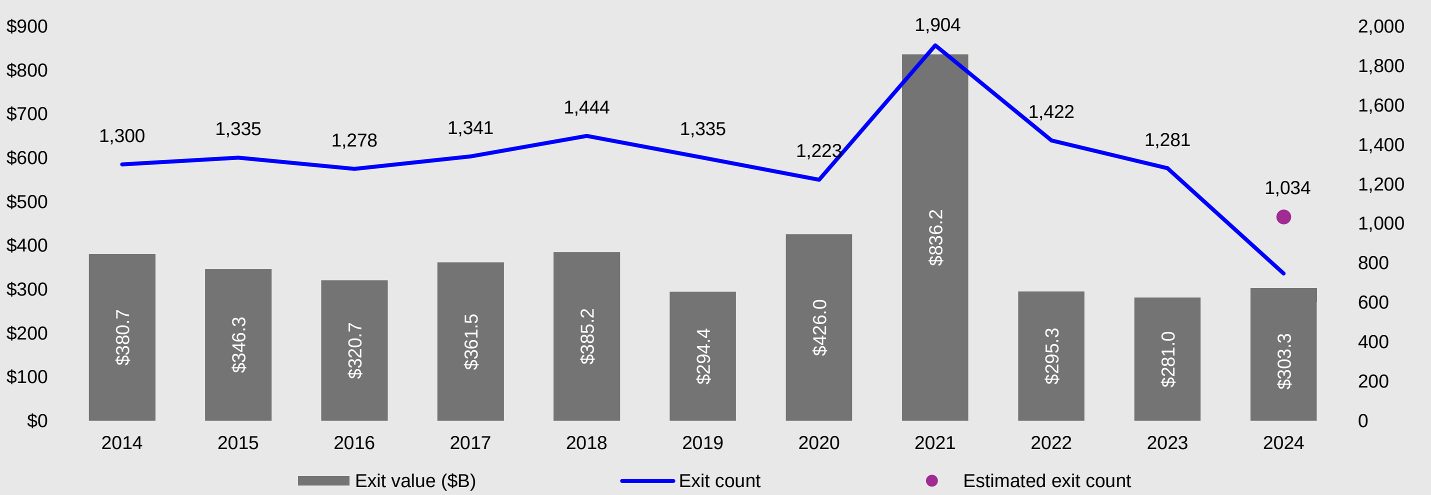
Q3 2024 NAV Lending Market Overview

Drivers of Demand

– Overall, fewer private equity exits by count in the market, with 2024 producing the lowest number of exits in over a decade: exits in 2022 and 2023 were slightly less than $300 billion, approximately a third of the record high in 2021 of over $800 billion

US Private Equity Company Exit Activity

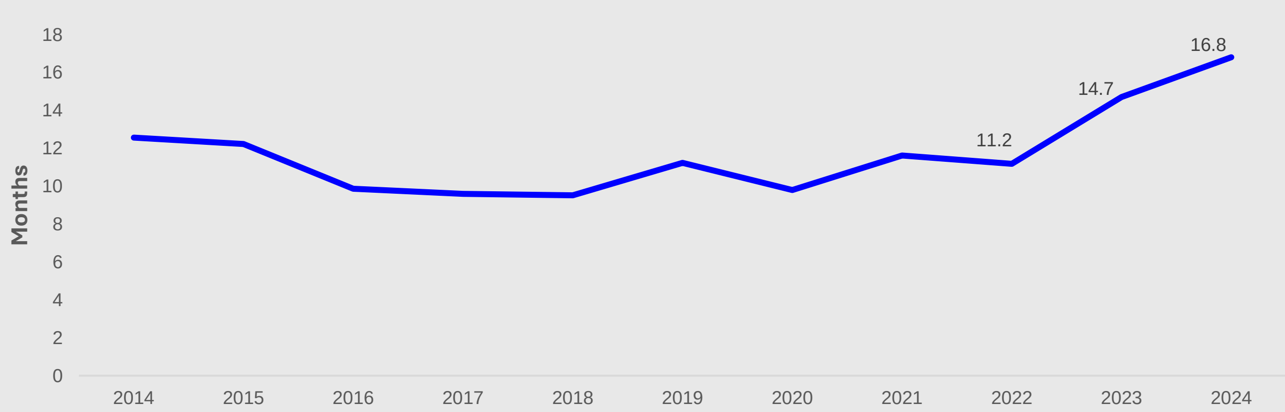


Source: PitchBook Q3 2024 US PE Breakdown

– Distributions to LPs decreased by more than half from 34% in 2021 to 15% in 2023. Capital call rates also fell by nearly 50% in 2021 to 35% in 2023, indicating that GPs were reluctant to call capital in the later stages of a fund if they have not generated DPI

– It now takes ~6 months longer than in prior periods to close new funds. This is likely more pronounced in the lower middle market, since large and institutional LPs are increasingly allocating to large mega funds in an effort to consolidate their private equity relationships, making it more difficult for lower middle market sponsors to raise funds

US Private Equity Average Fundraising Closing Time in Months



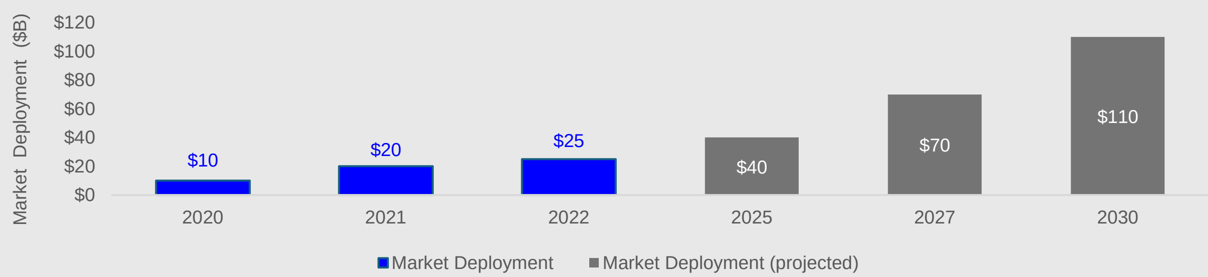
Source: PitchBook Q3 2024 US PE Breakdown

- As a result, on average, portfolio companies are being held for ~6 years, the longest period in a decade
- Lower distributions to LPs result in slower fundraising and decreased ability to continue supporting portfolio companies

How does this impact NAV lending?

- NAV loans continue to gain traction in the market with a 30% growth rate over the last 5 years. Annual deployment has grown from $10 billion in 2020 and is expected to grow to over $100 billion by the end of this decade

Annual NAV Loan Deployment



Source: Bloomberg / Preqin

- Growth this year has been more muted given negative press, particularly around the use of NAV loans for distributions. While we at Hark do not engage in NAV loans for LP distributions, these articles made the private equity community nervous and less willing to explore a NAV loan, even if used for more legitimate reasons like funding growth or fixing an overlevered balance sheet
- Recent ILPA guidance issued this summer should clarify the path forward for GPs and LPs alike: fund documents should include language that specifically allows for fund indebtedness beyond subscription lines, consider restrictions on the amount of NAV debt, how long a loan can be outstanding, and specifically clarify what constitutes a "good" use of a NAV loan.
- GPs should also be more upfront when considering a NAV loan and engage in active conversation with their LPACs
- New entrants and a slowdown in demand have led to slight contraction in lending spreads and improved covenants for borrowers (higher maximum LTVs and lower diversification requirements)
- The NAV loan market has become trifurcated, with the lowest spreads for large sponsors (AUM over $3 billion) and slightly higher spreads for traditional middle market ($1 to $3 billion AUM) and lower middle market funds (below $1 billion)
- While banks typically have a natural advantage with lower cost of capital, increasing regulation and high capital charges will continue to partially hinder banks' participation in this market, mostly relegating them to the larger sponsors where they can offset lower spreads with other investment banking fees (M&A, IPOs, leverage finance)
- Nonetheless, we are already seeing improved demand after Labor Day as the market continues to digest ILPA pronouncements
- The market will resume its dynamic growth as LPs and GPs become more familiar with this new product. As was the case with sub lines and CVs, adoption will grow as both LPs and GPs become more familiar with NAV loans, create clearer guidelines for how they should be used and come to understand that "not all use of proceeds are the same".