**NAV, Hybrids and Preferred Equity: An International Perspective**[1]

By Dylan Glazier, Brandon Spleen and Craig Unterberg

The focus of this panel was the current state of NAV facilities in the market and expectations for years to come. What follows is a high-level summary of some key points discussed by the panelists.

- The panel started with a discussion of what constitutes a "NAV" or "net asset value" facility. While a NAV facility is akin to the subscription line, its key feature is that it *looks downstream* to a fund's portfolio investments for purposes of repayment of the facility (vs. *upstream* to uncalled capital of Investors/LPs in the case of a traditional subscription line).

- There are two financial metrics that are generally used to determine the financial health of the fund's investments and the collateral in a NAV facility: (1) the NAV test, which measures the net asset value of the fund's portfolio investments and (2) the LTV (loan to value) test, which, in simple terms, measures the fund's indebtedness against the value of the portfolio assets and indicates how collateralized the loan is at the time of the test. A failure to maintain specified covenant levels will result in an event of default, but credit agreements will often also provide for a tightening of terms in response to an increase in LTV, such as (i) restrictions on a borrower's ability to withdraw funds from collateral bank accounts, (ii) prohibitions on making restricted payments, and (iii) required mandatory prepayments, among others, to provide more protection for the lenders.

- Panelists are starting to see more NAV facilities entered into in tandem with subscription lines, which can result in intercreditor issues depending on how the facilities are structured and balanced. "True hybrid" facilities that utilize the full leverage capabilities of a fund (*upstream and downstream assets*), for collateral and borrowing base purposes, remain unique, but there is potential to see more of them in the coming years. Lenders who can effectively offer true hybrid facilities have significant opportunities to develop long-term relationships with sponsors by virtue of being able to offer financing throughout the term of the fund's lifecycle.

- While true hybrids can provide important benefits for lenders and funds, it can be difficult for the lender to get comfortable committing to an advance rate on portfolio assets at the outset of a fund's investment period without having certainty on the portfolio assets and timing for capital deployment. Additionally, borrowers will tend to gravitate towards traditional subscription lines if available, given their relatively lower pricing. Lenders may also utilize a hybrid facility to increase the advance rate, decrease the pricing or correct for concerns with the investor pool by gaining additional protection through the introduction of additional collateral. In these situations, although the facility is secured by portfolio assets, borrowing base credit will not be given to investments and uncalled capital will remain a lender's primary source of repayment.

- The uptick in NAV facilities to private credit funds secured by a portfolio of loans has been evident. These facilities will typically include heightened focus on eligibility criteria for inclusion in the borrowing base,

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[1] Panelists included Juan Campos, Partner at Hg Capital; Bronwen Jones, Partner at Reed Smith; Ed Saunders, Partner at Goodwin Procter LLP; Michael Timms, Investment Director at 17Capital; Daniel Toblib, Vice President, Structuring, Fund Finance at Macquarie Group; and Craig Unterberg, Managing Partner – New York, Haynes and Boone, LLP.

including the jurisdiction of the borrower in the underlying loan, whether loans are currently being amortized or are interest only payments for a certain period, and tenor and type of loan. Additionally, lenders will often impose concentration limits regarding industry sectors, jurisdictions, types of loans and servicers and originators, among others. One key consideration is that lenders want to understand the asset class and composition of the portfolio, which can take some time to diligence and structure.

- The panelists moved on to discuss the development and increased usage of NAV facilities secured by pooled private equity fund assets. The panelists noted that private equity managers have historically utilized these facilities more towards the end of the fund's life cycle if there are restrictions on drawing down on unfunded capital commitments and market conditions that are not optimal for disposing of assets. These facilities provide liquidity to meet portfolio funding requirements, acquire portfolio assets, to the extent permitted by the fund partnership agreement, and make bridge distributions to investors. However, there is an increasing trend where funds will use these facilities earlier in their life cycle during the investment period to make distributions to investors, which can later be recalled.

- Additional facility structures are popping up in the market, including NAV facilities with a more concentrated pool of private equity assets, financing to continuation funds, co-invest facilities and preferred equity. These facilities will typically serve the same general purposes of fulfilling liquidity requirements and in certain situations can be utilized when a fund’s portfolio does not support a traditional NAV facility.

- Typically, in a NAV facility, valuation provisions will be a heavily negotiated point. The credit agreement should clearly provide mechanics for determining the net asset value of the portfolio assets, including the timing and frequency of valuations, when and to what extent valuations may be performed internally by the asset manager as opposed to a third-party appraiser, costs of valuations and conditions under which the lender can challenge a valuation or appoint its own third-party appraiser. Funds will usually push to have their asset manager be primarily responsible for providing the valuations and monitoring of portfolio assets in accordance with their customary practice, while lenders will want to retain rights to seek an independent appraisal in the event there is uncertainty over the valuation or other concerns over the method of valuation or financial health of a portfolio. Ultimately, valuing the portfolio assets is a critical part of underwriting a NAV facility, and a valuation error ought to be seen as a relationship error. Transparency and relationship value play a major role in NAV facilities.

- Projections for 2023 include: (i) an increase in hybrid activity, (ii) continued growth in the NAV industry generally, (iii) increased uniformity and market standards across NAV credit facility documentation, (iv) partnership agreements becoming stronger and better documented to support NAV facilities, and (v) borrowers being more strategic in conversations with lenders by assessing their leverage needs (including, size, tenor and purpose), prior to approaching lenders.

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