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What's in a NAV Loan?

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The purpose of this article is to unpack the basic building blocks of what constitutes a NAV Loan to make sure that market participants have a basic understanding of what is in a NAV Loan and their key negotiated issues. As noted in prior articles, and as discussed in various panels at Fund Finance industry events, what constitutes a NAV financing transaction often means different things to different people. A fairly broad description that we have used previously is that a NAV financing transaction ("a NAV Loan") is primarily a loan to a private equity ("PE") fund where the value of the investment assets of the PE fund provide support for the borrower's loan obligations. While even this broad description doesn't capture everything that bankers and lawyers in the industry think of when they hear NAV Loan, it's sufficiently broad for purposes of this article.

Investment Assets of the PE Fund

The use of NAV Loans has been steadily increasing in the past few years, and a closer look at the above description can provide some insight as to the reasons for this (as well as some of the challenges posed by this product). First, let's look at "the investment assets of the PE fund" – unlike a subscription facility, where typically 100% of the PE fund's capital commitments are pledged, NAV Loans are often underwritten against a PE Fund's entire portfolio, but often just on a sub-set of its investments (if there are, e.g., restrictions on pledges, other debt or some other reason the PE Fund is not able to pledge its entire portfolio of investments). And while some lenders prefer to lend against certain types of PE fund investments (both from a primary versus secondary perspective but also with respect to investment strategy/industry), many lenders are industry-agnostic, relying instead on haircuts, concentration limits, eligibility criteria and exclusion events, among others, to provide a borrowing base that they are comfortable lending against. Indeed, it is this versatility and flexibility of NAV Loans that makes the product so attractive to both borrowers and lenders and that has led the industry to find more and different ways to use the product, especially during the recent liquidity constraints affecting capital markets. We're also seeing innovations in the use of NAV Loans at an accelerating rate, as new lenders and lawyer practice groups make their way into the industry – I have had two wholly new use cases of NAV Loans come across my desk in just the past few weeks.

Value

Next let's look at "value", as this is a particularly relevant point for NAV Loans. Because the investment assets are illiquid assets with no readily ascertainable market value, the determination of value is often a heavily negotiated terms in NAV Loans. There are three valuation techniques that we generally see – reported value (from the underlying investments/PE fund investments (with respect to fund of fund and secondaries NAV Loans), value determined pursuant to the borrower's valuation policy (which would be provided up-front for review by the lenders, and which would be restricted from revision by negative covenants) and third-party valuation. The use and interplay between these valuation methods is beyond the scope of this article, but it should be noted that this point becomes a particular focus during large market disruption events (a good example of this is the COVID crisis, which saw a pull-back in new financing activity until post-COVID valuations were generally available in the industry). Another aspect of value are reductions to and/or exclusions from the borrowing base.

- Reductions to Value: Reductions to the value are typically done on a portfolio basis and include provisions such as haircuts/concentration limits based on strategy/location diversification of underlying investments, exposure to single investments or sponsors (or the top x number of investments), minimum number of investments and similar tests, and it is typical that only the portion of the portfolio of investments in excess of the concentration limits is excluded from the borrowing base.

- Exclusions from Value: Exclusions from value generally take two forms – eligibility criteria (so the failure to meet this criteria would result in exclusion from the borrowing base) and exclusion events (which could cause an otherwise eligible investment to be excluded from the borrowing base). Eligibility criteria tend to be structural – some examples include the manner in which the investment is held (e.g., that it is subject to the collateral package), the absence of liens and/or debt, minimum size requirements, etc. Exclusions from value tend to be more event-driven – some examples include bankruptcy at the investment, default by the borrower in its obligations owing to the investment, failure to report, etc. We will also sometimes see performance-related exclusion events.

These reduction to value and exclusions from value can vary substantially from deal to deal based on the nature of the portfolio of investments – this is not meant to be an all-inclusive list or a minimum-required list. And to the extent there are multiple level of entities between the borrower and the underlying assets (e.g., if they are held in an SPV or holding vehicle), these exclusions will often apply at those levels as well. It should be noted, however, that we've been seeing an increased level of syndication and/or lender joinder activity in this space, and these provisions are a focus of joining lenders to the extent they deviate from their expectations and/or their underwriting criteria.

Provide Support for the Borrower's Obligations

There are two primary aspects to "provide support for the borrower's obligations" – whether there is sufficient value in the PE fund's investments to pay back the NAV Loan and whether the collateral package is sufficient for the lenders to capture that value in a distressed scenario.

- Sufficient Value: This is the focus of the valuation points discussed above, to make sure that the PE fund's portfolio of illiquid assets with no readily ascertainable liquidation value would be sufficient to repay the lenders in full in a distressed scenario. The points above are meant to come up with a fair market value of the portfolio, and also to protect against over-exposure to a particular sponsor, investment strategy and geographic location, among others. An equally important aspect of this calculus is the LTV ratio for NAV Loans – in large part due to the nature of the particular investments that are being financed here, the LTV ratios for NAV Loans are much lower than subscription facilities. In addition to protecting the banks from losses in a poor selling environment, this also has the added benefit of encouraging cooperation from the borrowers in a default/repayment scenario, as the portfolio of investments should have value in excess of the NAV Loan that the borrower would be economically incentivized to retain.
- Collateral Package: We won't go into too much detail here, as the collateral package for NAV Loans varies a great deal from transaction to transaction, from a pledge of individual investments to a pledge of a distributions accounts where all distributions from the portfolio of investments is paid. It should be no surprise that this is an area of focus of external counsel representing the lenders and that different collateral structures can require substantial amounts of legal diligence and may also require collateral documents in various locations (depending on the country of formation of the pledged investments, SPV or holding vehicles).

Conclusion

We've written about this in more detail in other articles[1] (including one earlier this year[2]), but we did want to mention some of the various use cases for NAV Loans, which, along with the flexibility discussed above regarding the types of investments that can be financed by NAV Loans just goes to emphasize the versatility of this product, which supports our expectation that NAV Loans will continue to be an important financing product in the fund finance industry and that the use of NAV Loans will continue to evolve as more implementation cases present themselves.

- Adding Strategic Investments and Maintaining Existing Investments
- Capital Returns to Investors
- Financing for Management Companies
- Aftercare Facilities
- Facilitate Continuation Funds
- Provide Working Capital

[1] https://www.cadwalader.com/fund-finance-friday/index.php?eid=1569&nid=208&search=swiss

[2] https://www.cadwalader.com/fund-finance-friday/index.php?eid=2088&nid=292&search=calves