KEYNOTE INTERVIEW

# Bridging the gap in fund finance

*NAV finance wasn't invented yesterday, but it's becoming a valuable tool in any GP's toolbox, says Hark Capital's managing partner and founder, Doug Cruikshank*

It's only natural that as the market for private equity, and alternatives in general, has grown by leaps and bounds, that we would have a growth in innovations to service the unique needs of the asset class. NAV finance is one such innovation, and it looks to play an even greater role as the global economy grapples with inflation, war and other pressures that will make delivering outsized returns to LPs even harder.

So we sat down with Doug Cruikshank to take a look at this financing option, and when to take advantage of it.

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**Q Could you tell us the proper definition of NAV loans within fund finance, and how they are being used at the moment?**

A NAV loan is one made to a sponsor's portfolio company or to the sponsor's fund itself based not on the sole standalone credit of that portfolio company, but on the total net asset value (ie, the unrealized value) of the fund. Sponsors use NAV loans when dry powder is limited and for a number of different purposes, but most fall into two broad categories.

The first category I'd define as "defense." This is when there is an issue with one or more of the portfolio companies. Perhaps they're going through some sort of pivot, or perhaps the company has appointed a new CEO. The capital structure may be ill-suited to the company's financial performance.

Because of any such issues, the portfolio company requires equity to solve the problem. Instead of using equity, the general partner of the fund will employ a NAV loan to provide that capital, but at the cost of debt, rather than the cost of equity. By diversifying risk through a NAV loan, a GP is able to transform one company's standalone equity risk into debt risk spread across the entire portfolio.

The second category I'd call "offense." This is when a portfolio company or a platform is performing well enough that there's an opportunity for growth. Maybe that's through a bolt-on acquisition, or maybe that's through additional working capital or more inventory to service a new customer or contract.

Because of the capital structure of that portfolio company, equity is required to finance that growth. Oftentimes, the sponsor will be well beyond its investment period, so it won't have the dry powder left over to do that. In this case, they'll use a NAV loan to solve an equity need at the cost of debt, because of the diversification provided through the NAV loan. NAV loans can also be used at times for cashflow optimization, should GPs want to make distributions to LPs prior to a sale or for other reasons.

## Q Are there particular types of private capital firms best suited to use NAV loans? Is there a particular vintage of fund well-suited to this financing?

In general, our best clients are private equity firms, including those devoted to real estate, growth equity firms, and in certain cases, venture capital firms. I'd also say the vintage of a fund is key. Our target-rich environment tends to be funds that are five to nine years old because they are typically out of their investment period or close to being out of that period but are still busy creating value in the portfolio.

## Q Could you give us an ideal scenario for deploying a NAV loan?

A potential scenario is a lower mid-market sponsor that's on fund three, but fund two still has an active portfolio and is seven years old, so it's out of its investment period. They come across an acquisition for one of their platforms that they hadn't expected, one that's particularly synergistic, but requires capital they don't have.

The sponsor doesn't necessarily want to bring aboard a co-investor because they don't want to share all the upside, and to be honest, it's just a longer process to bring in an equity investor. Instead, they leverage the power of their portfolio to use a NAV loan where we provide the money for this company to do the acquisition and increase returns for the LPs in fund two and for the GP in a non-dilutive way.

> *"The good news is that although NAV loans are a relatively new product, they're becoming much more recognized in the market"*

## Q Given the questions about the near-term health of the global economy, what's the outlook for this style of NAV financing?

There are a lot of tailwinds from the current market environment supporting NAV loans including a hangover from the past few years. It's no surprise to most market participants that sporty multiples were paid up until very recently. Those were relying on a set of "Goldilocks assumptions" in terms of the economy, the inflationary environment, supply chains and geopolitical stability. There was also a vibrant IPO market and a very open leverage finance market that was accommodating of aggressive terms. And frankly, those days are over.

As a result, M&A volume and the transaction volume of realizations for sponsors has already started to slow down, because the next buyer isn't going to want to pay quite as much as the first buyer. Now, sponsors will have to stick with their existing portfolios longer than they had in the past. They won't be able to rush to the next fund and they'll need to spend more time rubbing sticks together to create a spark when those sticks are kind of damp now.

These effects create a tremendous appetite for NAV loans in a space I'd call the middle-aged portion of a fund's life, that period from year five to year nine or 10. That "middle age" has historically offered meager options for capital. NAV loans have arrived to help during this period and provide liquidity similar to the way continuation funds did over the last several years.

The good news is that although NAV loans are a relatively new product, they're becoming much more recognized in the market and much more accepted by LPs and GPs as not only an acceptable, but an attractive way to solve certain problems. Problems that won't be going away anytime soon.

## Q In some cases, we have seen GPs using NAV loans for additional equity between fundraisings. How does that work?

Using NAV loans as a bridge between funds usually indicates the GP has a "high class" problem: great dealflow outpacing their fundraising. They've had maybe one or two closes, but their sourcing is strong and they don't want to call all of the capital from their first close. What we'll do is lend money against the nascent portfolio, plus the dry powder that they have left and build a bridge to future closings. And of course, early in a fundraise a GP will have a limited number of investors, so it's harder to get a capital call line, which is why a NAV loan can be helpful. ■