated to a Subscription Facility as to the Remaining Investor Commitments (a not uncommon lending construct in the market for private equity funds of higher tier profile). Additionally, should an event of default occur under the Subscription Facility, the agent under the Subscription Facility could be expected to take exclusive control of the related collateral account and direct all payments funded by the Ultimate Investors to the repayment of the Subscription Facility. Such an event could create a meaningful impediment to the timely payment or collection of the Equity Commitment. To get comfortable with this subordination, Lenders often look for some additional credit enhancement from the Fund's NAV. As the NAV is often significantly greater than the Equity Commitment, a truly significant asset value deterioration event would have to occur before the Investments become so distressed that their values are insufficient to

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ultimately enable the funding of the Equity Commitment. For this reason, ECFs often include an NAV floor or related protective covenant.

2. Multiple Funds and AIVs. In most ECFs, the "Fund" will never be a simple, single entity. There may be multiple distinct Funds involved, likely the sponsor's comingled Fund along with one or more separate accounts. And even within a Fund, there will be parallel vehicles. Alternative Investment Vehicles ("***AIVs***") are often utilized as well, and the Investments of the Fund will likely be held in multiple AIVs. To the extent the Lender values NAV as an additional source of repayment, it should only value the NAV of the AIVs party to the Equity Commitment, not the NAV of the Fund in its entirety. In an insolvency scenario, we cannot confirm whether all of the AIVs and the main Fund would be consolidated into a single bankruptcy estate. Similarly, the various Fund entities and vehicles may not commit to the Equity Commitment on a joint and several basis. Thus, the analysis may have additional underwriting complexities. In theory, this risk could be solved by all of the Fund entities guaranteeing the Equity Commitment. However, in our experience, such a request can be commercially challenging.
3. Fund level due diligence. To properly underwrite an ECF based on the Fund's Ultimate Investors, the Lender has to do a certain level of due diligence on the Ultimate Investors and their Remaining Investor Commitments. Often, the ECF Lender is a lender in the Fund's Subscription Facility, enabling it to piggyback somewhat off the diligence done for that transaction. Regardless, many Lenders still conduct Ultimate Investor due diligence by review of the Ultimate Investor list, the Fund structure chart and its partnership agreement. Subscription agreement and side letter review are required in certain, but not all, circumstances.
4. Fund covenants. Fund covenants, typically included in the Consent, are often negotiated at length. Of course, the Lender wants the continued existence of its initial lending expectations, and the Fund wants to be able to conduct its ongoing business in the ordinary course without undue burden. Thus, matters such as the consent standard for amendments to the partnership agreement of the Fund, and the implication of wholesale Ultimate Investor transfers, can be challenging.
5. Default triggers. The events of default in an ECF include, of course, all of the standard credit triggers customary in corporate credit transactions. But, because the underwriting focuses on the Fund's ability to honor the Equity Commitment, there are typically additional triggers tailored toward the Fund's liquidity and compliance with the terms of the Consent. For example, ECFs typically include a cross default to the Fund's Subscription Facility, a tight trigger based on Ultimate Investor funding defaults (depending on the actual advance rate in the Fund's Subscription Facility) and, in certain cases, an event of default based on NAV declining below a certain percentage of Investment acquisition costs.

Conclusion

ECFs can provide a compelling financing solution to Funds and Portfolio Companies while providing Lenders increased yield from a repayment source they have significant familiarity with. While there are a variety of nuances and complexities, ECFs are sound transaction structures, and a financing tool we anticipate seeing utilized more frequently in the coming years.

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Mike Mascia is Co-Chair of the firm's Finance Group and a member of the firm's Management Committee. He has a globally recognized fund finance practice, having represented lenders in subscription credit facilities to real estate and private equity funds sponsored by many of the world's pre-eminent fund sponsors. He has been lead counsel on numerous hybrid facilities, and is one of the few attorneys in the United States with experience in both subscription credit facilities and CLOs. Mike represents lenders on leverage facilities to secondary funds and other credits looking primarily to fund assets or NAV for repayment. Mike is the founder of the annual Global Fund Finance Symposium, now in its 8th year, and he is a founding member and the Secretary of the Funds Finance Association.

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Tim's practice focuses on fund finance, and he has significant experience negotiating and documenting subscription credit facilities made to multijurisdictional fund vehicles, including private equity, real estate, REIT, infrastructure and debt funds. He routinely serves as counsel to lenders and lead agents on bilateral and syndicated credit facilities with complex fund collateral structures, including subscription-secured credit facilities, net asset value secured credit facilities and management fee secured credit facilities. Tim's experience also encompasses working with fund-related borrowers on the negotiation of third-party investor documents with institutional, high-net-worth and sovereign wealth investors.

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