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Overview of NAV facilities

Net asset value-based (NAV) financing, a type of credit facility in which the borrowing capacity is determined by the net asset value of the borrower's underlying investment portfolio, has gained popularity in recent years. Traditionally, NAV facilities were predominantly utilised by primary buyout, infrastructure, and real estate equity funds and secondary funds (so-called "funds of funds").

Due to its versatility and suitability for a broad array of purposes, the usage of NAV financing has expanded to other market participants, such as credit funds and open-ended funds, and has gained traction across Europe, the United States and the Asia-Pacific region.

Today, the size of the global NAV loan market is estimated at just under USD100 billion, with USD30 billion of that amount originating in 2022 alone. Some experts forecast that the market could reach USD700 billion by 2030.[1]

Accordingly, NAV facilities have become both an increasingly important and permanent part of the general partner (GP) financial toolkit. As investment strategies continue to evolve, the adoption of NAV facilities is likely to increase, offering flexible financing solutions tailored to the specific needs of individual investment portfolios.

NAV facilities and institutional investors

The decision to access the NAV financing market is often driven by a variety of bespoke factors. However, in their most prevalent application, NAV facilities empower GPs to provide liquidity and support to portfolio companies without necessitating a sale of assets.

The NAV financing market is now evolving: we are seeing more institutional investors, such as sovereign wealth funds and pension funds, and other types of investors in private funds, such as family offices (collectively, LPs), utilising the NAV product themselves. Indeed, the NAV loan use case for LPs is frequently similar to the NAV loan use case for GPs, albeit with some interesting departures.

For some LPs, including Employee Retirement Income Security Act (ERISA) plans or sovereign wealth funds, NAV facilities offer a strategic tool to alleviate overallocation to certain private equity managers or sectors and a way to free up capital on the balance sheet. They also permit LPs to maintain positions in high-performing private equity assets while generating liquidity to meet liabilities or reinvest in other areas.

Other LPs, such as secondary funds, use NAV facilities with more traditional use cases, including additional funding for follow-on investments, capital funding for existing investments, or funding distributions to their own limited partners. With NAV facilities offering flexible and tailored finance solutions for LPs, this upward trend of LPs accessing the NAV market is expected to continue.

Lending risks

Lenders providing NAV facilities to LPs are encouraged to be aware of the inherent risks and the structuring required to mitigate these risks. There are often fund, tax, and regulatory considerations that underlie NAV facilities, and extensive legal and business diligence of the underlying asset portfolio is likely required to minimise any risks.

Valuation and calculation

The fundamental risk in NAV facilities lies in the accurate valuation of the underlying portfolio of assets. This risk is likely best addressed with third-party valuation rights or dispute rights, especially in scenarios where the applicable LP is an anchor investor in the applicable fund or has affiliates that manage the applicable fund it invests in. From inception, stress testing is also important to understand the impact of varying market conditions on valuations.

Liquidity risk

NAV facilities are usually repaid through liquidity events, such as sales of fund interests, portfolio companies, or other asset disposals. However, if the market is unfavourable or the timing of these liquidity events is delayed, it can lead to repayment issues.

For example, private equity portfolios might face extended holding periods during market downturns, reducing the availability of exit opportunities and making it difficult to meet repayment schedules. Many times, a lender's most practical approach is to push for provisions that require the borrower to provide a cure plan that includes projected repayment actions and related timelines.

Equity pledge

Three main issues may arise related to the pledge of the borrower's equity or any holding company's equity: (i) perfection; (ii) direct and indirect transfer restrictions and change of control provisions; and (iii) tax issues.

Many lenders – especially newer entrants into the space – may not understand that most of the underlying limited partner agreements or limited liability company agreements related to the fund or portfolio investments contain provisions restricting any indirect pledge or transfer of the applicable fund or portfolio interest (which can be triggered just by pledging the equity of the borrower at closing), the violation of which can lead to draconian circumstances (*e.g.*, a write-down of the value of the applicable fund or portfolio interest or being declared a "defaulting investor").

Payment direction letters and deposit account control agreements can assist in providing practical control of any payment streams related to the applicable fund or portfolio interest, but do not provide any voting control. Even where perfection is straightforward, issues may exist with respect to equity pledge enforceability due to the cost of enforcement and the hurdles to obtain required third-party consents.

Also, significant tax liabilities for the ultimate equity holders of the borrower could exist with pledging the equity of any non-US entities, as the pledge may constitute a deemed dividend affecting the fund sponsors and investors.

In the context of the above, lenders have demonstrated an increasing appetite for Luxembourg structures to mitigate risks associated with the security package perfection and enforcement. Luxembourg law provides a robust legal framework for security interests over claims and financial instruments (including, but not limited to, shares, cash, and securities standing on bank accounts and intragroup receivables), particularly through the 2005 Luxembourg law over financial collateral arrangements, as amended.

This framework enables the creation of pledges that are efficient, cost effective (no requirement for notarisation or for a registration on a public register), and protective of lender rights, notably offering simplified enforcement mechanisms, strong protection against third-party claims, and bankruptcy-proof status.

Structuring around risks: due diligence and reporting

NAV lenders can help mitigate some of the risks in part through diligence measures prior to closing and enhanced reporting following closing. Two special interest areas for lenders to diligence from a legal perspective are (i) transfer restrictions on underlying assets, and (ii) fund or portfolio investment terms that may affect the value, liquidity, or risk profile of the assets.

Transfer restriction and "change of control" analysis

The lenders' counsel is encouraged to review the governing documents for consent requirements, "change of control" provisions, any lock-up period, required conditions precedent for transfer (*e.g.*, legal opinions), and other process requirements or deliverables. Results of review may impact the structuring of the loan, including moving from a pledge of the assets to a pledge of only the economic interests of the assets. Ideally, the transfer and contribution documentation or GP consent will mirror and satisfy the requirements in the fund or portfolio investment governing documents.

Fund or portfolio investment terms

Lenders and their counsel are encouraged to review fund or portfolio investment governing documents for terms that may affect the pricing or risk attached to the borrowing base assets for the NAV facility, such as (i) basic economic terms and rights of the interests (including fees charged, distribution waterfall terms and priority, etc.), (ii) investment term, extension, and early termination rights and triggers, (iii) issues surrounding illiquid investments (side pocketing, size of portfolio, valuation issues) or similar risks related to non-marketable in-kind distributions, (iv) suspensions of redemptions or withdrawals, which may be notable should the lender ever hold the interests directly in a foreclosure scenario, (v) reserves or other withheld amounts that may affect pricing, or (vi) review of side letter for any terms affecting the above. Lenders may consider addressing the issues flagged in the governing documents in the credit agreement or transfer documentation. For example, borrowers could be required to notify the lender of material events at the fund or portfolio investment level (*e.g.*, a key person event) that may suspend investment activity or lead to an early liquidation of the assets.

Regulatory and market trends

Time will tell whether the increased interest in NAV facilities will result in new regulatory compliance requirements. Already, NAV facilities may prompt compliance with certain regulatory schemes in the US and abroad. In the EU, the Alternative Investment Fund Managers Directive (AIFMD) regulates the financial activities of alternative investment fund managers, and the directive may impose leverage limitations on certain funds, impacting how much capital institutional investors are able to borrow.

There is growing interest in NAVs in Asia, but lenders there generally prefer a more conservative approach by requiring collateral support for NAV facilities. The collateral varies from equity pledges to security over bank accounts. Given the challenges in providing collateral, lenders have seen an increasing interest in hybrid facilities that include aspects of both a subscription line financing and a NAV facility.

Similarly, in the US, potentially stemming from the increased participation in NAV facilities by insurance companies, the National Association of Insurance Commissioners (NAIC) has been actively reviewing the regulatory oversight of private equity and complex assets within the insurance industry. In particular, the NAIC has adopted amendments to statutory accounting reporting requirements to state that certain structures similar to NAV facilities (*e.g.*, notes issued by a rated feeder fund that invests into a private equity fund) may no longer automatically be given the risk-based capital (RBC) treatment that they had been historically given.

Conclusion: NAVs and institutional investors

NAV financing offers institutional investors a mechanism that can be uniquely tailored to a specific need while maintaining the integrity of long-term investment strategies. These facilities enable investors to access additional capital without the need to liquidate existing assets, thereby preserving the continuity and potential growth of their investment portfolios. NAV finance may still be evolving and solidifying its position in the next generation of financing options, but NAV loans are expected to continue to be an attractive financing tool for both GPs and now LPs.

Acknowledgments

The authors would like to thank Yann Zellet and Inna Torres for their valuable contribution to this chapter.

Yann is a banking, finance and restructuring lawyer. He focuses on banking, finance and restructuring work, with a particular focus on fund finance, green finance, secured lending, leveraged finance and real estate finance. Yann also regularly handles restructuring matters and securitisation transactions.

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Endnote

1 https://www.bloomberglaw.com/external/document/X7J1B52G000000/finance-professional-perspective-rising-popularity-of-nav-loans-

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