

FUND FINANCE FRIDAY

NAV Finance Market Update

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Between Omicron, the holidays, and down-to-the-wire end-of-year closings, it was a hectic finish to 2021. But now that the calendar reads 2022, we wanted to reflect this week on the state of the NAV finance market and provide some thoughts on trends we're observing as 2022 gets underway:

Transactional Volume. 2021 was another year of significant growth in the demand for NAV financing products. This growth is set to continue through the start of the new year. Where in past years (even 2021), we saw some softening in deal activity in January (presumably as everyone took a breather after the busyness of December), this year we are moving full steam ahead with a full slate of new deals.

New Lenders. We have seen a noticeable uptick in new lenders (including both banks and private lenders) entering the NAV market and potential new lenders showing curiosity about the range of potential product offerings. Of particular note are asset managers and insurance companies, which have been leading the charge on some sizeable transactions. Our hope is that, as more lenders enter the market, NAV loans will be viewed as less esoteric and become more broadly accessible for sponsors looking for leverage and liquidity enhancements.

Diverse Borrowers. In addition to private equity funds, secondaries funds, hedge funds and funds of hedge funds, we saw notable demand for financing in 2021 from alternative registered investment companies, family offices and pension funds.

- Alternative registered investment companies are public investment funds registered under the Investment Company Act of 1940 that invest in a portfolio of private equity funds or

engage in hedge fund-like or private equity-like investment strategies. They often rely on credit lines for investment leverage, for cash management or to fund periodic repurchases of shares from their investors. We are currently working on several loans to such investment funds.

- The sophistication of family offices continues to increase, and family offices were the borrowers on many of the biggest NAV, secondaries and fund of hedge fund deals we worked on in 2021. Having closed several large family office transactions in the closing days of 2021 and these first days of 2022, we anticipate working more with family offices in the coming year.
- While we didn't see a huge volume of transactions for pension funds close in 2021, the ones that did were big. And we spent a lot of time refreshing clients on issues such as UBTI, sovereign immunity, and capacity and authority. Based on the number of inquiries, we expect an increase in the number of financings for pension funds in the coming year.

Spreads. Spreads can be difficult to track in the NAV finance market given the breadth of products, the diversity of risk profiles, and the array of lenders and borrowers. However, looking at just comparative subsets of deals, the trend lines are clear. Spreads have narrowed from their pandemic peaks of Q4 2020 and Q1 2021. That said, spreads still have not reached their pre-pandemic levels. For 2022, it will be interesting to monitor the tug-of-war between (potentially) rising rates and increased competition as new lenders enter the NAV market. Market volatility (or lack thereof) will surely be another key factor to watch.

Products.

- *Continuation Financing for PE Funds.* Despite run-ups in equity values, many sponsors still see the potential for substantial returns from their core investments. Sponsors have deployed fund-level debt to finance dividend recapitalizations and facilitate the launch of continuation funds, which has enabled them to delay realization events and extend the life of those investments.
- *Margin Loans and Pre-IPO Loans.* The market for pre-IPO loans and margin loans has been on fire, with lenders increasingly gaining comfort financing portfolio positions through the transition from private to listed ... and beyond. Lofty valuations, a busy IPO market and low interest rates in 2021 presented ideal conditions for a significant uptick in these types of financings. We'll wait to see whether rising interest rates and increasing volatility in the public equity markets will dampen the enthusiasm we saw this past year for these products or if the market's appetite for these products will continue unabated.
- *Preferred Equity and Preferred Leverage.* In addition to the usual players in the preferred share space, we saw robust participation by secondaries funds in the market for preferred shares in 2021. The preferred shares were often accompanied by a financing – either in connection with the acquisition by the secondaries fund or as a dividend recapitalization by the issuer of the preferred share.
- *Secondaries Financing.* With top secondaries fund sponsors continuing to raise record amounts of capital, mega-funds are likely to support robust trading levels in the secondaries market. And we expect a material portion of that trading to be funded with debt.

- *Hedge Fund Financing.* 2021 was a strong year for financing for hedge funds. Not surprisingly, much of that activity was the result of new fund launches by, and large mandates for separately managed accounts awarded to, the largest investment managers of funds of hedge funds. But we have also noted a recent surge in single-manager hedge fund transactions (loans to feeder funds, general partners, management companies or principals secured by interests in a single affiliated hedge fund). This market has been comparatively quiet the past few years.
- *Portfolio Hedging.* LIBOR amendments dominated lawyer time sheets in Q4, but we are having a lot of discussions with lenders and borrowers around strategies for most efficiently incorporating currency and interest rate hedging programs into financing offerings. Given the increasingly international focus of investment portfolios and concerns about potential increases in interest rates, we expect to spend more time on portfolio hedging issues in 2022.
- *Upsizes.* While new deals get all the attention, upsizes of existing deals have been the quiet drivers of profit growth for a lot of NAV-focused businesses. Staying close to clients and providing flexibility to meet their evolving needs pays off. Valuation increases in investment portfolios and investor expectations for accelerated returns of capital have been material factors driving upsizes.

ESG. Environmental, social and governance dealmaking has been an increasingly relevant topic the last couple of years and, as has been discussed extensively in *Fund Finance Friday*, has become a growing component of the subscription fund finance market generally. However, on the NAV side of the market, we have yet to see ESG make meaningful inroads in deal structuring and documentation. NAV facilities are typically provided to funds in the later stages of their investment activity or to funds that are using NAV financing to acquire or leverage a specific investment or portfolio of investments. This obviously makes it more difficult to provide financing incentives to a fund based on ESG investment metrics in these contexts. Nonetheless, it will be interesting to see how ESG continues to impact the fund finance markets in general and whether we will start to see ESG make an impact on the NAV financing market in particular.

LIBOR/SOFR Amendments. While LIBOR remediation has been in full swing for quite some time in the subscription finance world, the LIBOR transition has really just begun in the U.S. NAV markets. Given the more targeted use of NAV financings in general, there is typically a smaller subset of currencies available to borrow for any particular facility. As a result, the December 31, 2021 LIBOR transition date for non-USD LIBOR rates had a much smaller impact on NAV financings (at least in the U.S.) than it did in the subscription space. We expect 2022 to be a different story.

Pandemic 4.0. Other than some cancelled plans and a short-lived (we hope) return to WFH, the market has thus far proven to be impressively resilient in the face of Omicron and its staggering case counts. Whether it's because the prevailing wisdom is that this latest wave will ebb as quickly as it flowed or that we are all just much more familiar with the pandemic playbook at this point, deal flow is full steam ahead and the new world order macroeconomic concerns are once again focused on mundane things like a hawkish Fed and inflation.

We wish everyone a happy and healthy New Year. We are very excited to get some face time in Miami at the FFA Global Symposium next month and to work alongside you again this year, whatever 2022 may bring.