Proskauer

ILPA Guidance on NAV Facilities

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Background

On 25 July 2024, the Institutional Limited Partners Association ("**ILPA**") published guidance (the "**Guidance**") on the use of net asset value ("**NAV**") facilities. The Guidance specifically applies to private equity funds and does not address the use of NAV facilities in other strategies, such as secondaries, private credit or real estate.

NAV facilities are debt facilities backed by the value of a fund's underlying assets, commonly used when most of a fund's commitments have been drawn from investors. As ILPA notes in the Guidance, there are various use cases for NAV facilities, including generating defensive capital to protect portfolio value, financing value creation opportunities such as add-ons and making distributions to investors. Structurally, the borrower of a NAV facility may be the fund or a special purpose vehicle ("**SPV**") sitting directly or indirectly below the fund. The collateral package almost always includes security over the fund's accounts into which distributions are paid, and in some cases, the fund's rights in relation to distributions and share pledges over the fund's equity interests in the controlling vehicles of the underlying assets. NAV facilities can thus be contrasted with subscription lines, which are revolving credit facilities entered into primarily for the purposes of assisting with liquidity management and increasing operational flexibility, and which are secured by undrawn commitments of investors.

ILPA has previously issued guidance on subscription credit facilities (originally in 2017 with follow-on guidance in 2020). The key aim of that guidance was to ensure alignment of interest between LPs and GPs and to promote transparency around the use of subscription lines. The new Guidance on NAV facilities follows a similar theme. ILPA does not recommend against the use of NAV facilities but rather seeks to promote more standardization in fund documents and greater transparency in reporting and LP engagement.

Further background information on NAV facilities can be found in Proskauer's report on the NAV lending market.

Concerns Around Use of NAV Facilities

One feature of a NAV facility is that the lender's credit decision is based on a holistic view of the value of all of the secured assets (often comprising the entire portfolio). While the Guidance acknowledges that foreclosure against assets is likely to be rare (and we are not aware of any formal or informal enforcement processes in connection with NAV facilities), lenders naturally expect some protections in exchange for the funding they advance. As such, the legal documentation for a NAV facility will bestow certain rights on the lender in connection with the fund's underlying assets. In light of this, there is a perception that NAV facilities increase risk across the whole portfolio, such that well-performing portfolio companies may be negatively impacted if a default arises.

In the context of this perceived increased risk, ILPA notes the following specific concerns for investors:

- lack of LP insight into when NAV facilities are being used;
- lack of clear language around the use of NAV facilities in LPAs, particularly for older funds;
- inconsistent interpretation of borrowing limits in LPAs;
- insufficient consultation with LPs or LPAC around the use of NAV facilities; and
- potential use of NAV facilities to artificially enhance fund performance.

ILPA raises a particular concern with NAV facilities used for the purposes of making distributions to LPs, especially when such distributions are recallable. Early distributions impact IRR and DPI performance figures as capital is returned to investors earlier than it otherwise would have been. Further, where distributions are recallable, this may impact LPs' ability to allocate capital to other funds or make distributions to their own beneficiaries, and may create tax complexities.

ILPA also highlights the potential for misalignment in circumstances where a struggling GP uses a NAV facility to increase assets under management (and therefore their management fees if calculated on cost) or to achieve carry and prove viability in a more challenging fundraising environment.

ILPA's Recommendations

To address LP concerns, the Guidance sets out several recommendations to increase transparency and consistency in documentation:

- unless a NAV facility is explicitly permitted by the LPA or the GP has received prior consent, GPs should seek LPAC consent to use a NAV facility;
- even where a NAV facility is explicitly permitted in the LPA, if it is to be used for generating distributions, it should be subject to specific LPAC consent;
- when seeking LPAC consent, GPs should provide LPs with the rationale for using the facility, an overview of the key commercial and economic terms and an indication of whether any obligations are imposed on LPs and whether distributions are recallable; and
- GPs should provide all LPs with standardized disclosures about the use of NAV facilities after they have been put in place, with a recommended set of disclosures provided in the Guidance.

From a legal documentation perspective, ILPA notes that many older LPAs do not specifically reference NAV facilities, which has led to inconsistency in interpretation among fund managers. In particular, some fund managers do not take into account SPV-level NAV indebtedness when determining compliance with LPA borrowing limits. ILPA's view is that a NAV facility entered into by an SPV below the fund should be counted for such purposes. The Guidance also recommends that LPs should ask GPs if they view a lack of explicit drafting as permission to use NAV facilities.

The Guidance recommends that new LPAs be drafted to clearly define the amount of leverage that a GP can incur through NAV facilities, whether at the fund level or through an SPV. ILPA does not recommend a specific threshold to limit the amount of NAV facility exposure, noting this should be determined by LPs and GPs during LPA negotiations. The Guidance sets out example LPA drafting, including a proposed definition for “NAV-based facility.” The example language suggests that even where limits are included in an LPA with respect to the amount of NAV borrowings that may be incurred by a fund or SPV, LPAC consent should be obtained in all cases before a NAV facility is used. This appears contrary to the earlier recommendation that additional LP or LPAC consent should not be required where a NAV facility is permitted by the LPA, except where the NAV facility is to be used to pay distributions. In any event, where LPs and GPs agree on a borrowing limit specifically linked to the use of NAV facilities in the LPA, the justification for including an additional requirement for LPAC consent at the time of entering into the facility is unclear.

ILPA’s definition of “NAV-based facility” assumes that the facility is secured in whole or in part by substantially all of the fund’s assets or rights to distributions. This definition seems to exclude NAV financing arrangements that are “security-lite” (i.e., secured only by account security) or unsecured.

Conclusion

Whether the Guidance will result in a noticeable shift in practice by lenders, GPs and LPs remains to be seen. However, it is likely to initiate a further education process regarding NAV facilities for both GPs and LPs, highlighting their use case as an important liquidity tool. The Guidance includes a series of questions to guide dialogue between LPs and GPs on the use of NAV facilities, so GPs should be prepared to address these questions as well as increased due diligence by LPs when a NAV facility is proposed.

GPs concerned about LP perceptions of increased risk can help alleviate these concerns by ensuring that the finance documentation of a NAV facility contains appropriate safeguards to minimize scenarios in which a lender may have the right to “take the keys.” While the terms of each NAV facility are bespoke, we regularly advise our GP clients to consider building in protections such as cure rights, early warning trigger LTVs and standstill periods.

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