NAV Financings and Alternative Lenders

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PRACTICES Fund Finance

Traditionally the fund finance industry has been synonymous with subscription lines as historically that has been the most utilised product, but over the last few years in particular there has been a large increase in NAV financings. This was accelerated by the COVID-19 pandemic, where funds sought extra liquidity in order to ride out the storm. This search for more liquidity during a time when a lot of banks were initially pulling back due to industry exposure concerns and capital adequacy requirements also led to an opportunity for non-bank lenders to step up into the gap. This article will look at both the topics of NAV lines and alternative lenders as answers to the liquidity problem.

NAV financings:

First of all, what do we mean by NAV financings? NAV (i.e. 'net asset value') financings are financings which are secured against the underlying assets of a fund, as opposed to subscription lines which are secured against the uncalled commitments of investors. NAV facilities can be put in place for a variety of asset classes, including private equity, infrastructure and secondary funds. They are typically put in place at the later stage of a fund's life cycle, where the investor uncalled commitments have reduced and been invested in the underlying portfolio. As a fund matures and calls down from investors, the value in the reducing undrawn investor commitments is theoretically transferred to the growing portfolio. From both the fund's and a lender's perspective, it makes sense to utilise the burgeoning value of portfolio assets by using them as collateral for debt. It's not unusual for a fund to have both a NAV facility and a subscription line in place at the same time as the separate financings will have separate collateral pools. However, care should be taken when drafting both facilities, especially when considering financial indebtedness and cross-default.

Like subscription lines, NAV facilities can be drafted as either borrowing base facilities or covenant based. For borrowing base NAV financings, assets will have to meet certain eligibility criteria to be considered included, and the occurrence of certain events will exclude them from the borrowing base. For covenant based NAV financings, typical covenants will include LTV coverage and maintenance covenants. It is also common for there to be an asset diversity covenant which requires the fund to hold a certain number of assets in order to spread risk. Given that NAV facilities are often put in place at the more mature end of a fund's life, it's possible that the fund may also be in divestment mode during the life of the facility. If that is the case, the facility will also need to include provision to allow assets to be released from security and for financial covenants to loosen. This will be coupled with a decrease in the available commitment. One issue which became even more evident during COVID-19 is how assets are valued for the purpose of evidencing satisfaction of the financial covenants. Valuation will depend on the type of asset, but nearly all lenders will require some form of audited/third party approved valuation. Failing a satisfactory valuation, many lenders will require the ability to carry out their own revaluation.

Similarly to subscription lines, due diligence at the beginning of a transaction is crucial in order to identify the most valuable assets. Once identified and a collateral pool is agreed, consideration should be given to how best to take security. As security can be taken over any number of assets, including security over the shares in portfolio companies or limited partnership interests in underlying funds, bank accounts and receivables, it should be noted at the outset whether any third

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party consents are required. For example, if a secondaries fund is granting security over its limited partnership interest in an underlying fund, if such security is enforced and the interest is transferred, does the general partner of the underlying fund have to consent to such a transfer to the secured party? It's worth considering whether any forms of consent need to be pre-signed as a deliverable to the security. Cash sweeps should also be considered alongside the security package. Due diligence should reveal where value lies and where receivables flow from and to. It's common for there to be a limit on how much can be held outside of blocked accounts, and also for certain events to trigger cash sweeps of any amounts into the collateral pool. A security package for a NAV financing is likely to involve numerous jurisdictions (dependent on the fund's investment criteria).

Although NAV facilities are a great way for a fund to effectively release value and leverage their assets for more liquidity, it does come at a price as NAV facilities are seen to be riskier than subscription lines and therefore lenders' margins tend to be higher in order to include a risk premium.

Alternative lenders:

As mentioned above, the last few years has also seen the rise of the non-bank lender as an alternative to traditional banks. This additional provider of liquidity was very welcome for the first half of 2020 when banks tightened their credit controls whilst trying to predict the impact of COVID-19. Alternative lenders include private debt funds, mezzanine funds, venture capitalists and insurance firms.

Alternative lenders automatically have more flexibility than the more traditional bank lenders as they are not under the same pressure to cross-sell different products of the bank and are not bound by internal targets. The flexibility that alternative lenders have also means that they are able to lend to structures that may not otherwise have received credit approval from banks who have more stringent criteria.

One big advantage that alternative lenders benefitted from during the COVID-19 pandemic was not being subject to regulatory capital adequacy requirements, which ironically had the potential to restrict the provision of liquidity to suffering businesses after being put in place to protect tax payers and the banking system after the 2008 crisis. The fact that more than one funding source was needed was made evident by the disruption caused to the banks in the early months of COVID-19.

The higher returns yielded by direct lending have attracted institutional investors, such as pension funds and insurance companies. A number of these institutional investors have experience in the fund finance market through their indirect exposure as an investor in a borrower, and are now looking to maximise returns by participating as a lender. However, where institutional investors are involved a facility is unlikely to be able to have the flexibility provided by being structured as a revolving facility, as most investors will need to term out. It's also worth noting that although non-bank lenders won't be subject to the same capital adequacy requirements as banks, they may still be subject to other regulatory restrictions (and indeed insurers will be subject to their own capital adequacy requirements).

Whilst the rise in alternative lenders does provide more options for borrowers, it also provides opportunities for banks as many alternative lenders will look to partner with banks for their agency and depositary etc. services.

Summary:

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Whilst the initial uncertainty in the market caused by COVID-19 has passed, the need for more liquidity has not. In the fund finance space both bank and non-bank lenders are looking at innovative and novel ways to help provide the liquidity needed in the market, and we predict that the NAV facility will be riding high amongst those products for a while to come.

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