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PART 2:

LP Concerns Regarding NAV-Based Facilities

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

LP Concerns Regarding NAV-Based Facilities

While NAV-based facilities can be a useful tool for capital structuring or to provide financing to support assets, their use today presents concerns for LPs. This section details specific issues that should feature in dialogue between LPs and GPs about these facilities.

LPs often have limited insight into when NAV-based facilities are being used. Some GPs have been proactive in discussing NAV-based facilities with LPs and/or LPAC members, while others have failed to provide adequate transparency. It is not uncommon for LPs to learn that their GPs are using a NAV-based facility through a review of distribution notices or other financial reporting, rather than from the GP directly.

> To fully understand the risks associated with their investment in the fund and across their entire portfolio, LPs need to know that a NAV-based facility is in place and the terms of that facility.

Second, **LPs struggle with the lack of governance related to the use of NAV-based facilities, which drives the lack of transparency.** These facilities are typically used after most of the fund commitments have been drawn, or after the fund investment period. As a result, funds that have a NAV-based facility in place tend to be older and are governed by LPAs that were drafted without any express reference to the use of NAV-based facilities.

Where the LPA is silent, GPs have taken different approaches to how they treat NAV-based facilities. Because an LPA often provides the LPAC with the authority to waive borrowing limitations that are expressly described in the document, some GPs have gone to LPACs to get approvals to use NAV-based facilities. However, these approval requests are often for a broad, general ability to use a facility during the life of the fund. They are not waivers or requests to use a specific facility, i.e., once a GP has the waiver, they may use a NAV-based facility multiple times.

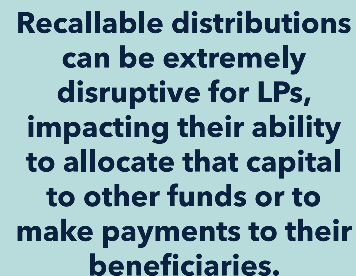
Furthermore, **some GPs have interpreted traditional fund-level leverage provisions in LPAs as providing sufficient authority for them to undertake NAV-based facilities without LP or LPAC notification or engagement.** As many NAV-based facilities involve the creation of an SPV below the fund, some GPs have interpreted LPAs to mean that NAV-based facilities are not captured by the fund-level leverage limits as prescribed in the LPA. Where NAV-based facilities are not included in fund-level leverage calculations, it is impossible for LPs to know how much leverage above the portfolio company level a GP can take out in the fund. This lack of transparency makes it challenging for LPs to properly assess the risks associated with the investment.

Lastly, **LPs have observed increased use of NAV-based facilities during the more challenging fundraising environments of recent years.** When used to provide early distributions to LPs, this practice leads to the inference that GPs are looking to improve DPI to attract LPs to commit to their next fund, rather than using NAV-based facilities as an accretive leverage tool. Additionally, distributions from NAV-based facilities come at a cost for most LPs, both due to the interest expense of these facilities and the often recallable nature of such distributions. Finally, due to heightened media attention surrounding NAV-based facilities, LPs are receiving more questions from their stakeholders, which can be challenging to address considering the limited and varied insight LPs have to the overall use of NAV-based facilities in their portfolio.

More information on how GPs should engage the LPAC, and LPs more broadly, around NAV-based facilities can be found in Part 3. Detailed guidance on recommended disclosures to LPs can be found in Part 5.

In Focus: Use of NAV-Based Facilities for Early Distributions

The use of NAV-based facilities to generate early distributions presents challenges for LPs, given the impact on IRR/DPI, interest expenses associated with these vehicles, and the fact that such distributions are often recallable.



Early distributions generated by a NAV-based facility have a material impact on IRR and DPI performance figures, since capital is returned earlier than it would otherwise be if a NAV-based facility were not used. This impact can create perverse incentives for a GP to utilize a NAV-based facility in the absence of LP support, to improve their headline performance figures. Additionally, given the lack of transparency around the use of such facilities, more vigilance is required to isolate their impact, effectively requiring LPs to create a "synthetic" DPI figure to monitor a GP's performance. Furthermore, inconsistency in disclosure around the use of such facilities makes it harder to compare different GPs' performance figures during due diligence and the manager selection process.[3]

As mentioned, distributions generated from a NAV-based facility are often recallable; if the facility starts to underperform, i.e., falls out of compliance with the required LTV ratio, GPs can recall the distributed capital to pay down the facility. Recallable distributions can also be an administrative burden for LPs and disrupt their cash flow planning. The possibility that LPs will unexpectedly need to return distributions to the fund impacts LPs' ability to allocate that capital to other funds or strategies, or to distribute that cash to their beneficiaries. Additionally, recallable distributions create significant tax complexities for taxable LPs as well as accounting treatment challenges for insurance and other LPs. Many LPs are further frustrated when they must pay interest expenses on recallable distributions.

Lastly, NAV-based facilities come with significant interest expenses and other costs. These expenses may negatively impact returns for LPs, as they are often charged as partnership expenses. In cases where individual LPs in the fund are pushing for a distribution, there may be more cost-effective LP-led options that lead to better returns. These options include LP secondary sales or LP financing/credit solutions or even an LP-led NAV-based facility.

[3] More information on how ILPA recommends addressing performance reporting can be found on our Quarterly Reporting Standards Initiative webpages.

In Focus: Use of NAV-Based Facilities for Portfolio Support

Separately, the use of these facilities to support the portfolio may also prompt LP questions or concerns. At the outset, funds should have significant and sufficient reserve capital to support portfolio companies after the end of the investment period, to fund potential follow-on investments or opportunitistic investments, or to support portfolio companies in challenging market environments. If a NAV-based facility is needed to support the portfolio and GPs do not engage LPs around the rationale for the facility, LPs may suspect that the GPs have mismanaged reserve capital or over committed the fund. This is why it is critical for GPs to be proactive in discussing the rationale behind the usage of a NAV-based facility with LPs.

Additionally, NAV-based facilities to support the portfolio may introduce cross-collateralization risk, particularly when a portion of the proceeds from a facility are used to support a struggling portfolio company with unclear future prospects. Differentiated returns are a key reason why LPs invest in private equity, but a facility of excessive size, particularly if secured by a blended group of assets with varying upside potential, could compromise a key factor in alpha generation within a private equity strategy.

Lastly, LPs are particularly wary of GPs that are struggling to fundraise utilizing a NAV-based facility to support the portfolio of their most recent fund, particularly after all capital has been called. LPs are concerned that struggling GPs may be taking out a NAV-based facility to increase their assets under management (and therefore their management fees if the management fee is calculated on cost). When a successor fundraise is challenged or in doubt, use of the facility might reflect a GP's drive to achieve carry and prove their viability. As a result, these situations present the greatest potential misalignment of interests associated with NAV-based facilities.

More information on how to engage LPs can be found in Part 3.

CONTACT US

Institutional Limited Partners Association

industryaffairs@ilpa.org

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

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