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# Key Drivers Behind Widespread Adoption Of NAV Financing

**Law360** on **August 24, 2023**

For the past several years, market participants in the fund finance industry have discussed the emergence of net asset value-based lending, or NAV lending, as a key financing tool for sponsors and investors.

However, while various potential deals and term sheets have circulated for years among lenders and borrowers, relatively few NAV financing deals were actually getting done. This year, though, it appears that NAV lending is finally starting to move into the mainstream, for a number of reasons related to the broader economy and the secular change in the interest rate environment.

First, though, the term "NAV financing" is used generically in the market to refer to a number of different products. For purposes of this article, we consider NAV financing to mean a fund-level or SPV-level debt financing incurred by a private fund that is primarily backed by the value of that fund's investment portfolio, net of any asset-level debt or preferred equity financing.

A common NAV lending structure conveys the NAV of the portfolio to the credit provider by way of a fund-level guaranty or equity commitment letter. We distinguish this type of facility from a private equity secondaries facility, which is typically secured by a portfolio of private equity and other private fund interests.

The uncertainty around the phrase "NAV financing" itself is reflective of the broader complexity around NAV lending use cases and overall financing strategies. Lately, however, as market participants have wrestled with persistently high inflation, increased costs of debt and sharp declines in fund raising, NAV lending has emerged as a potential solution for a number of related issues facing sponsors and investors.

This article delves into the key reasons for the widespread acceptance of NAV financing among sponsors and investors.

## LBO Debt Shortage

The disappearance of a robust leveraged buyout, or LBO, market in the second half of 2022 has been one of the key factors behind the recent growth of the NAV loan market.

Traditional LBO syndicate banks suffered record losses on debt commitments, and understandably have been reluctant to reenter the market prematurely.

Mergers and acquisitions activity has plummeted accordingly, but some transactions are still getting done. How? In many cases, sponsors have turned to the NAV loan market.

Whereas in the past, a significant part of the debt would be sourced in the regular way from the LBO market, now sponsors have begun turning to the NAV loan space for a material part, if not the entirety, of the debt financing for acquisitions. In many cases, these transactions have been structured in a similar manner.

The sponsor will establish a corporate tax blocker holding company, or holdco, that will serve as the borrower. The sponsor will structure the acquisition so that the target equity acquired by the holdco can be pledged to the NAV lender.

However, the equity in the remaining portion of the portfolio is often subject to debt or preferred equity covenant restrictions, and is unable to be pledged. Instead, the NAV of the other assets in the fund's portfolio will support repayment of the NAV facility, through a fund-level guaranty or equity commitment letter.

The NAV conveyed through the guaranty or equity commitment letter will allow for a closing loan-to-value that is substantially lower than the LTV of the NAV loan solely against the value of the target company itself.

**DPI Focus Over IRR**

A fund's internal rate of return, or IRR, has historically been a key measure of the success of investment in a fund. However, IRR itself does not necessarily mean investors have been receiving periodic distributions or other liquidity — particularly in the current dormant M&A and initial public offering markets.

Investors are now increasingly looking to another essential performance metric — distributions to paid-in capital, or DPI. This is a measure of the total value of distributions returned to an investor, compared to the initial capital it contributed.

A DPI ratio above 1.0 indicates that the fund has returned more money to its investors than they originally put in, signifying a profitable investment. However, with exit opportunities scarce, DPI ratios have been under stress.

A NAV loan effectively allows sponsors to accelerate a liquidity event, or bridge the period of time until a liquidity event materializes. The use of proceeds as a distribution to the fund's investors improves the fund's DPI, particularly in comparison to other funds with similar liquidity constraints that have not raised funding in the NAV loan market.

**Cost of Capital**

As discussed above, a NAV facility by definition is supported by the residual equity value of a fund's investment portfolio. That is, the equity value of the portfolio assets effectively cross-collateralizes a NAV financing — "effectively" in the sense that the equity in many NAV financings cannot be pledged due to covenant restrictions in the asset-level debt and preferred equity documentation.

However, due to the portfolio-level support of a NAV facility, in many cases, closing LTV ratios are less than 25%. For some of the larger megacap sponsor NAV facilities, as discussed below, the closing LTV ratios have been less than 10%.

Therefore, a NAV financing with equity subordination of up to 90% — particularly for a long-established institutional private equity sponsor — will generally price well inside where financing may price for one specific company with leverage ratios of seven or eight times that company's earnings before interest, taxes, depreciation and amortization.

**Fundraising Challenges**

As has been widely reported, fundraising across strategies and asset classes has been challenging. Insufficient equity raises have resulted in sponsors missing opportunities to acquire or participate in acquisitions of target assets.

Some sponsors who have been facing these fundraising challenges have turned to the benefits of nondilutive capital, in the form of a NAV loan. The use of proceeds is directed toward the acquisition of one or more assets, and the value of the assets themselves increases the borrowing power of the overall facility.

The repayment of the NAV loan can be linked to the expected time of disposition of the asset, or otherwise repaid when more traditional financing may become available.

**Megacap Sponsor Adoption**

NAV lending historically has been a market that newer sponsors, or smaller sponsors with one or more troubled assets, would turn to when other traditional sources of financing were unavailable.

However, the issues facing private equity sponsors and the broader private market industry — including lack of LBO financing, lack of company exits and fundraising downturns — have been affecting even the largest, most well-known sponsors. Accordingly, these sponsors have also turned to the NAV loan market for potential solutions, particularly to increase DPI.

News accounts of global megacap sponsors in the market for sizable NAV facilities in excess of $1 billion tend to drive acceptance across smaller sponsors who otherwise may not have considered NAV financing, or who may not have had much familiarity with NAV lending.

As a result, just over the past 12 months, the NAV market has seen deals ranging from as large as $1.5 billion to as small as $10 million to $20 million.

**Adoption Across Asset Classes**

NAV financing originated primarily with smaller private equity buyout sponsors who did not have access to traditional sources of financing and liquidity. The NAV market continues to be dominated by private equity buyout sponsors.

However, the concept of NAV lending, and the structures that have been used in the private equity space, have been flexible enough to be adapted to other asset classes. For example, many of the same issues for NAV lenders in the private equity space appear in commercial and residential debt and equity real estate portfolios.

In many cases, additional asset-level financing — in this case, mortgage debt — may be unavailable, or the properties have been fully financed. The equity in the portfolio may be unavailable as security for the NAV loan, but the residual value of the real estate portfolio can be conveyed to the lender by way of a fund-level guaranty.

A similar analysis can be done for funds that invest in infrastructure, private credit and other asset classes.

**Conclusion**

The recent emergence of NAV loans as a widely adopted financing strategy — across different types of sponsors and asset classes — is attributable to the difficult market conditions sponsors have been facing over the past 12 to 18 months. The combination of persistent inflation, increased interest rates and lack of exit opportunities has raised a host of industrywide issues for sponsors.

NAV financing, with its various use cases, has finally become a widely adopted tool for sponsors and investors to mitigate, or even solve, many of these issues and challenges.

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