

Fund Finance Friday



NAV Facilities – The Swiss Army Knife of the Fund Finance Market

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We continue to see significant interest in NAV financing products in both the U.S. and European markets, which is reflected in double digit year-over-year growth in our deal activity for these facilities to date. As compared to years past, there has been a noticeable uptick in new lenders willing to provide NAV financing (including both banks and private lenders). In mid-2020, at the outset of the pandemic, the spike in interest in NAV lending from sponsors was anecdotally explained by (i) sponsors being hesitant to call capital from LPs during the uncertainty of the pandemic and (ii) the inability of private equity-backed companies to obtain affordable financing during the disruptions caused by COVID shutdowns. Nonetheless, as these pandemic effects continue to fade and we shift to a very different macroeconomic environment, the demand for NAV lending remains strong. Below is a high-level summary of some of the key features of NAV loans, many of which are the focus of our conversations with clients.

The allure of NAV loans isn't that NAV lending provides a silver bullet to a particular issue faced by the alternative investment market at-large. Rather, it's that NAV loans can be structured/tailored to address any number of issues. It's this flexibility that drives the value of this product to both sponsors and investors (and keeps loan structurers and their lawyers alike on their toes and up late at night).

To illustrate this from the perspective of outside counsel, a typical request that we often get from lenders that are interested in exploring adding NAV loans to their product offering is to provide them with a sample term sheet to review. Since NAV loans aren't a one-size-fits-all product, there isn't yet a truly one-size-fits-all term sheet. Instead, to start putting together the skeleton of a term sheet for a NAV loan you would need to know the following (among other things):

- (i) what is the structure of the borrower, and where in the structure will the financing be provided;
- (ii) is the facility a revolver or a term loan (or a combination thereof);
- (iii) is the borrower a hedge fund, private equity fund, private debt fund, secondaries fund, family office, etc.;
- (iv) is the facility secured or unsecured;
- (v) what are the underlying assets, and what obstacles apply to the pledge and potential foreclosure of such assets;
- (vi) what is the holding structure for the investments and what jurisdictions are implicated;
- (vii) how will the underlying assets be valued and what rights will there be to obtain independent valuations;
- (viii) what is the lender's approach to borrowing base eligibility, concentration limits, etc.;
- (ix) are there co-investors and where do they enter the structure;

- (x) will there be a bullet repayment or an amortization based on cash flows, LTV, time to maturity, etc.;
- (xi) will there be additional credit support provided, such as pledges of capital commitments, guarantees or equity commitment letters from parent funds;
- (xii) will the facility be used to finance an acquisition or are the underlying assets already owned;
- (xiii) is the investment portfolio static (*i.e.*, pre-approved portfolio) or dynamic;
- (xiv) and does the borrower have other creditors.

When we discuss NAV loans with clients that are new to the space, we generally describe such loans as falling into several broad categories:

1. Negative Pledge/“Collateral Lite” Loans: The first consists of very low loan-to-value facilities to larger, more diversified funds, where lenders typically do not take investment assets as collateral but instead underwrite the value of the fund as a whole (often coupled with a negative pledge of the fund’s assets and a pledge of the fund’s bank accounts). See previous discussion of these types of facilities from our colleague Leah Edelboim [here](#).
2. Fully Secured Loans: The second bucket consists of what are typically higher loan-to-value facilities or facilities to more concentrated funds (or subsidiary vehicles of such funds), where lenders will take a security interest in the fund’s investment assets (often indirectly, as previously discussed [here](#)). These facilities tend to have much more structured collateral and credit support. In addition, since these facilities are underwritten based on the value of specific investments (rather than the value of the fund itself) it is imperative that lenders understand all aspects of the investments supporting the loan, and lenders may look to map out in detail an exit plan should the facility go into default. See our prior coverage [here](#) of the common issues that arise in evaluating security structures for these types of loans.
3. Structured Products: The third bucket consists of preferred shares or similar structured products whereby financing is provided to a fund in the form of a purchase of a security issued by the fund. The security can provide for a fixed rate of return, a floating rate of return (typically tied to a benchmark or index) or a structured rate of return that is dependent on the performance of the fund’s assets. Such structured products tend to arise in the middle of the capital structure, behind secured creditors but ahead of equity investors. They tend to have longer terms and higher rates of return. And they can be structured to differentiate returns among holders of the products, including by class or series. We’ll provide a more detailed discussion of such products on another day.

We also typically highlight common uses for such loans, including:

- Adding Strategic Investments. We commonly see NAV loans structured in connection with the addition of strategic investments by a fund. These loans can be structured to provide acquisition financing, or to provide back-leverage to a fund to finance the equity portion of its acquisition costs for the particular investment(s). Such facilities are typically used later in the investment cycles of funds once capital commitments have largely been called or are no longer fully available.
- Capital Returns to Investors. As average hold periods for private equity portfolios increase, there is continued pressure on sponsors to monetize their investments and provide liquidity to their investors. As a result, a common use of NAV loans is for sponsors to borrow at the fund level to return capital to investors. Lenders are repaid later after realization events with respect to one or more investments of the funds. In this instance, a NAV loan allows the fund to return capital to its investors in advance of one or more realization events with respect to its investments.
- Financing for Management Companies. General partners and management companies use NAV loans for a range of purposes, including working capital, funding increased investment in the funds that they manage, payment of taxes, payment of bonuses, technology upgrades, distributions to owners, and succession planning (*i.e.*, transferring ownership interests in managed funds from founders to the next generation of investment professionals), to name a few. Such facilities may be secured by fee streams from the funds or by equity in the funds.
- Aftercare Facilities. For funds with ongoing liquidity needs after the expiration of their investment periods, 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 to increase borrowing capacity (*e.g.*, 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 will 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 for these facilities and look “downward” at the asset value of the fund’s investments. See our colleague Chad Stackhouse’s in-depth discussion of these types of facilities [here](#).

- Facilitate Continuation Funds. The use of financing for continuation funds has received a lot of press as of late. A continuation fund will be set up to transfer assets from an existing fund. The investors in the existing funds can elect to either be cashed out of the investment or to roll their equity into the new fund alongside new and existing investors. The purchase payment by the continuation fund for the transferred asset(s) (which is used to pay out exiting investors) may be funded in part using debt under a NAV loan.

Recession, war and interest rate increases are among the many headwinds for markets in the coming months/years. It remains to be seen how the macroeconomic and political environment will affect sponsor appetite for NAV loans. While continued pressure on asset valuations may slow down implementation, NAV loans are a natural tool to address LP and sponsor demand for liquidity and as a supplement to equity capital in what will likely continue to be a challenging fundraising environment. It is the flexibility of NAV structures and their myriad of applications for sponsors that serve as the best prognosticator for continued robust growth.