

FUND FINANCE FRIDAY

In Defense of NAV Loans

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NAV loans are getting constant coverage in the press now. For those of us that spent years trying to direct focus to the potential of NAV lending, this is a welcome development. Admittedly, not all of the coverage is positive. It seems that there is a new article out every week with a negative take on NAV. As a result, we've been receiving a lot of calls from clients asking questions about the status and trajectory of the NAV loan market. We welcome the attention, positive and negative. A discussion on the merits of NAV lending is warranted, and the positives will, over time, win out over perceived negatives. In the meantime, we continue to see robust NAV loan activity, and we remain unequivocally bullish on this segment of the fund finance market. Let's recount some of the reasons why:

Flexibility

The terms and structure of NAV loans are flexible. They can be inserted at different points within a fund structure – while some NAV loans are provided at the fund level and underwrite the full investment portfolio of the fund, others are provided to subsidiaries or holding companies further down in the investment structure, and may be underwritten based on a specific sub-set of a fund's assets. NAV loans can also incorporate different forms and combinations of credit support, such as equity or debt interests in portfolio companies, interests in holding vehicles, investment proceeds, parent guarantees, equity commitment letters, pledges of internal capital contribution obligations and/or covenants to maintain access to liquid assets and other external capital sources. As a result, NAV loans are much more adaptable to differing structures, circumstances and needs than other types of financing (such as subscription facilities and portfolio company loans).

Market Conditions

Market conditions continue to support the need for flexible and affordable sources of debt capital.

From an investor perspective, the lack of distributions by private equity funds has been a matter of intense focus. A recent Bloomberg [article](#) (*subscription required*) noted that private equity payouts at major firms have decreased by 49% in two years, and highlighted an investor focus on DPI over IRR. The secondaries market continues to grow and has become a key source of liquidity for investors in private equity funds that are searching for cash, but is insufficient to offset the lack of distributable revenue from funds. A recent [article](#) from ION Analytics estimated that the supply of potential secondaries materially exceeds demand from secondaries buyers. Sponsors are increasingly taking the lead by using continuation funds to generate investor liquidity. NAV financing is being used in a number of ways to facilitate solutions to investor liquidity challenges.

From a fund perspective, the fundraising environment has been challenging, limiting the firepower that funds have for acquisitions of new investments. In addition, interest rates have remained stubbornly high, making it more costly for portfolio companies to borrow. NAV financing can be useful in addressing these portfolio management issues as well.

Multiple Uses

There are many use cases for NAV financing. A few of the most common uses are discussed below:

- **Investor Liquidity.** We discussed above the challenges facing investors in search of liquidity, such as a lack of fund distributions and a supply/demand imbalance in the secondaries market. NAV loans can be useful in addressing these issues. Loan proceeds can be used to return capital to investors, deployed for portfolio management and operating expenses in order to free up other capital that can be returned to investors, or to facilitate continuation funds which provide investors optionality to continue or exit their investments. Borrowing to fund investor distributions is far and away the most controversial use of NAV financing, and the aspect most frequently critiqued in the press. Critics write that NAV financing can be used, at a high cost to investors, to artificially accelerate distributions in order to juice financial performance metrics. They also posit that if investors want liquidity in this environment of reduced distributions, they have other ways to achieve that (including selling their investments in the secondary market or obtaining their own financing). We think these criticisms are overblown. Our experience is that borrowings to fund investor distributions comprise a relatively small portion of NAV loans in the market. When loans are used to generate liquidity, such usage is often at the request of, or after consultation with, investors, as highlighted by [Bloomberg](#) (*subscription required*) for a recent NAV loan by a top-tier sponsor. Further, many investors don't have access to other sources of liquidity for their investments in private equity funds – such access is limited to the largest and most sophisticated investors. Or they may not like the discount required to effect a sale of a particular investment. Financing allows an investor to retain its exposure while accelerating realization of a portion of the value. Sponsors are often in the best place to source and execute transactions to generate liquidity for investors.
- **Strategic Investment Opportunities.** In a tough fundraising environment, and for funds where capital commitments have largely been deployed, NAV financing can be essential to

help sponsors to capitalize on attractive investment opportunities. These opportunities can come in the form of new investments or add-on investments to existing positions. We are increasingly structuring NAV loans where the purpose is acquisition financing for such investments. Without a NAV loan, sponsors in some circumstances would have to pass on such opportunities.

- **Cost Effective Deployment.** While critics cite the cost of NAV loans, NAV loans can actually be quite cost effective relative to other types of financing. The costs for individual companies to borrow have remained elevated. Further, many loans are maturing, and the cost to roll or replace expiring debt is increasing dramatically. NAV loans, which are supported by a broader and more diverse set of investments than loans to individual companies, can help to mitigate the impact of a higher rate environment by providing lower fees and interest rate spreads. We have recently been involved in a series of facilities that were used to refinance higher cost debt, or to support a struggling portfolio company that would otherwise have to pay a much higher rate to borrow in the corporate loan market. The longer current interest rates persist, the more we expect to see NAV loans used for this purpose.
- **Continuation Funds.** Much attention has been given to the proliferation of continuation funds. A recent [article](#) (*subscription required*) by Secondaries Investor discussed a jump in the use of multi-asset continuation funds. These funds can create optionality for investors – they can choose whether to continue their investment or to cash out. We frequently work on NAV financings structured to facilitate the closing of continuation vehicles. Such financing can be used to bridge the gap between capital committed to a continuation fund and amounts owed to exiting investors in the discontinuing fund.

Attractive Returns

Bank and non-bank lenders alike are increasingly being drawn into the NAV loan market. Non-bank lenders include private credit funds, secondaries funds, insurance companies, family offices and pension funds. Lenders like the higher returns of these loans relative to subscription lines, as well as the more diversified risk compared to corporate loans. The expanding set of participating lenders should support the continued growth of this market. Increased competition has acted as a constraint on rates and fees, which should support broader usage by fund borrowers.

Conclusion

NAV loans do not make sense in all scenarios. But, properly used, they can help sponsors and investors to generate liquidity, capitalize on investment opportunities, lower costs and facilitate tailored structural solutions. The number of funds and sponsors that have deployed this financing tool are relatively few in relation to the overall size of the private equity market. We expect the number of funds using NAV financing to rise steadily in the coming years. The reasons for optimism about the NAV loan market should not be overshadowed by any near-term negative press.