EXPERT COMMENTARY

NAV financing is now considered a well-established tool for improving fund performance, but finding a trustworthy partner is crucial to success, says Doug Cruikshank, managing partner and founder of Hark Capital

Choosing the right partner for a NAV loan

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On the back of another record-breaking year, NAV financing continues to develop into a distinct asset class within both private credit and the overall fund financing ecosystem. Once used primarily to support challenged assets and viewed with skepticism, NAV loans are now considered a well-aligned tool to improve fund performance, benefiting both LPs and GPs. NAV loans have clearly emerged as a bona fide asset class.

Increased education has led sponsors to explore how NAV loans can not only support turnaround investments, but also finance opportunistic growth initiatives and help efficiently manage capital. As awareness rises and momentum continues to build, the current economic and market fundamentals have set the stage for growth of the NAV financing market to accelerate in the coming years.

Demand growth

NAV lending volume increased by 50 percent and average transaction size grew by 40 percent in the 12-month period to September 30, 2022, according to *Private Funds CFO*.

While strong growth in 2022 demonstrates increased education and adoption of these facilities as an alternative financing source, many sponsors are still unfamiliar with the product, and lending volume is still small compared with the $2.3 trillion of assets held in private equity buyout funds (net of debt). At Hark Capital, we estimate that only approximately 5 percent of managers are currently using some form of NAV-based lending and only 20-25 percent are fully aware of the benefits the product offers.

Given the opportunity for greater market penetration, market participants project annual deployment for NAV lending will grow from $25 billion during 2022 to $110 billion by 2030, according to Preqin data and

internal projections by 17Capital and Hark Capital.

The current economic environment has led to accelerated growth of the NAV lending market over the past year. Inflation, rising rates, supply-chain disruptions, volatility in the public markets and the recent banking crisis have significantly reduced the traditional financing sources used by private equity managers to support their portfolio companies. Higher interest rates have raised the all-in debt costs for privately owned companies, straining cashflows and lowering interest coverage ratios. Default rates have subsequently increased, and with bank lenders de-risking, the opportunities to refinance at an affordable price are scarce.

Sponsors have historically accessed liquidity by recycling proceeds from exiting investments via a sale, M&A, or an IPO. However, the number of exits in 2022 and 2023 has fallen markedly. As these factors force sponsors to hold assets for longer and provide additional capital to support their businesses, more managers are turning to NAV loans to reach their desired outcomes.

Loan supply

Banks have historically avoided lending against private equity portfolios, particularly concentrated ones for smaller sponsors, and private lending funds have stepped in to address this supply-demand imbalance. Banks have further tightened their credit standards following the recent banking crisis that led to the failure of Silicon Valley Bank (SVB), Signature Bank and First Republic, all active participants in the fund finance market.

To fill that void, new lenders have entered the market including asset managers, insurers and direct lenders. However, loan structures and pricing vary by lender type. Banks and insurance companies can offer larger loans at lower rates, but typically require enhanced security packages, lower loan-to-value ratios and formal ratings of their loans. Banks and insurers have focused on upper mid-market and large-cap sponsors seeking larger facilities and prioritizing a lower cost above structural flexibility.

In the lower mid-market, supply contracted after SVB failed. With larger capital providers focused on larger and lower-risk transactions, the supply gap in the lower mid-market is being filled by specialized NAV lenders and private debt funds. These lenders offer more flexible loan structures, usually unsecured or security-lite with less restrictive covenants. However, increased flexibility comes at a higher cost to sponsors as private lenders must meet the minimum returns promised to their investors.

Picking a NAV lender

While pricing is an important factor when considering a NAV loan, sponsors should consider other key terms:

- **Borrower:** Will the borrower be the fund, a "super holdco" or a portfolio company?
- **Security:** Security can range from no security, "security-lite" packages and full security on the bank account that receives realization proceeds or pledges of the equity in the underlying portfolio companies.
- **Covenants:** These typically consist of maximum LTV, minimum number of portfolio investments and concentration adjustments.
- **Sweeps upon portfolio realizations:** Banks typically require at least partial sweeps on each realization, whereas private lenders are more comfortable allowing LP distributions outside of an event of default.
- **Prepayment premiums:** Sponsors should consider how soon they might want to repay the NAV facility and the costs associated with early termination before maturity, which can range from a few percentage points to a minimum MOIC multiple.
- **Execution speed and certainty:** To win deals in a competitive M&A process, sponsors often need an expedited close with a high degree of financing certainty. Choosing a NAV loan provider with the "reps and reputation" sufficient to ensure a successful bid is crucial.
- **Valuation challenge rights:** Given the increased uncertainty around valuations, many lenders build into their terms the right to challenge a sponsor's internal valuations by hiring an outside valuation firm. Who pays for this usually depends on how close to the internal valuations the outside valuations are.

Once the appropriate lender type is identified, finding an experienced and trustworthy partner is crucial for a successful NAV financing. An experienced lender will be able to structure for the sponsor's primary needs and restrictions, and, in the event of default, reach the most desirable outcome for all parties.

Adoption arc

It is an exciting time for NAV lending, as the demand drivers described above continue to push the market forward and market participants continue to learn about the benefits of NAV lending. Rede Partners conducted a survey of sponsors, limited partners and lenders and, based on the results, believe the growth of NAV financing will follow a similar trajectory as traditional subscription lines.

Roughly a decade ago, the subscription facility market was in its early stages and viewed as an aggressive fund management tool. Now, it is a feature used by 90 percent of private equity funds, according to Rede Partners *NAV Financing Market Report – 2022/23*.

More recently, continuation funds have followed a similar adoption arc. It is reasonable to assume that if the market continues to become more standardized and the dynamics described above persist, NAV loans will take their rightful place as an important, established asset class within private credit. ■