Net Asset Value financings

INTERNATIONAL DEBT FINANCE INTELLIGENCE REPORT 2024 SUPPLEMENT

DLA PIPER

Net Asset Value financings

The rise of NAV financing as a tool for funds and Limited Partners

With the various challenges funds are facing in the current macro-economic environment, access to liquidity for both General Partners (GPs) and Limited Partners (LPs) is an important topic for market participants. While net asset value (NAV) loans are not a new product (they've been used by secondaries and credit funds for some time), the continuing evolution and popularity of NAV facilities since COVID-19 has been frequently talked about – both in the market and the press – putting this product in the spotlight.

Anthony Lombardi
Partner
London

What is a NAV facility?

Capital call facilities are now a well-established financing tool for funds and has become the go-to strategy for managers seeking to generate liquidity. By way of recap, a capital call facility is a bridge/short-term loan collateralised by the uncalled capital commitments of the fund's LPs. Capital call facilities are typically provided on a revolving basis, to permit a fund to bridge the period between the close of the fund/the making of investments and the date capital contributions from the fund's LPs are received following a capital call (which can be as long as 90 days after a call is made). It's worth remembering that these types of facilities also faced significant scrutiny until recently, while LPs and other market participants became comfortable with their benefits.

Unlike a capital call facility, a NAV facility (note this article does not cover preferred equity NAV financings) is not secured against LP commitments but, instead, against the underlying investments, cash flows and distributions that flow up to LPs from the underlying assets. Therefore, the creditworthiness of the LPs of the fund has little importance (if any) compared to the value of the underlying assets. Also, unlike capital call facilities which are typically revolving, NAV facilities tend to be term loans.

A fund will typically use a NAV facility to:

Address liquidity squeeze due to the slower fund raising environment and higher costs of capital;

Support underperforming assets (defensive) or take advantage of market dislocation (offensive). Note that the offensive use is currently reported as the most common reason for using NAV facilities; and

Generate distributions. This is perhaps the most debated use of NAV facilities and is receiving significant press attention following the use of such facilities by Carlyle, Softbank, Nordic Capital, HG Capital and Vista Equity Partners.[1]

The average term of a NAV facility has traditionally been three-five years. However, as highlighted by Pitchbook's report,[2] tenors have been reducing.

Spreads for NAV facilities ranged between 4-10+% above the relevant base rates, with the typical interest rate between 5-7% above the base rate. However, due to increasing market competition, we have recently seen NAV facilities price lower in the 3% above base range.

On average, LTV ratios range from 5-20% for concentrated (fewer than ten assets)/illiquid portfolios, to 50%+ for very liquid/diverse portfolios (more than ten assets).

Typical security package

Security packages for NAV facilities vary depending on the type of fund. A single point of entry is the most important consideration for a lender. The typical security package for a non-Pref Equity NAV deal is:

- Pledge of the equity/share charge of the SPV holding the assets (most common)
- Pledge over bank accounts (specifically accounts into which proceeds of the underlying assets are paid at the fund level) (most common)
- Portfolio assets directly (to the extent feasible)
- All asset security granted by the holding SPV/investment vehicle (to the extent feasible)
- Guarantees from the fund or other fund entities (less common)

TYPICAL COVENANTS/LENDER PROTECTIONS

Loan To Value (LTV) Covenants

The LTV covenants are the key covenants in a NAV facility. NAV facilities can include maximum and minimum LTV features, which in turn can trigger an interest rate increase (in line with an LTV increase) or decrease (in line with a LTV decrease), cash sweeps (see below), requirements for sales of assets to pay down the loan (either via a GP led process (borrower friendly) or via a lender lend process), other mandatory prepayments or an event of default.

Eligibility criteria/concentration limits

NAV facilities will include a list of criteria that each individual asset must comply with for that asset to qualify for lending against. Typical eligibility criteria include restrictions on assets in certain jurisdictions or geographies, certain redemption terms or certain asset classes. Common parameters for concentration limits include exposure to certain sectors, asset classes or geographies. When negotiating the relevant criteria or concentration limit, Managers/GPs need to ensure they're wide enough to continue acquiring assets permitted under their investment policy while ensuring such assets will be included in the LTV or other financial covenants (as applicable). A lender will try to make the criteria and limits as narrow as possible to reduce the credit risk exposure in the portfolio that it's lending against.

Veto rights

Like valuation rights, veto rights are a debated topic for discussion. A veto right permit the lender a right to agree which asset a fund can purchase and include in its portfolio. However, a manager/GP will typically insist that a lender has no right to choose which assets it includes in its portfolio as that fetters the managers/GP's ability to effectively manage the fund for its LPs. Instead, the manager/GP will argue that if the asset does not fit into a predetermined eligibility criteria with the lender, it's simply excluded, or a discount applied, from any LTV calculation. So a very clear set of eligibility criteria needs to be agreed upfront.

[1] Buyout Groups Raise Debt Against Portfolios to Return Cash as Dealmaking slows, *Financial Times* 17 July 2023.

[2] NAVigating Considerations and Controversies Around NAV Loans – What to know about these bespoke and evolving facilities, December 2023.

Cash sweeps

Cash sweeps are one of the most common features of NAV facilities. However, their application is a topic of significant negotiation. Some lenders insist that the proceeds of all asset sales (less costs, expenses and tax relating to such sale) are used to repay the loan until the loan has been amortised to a certain amount. Most commonly, the cash sweep mechanism is tied into the LTV ratio rachet. When in compliance or at a certain LTV level, the lender will permit the payment of management fees and distributions to LPs. However, over certain thresholds the lender may limit or block these payments until the LTV ratio is back in compliance.

Valuations

Valuation of portfolios/portfolio assets challenges is also a hot topic.[3] Clear parameters for challenge such as the frequency, number of challenges permitted, and the grounds permitted to trigger a challenge must all be clearly identified. The current market standard is for lenders to have a couple of challenges a year. Who is the payee will depend on how differentiated the fund's own valuation of its portfolios/portfolio assets are versus the external valuation. Valuation rights remain in the spotlight and the market is paying close attention to the Financial Conduct Authority's review of private market valuations, which may have a significant impact on how vigorous lenders are on this point going forwards.

[3] As recent as 30 November 2023, The Drawdown published an article regarding the controversy surrounding valuations in NAV loans. Trigger Warning, The Drawdown 30 November 2023.

Why NAV loans have become popular for buy-out funds and other funds with illiquid assets

In the new world of high-inflation and higher for longer interest rates, asset level financings/refinancings have become expensive and exits have slowed significantly, forcing funds to hold onto assets for longer. Managers and general partners (GPs) have had to turn to alternative liquidity options to service and support their portfolio companies/assets through these unprecedented and stormy times. Borrowing against a pool of assets (i.e., the fund's portfolio) versus individual or several asset level leverage (i.e., portfolio level leverage) is generally cheaper and more cost effective for a manager or GP. Further, NAV facilities typically don't restrict usage and the proceeds are fungible so they can be allocated flexibly by a GP across the portfolio as required. This is against an individual asset level financing which will likely restrict the use of proceeds significantly. Using the proceeds of NAV facilities to assist portfolio company growth is ultimately beneficial for LPs and avoids a costly forced exit in the current environment. Avoiding forced sales for funds holding illiquid assets is another key advantage of NAV facilities. LPs can also use NAV facilities as an alternative to a time-pressured and costly secondary sale, which could force a more than double digit loss at current valuations.

Another advantage for GPs is that NAV facilities often utilise Payment in Kind interest, offering the GP greater flexibility to manage cash flows.

Why LPs and other market participants raise concerns regarding NAV Financing

NAV facilities have seen a lot of attention in the press recently. The main points being discussed range from a lack of transparency from GPs regarding the nature and terms of the NAV facility, subordination of the LPs' distributions to the lenders (specifically if certain cash sweeps apply), cost implications of the facility, using NAV loans to make recallable distributions and using NAV facilities to artificially boost IRR and DPI etc.

While a lack of transparency has been raised as a concern by LPs, the general market view is that GPs are engaging with their LPs in relation to NAV facilities and their proposed uses from the get-go. This is despite circumstances where the fund documentation permits entry into a NAV facility without LP consent or consultation. The key for GPs is to continue this dialogue with their LPs, making sure their LPs fully understand the terms of the financing and specifically what portfolio assets are exposed/secured by the financing and any knock-on risks to the fund waterfall or clawback provisions if the facility is in default. In addition, GPs should have a strong and detailed case as to why the NAV facility will generate greater returns for its LPs versus not using a NAV facility. This is particularly important to justify the cost implications of the facility and subordination of any LP distributions.

Using financial engineering to boost IRR and DPI is not a new concern. LPs raised similar concerns regarding the use of capital call facilities. Given investors are wise to such uses, and it will likely be easily identifiable in fund financials, GPs are focused on the accretive benefits for LPs and GPs alike in the long term, rather than a temporary measure to boost IRR or DPI.

Size of the NAV market

To give a sense of the growth in NAV facilities over the past year lenders reported deal flow increased by over 80%. Market reports state that approximately USD21 billion – USD25 billion was lent in 2022, with predictions for the size of the market to increase to between USD250 billion – USD700 billion by 2030.[4]

Transaction size has grown 40% in the 12-month period to 30 September 2022. Before 2021, deal sizes were up to USD500 million, but 2022 saw single deal sizes over USD1 billion (this year, Vista Equity Partners entered into a USD4.8 billion NAV loan of which it used USD1 billion to pump into one of its portfolio companies).

What the future holds

The growth in use of NAV facilities is following a similar path to capital call facilities, GP-led secondary sales, Collateralised Fund Obligations and other similar products. Initially there will be a period where LPs and others become more familiar with the benefits of NAV facilities in managing portfolios to provide greater returns, leading to less debate.

As the market matures, as with capital call facilities, standard NAV facility wording will be included in fund documentation to explicitly permit NAV facilities but setting clear parameters, as leverage limitations, percentages of portfolio assets which are capable of being secured in favour of a lender etc.

There may be a continued bifurcation between secured and unsecured NAV facilities and bank led and private capital led facilities.

From our discussions with key market participants, they are predicting a continued upwards trajectory with increased single deal sizes continuing to increase year on year. With significant new market participants entering the NAV space such as Apollo Global, Ares, HPS, Pemberton, as well as a number of insurers and new bank participants, the general consensus is the NAV financing market is here to stay.

[4] NAV Facilities Gain Momentum Among Alternative Funds, Citco, February 2023. The NAV Puzzle, Key Questions every investor needs to ask, Private Funds CFO Fund Finance August/September 2023.

DLA Piper is a global law firm operating through various separate and distinct legal entities. Further details of these entities can be found at dlapiper.com. This publication is intended as a general overview and discussion of the subjects dealt with, and does not create a lawyer-client relationship. It is not intended to be, and should not be used as, a substitute for taking legal advice in any specific situation. DLA Piper will accept no responsibility for any actions taken or not taken on the basis of this publication. This may qualify as "Lawyer Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.
Copyright © 2024 DLA Piper. All rights reserved. | MAY24 | A22743-6