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Fund Finance Growth Analysis and the Case for NAV Lending

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I was able to watch a good number of the sessions at the Fund Finance Association's Virtual Conference this week and enjoyed the event. Congrats and thanks to Michelle Bolingbroke, the event planning team at Sequence, and the regional chairs and committees on a job well done. I especially enjoyed the session with Ronald Cohen; his thoughts on quantifying and measuring the societal impact of private enterprise were enlightening and worth a watch for anyone who was not able to see the session live. One of the clear themes coming out of the conference is the heavy interest and support for ESG initiatives in both the private equity and fund finance communities. While that is massively positive in its own right, I actually think this industry-wide focus will ultimately be a meaningful growth driver of NAV-oriented lending and related fund-level leverage. Hear me out on this.

From the Business Roundtable's shift from shareholder to stakeholder primacy all the way to Elizabeth Warren's proposed "Stop Wall Street Looting Act," it is clear that private equity is going to (and needs to) lean further into ESG. Sponsors do not really even have a choice: their investors are going to demand it, their employees are going to demand it, the communities where their portfolio companies are based are going to demand it, and, potentially even at some point, regulation is going to require it. This is, in my view and I am sure in most everyone's, an important and productive directional shift in private industry. Addressing diversity and inclusion, environmental impact and climate change, the gender wage gap, safe working conditions, and economic inequality are essential corporate and societal priorities.

I also buy into the "doing well by doing good" narrative and that many of the firms that contribute meaningfully to these ESG priorities will ultimately be rewarded with higher financial returns for their equity holders compared to their lower contributing peers. But, as we all embrace and encourage stakeholder primacy, I think we need to be realistic that a sizeable portion of the forecasted financial return improvements will not be realized until the long run. And if ESG is to be real and not just lip service, improved economic performance driven by these initiatives will in many cases require not insignificant short-term investment. Thus, furthering these priorities in a committed and holistic way is going to require PE funds at times to spend and allocate resources at the expense of portfolio company short-term profitability. How long is the "long run" and how expensive is the short term will depend on the specific circumstances of each specific portfolio company. But many prospective portfolio companies, particularly in the middle market, will need to make substantial improvements to get in line with a top-tier sponsor's ESG values and priorities. For example, a sponsor that wants a portfolio company to provide all employees with a livable wage and eliminate a gender pay gap may need to make substantial increases to payroll. A sponsor that wants a portfolio company to reduce the likelihood of widespread employee layoffs may need to operate at a lower than historical leverage level. Reducing pollution, enhanced employee safety, etc. all require upfront capital allocation. I mean, a polluter polluted in the first place because polluting was cheaper and faster in the moment than responsible disposal.

There are, of course, great impact investors at certain sponsors that will make terrific decisions and still deliver outsized returns. But on an industry-wide basis, it is hard not to think that the increased upfront investment and time period it takes to get new portfolio companies ESG-acceptable and ready for sale will in many cases stretch the traditional PE hold periods. The industry average "J" in the J curve will get a little lower and a little longer. Portfolio companies are going to need to run at somewhat lower leverage multiples than historical averages. And increasing employee compensation will test margins, and in turn, multiples. And all of these things are likely to put near-term downward pressure on fund investment returns, at least in the aggregate (which we are all saying we are OK with; that is sort of the whole point of moving away from shareholder primacy).

Yet, across the world, we still have a huge problem with underfunded pensions. This matters; it is an important “S” in ESG, too. Society needs to keep our collective promises to retired workers. To have any chance at doing so, pension investors are still going to need meaningful returns on their private equity investments. This is all the more heightened by COVID-19: governments are fiscally stressed and wholly unable to increase their pension contributions while, at the same time, pensions are earning borderline nothing on their fixed income portfolios (current monetary policy is awesome until you want to buy a treasury bond).

So how can PE funds still deliver handsome returns when they need to increase their capital outlays to, decrease the leverage at, and expand the hold period of many of their portfolio companies? There is no simple answer, but part of the solution involves replacing some of the reduced leverage at the portfolio company level with leverage at the fund level. On an industry wide-basis, especially in the buyout sector, the aggregate fund balance sheet has a leverage ratio that is virtually zero. Very few optimized balance sheets in any business sphere operate with zero debt like this. Modest amounts of leverage can be added without materially impacting the risk analysis while improving the return profiles. Fund level leverage in most cases costs less than portfolio company leverage as well, reducing gross spend. And Fund level leverage has both a greater degree of repayment diversification and is a step removed from large payrolls, thus being far less likely to cause corporate bankruptcies and create painful human costs like widespread layoffs.

We think these things are largely obvious, not insightful. And sponsors have been employing leveraged strategies in their debt and secondaries product offerings for years; adding a levered sleeve option to their equity strategies to enhance prospective return profiles is deploying a known tool, not innovation. It’s not hard. We also understand that certain investors have a reflexive negative reaction to the word “leverage.” But that is solvable as well. We forecast that more funds will be offering levered optionality to their investors – separate levered and unlevered parallel fund options – allowing the investor to select the fund balance sheet structure and the risk/return profile best aligned with its investing preference.

Considering this in totality, NAV-lending products are frankly well-aligned with and support both a sponsor's and an investor’s overall ESG commitment and priorities, while offering investors a return profile that will help enable the meeting of future beneficiary obligations. Thus, we think the NAV-lending sphere is poised for long-term incremental growth in the go forward.

FFF is taking off next week for the Thanksgiving holiday in the U.S. We in fund finance all have a lot to be thankful for this year. Have a great weekend.