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Navigating ILPA's NAV-Based Facility Guidance

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

Key takeaways

- The Institutional Limited Partners Association recently released guidance regarding the use of the burgeoning suite of private capital fund liquidity/portfolio management tools known as NAV facilities, a product that is expected to grow to $600 billion this decade.

- ILPA's guidance provides a history of NAV-based facilities, a collection of LP concerns regarding their use and transparency, recommendations for GPs on engaging their LP base, proposed legal language, and additional recommendations regarding disclosures.

- The past several years have presented significant shifts in LP/GP relationship dynamics, and as fund terms and GP tools become ever more complex, ILPA encourages LPs to bring a united front to the negotiating table.

Introduction

On July 25, the Institutional Limited Partners Association (ILPA) released its much-anticipated guidance around the growing net asset value (NAV) loans market. While NAV facilities have existed for a couple of decades, as covered in PitchBook's Q4 2023 Analyst Note: NAVigating Considerations and Controversies Around NAV Loans, NAV lending has grown to become a $100 billion industry, with some expecting it to grow to $600 billion by 2030.[1] The rapid adoption of NAV facilities has led to conflicts that have necessitated a concerted effort to develop best practices around these loans.

As NAV loans and related products become increasingly prevalent tools used by GPs, the ILPA guidance addresses the challenges that LPs have encountered when faced with these facilities. The guidance also emphasizes that GPs and LPs should take a proactive approach toward communication to address the confusion, tension, and controversies that have emerged with NAV facilities' rapid growth.

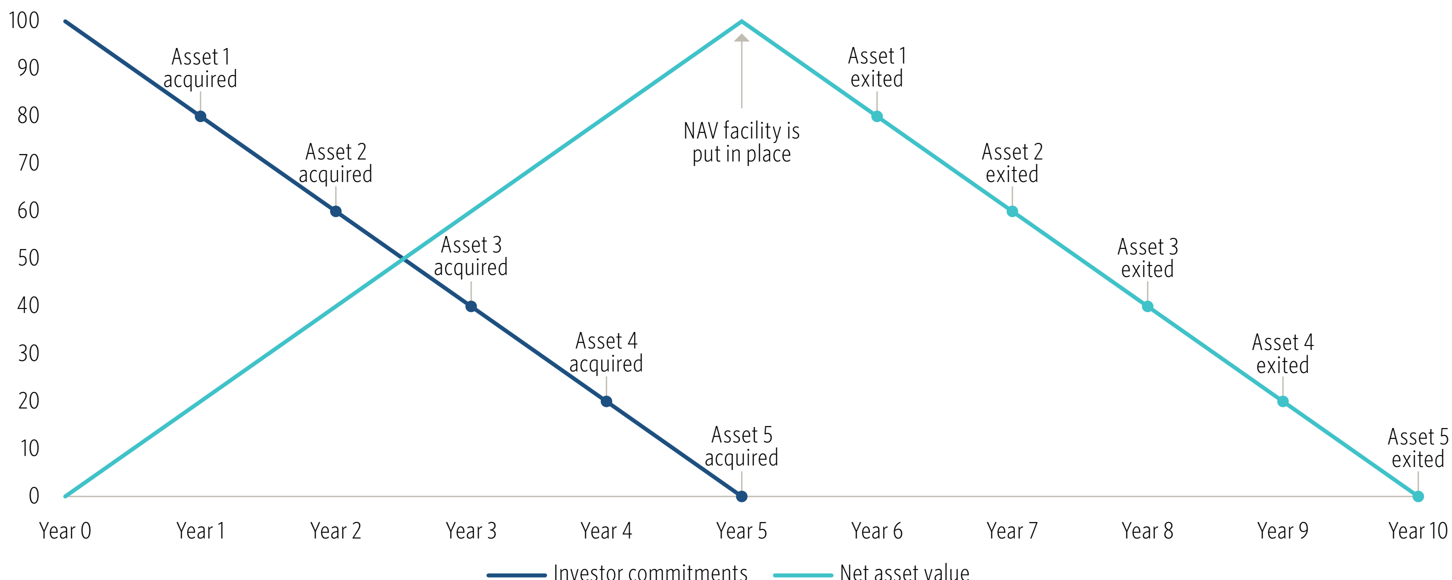
The topic of NAV facilities was discussed at length by PitchBook Lead Analyst Zane Carmean and Senior Strategist Hilary Wiek alongside ILPA's Director of Industry Affairs, Brian Hoehn, in PitchBook's second installment of its Allocator Atlas webinar series, "Navigating the LP/GP Relationship: A Conversation with ILPA."

History of NAV loans

NAV loans are the counterpart to capital call facilities:[2] Once a fund has drawn down its LP commitments and made investments, it is at this point that funds can utilize NAV facilities, where the collateral of the NAV facility is based upon a fund's established portfolio of assets.[3] NAV loans are typically established during or after a fund's investment period and used from a fund's holding period up to the end of the fund life.[4] These facilities have various use cases, including supporting portfolio companies, paying down existing portfolio-level debt, making add-on acquisitions, or, more controversially, making speedier distributions to LPs in difficult markets.

1: "The Rise of NAV Lending in Private Equity," Moonfare, Sean Lightbown, July 6, 2023.
2: For further information, read PitchBook's Q3 2023 Analyst Note: The Changing Landscape of Capital Call Facilities.
3: ILPA's NAV-Based Facilities Guidance says, "Due to their additional structure and underwriting complexities, NAV-based facilities tend to have higher interest rates than do subscription lines. That said, because the facilities are cross-collateralized across multiple portfolio companies, NAV-based facilities tend to have a lower cost of capital than the debt a single portfolio company would be able to incur."
4: Some fund managers use "hybrid facilities," which transition from subscription-line-based facilities over to a NAV facility as the fund acquires assets.

Simplified example of capital call facility usage versus NAV facility usage during a fund's life



Source: PitchBook

Prior to the global financial crisis (GFC), NAV loans were products offered by banks to two primary types of borrowers: funds within the nascent private credit market and secondaries funds with portfolios of LP fund interests.[5] Loans to these funds were easy to underwrite because the diversification of these funds meant that asset volatility and risk were low. In the years following the GFC, however, regulatory constraints and capital requirements resulted in banks pulling back from offering portfolio-level loans. In their place, private lenders such as 17Capital and Hark Capital stepped up.

The COVID-19 pandemic broadened the base of borrowers that started using NAV facilities. Buyout fund managers began employing NAV facilities as "liquidity solutions" for portfolio companies and assets during the pandemic. Use of these facilities has gained further traction through 2024, as interest rates have driven the price of LBO- or asset-level financing materially higher. NAV loans have become a mainstream alternative to company-level leverage, as the more diversified asset-based loan with a lower loan/value (LTV) ratio could justify lower borrowing rates. Compounding these effects is the fundraising environment, which—due to a lack of distributions to LPs starting in 2022—has slowed down significantly, affecting GPs' ability to attract new fund commitments.

However, LP experiences with GPs' use of and transparency around these facilities has been incredibly varied. While some LPs have found GPs proactively forthcoming around disclosures regarding these facilities, others have found themselves discovering the presence of a NAV loan only after analyzing financial statements and working backward to determine the source of discrepancies.

5: For further information, read PitchBook's Q4 2023 Analyst Note: NAVigating Considerations and Controversies Around NAV Loans.

In the face of varying experiences with NAV loans and the potential for conflicts of interest, ILPA stepped in to offer guidance to the industry, considering the views of LPs, GPs, and lenders to hopefully provide a solution acceptable to and adoptable by all market participants. This NAV-Based Facilities Guidance comes at a time when there is widespread confusion regarding when it is appropriate for fund managers to use these facilities and in what circumstances GPs need limited partner advisory committee (LPAC) approval. In addition, because NAV facilities are a relatively new product for most market participants, the concept of portfolio-level leverage via a NAV facility has not been explicitly addressed in limited partnership agreements (LPAs), making it difficult for both LPs and GPs to know the best practices for an instrument of this kind.

ILPA's guidance sets out to inform both LPs and GPs about NAV facilities themselves, their pros and cons, and what best practices all parties can implement to ensure greater transparency, smoother communication, and better governance. ILPA also hopes that providing this guidance will improve efforts to standardize financial and performance reporting across the private markets.

ILPA's NAV-based facility guidance

ILPA's insights reflect feedback from hundreds of LPs and GPs worldwide and can act as a road map for all market participants. The guidance contains five sections:

- "Part 1: Overview of NAV-based facilities and current market practices"
- "Part 2: LP concerns regarding NAV-based facilities"
- "Part 3: Recommendations for improved transparency and LP engagement"
- "Part 4: Proposed legal documentation"
- "Part 5: Recommended disclosures related to the use of NAV-based facilities"[6]

Overview of NAV-based facilities and current market practices

The first section discusses all topics that would fall under a NAV facilities 101 chapter: educational material on how NAV loans are structured, how they are being used today, and their upsides as well as potential drawbacks. For instance, this section discusses how the dual special-purpose-vehicle (SPV) structure created when a NAV facility has been implemented has encouraged some GPs to exclude the NAV facility from fund-level leverage calculations to circumvent leverage limits in existing LPAs. As ILPA states and lenders have reiterated, NAV facilities should be considered fund-level leverage, and as such, disclosures must be made to the LPACs and arguably all LPs backing the fund.

6: "NAV-Based Facilities Guidance," ILPA, July 25, 2024.

LP concerns regarding NAV-based facilities

The second chapter is educational material aimed at GPs regarding five widespread LP concerns around NAV loans and how these facilities have been implemented. The guidance lists main five concerns from LPs:

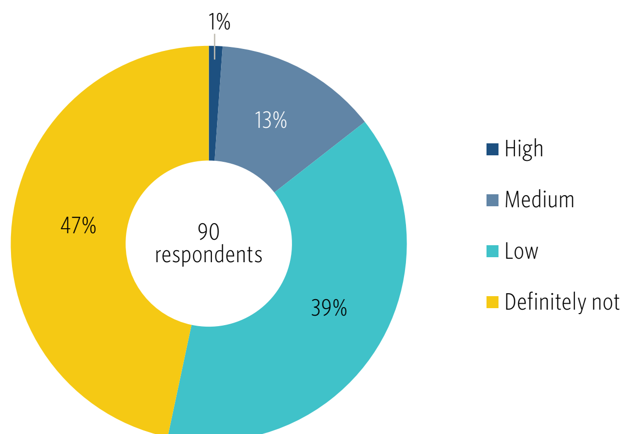
- "LPs often have limited insight into when NAV-based facilities are being used."
- "LPs struggle with the lack of governance related to the use of NAV-based facilities, which drives the lack of transparency."
- "Where the LPA is silent, GPs have taken different approaches to how they treat NAV-based facilities."
- "Some GPs have interpreted traditional fund-level leverage provisions in LPAs as providing sufficient authority for them to undertake NAV-based facilities without LP and LPAC notification or engagement."
- "LPs have observed increased use of NAV-based facilities during the more challenging fundraising environments of recent years."[7]

The second chapter also contains two spotlights on specific use cases. The first is on the controversial use case in which a NAV facility is implemented to fund early distributions. According to the guidance, the Fund Finance Association has estimated that 20% of NAV loans have been used for this purpose, which makes LPs nervous: "Early distributions generated by a NAV-based facility may have a material impact on IRR and DPI performance figures, since capital is returned earlier than it would otherwise be if a NAV-based facility were not used."[8] In addition to potentially manipulating IRR and distributions-to-paid-in (DPI) measurements, LPs also take issue with the fact that when NAV facilities are used to fund early distributions, LPs bear the brunt of the interest costs. The boost to IRR itself also introduces conflicts, as GPs may be using the NAV facility to generate carried interest upon these early distributions.

Additionally, the guidance says that "given the lack of transparency around the use of such facilities, more vigilance is required to isolate their impact."[9] Another conflict addressed in this spotlight is the potentially recallable nature of early distributions. The guidance explains that "If the facility starts to underperform [...] GPs can recall the distributed capital to pay down the facility. Recallable distributions can also be an administrative burden for LPs and disrupt their cash flow planning. The possibility that LPs will unexpectedly need to return distributions to the fund impacts LPs' ability to allocate that capital to other funds or strategies...."[10] LPs should be on the lookout for distributions stemming from a NAV facility. More than half of GPs responding to our recently completed Sentiment Survey are at least considering implementing a NAV facility to provide liquidity to LPs in the next 12 months.

7: "NAV-Based Facilities Guidance," ILPA, July 25, 2024.
8: Ibid.
9: Ibid.
10: Ibid.

PitchBook Sentiment Survey: What is the likelihood you will use a NAV loan for providing liquidity to LPs in the next 12 months?*



Source: PitchBook • Geography: Global • *As of July 22, 2024

The second spotlight digs into the less controversial and more widely accepted use case of NAV facilities providing portfolio support. GPs that use a NAV loan to fund follow-on investments or prop up struggling companies in the portfolio should have a good rationale as to 1) why it is prudent to do so and 2) why a NAV facility is the best option among all possible alternatives to provide that additional capital. LPs should question whether or not GPs have mismanaged reserves, and GPs should be prepared to provide a transparent rationale regarding the facility. This concern stems from the fact that portfolio-supporting NAV facilities cross-collateralize the risk across the other assets in the fund. It may be cheaper to do so, but if a portfolio company supported by a NAV loan ends up failing, the rest of the companies in the fund will have to be used for collateral to foot the bill. Lastly, LPs are encouraged to be skeptical of GPs that are struggling to raise capital for a follow-on fund and use a NAV loan to support its predecessor. The guidance states that "LPs are concerned that struggling GPs may be taking out a NAV-based facility to increase their assets under management (and therefore their management fees if the management fee is calculated on cost)."[11] Managers should be aware of the challenges that LPs have faced with NAV facility implementation.

Recommendations for improved transparency and LP engagement

The third section covers ILPA's recommendations for when and how GPs should engage their LP bases. GPs should be proactively approaching their LPACs and be prepared to discuss their rationale for the process, the size and structure of the facility, and key economic terms. In instances where the GP is hoping to use NAV loans to generate early distributions, the GP should seek LPAC approval. LPs are encouraged to question why a NAV facility is a better alternative to the various ways a fund can generate liquidity for its investors.

11: "NAV-Based Facilities Guidance," ILPA, July 25, 2024.

Proposed legal documentation

The next section details ILPA's recommended legal language in both existing and future LPAs regarding NAV loan facilities. In the instances in which an existing LPA does not give explicit permission to use NAV facilities, the GP should approach and disclose this to the LPAC and request a waiver. Even if explicit language does not bar this borrowing, GPs should not assume that they can move ahead with a NAV facility without first consulting the LPAC. In the current fundraising environment, a poorly run process may dissuade LPs from re-upping their commitments with the fund manager in question.

For future negotiations, ILPA offers some language in its guidance. It will be important for future LPAs to explicitly define NAV facilities as well as appropriate or inappropriate use cases, acceptable maximum and minimum LTV ratio thresholds, and well-articulated leverage limits. Future LPAs should also clearly outline when a GP must consult the LPAC prior to enacting any decisions regarding NAV loans.

Recommended disclosures related to the use of NAV-based facilities

The final section discusses the information that LPs should be seeking and that GPs should be disclosing about NAV facilities as they are being contemplated. It also includes two lists of questions that LPs should be asking their GPs and GPs should be asking their LPs. In terms of information that GPs should be disclosing to LPs about NAV facilities, GPs should disclose who the lenders are, what the LTV ratio is, and what would happen to the portfolio and underlying assets in the event of a default.

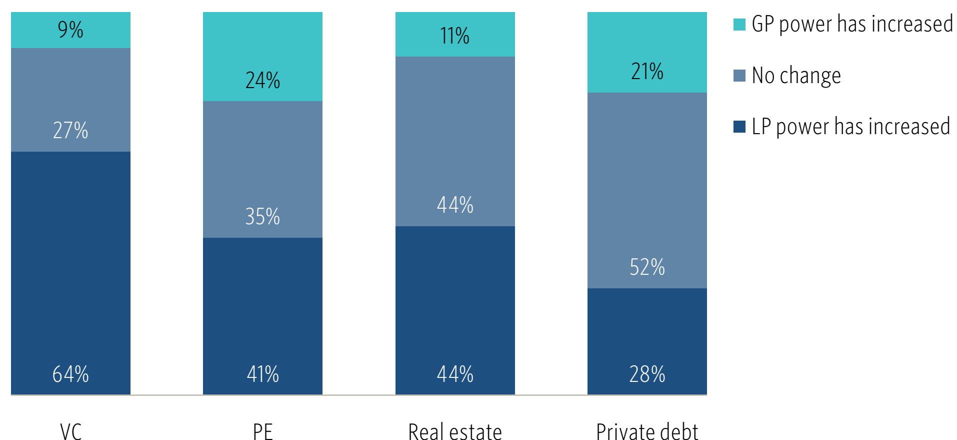
While GPs may use a NAV facility against the portfolio of a fund once or a handful of times every few years, LPs are seeing many NAV facility usage proposals across their desks, given the multiple managers these LPs work with. GPs can learn best practices from this guidance and their own LPs, who encounter these proposals frequently and can provide GPs with a broader perspective on how these loans are received by LPs. As such, this guidance is as much of a valuable resource for GPs as it is for LPs. LPs should feel encouraged to share this guidance with their managers.

Additional considerations regarding LP/GP relations and negotiations

ILPA's NAV-based facility guidance comes at a time when LP/GP relationships appear to be drifting further out of alignment with each passing negotiation. From what ILPA has heard from its members, for years GP legal counsel has been much more aggressive in pushing GP-friendly terms with each successive fundraise. LPAs today are starting from a more neutral position—LPs have had different levels of success in getting GPs to enact certain changes that the LPs would like to see. While ILPA recommends first trying to negotiate through the LPA, it is also possible to introduce changes in LP side letters. The generally larger GPs with stellar track records still wield quite a lot of negotiating power, but for funds that are competing to stand out, managers have offered fee offsets, management fee breaks, more co-investment rights, and other such benefits.

To gauge how LPs are feeling with regard to whether the fund formation terms in the market are more LP friendly or GP friendly, we surveyed dozens of LPs as part of our recent Sentiment Survey. While the tough fundraising environment might cause some to expect that the market is currently LP friendly, LPs do not necessarily feel the same way. While a greater number of LPs find that negotiations in VC are LP friendly, this is less true across other asset classes.

PitchBook Sentiment Survey: How do you perceive the power balance between LPs and GPs has shifted in 2024?*



Source: PitchBook • Geography: Global • *As of July 22, 2024

Once a fund is formed, the LPAC plays a critical role in representing the LPs in the fund, and GPs are encouraged to operate as true partners to their investor base. A common theme among both ILPA's continuation fund guidance and NAV loan guidance is how GPs engage their LPAC. Given how much longer portfolio companies are being held in the current environment, GPs are going to have to make some important decisions about the future of these assets. LPACs can make for helpful sounding boards for LPs, so GPs should feel encouraged to be as transparent as possible with LPACs.

With regard to what LPs can do to improve LPAC efficiency, ILPA recommends that LPs send the same person—preferably someone who has authority within the organization to vote on these matters—to a GP's LPAC meeting as consistently as possible. It is also important for GPs to give LPs a chance to discuss matters without the GP present. While LPs must act as fiduciaries for their own investment portfolios, it can be helpful to hear other LP viewpoints to bring best practices to the LPAC table and aid in informed decision-making.

For more on NAV facilities, continuation funds, changing LP/GP dynamics, and ILPA's role in the industry, watch our recently released webinar recording, "The Allocator's Atlas: Navigating the LP/GP Relationship, a Conversation With ILPA."

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