INSTITUTIONAL LIMITED PARTNERS ASSOCIATION

2024

PART 1:

Overview of NAV-Based Facilities and Current Market Practices

Excerpt from ILPA's *NAV-Based Facilities: Guidance for Limited Partners and General Partners*

Overview of NAV-Based Facilities and Current Market Practices

Background

Net asset value (NAV)-based financing facilities have been commonly used in secondaries and private credit for some time, but their prevalence in private equity strategies has noticeably increased in recent years. The Fund Finance Association estimates that the market for NAV-based facilities is currently 100 billion USD and is expected to grow to 600 billion USD by 2030.[1] The additional liquidity generated by these facilities can help the GP manage indebtedness, provide interim liquidity to investors or supply additional capital to grow or support fund assets all while retaining future upside. NAV-based facilities can serve as an alternative to single company dividend recaps, M&A, IPOs, asset sales or secondary market solutions such as continuation funds.

Overview

NAV-based facilities are credit facilities that are backed by the value of the fund's investments. Where subscription lines are backed by the undrawn commitments of the fund's LPs, NAV-based facilities are backed by the underlying portfolio. These facilities can be structured to cross-collateralize the equity of multiple portfolio companies.

The borrowing base (i.e., the total size of the facility) is calculated by the net asset value of fund interests/portfolio companies. If at any time the ratio of the facility exceeds the specified Loan-to Value (LTV) ratio, the terms of the facility may require the borrower to repay the loan whole or in part to return to the prescribed LTV limit. Alternatively, the facility may sweep cash generated from the underlying assets to bring the LTV ratio back into compliance. LTV ratios tend to decline over the life of the fund, as residual value of the equity in the portfolio reduces as assets are sold.

The collateral used in NAV-based facilities is generally cash received in the bank accounts of the borrowing entity, i.e., the fund or a fund subsidiary, together with a preferred equity interest in the fund's income and distributions from the fund investments. It can also extend to a direct or indirect pledge of the fund's equity investments, or a subset thereof.

NAV-based facilities are generally used after the remaining commitments of the fund have been drawn, and/or after the end of the investment period or early in the fund's harvest period, and/or after reserve capital has been exhausted. In some instances, the facility may be structured as a hybrid facility blended alongside a subscription line or other financing arrangements. Due to their additional structure and underwriting complexities, NAV-based facilities tend to have higher interest rates than do subscription lines. That said, because the facilities are cross-collateralized across multiple portfolio companies, NAV-based facilities tend to have a lower cost of capital than the debt a single portfolio company would be able to incur.

[1] 17 Capital, *In Defence of NAV Financing* (March 2024)

Structure and Recourse

NAV-based facilities often involve creating two special purpose vehicles, or SPVs. The first SPV is created to incur the financing under the NAV facility and hold the equity interest of the second SPV (Holdco), which aggregates the underlying fund interests in the borrowing base. The structure of the SPVs can provide the lender the option when in default with the right to foreclose on the equity collateral. This could provide the lender with the ability to manage the underlying portfolio companies or force a sale.

Because portfolio companies are cross-collateralized, strong performing portfolio companies could be impacted in the event of a default. Lenders can have additional options upon default, including the rights to economic interests in the assets (e.g., proceeds from realizations), or the right to require the GP to make capital calls (if there are undrawn commitments remaining) and/or provide and adhere to a monetization plan.

Other types of NAV facility structures include but are not limited to fully secured loans (or notes) and flexible preferred equity structures where the fund itself is the borrowing entity.

Lenders note that a full foreclosure is a rare event. It is expected that if the facility is underperforming, the lender and the GP will work together to refinance or discuss other repayment options that do not involve the lender assuming control over the underlying portfolio.

The dual SPV structure created to implement the NAV facility can create challenges. Some GPs have taken the approach that the SPV does not count towards the calculation of fund-level leverage, meaning that the SPV is not restricted by typical fund-level leverage limits in LPAs.[2] It is ILPA's position that NAV-based facilities constitute fund-level leverage and, as such, should be included in borrowing limitations.

Role of Lenders and Rating Agencies

Many different types of organizations provide NAV-based lending, including traditional banks, specialized funds (such as private credit funds) and direct lenders (such as insurance companies and pension funds). The lender conducts diligence on the manager, the fund and the selected portfolio companies before providing lending. Lenders can be expected in certain cases to engage a Nationally Recognized Statistical Rating Organization (a "rating agency") to evaluate the creditworthiness and risk profile of a transaction. Rating agencies will then evaluate the GP, the lender, the structure of the facility itself and the potential underlying assets on factors including financial strength, operating performance, leverage levels and risk management processes, in order to to assign credit ratings.

A higher credit rating typically translates to lower borrowing costs and potentially higher LTV ratios, as lenders perceive lower default risk. Conversely, lower credit ratings may result in higher borrowing costs to compensate for higher default risks.

[2] More information on this can be found in Part 5

Use Cases

Most commonly, GPs use the proceeds from NAV-based facilities to create early distributions, to generate liquidity to support the portfolio, or to fund follow-on investments.

When used to support the existing portfolio, proceeds can be used as defensive capital to protect portfolio value, for example by recapitalizing a portfolio company to reduce the cost of existing leverage. NAV-based facilities can also be used to finance value creation opportunities, such as capital for add-on acquisitions or other follow-on investments.

When used to fund an early distribution to LPs, proceeds can be, and often are, recallable. NAV-based facilities used for distributions are often in lieu of exits that generate cash realizations from individual portfolio companies, with a portion of future distributions used to repay the NAV facility.

The Fund Finance Association estimates that 80 percent of NAV-based facilities have been utilized to support portfolio companies, while 20 percent have been used to make distributions.

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of NAV-based facilities to date have been utilized to support portfolio companies, while 20 percent have been used to make distributions.

Source: Fund Finance Association

More information on Early Distributions is available in Part 2.

INSTITUTIONAL
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CONTACT US

Institutional Limited Partners Association

industryaffairs@ilpa.org

1776 I St. NW, Suite 535
Washington, D.C., USA, 20006