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Private Lenders See Bank Turmoil Helping an Exotic Debt Business

- **Firms look to make more loans financing whole PE funds**
- **Trouble at banks may increase demand for alternative funding**

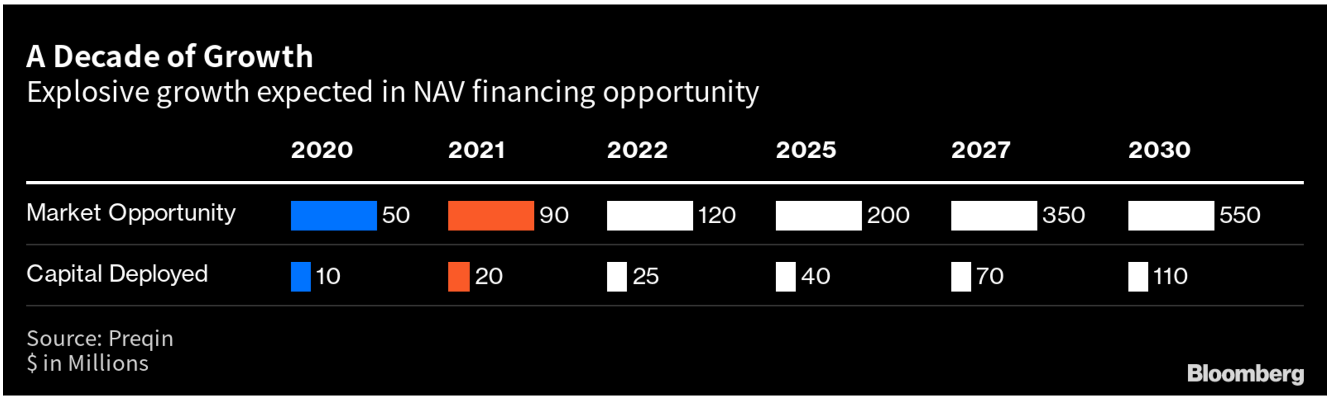
By John Sage and Silas Brown

(Bloomberg) –– Turmoil in the banking system is making some private lenders hopeful they can increasingly finance entire private equity funds, instead of just individual transactions.

The debt, known as net asset value loans, can help an LBO fund to prop up individual companies that might not otherwise be able to get financing, or to fund new buyouts. There were about $25 billion of NAV loans made last year, according to research firm Preqin, which estimates volumes will rise to $40 billion in 2025.

The leveraged loan and junk bond markets are seeing less lending, as investors look to take less risk. The initial public offering market is all but closed, making it harder for firms to go public, pay down debt, and offer a payday to their equity owners. Trouble at firms like US regional banks and Credit Suisse Group AG only raises more questions about where financing will come from.

“The recent disruptions to banks will make the surviving banks less willing to take risk, making it harder for individual portfolio companies to find cheap bank financing,” said Rafael Castro, partner & co–founder at Hark Capital, an NAV lender. “Fund finance tools like NAV–loans from a private lender can be an elegant solution to that problem.”



It’s the latest sign of how monetary tightening globally is forcing many investors and companies to look harder to find funding. The leveraged loan and junk bond markets are seeing less lending, as investors look to take less risk. The initial public offering market is all but closed, making it harder for firms to go public, pay down debt, and offer a payday to their equity owners.

Firms including 17Capital, Crestline Investors Inc. and AlpInvest Partners have set up funds that make these loans in recent years. Private lenders have been boosting their presence in NAV loans while also making bigger loans to fund individual buyouts.

Watch: The historic collapse of Silicon Valley BankSource: Bloomberg

Banks have historically offered hundreds of billions of dollars of a product similar to NAV loans, known as revolving subscription facilities. Silicon Valley Bank, which collapsed this month and First Citizens BancShares agreed this week to buy, had a subscription line business that was around $40 billion at the end of 2022. John Moran, a spokesman for First Citizens, said it's business as usual for both banks, "which remain active lenders in serving their customary clientele."

First Citizens and SVB have extensive experience lending to PE and venture capital firms and their portfolio companies, he said.

But at least some banks have been pulling back from the business in recent months, in part because of concerns about the profitability of the loans.

No Exit?

Private equity firms were eager to get more financing even before this year. LBO funds were able to exit their investments, through for example, selling a company to another corporation or doing an initial public offering, 35% less often in 2022 than the year before, according to Preqin.

Now that leveraged buyout funds are stuck holding onto companies for longer, they're looking for other ways to fund them, particularly when they are no longer eligible to invest equity in funds.

But many funds aren't familiar with NAV loans, Hark's Castro said in an interview. The volume of lending is small compared with the $2.3 trillion of assets that LBO funds have after subtracting debt.

"Five years ago, the market did not know about NAV lending, and now we estimate that less than 5% of asset managers are using them," Castro said. "Probably only 20% know what they are."

In making these loans, private capital firms are boosting the embedded leverage in the financial system, potentially increasing overall risk. An NAV loan can be around 30% of net assets for a fund, but is often closer to 10% to 15%, Castro said.

That leverage is relatively modest. And direct lenders often have their funding tied up for five or more years, meaning they can usually extend loans for two years or more, compared with a year or less for banks, without worrying about returning money to their investors.

Adding debt to an already leveraged portfolio does entail boosting risk. As central banks lift rates globally, the valuations for many companies are under pressure. A fund that finds that too many of its companies have been marked down may have to pay more interest on its NAV loans and repay the debt before making distributions to investors.

But investors that provide capital to private credit firms are eager to gain more exposure to these kinds of loans, said Jess Larsen, founder and CEO of Briarcliffe Credit Partners, a firm that helps private credit funds raise money.

"Of the opportunity set private credit investors have available, some of the strongest demand is for NAV lending," Larsen said in an interview.

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To contact the reporters on this story:
John Sage in New York at jsage13@bloomberg.net;
Silas Brown in London at sbrown629@bloomberg.net

To contact the editors responsible for this story:
Claire Boston at cboston6@bloomberg.net;
Bruce Douglas at bdouglas24@bloomberg.net
Dan Wilchins

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