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Asset Valuation Issues for NAV Loans

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This article focuses on how private company and private fund interests are typically valued in NAV loan facilities and the increased focus we have seen lenders place on valuation issues since the beginning of the pandemic. For our purposes, NAV loans are loans to private equity funds that are supported, either on a secured or unsecured basis, by the value of the assets of the private equity fund (*i.e.*, private company interests held by "primary" private equity funds or private fund interests held by "secondary" private equity funds). The key measurement that lenders use for evaluating the level of risk for NAV loans is the LTV ratio (*i.e.*, the ratio of the loan principal to the value of the assets supporting the borrower's loan obligations). In order for NAV loans to remain out of default, LTV ratios need to remain below certain pre-agreed thresholds ("LTV triggers"). Breaching an LTV trigger could result in implementing negotiated cure plans, mandatory prepayment of the facility or even foreclosure. With all of this in mind, it's easy to understand why the methodology used in determining the value of the assets included in the LTV ratio calculations are a point of interest for any lender underwriting a NAV loan.

As previously discussed **here**, during the volatile (albeit short-lived) Q1 2020 bear market, the precipitous declines in stock prices resulted in margin loans (*i.e.*, loans secured by public equities) breaching price and LTV triggers almost daily. As a result, the bear market set off frenzied efforts by both lenders and borrowers to remedy defaults, including borrowers posting additional credit support, the parties entering into forbearance agreements and cooperative workout arrangements, and, in some cases, lenders foreclosing on collateral and liquidating positions. Yet, by and large, NAV loans were not stressed by these deteriorating market conditions. For both primary and secondary private equity funds, impaired asset values would not be reflected until the first-quarter valuation statements started trickling in during the back half of the second quarter of 2020. However, by this time, public markets were already surging on the wave of the bull market that we have been riding to date. As a result, the 2020 first-quarter valuation statements reflected these improving market conditions and, for NAV loans in general, it was as if the bear market never happened.

While NAV loan borrowers and lenders (and their outside counsel) alike were more than happy to have largely avoided dealing with the distress that plagued margin loans during Q1 2020, lenders were nonetheless left asking themselves what would have happened had any of the more dire economic forecasts from the beginning of the pandemic come to fruition. In particular, would lenders be willing to again sit on the sidelines while asset prices continued to decline across markets and whether lenders were comfortable with relying on borrowers to mark their own positions given another bout of extreme market volatility? Not surprisingly, we have since seen lenders more focused on asset valuation issues in NAV loans.

Common Valuation Approaches. Before delving into the asset valuation issues that lenders have been focused on of late for NAV loans, we must first discuss common asset valuation approaches and how they differ for loans to primary private equity funds ("Primary Facilities") and loans to secondary private equity funds ("Secondary Facilities").

Primary Facilities. For Primary Facilities, the assets supporting the borrower's loan obligations are the borrower's interests in the various private companies that it owns. Most commonly, for purposes of calculating the LTV ratio for the facility, lenders will use the values that the borrower assigns to its private company investments on its own books and records, which will be the same values that the borrower uses when preparing valuation statements for its investors. Lenders typically extensively diligence the borrower's valuation policies in order to get comfortable with how the borrower is valuing its assets and make any appropriate adjustment to LTV triggers. Loan documentation would then require lender consent for any changes in the borrower's valuation policies going forward. For Primary Facilities where it is contemplated that any of the private companies included in the LTV calculations may go public, loan documentation will include flexibility to value the interests in any of these companies based on the post-IPO market price.

Secondary Facilities. For Secondary Facilities, the assets supporting the borrower's loan obligations are private fund interests held by the borrower in third-party funds. Lenders will value a private fund interest for purposes of calculating the LTV ratio for the facility as the lower of (a) the value of the interest provided to the borrower from the underlying fund and (b) the value that the borrower has assigned to the interest on its own books and records. This value will then be adjusted when it is reported to the lender to account for any borrower capital contributions to the underlying fund and/or distributions from the underlying fund to the borrower.

Valuation Issues and Solutions. There are two main issues that lenders are focused on with these common valuation approaches for NAV loans. The first is the time delay for valuations to be provided to lenders and the second is the lack of independently provided valuations.

Time Delay for Valuations. For margin loans, where the performing assets are publicly traded stock, values are essentially updated in real time. However, as discussed above, for NAV loans, asset valuations are only provided on a quarterly basis and, even then, there is typically a fairly extended delivery period for borrowers to provide the updated marks to lenders (*e.g.*, first quarter marks are often not due until 60-90 days after the quarter-end). The time delay for Secondary Facilities is even more exacerbated, as a secondary fund borrower has to wait to receive valuation statements from each of the underlying funds it is invested in before providing valuations for its portfolio to its lenders. By the time LTV ratios

are updated with the most recent asset valuations, market conditions may have changed. Accordingly, we are more frequently seeing lenders look to address this concern by pushing to include the following types of provisions in their loan documents:

- *Lender Dispute Rights*. In the event that the lender has a reasonable belief that a valuation provided by the borrower is not correct (*e.g.*, as a result of significant changes in the macro-economy), the lender would be permitted to value the position itself or use a value from an approved valuation agent (more on the use of valuation agents below) for purposes of calculating the LTV ratio. This right is typically coupled with the obligation of a lender to notify the borrower of the revised valuation, along with reasonable detail as to how the lender calculated the updated valuation and support for the lender's determination that the original valuation was incorrect.
- *Lender Write-Down for Stale Valuations*. For Secondary Facilities in particular, to the extent a valuation statement from an underlying fund is not available for a particular position within a prescribed amount of time following the relevant quarter-end, rather than permit the position to remain in the calculation of the LTV ratio at the previous (now stale) valuation, the position is either excluded entirely or the lender is permitted to write-down the value of the position.
- *Link to Market/Sector Index Declines.* In direct response to the Q1 2020 bear market and its effect (or lack thereof) on NAV loans, as discussed above, we have seen some lenders tie precipitous declines in market-wide or sector-appropriate indexes to automatic write-downs of asset valuations. For example, in the event that the S&P 500 were to decline by 20% or more during a calendar quarter, rather than wait for the declines to be reflected in the valuation statements for that quarter (which may not be delivered for another 2-3 months), the current asset valuations included in the calculation of the LTV ratio would be subject to a corresponding write-down. A different market and/or sector-specific index may be a more appropriate benchmark where the relevant assets are concentrated in a particular geographic area or industry.

<u>No Independent Valuations</u>. Another way in which NAV loans differ from margin loans is that (aside from post-IPO positions) there is no public market price for the private fund interests or private company interests included in the LTV ratio. Instead, as discussed above, the values are typically derived directly by the borrower or, in the case of a Secondary Facility, from the underlying fund. Even though the valuations provided by the borrower will be required by the loan documentation to be made in accordance with its valuation policies or, in the case of Secondary Facilities, will be provided by a third party, a fund does not necessarily have the same incentives as a NAV loan lender to mark its positions conservatively. In addition, as any person that has taken Corporate Finance 101 is aware, there are numerous forecasts, educated guesses and subjective components that may be present in determining the enterprise value of any going concern (even Warren Buffet has been quoted as saying that "[v]aluing a business is part art and part science"). Accordingly, given the diverging interests between lenders and funds to market positions conservatively, especially during periods of extreme market volatility where there is arguably a larger spectrum of defensible valuations for an investment, we have increasingly seen the following types of provisions included in NAV loan documents to address this concern.

- *Third-Party Valuations*. The most common approach to address lender concerns regarding the lack of independent asset valuations is to appoint a third-party valuation agent. Typically, the parties will pre-agree to a list of acceptable valuation agents. Valuation agent marks are most commonly used either in connection with a periodic review of the borrower's assets or to settle a dispute raised by the lender over a borrower-provided valuation. When used for periodic reviews, parties will often negotiate the frequency of the reviews (*e.g.*, annually, quarterly, etc.), the portion of the portfolio to be covered in each review (*e.g.*, entire portfolio, half of the portfolio, largest positions only, etc.), and any cost-sharing arrangements between the borrower and the lender. When used to settle disputes, the parties will typically negotiate how often a lender can request a valuation agent review (*e.g.*, no more than once per calendar quarter), whether the borrower has the right to further dispute the valuation agent's mark and any cost-sharing arrangements.
- *Lender Valuations*. While less common, we do occasionally see provisions that provide lenders with the right to value positions instead of borrowers. Generally, NAV loan facilities where the lender is valuing a private equity fund's assets for purposes of calculating LTV ratios are limited to circumstances where there is a fairly robust private secondary market for a particular private company interest and the lender is active in this market. In these instances, lenders will also typically provide evidence supporting their valuations of any relevant positions to borrowers upon request.