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U.S. NAV Finance Market Update – What a Year!

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It's already been two weeks since we wrapped up the Cadwalader Finance Forum in Charlotte, which featured a panel on "New Approaches in the NAV and Secondary Market." The panelists provided attendees with an entertaining and very educational discussion explaining what exactly is NAV finance (see summary of panel discussion **here**). Given the packed crowd for the panel and the general buzz at the conference, it should be obvious to even the casual observer that interest in NAV finance is at an all-time high (which is saying something since it has consistently been one of the hot topics at industry conferences in recent years). So, as we enter the home stretch of 2023, we wanted to reflect this week on the state of the U.S. NAV finance market and provide some thoughts on trends we are observing and what we are hearing in the market as we get ready to wrap up what has been a dynamic year.

Transactional Volume and Outlook

While the onset of the pandemic saw a large uptick in the use of NAV financing as a way to provide capital to portfolio companies that were reeling in response to global lockdowns and supply chain disruptions, the current drivers of demand for NAV financing are more varied. Sponsors looking to create liquidity for investors in light of a slowdown in private equity exits is a frequently cited reason for an increase in the use of NAV financing. Additionally, now that we are a few years out from the onset of the private equity fundraising boom that lasted from the late 2010s to the early parts of the pandemic, many funds are looking to transition from subscription credit facilities (as investor capital commitments are drawn down) to NAV facilities in order to maintain liquidity levels.

As a result, even in light of a rising interest rate environment, 2023 has been another year of growth in the demand for NAV financing. While we are hopeful that rates have reached their peak in light of this week's Fed meeting (fingers crossed), the market participants we have spoken with view NAV financing at current rates as still being accretive to fund equity holders and expect continued robust growth in the use of NAV financing.

New Lenders

We have seen a noticeable increase in new lenders (including banks, insurance companies and private lenders) entering the NAV market. While in past years we fielded numerous calls from potential entrants, showing curiosity about the range of potential product offerings, we are now seeing new lenders entering the market and looking to deploy balance sheet. In the U.S., Cadwalader has represented over thirty lenders this year alone on NAV financing transactions. Of particular note are asset managers and insurance companies, which have been leading the charge on some sizeable transactions. While still considered novel to some, the NAV finance market has matured significantly, increasing access to sponsors looking for leverage and liquidity enhancements.

Investor Education and Mainstream News Coverage

Possibly one of the strongest indicators of the development of the NAV finance market is its recent coverage in mainstream financial news publications such as the *Financial Times* and *Bloomberg*. The coverage has been, at least in part, critical (unsurprising as nothing sells newspapers (or online subscriptions) like controversy (real or not)). The overwhelming response by market players has been that education and transparency are the best tools for sponsors to use in response to this type of news coverage. This is not dissimilar to the market response to investor concerns and critical coverage regarding the use of subscription credit facilities that has occurred in the past (and look at how well that has turned out).

New Borrowers

While the universe of funds that we see as users of NAV financing products is already very large (*e.g.*, private equity funds (including buyout, real estate and infrastructure focused funds), secondaries funds, hedge funds, funds of hedge funds, alternative registered investment companies, family offices and pension funds) we have seen an uptick in private credit funds as borrowers in these facilities. Additionally, while only a few years ago the NAV financing market was dominated by a small number of sponsors that were serial users of NAV financing, there has been a rapid increase in new borrowers in this space, and, for Cadwalader, this year has been notably characterized by a lot of deals with sponsors entering into their first NAV loan (with hopefully more to follow).

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 a comparative subsets of deals, the trend lines are fairly clear. Spreads have widened considerably from their lows of early 2022 (we have seen similar trends in the subscription finance market). We find this unsurprising in light of the rising interest rate environment, increased market volatility, bank balance sheet constraints and robust demand for fund finance products in general.

Larger Lender Clubs and Syndicates

The NAV financing market has traditionally been one of bilateral and small club deals. However, as of late there has been a rise in larger club deals and syndicated credit facilities as lenders look to juggle increased demand and size for NAV Loans with balance sheet constraints and credit limits (in addition to more lenders available to join syndicates).

Market Disruption

While the March regional banking crisis in the U.S. has had far reaching effects in the lending market, the NAV market was much less impacted than the subscription market. Nonetheless, the NAV market was not immune to disruption in March, as the failure of Credit Suisse, and the acquisition thereof by UBS, resulted in the combination of two lenders that were very active in the NAV market at that time. While that transition is still underway (and likely will be for some time) the market has been very active in snapping up some very talented people from the Credit Suisse team to seed the launch of several new NAV lending businesses in the market.

Trends

One of the most attractive aspects of NAV financing is that NAV loans can be tailored to address any number of issues. It is this flexibility that drives the value of this product to both sponsors and investors (*i.e.*, as opposed to a one-size-fits-all product that is easily replicated). That said, there were a few trends that stand out this year upon reflection.

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 in difficult market conditions and extend the life of those investments.

Secondaries Financing. With top secondaries fund sponsors continuing to raise record amounts of capital and LPs in need of liquidity, mega-funds are likely to continue to support robust trading levels in the secondaries market. We expect a material portion of that trading to be funded with debt.

Portfolio Hedging. We have seen robust demand for incorporating currency and interest rate hedging programs into NAV financing offerings. Given the increasingly international focus of investment portfolios and the volatility in currencies and rates, we expect this trend to continue in 2024.

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. The financing needs of struggling operating companies, the desire to seize strategic opportunities, delayed investment exits and investor demands for liquidity have all been material factors driving upsizes.

Negative Pledge. 2023 so far has also been marked by growth in the use of negative pledge NAV facilities (*i.e.*, secured loans where the collateral package is limited to a bank account into which proceeds of the fund's investments are deposited coupled with a covenant not to encumber the fund's investments with other liens – a "negative pledge". See further discussion of these facilities **here**). In particular, we have seen a number of lenders that have more typically focused on subscription lending use these types of facilities as a way to meet client demands for NAV financing without wading in too deep into some of the more complex and structured collateral packages that are prevalent in other types of NAV loans.

Regulatory Capital

Finally, while not specific to the NAV market, you cannot have a financing market update these days without at least some discussion of bank regulatory capital, and in particular in the U.S., the proposed Basel III endgame rules (although, note the Basel III endgame rules are still just in proposed form and will be subject to significant industry comment, so we will have to wait and see how the final rules play out). Nonetheless, the take away from discussions with market participants is that regulatory capital requirements are likely to increase, both for the largest U.S. banks and for regional banks with more than $100 billion in assets. If this holds true, banks will need to be even more discerning in allocating balance sheet to clients, which should continue to present opportunities for alternative lenders to enter the market to help meet sponsor demand.