NAV Lending to Buyout Funds[1]

By Jennifer Passagne and Karina Oshunkentan

Net asset value ("***NAV***") lending, which is a type of financing tool that looks at the net asset value of the fund's portfolio of investments has received some recent negative press. The NAV Lending to Buyout Funds panel explored some of the concerns about NAV facilities and discussed trends and developments.

Among investors, there seems to be a split between those who support NAV facilities and view them as valuable tool that allows deployment of capital at different life cycles of a fund and those who are apprehensive about the use of NAVs. One of the biggest reasons for this hesitation is the perceived lack of transparency and poor communication to investors about the rationale for such leverage and how the financing is being used. It was discussed that many investors often only learn about a fund obtaining a NAV facility after the fact through the fund's periodic financial reporting. This has led to many investors requesting more transparency from the fund even though its limited partnership agreement may broadly permit debt incurred from a NAV facility without any prior consent of or notice to the limited partners.

There seems to generally be a lack of support for NAV facilities coming from larger limited partners, such as insurance companies, who argue that they can provide the liquidity themselves with better terms. For example, if fees associated with NAV based facilities are greater than fees incurred by limited partners to provide more liquidity, then these limited partners would prefer to fill the fundraising gap.

Investors have particular concerns where NAV loans are used to fund early distributions, especially where distributions are recallable. Another reason for caution by many limited partners is that NAV financing could be viewed as a red flag indicating the possibility of mismanagement of capital by the fund and underlying concerns with management of its portfolio companies.

Additionally, limited partners are increasingly focused on how limited partnership agreements are addressing NAV facilities. By way of comparison, subscription facilities are typically addressed in great detail in limited partnership agreements, these facilities as they are secured by the capital commitments of the limited partners. Asset based financing, on the other hand, is usually only generically addressed in these agreements with some parameters on the debt amount but without much specificity otherwise. There have been some discussions among limited partners who want limited partnership agreements to expressly address NAV financing and what level of disclosure or if a consent requirement should be necessary before NAV debt can be incurred.

Institutional Limited Partners Association ("***ILPA***") will soon be issuing NAV-based guidance (it is currently working with firms, banks and investors to produce this) that will focus on education (benefits, risks and

[1] The panelists were Doug Cruikshank, Managing Partner and Founder of Hark Capital; Brian Foster, Partner, Cadwalader, Wickersham & Taft; Neal Prunier, Senior Director, Industry Affairs, Institutional Limited Partners Association (ILPA); Harsh Shah, Managing Director, Head of Fund Financing, Citigroup; and Jasen Yang, Managing Director, Credit, Apollo Global Management. The panel was moderated by Leon Stephenson, Partner, Co-Head Fund Finance, Reed Smith LLP.

mechanics), transparency and rationale in respect of NAV facilities. The guidance will also include questions to raise during the investor diligence process and what provisions to look out and push for in a limited partnership agreement in respect of NAV facilities.

Terms of NAV deals vary between markets (USA & Europe), whether the underlying portfolio is concentrated versus diversified, whether it's a large cap versus mid-market sponsor, the loan-to-value ratio and the cycle of the fund. Sponsors in the large cap and upper middle-market space have been pushing security-lite structures, and this trend is moving down to the middle-market (although with less traction).

A panellist commented that they have seen an uptick of NAV facilities close in the last few months to open-ended private equity funds. There is also a growth of interest in NAV lending to continuation funds that provide optionality for investors to come in and elect to be a funded investor or leveraged investor. However, there are challenges here due to concentrated portfolios of assets in a NAV lending market that prefers more diversified pools.

As the market for NAV facilities develops and matures, one panellist thought this would help with overall transparency as the concepts, forms and documents will become more uniform, as has been the case in the sub line space.