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The Impact of COVID-19 on NAV and Hybrid Credit Facilities

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For private investment funds with limited or no remaining uncalled commitments, net asset value (NAV) and hybrid credit facilities can provide a useful source of liquidity to support underperforming assets or allow funds to engage in opportunistic acquisitions. These types of facilities are receiving renewed attention for funds seeking liquidity in light of the uncertainty created by the COVID-19 global pandemic. However, in the case of NAV or hybrid credit facilities that were put in place prior to the onset of the pandemic, more recent valuation reporting has created challenges for some funds in complying with the financial covenants under such facilities, necessitating mandatory prepayments, amendments and/or waivers. This article explains the key features of NAV and hybrid credit facilities and discusses how such facilities may be both a benefit and a burden to funds during the COVID-19 crisis.

NAV Facilities

NAV facilities provide leverage to a fund based on its portfolio of assets. Unlike subscription facilities, there is typically no recourse to the uncalled commitments of investors. Rather, NAV facilities “look down” to the underlying assets of a fund but do not “look up” to investors as part of the credit analysis. The portfolio of assets available to support a NAV facility will depend on the strategy of the particular fund. NAV facilities are particularly well-suited to credit funds, secondary funds and funds of funds (which all have relatively liquid or transferable underlying assets), but there has also been an increased usage among private equity funds. The particular security package will be determined based on the lender’s due diligence and the specific assets available as collateral.

Because they rely on a portfolio of assets, NAV facilities have been most commonly put in place during the later stages of a fund's life. They can be desirable for a fund seeking liquidity at a time when there are no or limited uncalled investor commitments remaining. Such liquidity may be used for a variety of purposes, including financing unanticipated growth or follow-on opportunities, making distributions to investors (if permitted under the fund's governing agreements) and providing working capital. Of particular relevance in light of COVID-19, NAV facilities provide private equity funds with a means to support their portfolio companies which may be experiencing financial difficulties and covenant breaches under the terms of a portfolio company's financing arrangements.

Hybrid Facilities

Hybrid facilities combine elements of both subscription facilities and NAV facilities, and the security package includes a combination of uncalled investor commitments and the underlying assets of a fund. Hybrid facilities involve many of the same features and benefits of NAV facilities outlined above. The main additional benefit is that a hybrid facility is capable of being put in place earlier in the life of a fund and thus can provide a "whole of life" financing solution.

The potential benefits of a hybrid facility are most pronounced for credit funds, where investor capital is likely to be deployed during a relatively short timeframe and in respect of which the underlying assets lend themselves well to categorization through a set of eligibility criteria. As a result, this is where there is the most appetite for hybrid facilities.

Key Terms

The terms and security packages applicable to NAV and hybrid facilities are much more bespoke than those applicable to subscription facilities, as they must take into account the unique features and requirements of the relevant fund borrower and its assets. The key financial covenant will be a loan-to-value (LTV) ratio, testing the total financial indebtedness of the fund against the net asset value of the secured portfolio of assets. A leverage ratio (testing leverage at the portfolio company level) is also sometimes seen as a feature in NAV facilities made available to private equity funds. In addition, the valuation methodology will be an important point to negotiate given that it feeds directly into the LTV ratio. Funds will prefer to use their own methodology as reported in the information provided to investors, whereas lenders will generally prefer an independent valuation process and rights to supplement their own valuations (either at any time or on the occurrence of certain trigger events).

The Impact of COVID-19

NAV and hybrid facilities have seen a marked increase in popularity since the onset of the pandemic, as private investment funds explore ways to bolster liquidity. Existing lenders in this space have found themselves extremely busy, with increased demand over the last few months. For new facilities being negotiated since the pandemic began, there has been, in a number of cases, a shift towards higher pricing, lower LTV ratio levels and a more lender-friendly regime for challenging valuations produced by funds. Before the crisis, it would not have been unusual for lenders to be able to exercise rights to challenge valuations only where an event of default was continuing or if there was some other objective trigger. Increasingly, lenders have insisted on the ability to obtain their own valuations at any time.

On the other hand, some funds with existing NAV and hybrid facilities have faced challenges in recent months. For many funds, the value of their underlying assets has likely decreased as a result of the COVID-19 crisis. Such decreasing valuations put pressure on funds' compliance with the LTV ratios under their existing facilities. There are a variety of consequences depending on the terms of each facility, but typically there would be a cascade of effects as certain LTV thresholds are breached: first, a block on distributions to investors, followed by an inability to obtain new funding under the facility (where such facility otherwise permits multiple drawdowns), then mandatory prepayment requirements and, finally, an event of default. It will therefore be essential for fund sponsors to understand the timing and methodology applicable to valuations and to model the implications of increased LTV ratios. Lenders' rights to contest valuations are an important factor in these considerations. In many credit facilities, lenders will have rights to introduce their own valuations where they disagree with valuations produced by the fund. In the context of credit funds, such rights will generally be triggered by a list of prescribed circumstances including adverse credit events relating to underlying borrowers and material amendments to the underlying loan documents. For private equity funds, the trigger events will generally include insolvency events in relation to portfolio companies and significant drops in other performance metrics (such as EBITDA). In both cases, defaults occurring at the fund level may also give rise to general revaluation rights with respect to the whole portfolio of underlying assets.

While the easiest way to cure an LTV ratio breach will be an injection of cash to pay down outstanding facility amounts, this may not be an option for funds with limited remaining uncalled commitments. Some NAV facilities will include additional cure rights which may allow a fund to avoid defaults if a cure plan is agreed and carried out. For instance, this may be a plan to divest certain assets or raise additional funds in the short to medium term in a way which will result in the fund returning to compliance with financial covenants. Even where this right is not provided for in the credit agreement, lenders may be willing to negotiate a cure plan (or other amendments and waivers) given the difficulty involved in taking enforcement action. However, as a trade-off, lenders may impose one or more of the following requirements: (1) an increase in pricing or additional fees, (2) a requirement for all valuations to be prepared by the lender or a third party appraiser, and (3) additional restrictions on distributions and use of proceeds. It would be prudent for funds who expect to breach their LTV ratio to give consideration to cure options and to engage constructively with lenders at the appropriate time. Fund borrowers must also take care when negotiating cure plans to consider whether any changes to the terms of a credit agreement may trigger a “significant modification” of the loan for US federal income tax purposes, which could, in certain circumstances, result in the fund recognizing taxable income under the cancellation of indebtedness rules.

Proskauer's market leading international fund finance practice has considerable experience with NAV and hybrid credit facilities, both in the US and in Europe. Working together with the firm's corporate, tax and other practice groups, our fund finance practice is available to help our clients structure and implement such credit facilities to fit their needs. We are also able to advise on the consequences of breaches and to apply our insight to assist in formulating cure plans. Please contact us with any questions.

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