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PERSPECTIVE

The rise of NAV financing in private equity

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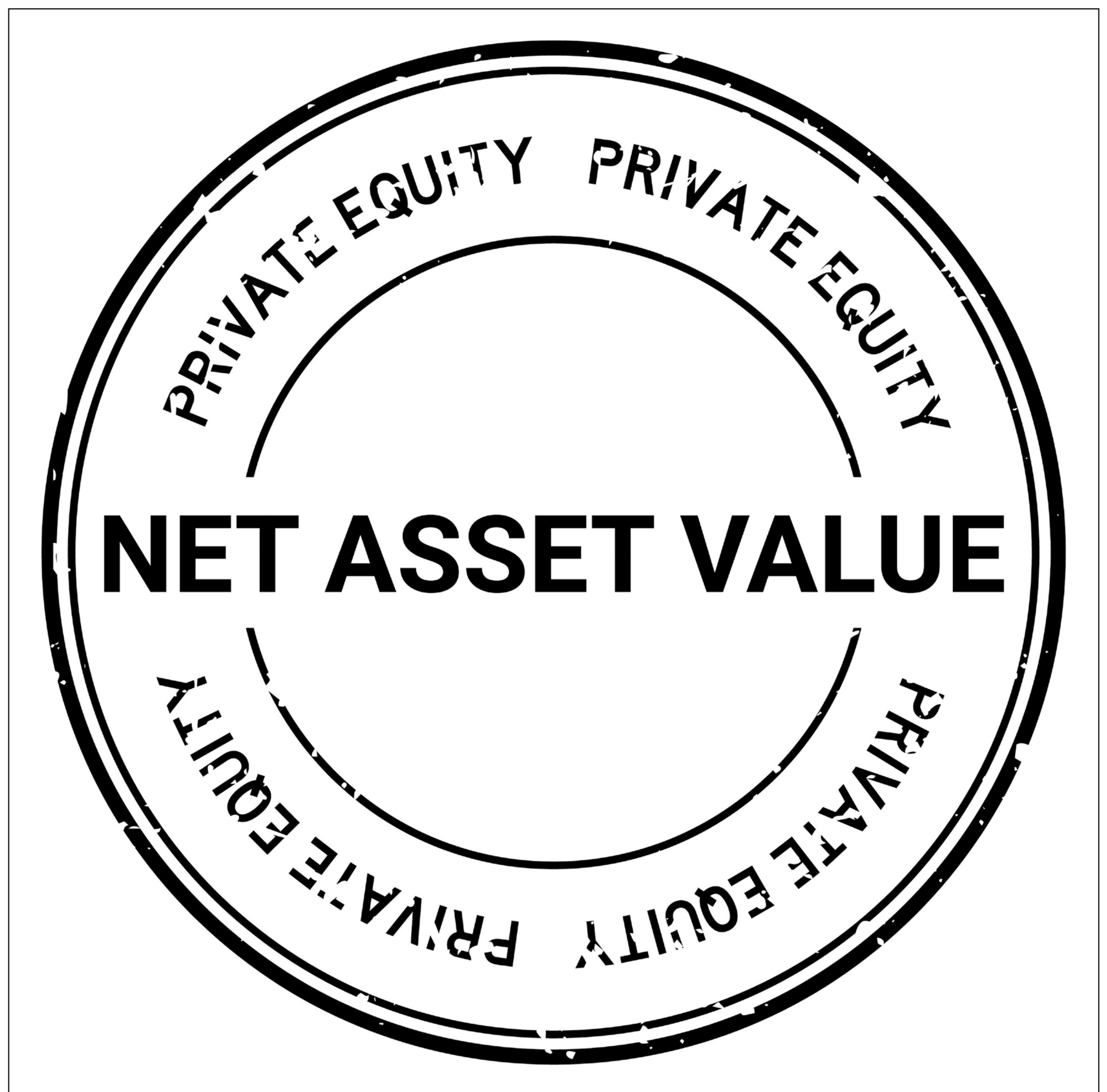

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Net asset value (NAV)-based lending has become an increasingly popular financing tool among private equity funds. NAV facilities are typically secured credit arrangements, structured as a term or revolving facility, that offer an alternative to traditional subscription facilities by leveraging the underlying assets of a fund's portfolio (i.e., downward looking) rather than its uncalled capital commitments (i.e., upward looking). Most often utilized by late-stage funds or funds that are otherwise unable to obtain a subscription facility to access borrowing, NAV facilities provide sponsors with the flexibility to achieve a number of strategic objectives, including limited partner distributions, follow-on investments, liquidity management and debt refinancing. The rise of NAV-based lending is in large part due to the challenges private equity funds have recently faced in selling assets within their planned holding period (typically three to five years) and, in at least some cases, the corresponding inability to return capital to limited partners in a timely manner.

Private equity funds contemplating an NAV facility should consider the following:

- **Can the fund secure an NAV facility?** A fund's governing agreements, and any financing agreements in place at the asset level, play a pivotal role in determining its ability to obtain an NAV facility. Such agreements must be carefully reviewed to, among other things, identify any restrictions on the pledging of the collateral and any required waiver or consent, whether in connection with such a pledge or otherwise. This is of particular importance for late-stage funds whose older governing documents may not have contemplated leverage outside of traditional subscription facilities and therefore may contain outright prohibitions on such a pledge. In such cases, if the pledged asset is under the direct control of the sponsor or its affiliates, obtaining the required waiver or consent may be simple.

On the other hand, if the sponsor is required to obtain a waiver or consent from unaffiliated parties, the process will likely be more burdensome. If a required waiver or consent cannot be obtained, it will either prohibit the sponsor from obtaining an NAV facility or, as discussed below, limit the size of the facility that will be available.

- **What size NAV facility can the fund secure?** The value of a fund's assets (taking into account, among other things, any existing debt encumbering such assets) directly affects the size and terms of any NAV facility that will be available to a sponsor. To qualify for NAV-based lending, sponsors will need to work with lenders to establish a loan-to-value (LTV) ratio, which requires a determination of eligible assets and consensus as to a valuation methodology. Negotiations typically arise around triggers for intra-normal course valuations, eligibility criteria for included assets and the lender's rights to challenge a sponsor's valuations, highlighting the complexity inherent in determining a fund's true value. Depending on the terms set forth in the loan agreement, a significant drop in NAV may cause the LTV ratio to exceed a previously agreed-upon maximum, thereby triggering remedial actions including, but not limited to, higher interest rates, mandatory prepayment or even foreclosure. Accordingly, considerations such as the selection of appropriate benchmark rates, adjustments for market changes between valuation dates and the thoroughness of fair value assessments are crucial.

- **What restrictions do NAV facilities typically impose?** NAV facilities typically borrow covenants commonly used in other leveraged finance transactions. These covenants are principally aimed at allowing lenders to maintain control over cash flows and asset management, uphold a desired LTV ratio and safeguard their interests. For example, cash sweep requirementsand provisions in NAV facilities are highly negotiated and nuanced, varying based on factors such as LTV ratios, the number of assets subject to the sweep and the presence of unfunded capital commitments. Additionally, some NAV lenders may restrict sweeps to the most valuable assets, while fund management will seek to preserve recyclable and recallable capital for expansion and flexibility. Among lenders, traditional banks might enforce scheduled amortization and cash sweep provisions, while alternative lenders may offer more lenient terms but levy ticking fees for delayed draws. Other typical covenants include prepayment obligations, restrictions on collateral account access, limitations on asset dispositions and debt service coverage ratio requirements.

- **What risks can be associated with NAV facilities?** Because NAV facilities are collateralized by either the aggregate value of a fund's portfolio or a subset of pre-negotiated assets, they can introduce new leverage upon assets already encumbered with debt, potentially adding financial instability to the portfolio through cross-collateralization. NAV loans can also carry higher interest rates and, despite being structured to minimize risk through low LTV ratios, they ultimately rely on an accurate valuation of illiquid assets. Further, leveraging an entire portfolio may both obscure and amplify risks to individual assets, as stronger assets may be used to support weaker ones, and enable funds to access more debt than they would otherwise be able to. For these reasons, limited partners may have concerns about the use of NAV facilities, particularly if the proceeds of such facilities are funding distributions. It should be noted, however, that this strategy is not much different from utilizing a dividend recap to fund distributions.

While NAV-based lending offers private equity funds significant strategic flexibility, it requires careful consideration of legal, financial and operational factors to mitigate associated risks and optimize its benefits. Collaborating with experienced legal counsel and advisors can help maximize the utility, and minimize the risks, of an NAV facility.

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