KEY POINTS

- Hybrid facilities have long offered the prospect of efficient financing through the use of subscription facilities and NAV facilities in a single product, with the resulting potential for improved credit.
- The reality has often fallen short of the hype. The complexity and lack of a developed market has hampered efficiency, while the demands of differing expertise and unfavourable regulatory treatment have limited the product's growth.
- The growing prevalence of continuation funds offers hope to this unloved product, falling in a sweet spot where subscription facilities and NAV facilities may not make sense individually, but offer better features when combined.

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Hybrid facilities: the promise, the reality and the hope

Have hybrid facilities evolved from a niche product into a full-fledged market? This article considers the features of subscription facilities, NAV facilities and hybrid facilities and explores why hybrid facilities have failed to flourish to date. It also considers how continuation funds can potentially rewrite this narrative.

BACKGROUND

Debt facilities provided directly to private funds typically fall into one of two categories: subscription facilities and NAV facilities.

Subscription facilities (otherwise known as subscription lines or capital call facilities) look to the uncalled capital commitments of the investors in that fund, typically highly creditworthy entities such as pension funds or family offices. The bank will take security over the rights of the fund to such uncalled capital commitments, the rights of the general partner (GP) to issue a drawdown notice to call such capital and the account into which such capital commitments are required to be paid. The main financial covenant will limit the borrowing to a percentage of the available uncalled capital commitments of the included or qualifying investors in the fund (those that meet the criteria specified by the bank providing the facility). Historically, such facilities were used to provide bridge financing for the short period investors are given to fund their commitments after they are called, which typically takes 10 to 15 business days. The market has since evolved and subscription facilities are often used for more medium-term financing, providing funds with working capital to make multiple investments and limit themselves to less frequent, larger and more predictable capital calls (all of which are welcomed by investors).

NAV facilities (otherwise known as asset-backed facilities), on the other hand, look to the investments the relevant fund has made or will make, whatever their nature. The bank will take the best security it can for the type of investment that is made, with market practices varying widely for different types of funds. In a NAV facility provided to a credit fund, lenders will often take security over the credit assets themselves, the shares of the vehicle that holds those assets and the accounts into which they are paid. In a NAV facility provided to a private equity (PE) fund, lenders will aim, if possible, to take security over the shares of a holding company for the portfolio investment (though a lack of such security and reliance on a negative pledge covenant is accepted in some parts of the market in the alternative) and the account into which distributions are made. This leverage tends to be much longer term, extending beyond the investment period of the fund and amortising as the investments are realised.

Subscription facilities and NAV facilities operate in different parts of a fund's lifecycle. A subscription facility is most valuable in a fund's ramp-up period, when there is a limited number of assets and significant capital commitments from investors. At this time, the portfolio is often worth comparatively little and suffers further from being concentrated in a smaller number of investments (increasing the overall risk of a NAV facility). By contrast, once a fund is significantly deployed, fewer capital commitments will remain. A NAV facility is then more feasible because banks can lend against a larger, less concentrated portfolio of investments.

THE PROMISE

The hybrid facility concept evolved in this context: a single facility that would remain in place throughout a fund's lifecycle combining the features of both a subscription facility and a NAV facility. This type of facility appears to offer significant efficiency advantages to both sides (the banks and the fund manager), as they will only need to structure and negotiate a single facility instead of two. In theory, the combined facility could have an improved credit profile (and therefore offer better terms) than separate facilities, particularly in the awkward part of deployment while the portfolio is not yet very large and diversified, but the pool of committed and uncalled capital has started to shrink.

THE REALITY

This promise has proven hard to fulfil.

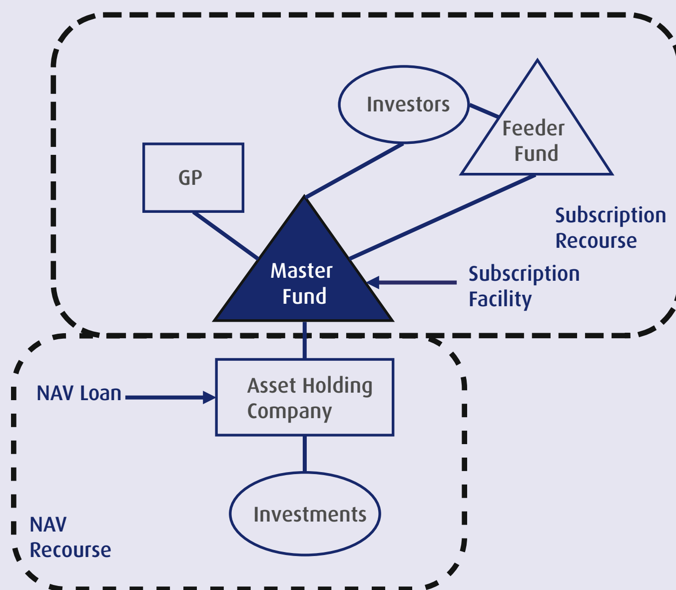
First, the efficiencies of negotiating a single facility were largely illusory. While a hybrid facility may be constituted by a single suite of documents, those documents must include all of the features, security and protections that were contained in both of the separate facilities. This leads to larger and more complex documentation. Worse still, while subscription facilities (and, to a lesser degree, NAV facilities) have developed market standard terms, hybrid facility terms tend to remain custom and heavily negotiated. Thus, while a subscription facility can often be negotiated and closed quickly, a hybrid facility often involves lengthy negotiations in which the facility risks not being in place in time for the "first closing" (when the capital call aspect of the facility is most valuable).

Box 1: "borrowing base"

A great example of the difficulties that hybrid facilities face in reality is the "borrowing base": the calculation of the maximum amount that may be borrowed under a facility. A naive assumption would be that the borrowing base of a subscription facility (a percentage of the uncalled capital commitments of included investors) could simply be added to the borrowing base of a NAV facility (a percentage of the value of the assets of the fund, with various adjustments for concentrations and differing asset quality). In reality, however, to reflect concentration and other credit concerns, the borrowing base of a hybrid facility often applies a haircut or a cap to the aggregate borrowing base. Alternatively, the borrowing base does not aggregate the credit given for uncalled capital commitments and fund investments but rather converts from the former to the latter at the point the borrowing base for the latter would first exceed the former. This can be for regulatory reasons, or because the bank team providing the facility has more experience of asset-backed facilities/NAV facilities (and accordingly will look to revert the facility to their more typical terms once the fund has ramped up to a sufficiently large and diverse portfolio). In each case, the result is the same: the fund can ultimately borrow less as a result of choosing a hybrid facility over a separate subscription facility and NAV facility.

Figure 1

A simplified fund structure showing the typical recourse package for a Subscription facility and for a NAV facility. A hybrid facility may be lent to either the Master Fund or an asset holding vehicle, provided that through guarantees and security it has recourse to the same package as the separate facilities.



Second, a significant crossover of the expertise required to provide a hybrid facility is lacking because the subscription facility and NAV facility markets evolved separately. Even in banks that are highly active in both markets, the teams that offer both facilities tend to be separate and have different credit processes and models. The due diligence requirements of both types of facility naturally differ; the focus of subscription facilities are the fund documents (which provide the rights to call unfunded capital commitments, the mechanics of drawdown, investor defaults, etc) and the focus of NAV facilities are the underlying portfolio, the enforceability of the security granted and the calculations of value. Accordingly, hybrid facilities often require collaboration between teams that do not typically work together.

Third, hybrid facilities are often subject to worse regulatory or capital treatment than separate subscription facilities and NAV facilities. For example:

- Under Art 6(4) of the Level 2 Regulations[1] of the Alternative Investment Fund Managers Directive (AIFMD),[2] alternative investment fund managers (AIFMs) must exclude from their calculations of leverage (which are subject to limits and disclosure obligations) borrowing arrangements that are temporary in nature and fully covered by contractual capital commitments from investors in the fund. This exception, specifically targeting subscription facilities, is difficult to apply to the portion of a hybrid facility lending against uncalled capital commitments.
- The EU and UK securitisation regulatory regimes require that the originator has not been established for the sole purpose of securitising exposures. In the context of a credit fund where European deals are typically structured as securitisations to benefit from better capital treatment, a hybrid facility may struggle to satisfy this requirement (at least to the extent that uncalled capital commitments and asset value are given credit in the "borrowing base" at the same time – see Box 1 above).
- The reality of hybrid facilities has therefore often fallen short of the promise. There have been pockets of hybrid facility activity, but it has not developed into a market in its own right and fund managers that have experimented with them will often choose not to repeat the experience (unless they are duplicating the facility for their next fund so that the complexities do not have to be renegotiated).

Biog box

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THE HOPE

Recently, however, the notable increase in formation of continuation funds has offered hope to this unloved structure. Continuation funds are formed to purchase a small number of assets from the end of an existing PE fund (typically by the same sponsor or its affiliates). The existing investors will typically be given the option to roll their investment into the continuation fund or cash out.

Subscription facilities are not well suited to continuation funds as the majority of investors will often choose to redeem when given the option and those that don't may not be willing to extend further capital. As a result, there tends to be a smaller and less diversified pool of investors with uncalled capital commitments to lend against. A similar problem exists for the NAV side of the facility: almost by definition their pool of assets are small and highly concentrated. Typically, only a subset of specialist lenders are willing to lend in such circumstances (and they are often on the pricier end of the market).

This creates a sweet spot for a hybrid facility that can benefit from the increased diversity of looking to both sources of value. In addition, the features of a continuation fund tend to result in better quality of the uncalled capital commitments and portfolio investments from a credit perspective. For example, as all investors will already be significantly drawn, they will have significant "skin in the game" and more incentive to fund their uncalled capital commitments. This is reflected in the competitive pricing of hybrid facilities offered to continuation funds and points a potential path to success for a product that has otherwise struggled. ■

1 Commission Delegated Regulation (EU) 231/2013.

2 Directive 2011/61/EU.

Further Reading:

- NAV, asset-backed and hybrid funds finance facilities (2016) 7 JIBFL 407.
- Structures, security and finance products: the increasingly sophisticated world of investment fund focused borrowing (2021) 1 JIBFL 46.
- Lexis+® UK: Banking & Finance: Practice Note: Fund finance.