NAVigating Considerations and Controversies Around NAV Loans

What to know about these bespoke and evolving facilities

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Contents

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 pullback from traditional sources of loans, the prohibitive cost of LBO financing, and the lack of recyclable capital being returned to LPs have encouraged fund managers to employ increasingly creative methods to extend the runway for certain portfolio companies, refinance leverage at more manageable rates, and manufacture liquidity for their investors at more reasonable costs. One such method has been NAV loans.

- In 2022, the Fund Finance Association estimated the size of the NAV facilities market to be approximately $100 billion, and some fund finance participants expect the market to grow to $600 billion by 2030.[1]

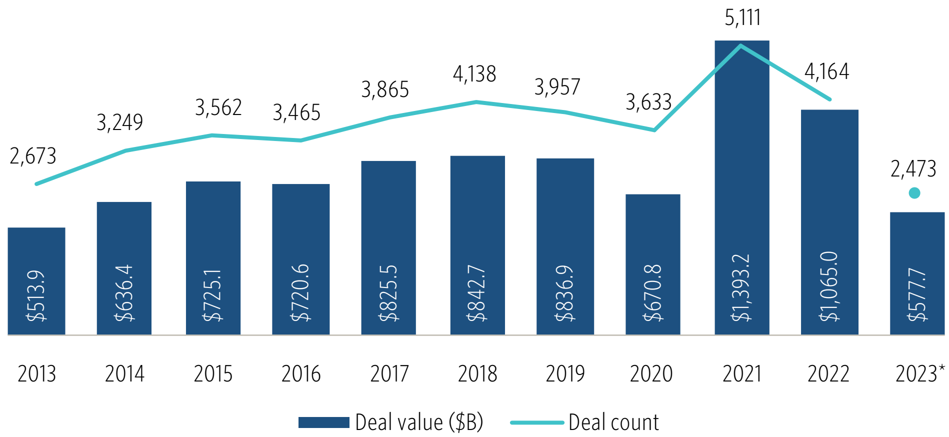
- However, some market participants are skeptical about NAV loans, particularly as they relate to funding distributions to LPs. PitchBook recently hosted a webinar called "NAVigating considerations and controversies around NAV loans" in which a panel of experts discussed these topics. Click here to view the webinar.

1: "NAV Facilities Gain Momentum Among Alternatives Funds," Citco, February 2023.

Introduction

Nine months into 2023, global private equity leveraged buyout (LBO) deal activity remains subdued with $577.7 billion in deal value,[2] which is in stark contrast to the $1.4 trillion and $1.1 trillion generated in 2021 and 2022, respectively. As interest rates have remained high throughout 2023, leverage associated with asset-level financing has become increasingly expensive, leading private equity funds to rely less on LBO financing to make acquisitions.

LBO PE deal activity

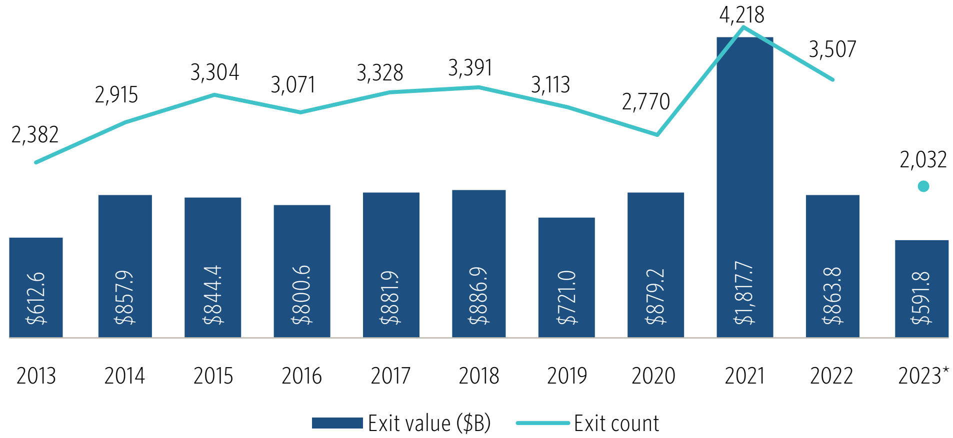


Source: PitchBook • Geography: Global
*As of September 30, 2023
Note: We used buyout and platform creation deals, excluding add-ons, as a proxy for LBO deals.

Simultaneously, global private equity exit activity remains sluggish with just $591.8 billion in exit value through Q3 2023. The 2023 annual figure is unlikely to surpass 2022's exit value of $863.8 billion and will be a far cry from the 2021 peak of $1.8 trillion. In fact, the average annual exit value between the nonpeak years of 2013 and 2020 was $810.6 billion, so 2023 is on track to miss even historical averages, highlighting the ongoing challenges in the exit environment.

2: We used buyout and platform creation deals, excluding add-ons, as a proxy for LBO deals.

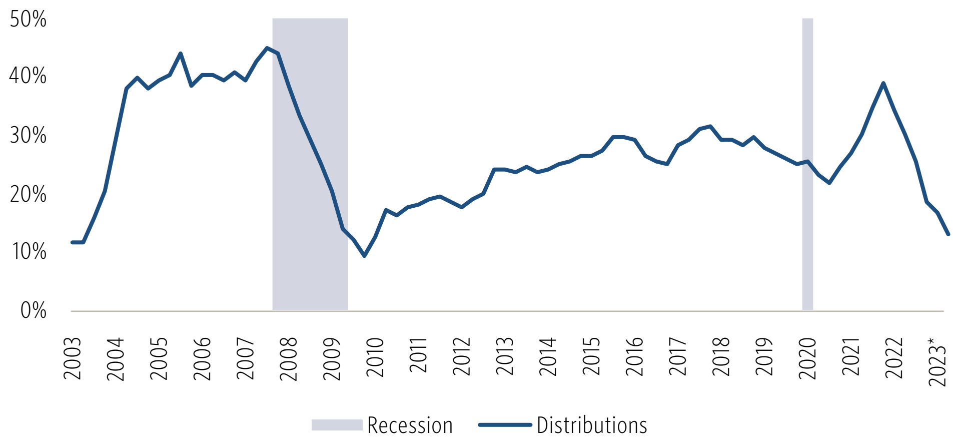
PE exit activity



Source: PitchBook • Geography: Global
*As of September 30, 2023

As exits have stalled, so too have distributions back to LPs. The average annual distributions for buyout funds between five and 10 years old have dropped from the recent peak in Q4 2021 of 39.0% of beginning net asset value (NAV) to 13.1% of beginning NAV as of Q2 2023, the lowest figure on record since hitting 9.2% in Q4 2009 and 12.7% in Q1 2010.

Average annual distributions for buyout funds between five and 10 years old as a percentage of beginning NAV



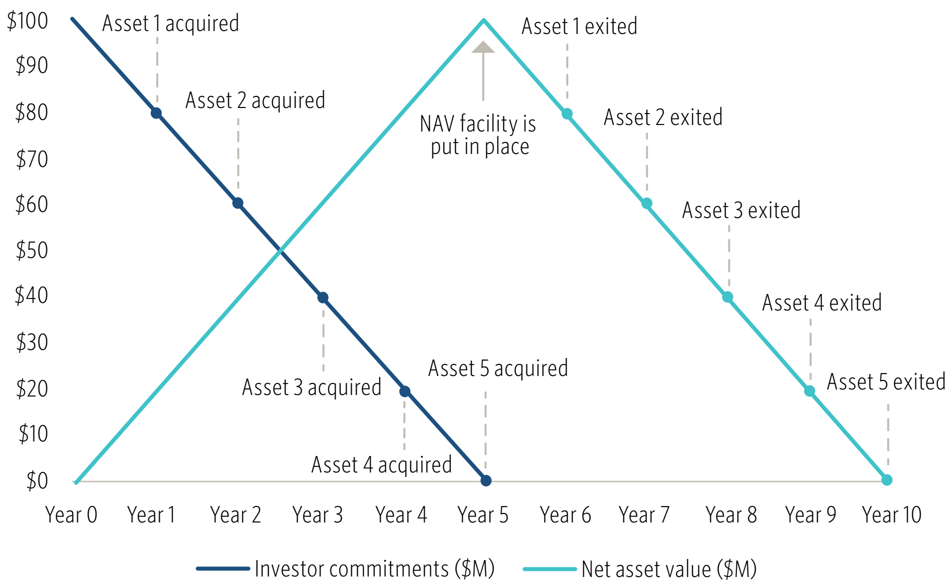
Source: PitchBook • Geography: Global
*As of June 30, 2023

The pullback from traditional sources of loans, the prohibitive cost of LBO financing, and the lack of recyclable capital being returned to LPs have encouraged fund managers to employ increasingly creative methods to extend the runway for certain portfolio companies, refinance leverage at more manageable rates, and manufacture liquidity for their investors at more reasonable costs. One such method that has been gaining popularity has been NAV loans. However, alongside their increased usage, there have also been debates about their validity. For the purposes of this note, we will be examining the use of NAV loans at the fund level, though as we detail in the "Borrowers and use cases" section, there are a number of other borrower types.

What are NAV loans, and what has driven their popularity?

NAV loans—also known as NAV facilities—are the counterpart to capital call facilities.[3] As detailed in our analyst note The Changing Landscape of Capital Call Facilities, capital call facilities are collateralized by the underlying investor commitments to a fund. As investor commitments are called down to make investments, the collateral base shrinks until all commitments are drawn down. It is at this point that the fund can utilize a NAV loan, where the collateral is based upon the fund's newly established portfolio of assets. NAV facilities are typically established during or after a fund's investment period and utilized through a fund's holding period up to the end of the fund life. In the simplified example in the figure below, a fund draws upon $100 million of investor commitments to make five $20 million asset acquisitions over the span of five years. As the acquisitions are made, the NAV of the fund increases until it reaches $100 million in assets. In this example, the NAV facility is put in place once all the assets are acquired. Then, as the fund exits the assets, the NAV of the fund—the collateral base of the NAV facility—will decrease. Maturities on these facilities will generally range from three to five years, though shorter tenors are also gaining popularity; according to a survey of fund finance professionals conducted by Haynes and Boone, 58% of average tenors seen within the last six months have been between one and two years.[4]

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



3: There is a distinction between NAV facilities and NAV finance. NAV finance is the umbrella term that encompasses the two main categories of NAV-based financing: NAV facilities, which are debt instruments, and preferred equity. While preferred equity is a component of NAV finance, it is not in the scope of this note.
4: "NAVember Live Poll Data," Haynes and Boone, 2023.

Because NAV loans can be made against funds of various asset classes with disparate underlying portfolios, the loans themselves can take very diverse and bespoke forms, structures, and terms. With that said, these loans are generally structured as term facilities at the fund level, collateralized by any remaining equity interests in the assets of the fund, the cash flows of the assets, or a combination of both. NAV facilities thus differ from LBO or asset-level financing, which is leverage applied at the individual-asset level or portfolio-company level. NAV loans are generally less expensive than asset-level financing due to the diversified nature of the collateral.

It is important to note that NAV loan providers are subordinate to asset- or portfolio-company-level finance providers in the capital stack with the exception of loans made to private credit funds.[5] While the factors that a lender considers in determining an appropriate loan/value (LTV) ratio—the amount a lender is willing to lend toward the value of the portfolio—will be discussed in further detail in a later section, a typical LTV ratio will hover between the 10% and 25% range. Referring back to the example above, if a lender offers an LTV ratio of 20% to the fund with $100 million in NAV at year five, the fund will receive a $20 million facility to draw upon.

5: Lenders providing NAV loans to private credit funds can generally structure them as senior secured loans, meaning that in the event of a default, the NAV loan provider would be the first to be repaid as the debt provider in the capital stack.

History of NAV loans

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 with many underlying assets. Loans to these firms were easy to underwrite because the diversification of these funds meant that asset volatility and risk were low. When lending to private credit funds, the underlying collateral are loans that—except in severe circumstances—have a principal that is paid back as well as interest generated over the life of the loan. These loans have neither equity upside nor downside that introduce any additional risk. With secondaries, a lender is loaning against a known portfolio of investments that are closer to their exits than assets within a typical private equity fund. Additionally, the nature of these funds allows for consistent cash flows, which boded well for low-risk, stable returns that banks were generally looking for when dispensing these loans.

In the years following the GFC, regulatory constraints and capital requirements resulted in banks pulling back from offering portfolio-level loans. The scarcity of these loans fueled the growth of nonbank lenders, particularly private credit firms, that stepped in to fill the gap and were able to command higher rates for the service, securing attractive returns. Private credit firms went from being one of the primary borrowers of these facilities to those actually offering these loans to other fund types. A number of prominent names specializing in fund financing products emerged in the private credit space, including 17Capital and Hark Capital.

While NAV loans have existed for decades, the reason that NAV loans are a trending topic in the current market is that buyout funds have begun utilizing them. Historically, buyout funds generally did not use NAV loans because they would tap LBO financing to secure asset-level leverage. In the previous low-interest-rate environment, these asset-level financings were inexpensive, and GPs utilized this leverage in hopes of boosting returns and writing bigger checks. However, when markets came to a sudden halt during the COVID-19 pandemic, fund managers found themselves in need of an interim liquidity solution to support portfolio companies through the turbulent conditions and turned to NAV loans for that bridge financing. Based on survey results from Haynes and Boone, buyout funds have emerged as the top strategy borrowing NAV loans in the past 12 months, at 37%, followed by infrastructure and private credit funds at 23% and 21%, respectively.[6]

Since 2020, the growth in NAV loans has been explosive. In 2022, the Fund Finance Association estimated the size of the NAV facilities market to be approximately $100 billion, and some fund finance participants expect the market to grow to $600 billion by 2030.[7] In addition, as interest rates have risen through 2022, the cost of LBO financing has skyrocketed, resulting in fewer LBO deals getting done and the cost of refinancing individual companies becoming much more expensive. Compounding these effects is the fundraising environment that has slowed down significantly, affecting GPs' ability to retain dry powder. As a result, buyout firms

6: "NAVember Live Poll Data," Haynes and Boone, 2023.
7: "NAV Facilities Gain Momentum Among Alternatives Funds," Citco, February 2023.

have turned to NAV facilities to fill the gap—while NAV loans are not inexpensive, they are more cost-effective relative to individual-asset-level leverage. However, a demand-supply imbalance has emerged between potential borrowers and available lenders, especially after several banks that were active in the fund financing space required rescuing in March 2023 and have been less willing to continue offering the service, including Silicon Valley Bank and Signature Bank.

To fill the void in the fund financing market, several new nonbank solutions have expanded their NAV facility offerings within the past several months. For instance, Apollo Global Management announced in August 2023 that it would be offering $4 billion in NAV loans in the coming years.[8] In late October 2023, it was reported that AXA Investment Managers' Prime unit, the investment division of the insurance company, was raising a $400 million vehicle to provide NAV loans to private market borrowers,[9] illustrating the growing enthusiasm for NAV lending. Within the last five years, several insurance companies have become nonbank lenders. Insurance companies have largely avoided getting involved in the subscription line space because the short-term, revolving nature of those loans is antithetical to insurance capital. On the other hand, because NAV loans are predominantly structured as term loans, these loans are more attractive.

Though banks did initially retreat from the fund financing space following the events in March, a number of banks weathered the storm and have recently launched fund financing platforms, including Axos Bank, EverBank, and Huntington National Bank. While some banks will focus more heavily on subscription line financing, others aim to make the NAV lending segment a larger part of their business over the next several years.

8: "Apollo to Lend Over $4 Billion to Struggling Buyout Firms," Bloomberg, Laura Benitez, August 15, 2023.
9: "AXA IM Private Capital Unit to Launch NAV Financing Fund," Bloomberg, Swetha Gopinath, October 26, 2023.

"Though small, one of the fastest-growing use cases is facilitating extensions and refinancings of portfolio company capital structures in a new capital markets environment, particularly for performing portfolio companies."[10]

Dane Graham, 17Capital

"There is an unfortunate narrative that casts a negative light on NAV loans as if it's one single thing, one product, and merely a GP carry enhancer. That's nowhere near the reality."

Michael Mascia, EverBank

Borrowers and use cases

Funds

NAV facilities are most commonly offered at the fund level, with funds themselves representing the majority of borrowers. According to Proskauer's nonbank lender survey, 56% of NAV loans were made to funds.[11] The most commonly cited use case for fund-level borrowing is portfolio-company growth, either through additive value creation methods or through financing bolt-on acquisitions.

Additional uses include borrowing against a NAV facility to pay down existing portfolio-company debt—as seen with Vista Equity Partners using part of its $1 billion NAV loan from Goldman Sachs to refinance its portfolio company Finastra's debt—or to make additional investments.[12] For instance, in December 2021, Apollo Global Management lent a $4 billion NAV facility to SoftBank against its portfolio companies in Vision Fund 2 for the purpose of acquiring new investments.[13] In Q1 2022, Apollo increased the facility to $5.1 billion, though it was unclear whether the additional loan proceeds were going to be used for the same purpose.[14]

The capital provided from NAV loans can also be used to facilitate distributions to LPs without having to sell any assets at suboptimal pricing. It has been reported that Vista Equity Partners, SoftBank, Nordic Capital, Carlyle, and Hg Capital have used some portion of their respective NAV facilities for this purpose.[15] According to the Rede Partners NAV Financing Market Report 2022/23, 61% of lenders surveyed noted that they observed increases in NAV transactions conducted for the sole purpose of increasing distributions to paid-in capital (DPI).[16] Despite the rising popularity of this use case among GPs, many LPs dislike that NAV loans are used to fund distributions; we discuss this in the following section, "What are the potential downsides of using a fund-level NAV facility?"

GPs or management companies

Also known in the fund finance industry as "ManCo" facilities or GP financing, these loans can be made against a GP's commitment into a fund, the GP's carried interest, management fees, or some combination of the three. Like NAV loans made at the fund level, GP facilities can be used to support portfolio-company growth. Additionally, these facilities can also be used to provide additional capital toward a GP's commitment to their fund for the purpose of illustrating increased alignment with their LPs.

10: All quotes are from the panelists in our webinar "NAVigating considerations and controversies around NAV loans." Click here to view the webinar recording.
11: "Insights on the NAV Lending Market," Proskauer, June 2023.
12: "Vista Tapped Goldman for $1 Billion Finastra Cash Injection," Bloomberg, Eleanor Duncan, Paula Seligson, and Carmen Arroyo, September 14, 2023.
13: "Buyout Groups Raise Debt Against Portfolios to Return Cash as Dealmaking Slows," Financial Times, Will Louch, Antoine Gara, and Chris Flood, July 17, 2023.
14: "Apollo Increases SoftBank Loan to $5.1 Billion From $4 Billion," Bloomberg, Gillian Tan, March 24, 2022.
15: "Buyout Groups Raise Debt Against Portfolios to Return Cash as Dealmaking Slows," Financial Times, Will Louch, Antoine Gara, and Chris Flood, July 17, 2023.
16: "NAV Financing Market Report 2022/23," Rede Partners, May 11, 2023.

While these facilities are considered a facet of NAV loans, GP financing is starting to develop into its own disparate category of fund financing. According to Proskauer, loans to GP management companies made up 19% of nonbank lending deal volume.[17]

Limited partners

Due to the lack of distributions in the current market, some LPs have found themselves in a position where they do not wish to sell their portfolio stakes and forgo any potential upside but are lacking capital that they can invest in newer vintage funds or use to honor upcoming capital calls. In such instances, LPs can also borrow NAV facilities. LPs can also utilize NAV facilities to finance their commitments to a fund or to rebalance their portfolio in times of stress. It has been reported that the California State Teachers' Retirement System may consider utilizing a NAV facility across its portfolio when the investment committee meets in January 2024.[18] While most NAV lenders will provide fund- or GP-level financing, not all lenders lend to LPs. Even among lenders that do, this borrower category tends to be the smallest portion of their business, as the majority of fund financing activity is driven by GPs.

Continuation vehicles

Managers of continuation vehicles (CVs) sometimes consider utilizing NAV facilities, though this use case is uncommon. As discussed in our analyst note [The Evolution of Private Market Secondaries], establishing a CV is one potential solution that enables a fund manager to avoid having to sell an asset or assets at a lower valuation or at a sizable discount and allows them to hold on to the asset(s) for an additional three to five years. Fund managers can launch a CV process to roll over an asset or set of assets into the new vehicle, giving existing LPs the option to maintain their stakes in the asset(s) or to take liquidity that arises from the sale. During this process, the manager establishing the CV will also proactively seek out interested secondary buyers to enter into the transaction as new incoming LPs that provide additional capital that can go toward supporting the single asset or multiple assets through the life of the CV.

However, some managers of these vehicles have found themselves in situations where the incoming secondary buyers do not provide enough fresh capital to fully support the needs for the asset or assets. As such, some managers have turned to NAV loans to fill the gap in funding. However, it is difficult to secure NAV facilities for continuation vehicles. Not many lenders, particularly bank lenders, are willing to lend against concentrated portfolios, especially when it is a single-asset continuation vehicle. In situations where nonbank lenders do lend toward such portfolios, all-in pricing can reach low double digits.[19] As such, deals of this nature are rare.

17: "Insights on the NAV Lending Market," Proskauer, June 2023.
18: "CalSTRS Expected to Consider Using Leverage to Manage Risk," Pensions & Investments, Arleen Jacobius, November 2, 2023.
19: "The 'Small' Approach That's Big News in Fund Finance," Hedgewood Capital Partners, October 5, 2020.

What are the potential downsides of using a fund-level NAV facility?

Despite the increased usage of NAV facilities across a spectrum of borrowers, there are segments of market participants that are wary of the potential negative impacts of these loans. In particular, some LPs in funds that employ NAV loans have voiced their concerns over fund managers' lack of transparency in their implementation of these facilities.

"We as lenders fully agree that LPs deserve and are entitled to transparency on the uses of fund-level indebtedness."

Michael Mascia, EverBank

Lenders that we spoke with emphasized that the GPs they engage with are proactive about communicating with their LPs and would feel very uneasy if it felt like a GP was using a NAV loan without disclosing it to investors. Additionally, lenders stress that they seek out legal opinions to confirm the permissibility of establishing a NAV loan within the confines of the limited partnership agreement (LPA). Some GPs may seek to make amendments to the LPA, which requires investor consent, but investors may decline to allow it, halting the deal. Lenders indicated to us that the COVID-19 pandemic encouraged fund managers to start including explicit language that enabled managers to implement NAV facilities, causing investors to become much more familiar with these terms.

However, some investors that we spoke with argued that GP transparency with these facilities has not been their experience and that it remains an ongoing issue. Some GPs have not informed or sought the consent of their LPs or their LP advisory committees (LPACs) when these facilities are being utilized. Contradicting lender sentiments, certain LPs have found that because LPAs do not explicitly bar portfolio-level financing, the lack of language is used as justification for its permissibility or preapproval without LP consent. Some LPs have reported finding out that a GP is using a NAV facility by examining financial statements rather than through the GP's explicit disclosure.

This lack of transparency means that LPs may not be able to question the GP about crucial elements of these facilities, such as how many portfolio companies or assets are exposed to the facility, the terms agreed upon, or the total portfolio- and asset-level leverage across a fund, making it impossible for LPs to implement risk management measures because the risks are hidden. LPs can find themselves in situations where leverage that they do not know exists is being used on their portfolios, making them subordinate to a newly introduced third-party lender whose interests are now above the LPs' in the fund. LPs may be left in the dark about what happens in the event of an asset default and how this could affect them with regards to waterfall or clawback provisions. When a fund distributes capital back to LPs, these investors may not be aware of how much of these distributions are coming from NAV facilities, nor of the potential cost implications later on in the fund life when the loan must be paid back with interest.

This leads to another major LP concern: that distributions paid out from NAV loans are being funded at a cost of capital above an LP's expected return. Though pricing does vary, NAV loans are not altogether inexpensive and can reach costs of debt in the high teens. As such, many LPs are dismayed by the fact that they are receiving distributions that will incur an interest charge that will eventually come out of the

"The DPI accelerator use case is the lowest value-add. We certainly are seeking distributions from our GPs, but that's not the method that we're looking for them—we'd consider that synthetic DPI, and when we look at our metrics around DPI, we'll carve out real DPI from synthetic DPI."

Neil Randall, Teacher Retirement System of Texas

fund's TVPI, resulting in lower distribution rates overall than if the fund had not used a NAV facility. LPs invest in the private markets knowing that they are committing to a long-term asset class and want the best return possible for their efforts rather than the most convenient return possible, especially when that convenience ultimately comes with extra cost. Where LP concerns emerged about capital call facilities artificially inflating IRR, NAV facilities may be juicing both IRR and DPI for the sake of benefiting a fund manager's future fundraising efforts.

The onus should be on GPs to not only disclose NAV facility usage but also demonstrate why they are a necessity for the fund and how the facility will ultimately benefit LPs. Given that this is not industry-wide practice, however, LPs can take proactive steps to protect themselves and demand transparency from their GPs. LPs may want to consider working with industry organizations such as the Institutional Limited Partners Association to make language around NAV loans more LP friendly. During this time when LP commitments are not flowing as freely as GPs would prefer, LPs have negotiating power that they can leverage toward more transparency and better terms should the issue of NAV facilities concern them. Where there is transparency from GPs about distributions from NAV facilities, LPs may also want to consider separating actual DPI calculations from any artificial DPI by subtracting potential loan repayments that will come from the fund once the facility comes due.

"LPs are not homogeneous [...] Using a NAV loan might be the answer for a fund, and while this may not suit all LPs, they'll accept it because it is better for the fund overall."

Gianluca Lorenzon, Validus Risk Management

LPs might also consider starting to include specific language around NAV facilities in their due diligence questionnaires. While it may be difficult for a GP to predict what it may do in five to eight years during the fund life, questioning the GP about any potential utilization of NAV loans can let them know that investors are aware of and concerned about these facilities, encouraging GPs to be upfront about any potential disclosures in the future. Similarly, LPs on the LPAC should be proactive about determining whether a GP has previously used NAV facilities or plans to use them in the future. If so, LPs may wish to press the GP about how the proceeds from the NAV facilities will be used and which portfolio companies or assets they expect to be affected by the facility. Finally, LPs should ensure that they are reviewing financial statements in greater detail to uncover whether or not a GP may be using a facility without LP knowledge. The select lenders, advisors, and LPs that we spoke with all agreed that GP best practice would entail GPs proactively approaching their LPAC and LPs with information about any usage of NAV facilities, providing full and transparent disclosures around costs and any risks to LPs upfront.

How do lenders diligence a portfolio?

Lenders generally begin their due diligence process by examining the fund manager and exploring a number of factors to determine their creditworthiness. How long is the manager's track record, and how well have their investments performed historically? How often has the fund realized investments, and through which methods? What is the fund's investment strategy, and how diversified are any underlying assets with regards to sectors, industries, or geographies? How well has the manager mitigated market risk within the portfolio? Certain lenders may also want a view into the fund's underlying LP base to ensure that the fund is supported by high-quality institutional investors and request that a fund manager make subscription documents available for review.

Lenders will also likely want to know what the NAV loan proceeds will be used for and will have preferences about how the debt will be used as well as when it will be paid back. Some lenders are particularly cautious when a fund manager intends to use NAV facilities for the purpose of distributions to LPs and will inquire about whether the fund investors have approved this usage, as the lenders will want to ensure all parties have approved NAV loan usage.

"We don't believe there is a strong enough portfolio that makes up for a noninstitutionalized manager, or a creative enough structure that makes up for a challenged portfolio."

Dane Graham, 17Capital

Once the initial manager due diligence has been completed, lenders will generally move their diligence process to the underlying assets of a fund. Different lenders have varying levels of comfort depending on the specific intricacies of a potential borrower's portfolio. For example, some lenders will lend only to funds that have already identified all assets within their portfolio and have eliminated all blind pool risk. Others may consider lending to a fund that either has not yet acquired any assets or has acquired only a handful of assets with some investments outstanding, but they may compensate for the existing blind pool risk by offering a higher credit spread or a very low LTV ratio. In some of these cases, though, the LTV covenant can be written to maintain some flexibility; if the fund ends up acquiring a diversified set of portfolio companies, thus increasing the overall fund NAV, the LTV ratio might be revised given that there are now more assets to lend against.

Additionally, diligence on a diversified portfolio will look different from the diligence done on a more concentrated portfolio. In the case where a lender is conducting diligence on a secondaries fund with thousands of underlying companies, examining each asset would be impossible, so the lender would likely focus their deeper company diligence on the larger assets driving a majority of the portfolio value. Should a portfolio be more concentrated and contain just one or a handful of assets, the level of diligence on the companies will be much more comprehensive, ensuring that any asset-related documentation is thoroughly examined and potentially involving on-site diligence visits in which the management of the portfolio companies or assets are interviewed. Valuation methodologies—discussed in detail in a later section—are another important due diligence consideration, and many lenders will use either private or public comparables to assess whether a manager's valuations are reasonably calculated. If the lender's assessment of the manager's valuation differs by a minor percentage spread, most lenders will not terminate the deal and will use their lower ascribed valuation for the LTV ratio. However, if the manager's valuation differs by a significant degree from how the lender has valued the asset, this may be considered a red flag and the lender may choose not to execute the deal.

Some lenders may avoid offering NAV facilities to funds of certain asset classes altogether. For instance, a lender may be very comfortable lending toward private credit funds, as the lender can structure the NAV facility as a senior secured loan, guaranteeing that the lender will be fully repaid first in the event of a default. That same lender may be very hesitant to extend a NAV loan to a buyout, real estate, or infrastructure fund because these asset classes are more likely to utilize asset-level leverage. In these situations, the NAV loan provider would be subordinated in the debt structure behind the asset-level leveraged loan provider. While asset defaults that are cross-collateralized by both asset-level and portfolio-level leverage have been rare, should a default occur, monetizing the distressed asset and determining how much of the distributions each party receives becomes an exceedingly cumbersome and costly exercise when there are so many levels of leverage under consideration. In the worst-case scenario in which the asset is entirely unprofitable, NAV loan providers can find themselves stuck if the deal is structured in such a way that there is no direct recourse with regard to the assets. As such, some lenders are unable to stomach that risk. Other lenders are willing to lend to different fund types as long as the asset-level leverage is within market standards. For instance, real estate assets can typically have anywhere between 50% to 75% asset-level leverage. As long as asset-level leverage has not exceeded market rates, certain lenders may be willing to extend NAV facilities in these circumstances. Fund managers may benefit from working with an advisory firm that has experience with navigating the diverse spectrum of existing lenders and pairing GPs with the appropriate lenders.

The length of the due diligence process depends on the factors detailed above. Additionally, the timing can also be influenced by how well the lender knows the manager and whether they have worked together previously; deals made with first-time relationships will take longer. Depending on the lender, the diligence process can typically take anywhere from four to eight weeks, though some lenders have noted that it can take up to three months to get comfortable with a particularly complicated portfolio.

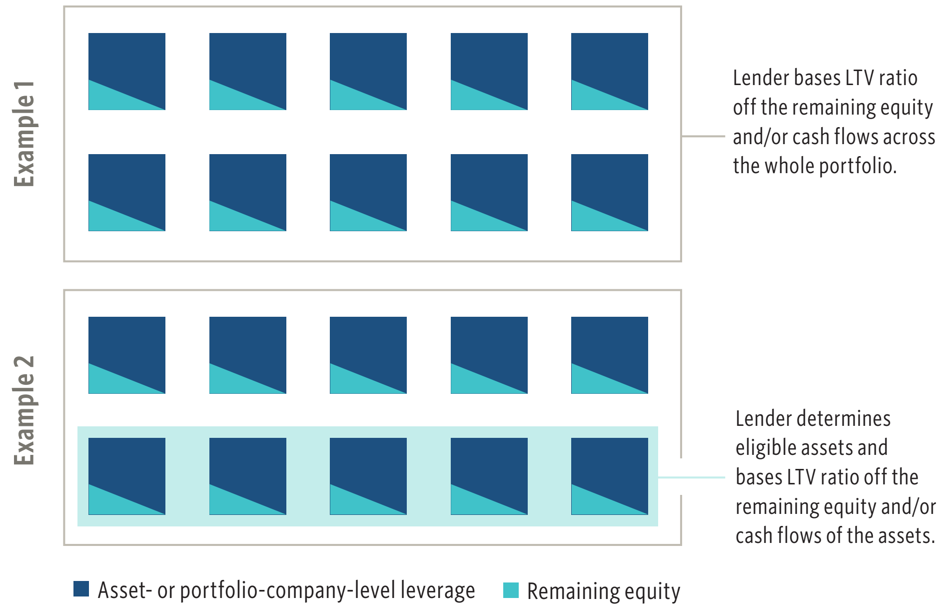
How are NAV facilities structured and priced?

Structuring NAV facilities

Given that NAV facilities are so customized in nature and can encompass such disparate assets, as detailed above, it is unsurprising that the structure and pricing of NAV facilities also cannot be distilled into a standardized format. However, there are some common structuring elements and covenants that do appear in most deal negotiations, which we will touch upon later in this section. It may be beneficial for borrowers considering using a NAV facility to think through some of the factors that are covered below.

One of the first questions that borrowers should seek to answer is what the collateral structure of the NAV facility will be. As mentioned previously, the collateral structure underpinning a NAV facility will generally take one of three forms: the remaining equity interests of the assets within a portfolio after excluding asset-level leverage, the cash flows of the full portfolio or a subsection of the portfolio, or a combination of both.[20, 21] If a borrower's portfolio contains 10 assets, is the lender expecting the collateral to be based upon the equity of those assets or the cash flows of those assets? If it is based upon the equity, is it the equity of all the underlying assets or specific assets that meet a lender's eligibility criteria? If it is based upon the cash flows, will it be the cash flows of the entire portfolio or from a select handful of assets? The complexity of the fund structure plays a significant role too: The collateral package for a straightforward single-asset continuation vehicle will generally consist of security over the asset, while a complex buyout fund with joint venture partners and assets across multiple funds may have a security package based on the cash flows of various assets.

Collateral package structure examples



20: There are select instances where a deal is "unsecured" and the debt has no underlying collateral package. However, deals of this kind are rare because most lenders are unwilling to lend against an unsecured structure.
21: There are also atypical instances where a collateral package is arranged to have direct recourse to the assets themselves, known as a "direct pledge." Most NAV facilities will be structured as "indirect pledges" where the remaining equity of the portfolio, the distributions or cash flows from the assets, or the combined collateral package will be placed within a special purpose vehicle.

It is important for the borrowers to establish the answers to these questions early on in the negotiation process because the security package of the underlying collateral will influence the LTV ratio that a lender will offer a borrower due to the different bankruptcy risks associated with equity versus cash flows. For instance, a borrower may receive two very disparate LTV ratios from two different lenders specifically because one lender is basing a higher LTV ratio off of the equity of the assets, while the other is basing a lower LTV ratio off of the cash flows of the assets.[22] In a similar vein, LTV ratios will vary depending on whether the underlying assets are diversified or if they are concentrated. A secondary fund is more likely to receive a higher LTV ratio than a buyout fund.

Potential borrowers should note that different lenders can offer very different LTV ratios, even against the same collateral package, depending on their risk appetite. LTV ratios generally range anywhere from 10% to 25% of a portfolio's net asset value, but a bank is more likely to take a conservative approach and offer LTV ratios of 10% to 15%. Insurance companies and private credit firms, on the other hand, are more likely to target higher LTV ratios at a higher cost of capital to the borrower. According to the Proskauer survey, 65% of nonbank lenders closed on LTV ratios within the 10% to 25% range, while 15% closed on LTV ratios between 5% to 10%, for funds of various asset classes.[23] Notably, 19% of LTV ratios were above 25%.

In most cases, NAV facilities are structured as term loans with maturities that range from three to five years. However, there are instances in which NAV facilities are structured to have both a term loan and revolving credit facility component, depending on the needs of the borrower. For example, a borrower may utilize a NAV facility's term loan component to make acquisitions during the fund's investment period. However, the borrower may also want the option to fund an add-on acquisition for one of the portfolio companies but does not know when this opportunity will arise—or if this opportunity will crystallize at all. In such a situation, a borrower may opt to include a revolver component of a NAV facility that can be used opportunistically. The revolving portion of the facility could be structured as either a committed or an uncommitted revolver. If the revolver is committed, this means that the lender will actually set aside capital for the borrower to potentially use in the future. If the borrower ultimately does not draw upon the revolver, the lender will charge an unused fee. If the revolver is uncommitted, the lender does not set aside capital. This option is less expensive than a committed revolver and does not carry an associated unused fee, but there is no guarantee that capital will be available if the borrower does end up wanting to draw upon the uncommitted revolver. If a potential borrower were to want to include a revolving structure in a NAV facility, the borrower would likely find more success approaching a bank or private credit lender rather than an insurance company lender, as insurance companies tend to avoid revolving structures.

22: There are also situations in which traditional banks and private credit firms may partner together to offer a borrower a blended cost of capital for a facility, ultimately resulting in a less expensive facility for the borrower.
23: "Insights on the NAV Lending Market," Proskauer, June 2023.

Common covenants

It may also benefit any potential borrowers of NAV facilities to know some of the standard covenants that arise in negotiations with lenders and can be written into formal lending agreements.

Cash sweeps

Cash sweeps are one of the most heavily negotiated terms within the agreement between a lender and a potential borrower. Cash sweep mechanisms determine how the proceeds from asset cash flows or the exit of an asset will be distributed and whether the lender or the fund LPs are first in line to receive that capital. For instance, a cash sweep may be structured in such a way that once the LTV ratio hits a certain level, any and all distributions or cash flows are first paid to the NAV lender. Once the LTV ratio is lowered to a certain threshold as the loan is repaid, the cash sweep mechanism may shift so that the distributions or cash flows are then split evenly between the lender and the fund LPs. As with all aspects of a NAV facility, the cash sweep structure will be highly dependent on the particular agreement between the lender and the borrower.

LTV triggers

Another well-negotiated point within the lender-borrower agreement will be LTV triggers based upon both minimum and maximum LTV ratios. If the value of the portfolio declines beyond a certain threshold, this may lead to mandatory prepayments, more aggressive cash sweep structures in favor of the lender, or, if severe enough, a potential default.

Valuations

Related to the LTV trigger covenant are covenants around valuation methodologies and how valuations will be calculated. Part of the lender's due diligence of a potential borrower will include a deep dive into the valuation methodologies that the borrower is using and looking out for any red flags, such as if the fund manager has changed its valuation methodology from a prior one. In the loan documentation, lenders will often restrict fund managers from changing their valuation policies without lender approval.

Some lenders will also stipulate that a third-party valuation auditor be appointed to conduct valuation checks on a regular cadence, such as quarterly or sometimes even monthly. In this vein, should a lender question how a manager is valuing its portfolio, it may include a covenant that allows the lender to request a third-party valuation or, if the lender has the capacity, enables the lender to conduct its own appraisal. Should the third-party or lender valuation differ materially from the borrower's determination, the lender will alert the borrower to this fact, and if the lender's valuation triggers any covenants, the borrower will have to abide by them. The lending agreement will also designate who is ultimately responsible for paying for these assessments.

Negative pledges

In many cases, a lender will require negative pledges in its agreement with a fund manager. A negative pledge is a covenant that restricts the fund manager from pledging its assets to any additional lenders once the agreement is made.

Veto rights

Though rarer, in cases where a fund is looking to establish a NAV facility for a portfolio that has not yet acquired all of its assets, some lenders will try to negotiate veto rights on the fund's future acquisitions so that they have a say in which assets ultimately end up as part of the portfolio. However, fund managers will typically dispute these terms.

Pricing

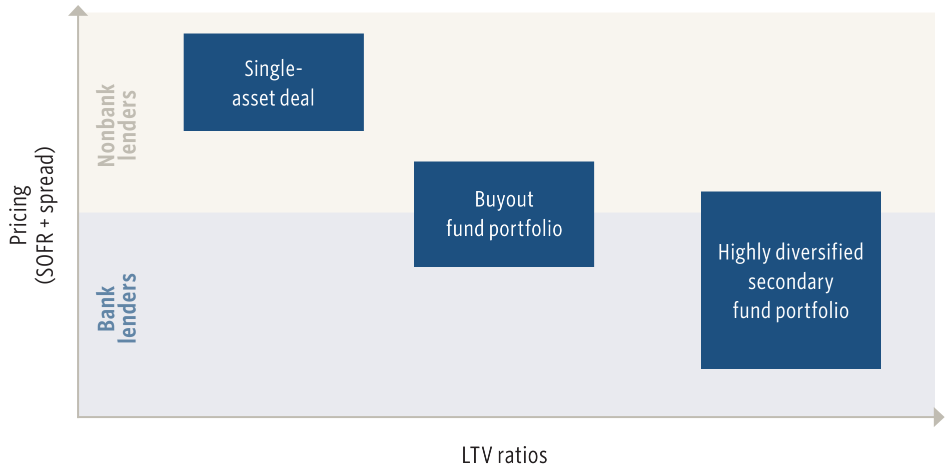
Due to the bespoke nature of NAV facilities, there is no standard approach to pricing, as cost will be dependent upon the specifics of each borrower and portfolio. However, this section should be able to give potential borrowers a general idea of how pricing is determined and what the cost ranges may be.

"Depending on all sorts of variables, you may have some NAV loan providers that have roughly the same costs as an asset-level provider, but the overall risk is lower."

Gianluca Lorenzon,
Validus Risk Management

With very few exceptions, NAV facilities are priced on a floating-rate basis. Included in the all-in pricing will be the spread above a benchmark rate (such as SOFR) as well as an upfront fee. According to the Rede Partners NAV Financing Market Report 2022/23, 65% of lenders will lend at spreads between 4% and 10% above a benchmark rate, while 24% lend at spreads 10% above a benchmark rate.[24] Combined with upfront fees that range between 1% and 2.5%, borrowers can expect pricing to be between 5% to 12.5% above a benchmark rate. There may also be an arranger fee should the deal be syndicated and a potential unused fee if there is a committed revolver capacity to the loan.

Pricing and LTV ratios across different fund types



24: "NAV Financing Market Report 2022/23," Rede Partners, May 11, 2023.

The spread on a facility will be situational. For instance, a very large and established secondary fund might see spreads of 3% to 4% above SOFR, while a single-asset deal will likely see substantially higher spreads, perhaps up to 10% over SOFR. Pricing is also dependent upon the lender's determined LTV ratio. Proskauer's survey illuminates how buyout funds in particular can be priced within LTV variability among nonbank lenders. Within the 5% to 10% LTV ratio range, the spread for a buyout fund averages around 619 basis points, while within the 10% to 25% LTV ratio range the spread increases to 740 basis points.[25]

Additionally, different lender types will generally target spreads within a certain segment. For example, a traditional bank that looks only at investment-grade assets might consider an appropriate spread to be 3% to 5% above the benchmark rate. Private credit lenders, on the other hand, may consider riskier assets that banks would not and offer spreads up to and above 7% to compensate for the higher risk.

NAV facilities are also often structured as payment-in-kind (PIK) debt, where cash interest payments are not expected from the borrower on a regular cadence but any accrued interest is added to the original principal, so the principal increases in size. At the end of the term of the loan, the borrower will pay interest upon the increased principal amount as well as the higher principal amount itself. However, the use of PIK debt will depend on the lender. While a private credit firm may be comfortable with this arrangement, a traditional bank may prefer to be repaid through regular interval cash flows on a current pay basis.

25: "Insights on the NAV Lending Market," Proskauer, June 2023.

Conclusion

NAV facilities are highly bespoke and tailored products that offer a variety of use cases across several borrower types. Today, the use of NAV facilities remains hotly debated. While some market participants, including certain LPs, remain skeptical of these loans, particularly when it comes to using them for fund distributions, fund finance professionals argue that not all NAV facilities are built the same and that there can be both appropriate and inappropriate uses dependent on borrower specifics. GPs should be more transparent and proactive about getting LPAC and general LP approval for these loans, thoroughly explaining the rationale behind the leverage and demonstrating both the specific costs and risks that will be borne by the fund and its investors. To protect themselves, LPs can also start including questions about NAV loans when conducting due diligence on managers or when LPAs are being negotiated. With the NAV facility market expected to grow tremendously over the next few years, establishing best practices and enhanced communication is crucial in ensuring the success of all parties involved in these transactions.

PitchBook recently hosted a complimentary webinar on this topic called "NAVigating considerations and controversies around NAV loans." The webinar was a panel discussion with the following experts:

- Gianluca Lorenzon, Head of Fund Finance Advisory at Validus Risk Management
- Michael Mascia, Co-Head of Fund Finance at EverBank
- Dane Graham, Managing Director at 17Capital
- Neil Randall, Managing Director of Private Equity at the Teacher Retirement System of Texas

To view the webinar, click here.