
EXPERT COMMENTARY

It's not unusual for new products to come under scrutiny in their 'growing up' phase, but some concerns around NAV loans may be misplaced, write [Samantha Hutchinson](#), [Brian Foster](#) and [Mike Hubbard](#) at Cadwalader, Wickersham & Taft



Cutting through the noise around NAV facilities

Although NAV financing – fund-level loans underwritten against investment portfolios – has long been a liquidity management tool employed in the private credit and secondaries markets, the impacts of covid led many buy-out managers to look closely at NAV financing for general liquidity, and defensive (portfolio protection) and offensive (market dislocation capitalisation) purposes.

Initially, there seemed to be more talk than execution as managers sought to better understand the product. However, the number of executed trades has surged recently and we have seen a corresponding increase in press articles criticising their use.

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It is easy to see why this topic is headline-worthy. The idea that private equity funds would incur more debt when interest rates have risen rapidly and valuations are under scrutiny may seem surprising; as may the concept of distributing borrowed money to investors to improve DPI and IRR calculations, when managers otherwise struggle to achieve exits and raise new capital.

We remind readers though of past concerns raised about the use of

subscription lines as recently as six years ago. Now, subscription lines are broadly understood and their usage and benefits accepted across the market, with most funds now using this product. NAV financing has to go through a similar 'growing up' phase.

Managers are being driven to explore alternative liquidity options due to a barrage of micro and macro challenges – including persistent inflation, unprecedented interest rate rises and a challenging exit environment, to name a few – coming after a bull-run of easy money and low interest rates.

Of course, questions should be asked, but there is clearly a liquidity gap that other solutions cannot fill in

“There is clearly a liquidity gap that other solutions cannot fill in the same way as NAV financings”

the same way as NAV financings, so a balanced and holistic analysis of the use and impact of such facilities is warranted.

In this article we address certain criticisms made in the press about NAV financing based on our first-hand experience of these transactions, and consider whether some of these criticisms may be misplaced.

“NAV financing adds leverage on leverage”

As lenders have recourse to entire portfolios on a NAV financing rather than an individual asset, managers are commercially incentivised to ensure overall debt levels are conservative and support the loan repayment terms. Initial loan-to-value (LTV) ratios are often around 15 percent (and may be significantly less) of the net asset value of a fund and typically cannot exceed 30 percent during the facility tenor. A diversified portfolio allows single investments to fluctuate in value provided other investments are sufficiently value-generative to compensate. Further, private markets typically experience less volatility than public markets.

One commonly used metric is that private equity has a beta of 0.5 compared to the S&P 500 total return. Using this metric and taking the five-year peak (4,766 in December 2021) versus trough (3,583 in October 2022) values of the S&P 500, this 25 percent reduction in public market values would

equate to a 12.5 percent reduction in average private equity value. For a 15 percent LTV loan, this decline in value would translate to a 17 percent LTV.

Even assuming a beta of 1.0 and reducing valuations by the equivalent declines of the S&P 500 (ie -25 percent), LTVs would increase only to 20 percent. These levels would not typically equate to an immediate event of default under a NAV loan facility. Further, as NAV loans are typically underwritten on mature assets, in practice underlying leverage is likely to come down throughout the life of the facility.

“Why risk the entire portfolio to support a troubled investment?”

If an investment is essentially strong but going through a period of stress, additional capital can help it to survive and recover to deliver value to investors. If that additional capital is not available at the asset level, or is prohibitively expensive, NAV financing, underwritten on the strength of the fund’s broader investment portfolio, is a way to support that investment without selling and foregoing upside.

The relatively lower cost of such financing compared to asset-level financing combined with the increased flexibility to determine the timing of an exit from that investment can support higher overall portfolio returns.

“Why not rely on traditional exit routes to deliver value to investors?”

High interest rates, inflation and volatility in public market valuations have contributed to reduced M&A activity and a soft IPO market. Bain & Company recently estimated that buyout funds are sitting on a record \$2.8 trillion in unexited assets – more than four times the level held post the global financial crisis.

This unrealised value is adversely impacting distributions to investors – Preqin reports that net cashflows from buyout funds to investors through March 2023 was \$63.3 billion in the

red and has been negative since 2019 (excluding 2021).

Tom Glover of BC Partners tells us that the dearth in exits has “created an accumulation of negative net LP cashflows unlike anything seen since the GFC”, and that “NAV-based liquidity is increasingly being seen by both sides as bringing real advantages versus continuation vehicles/asset sales, including speed, cost, no bid/ask spread, preservation of upside, and pre-payability”.

This exit slowdown has created an opportunity for buyout managers to acquire value-accretive assets for investors, but this can be constrained by limited available investor capital and limited capacity at operating company level to incur further debt to fund expansion. NAV finance can provide a cost-effective solution for managers, with the ability to arbitrage the differential between the cost of equity (around 22 percent using median IRR for buyout funds as a proxy) versus the cost of NAV finance (between 9 percent and 15 percent, including benchmark rates and spreads depending on diversity and credit quality).

As Scott Turner at Lloyds Banking Group notes: “The prudent application of NAV facilities in the right circumstances can deliver attractive value and liquidity enhancement.”

“Managers are using NAV financing to make investor distributions to artificially inflate DPI”

NAV financings have certainly been used to fund distributions to investors. But this isn’t a one-way street. Private equity investors have seen a dearth of exit activity for a prolonged period now, and distributions as a percentage of NAV have been at their lowest in over a decade. Investors want cash, and NAV financings can deliver this while allowing managers to retain value upside until market conditions improve.

“LPs could sell investments in the secondaries market but at a potentially deep discount, so benefitting from



Communication concerns

“Managers are not transparent in their use of these facilities, with investors often kept in the dark”

In our experience, this is simply untrue. We regularly see managers consult with their investors prior to putting NAV loans in place, even where the financing is permitted by the terms of the fund documents.

Regular communication is critical to managers successfully managing investor expectations. Moreover, we have seen many examples of investors asking to participate in these facilities directly, with an increasing number of NAV facilities now having a reserved allocation for investors. Rather than objecting to NAV financings, investors are viewing them as another way to get exposure to the performance of investment portfolios.

As Richard Sehayek of Ares Management’s alternative credit strategy tells us: “Many LPs we’ve spoken to recognise that NAV loans can provide an accretive solution to enhance liquidity. In fact, we’ve seen LPs themselves identify and bring these opportunities to NAV loan providers, and some have even co-invested alongside the primary lender.”

early distributions at low cost (versus future cashflows) for a portfolio and a manager they want to retain a relationship with can be a better route to liquidity,” says Dan Kumagai at NatWest Markets.

Certainly, debt-funded distributions improve DPI, but it would be extremely short-sighted for a manager to do this purely for this reason without discussing it with its investors and not expect this to be a factor taken into consideration

by investors for future fundraising. As Ian Wiese of MassMutual notes: “Investors are sophisticated, and it is very easy by looking at the fund financials to determine the origins of the DPI. There is no hiding the NAV line.”

“Distributions funded from NAV facilities that are recallable can’t be used by investors”

The circumstances under which distributions can be recalled will depend

on the terms of a fund’s LPA, which will have been negotiated between the manager and its investors at the outset of the fund.

The concept of recallable distributions was not created for NAV financings and (absent an express agreement by an investor) is not applied specifically to distributions from a NAV loan. NAV facilities do not increase the risk of distributions being recalled, and such proceeds will likely only be recallable under the same circumstances under which distributions from an investment exit are recallable, in which case it is right that such proceeds should be treated in the same way.

The benefits of discussion

As lawyers advising on these facilities, you might fairly comment that we have a vested interest in more managers using these facilities. We would respond that as advisers who structure these facilities, carry out fund document due diligence and participate in investor communications, we are well positioned to cut through the market noise.

One thing we firmly believe is that discussion and transparency around NAV facilities is a positive. As Tom Doyle of Pemberton Capital Advisors notes: “It is important for GPs to explain the purpose and benefits of a transaction. This enables a win-win when applied to the right situations, as NAV facilities are being adopted by proactive, successful GPs who are not looking to utilise facilities to artificially enhance returns, but rather drive accretive growth for their seasoned portfolio assets or conversely preserve the value they have created to date.”

NAV financings aren’t appropriate for all portfolios and in all circumstances, but they are and will continue to be an invaluable liquidity option for buy-out managers. ■

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