C A D W A L A D E R

NAV Covenants and Subscription Lines

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By **Chad Stackhouse**
Partner | Fund Finance

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.