NAV Lending to Credit Funds[1]

By Karina Oshunkentan and Alexander Grishman

Net asset value-based lending or NAV lending, which is a type of financing that looks at the net asset value of the fund's underlying assets, is typically used by buyout funds for the purpose of addressing specific needs where there is a fundraising gap (such as distributions to its limited partners). Conversely, NAV financing to credit funds (which are also called back-leverage or loan-on-loan financing) is typically used alongside other tools and products available to the funds and is primarily aimed at optimizing its liquidity position. Recourse on these facilities to credit funds is the portfolio of loans owned by such credit funds. While the use cases of NAV financing to buyout funds cover purposes such as distributions to its investors and liquidity for certain portfolio companies, credit funds typically use NAV facilities to enhance the internal rate of return or IRR of its investments rather than to make distributions to its limited partners (as the investors receive steady flows of distributions through cash interest payments on loans in the portfolio). Even a 10-15% leverage on the credit fund level can still meaningfully increase the fund's IRR.

With respect to the underwriting process, financing to private equity funds typically require a deeper dive into the assets as compared to facilities to credit funds, since there is likely a larger, less concentrated, pool of assets of a credit fund. Much of the underwriting process of NAV facilities to credit funds hinges not only on the portfolio of assets but also the track record of the manager as prior performance, which can be a significant indicator of future performance. In all cases, however, assets are still subject to eligibility criteria and concentration limits which may be heavily negotiated in the financing documents. Bank lenders typically target funds with larger NAV even if the facility spread is lower, while non-bank lenders have an appetite for smaller funds but will seek out higher spreads on these NAV facilities.

With respect to collateral, while NAV facilities in the United States market are still generally secured by a pledge of the underlying assets, lenders are likely more willing to go unsecured on facilities to buyout funds than to credit funds. It is important to note that when differentiating between secured and unsecured NAV facilities, lenders generally treat facilities with no pledge of assets though secured by the bank accounts into which asset realization proceeds are deposited as unsecured facilities, because the pledge of accounts only is insufficient to meet a lender's regulatory capital reserve requirement.

The type of fund may also give rise to differing enforcement options. Unlike buyout funds where lenders prefer not to take over the portfolio companies in an enforcement scenario, lenders are more readily able to foreclose on a credit fund's portfolio of loans, as managing such type of portfolio is within their field of expertise. Additionally, unlike lenders to private equity funds that face the challenge of tripping change of control

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[1] The panelists were Oliver Dunsche, Managing Director at Deutsche Bank; Gopal Narsimhamurthy, Managing Director, Global Head of Fund Ratings at KBRA; Seth Perlman, Executive Director at Morgan Stanley; Sherri Snelson, Partner at White & Case; and Darren Thomas, Executive Vice President at PIMCO. The panel was moderated by Patricia Teixeira, Partner at Ropes & Gray.

provisions if a pledge of assets is required, such issue is less prevalent in the credit fund space. Further, for certain portfolios of unsecured loans or unitranche loans, there is no active secondary market for them so a pledge of such assets may be less critical to the NAV lenders. Rating agencies are also more focused on other features that offer protection against value decline, deterioration in asset diversification and management of refinancing risks than collateral package. Cash sweep and loan-to-value triggers are put in place before a default is triggered with the intent of bringing all the stakeholders to the table when early signs of issues appear with the goal of avoiding a default and the need to liquidate its assets. These early pre-default triggers could be set-up to trigger early amortization or initiation of a plan to cure the breach.

Generally, the back leverage market in NAV space to credit funds is fairly flexible. Unlike limited partners in private equity funds, there appears to be less aversion to NAV facilities among limited partners in credit funds, though some institutional limited partners in single-asset funds are not willing to grant recourse back to the fund.

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