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The value in NAV facilities

Asset-backed or net asset value (**NAV**) facilities as a feature of the fund finance landscape are not new, but their prevalence and uses have increased over the last five years in particular.

This trend merits an analysis of the increased attractiveness of NAV facilities for fund managers and finance providers alike. It also suggests that the broad umbrella under which facilities secured on underlying fund assets are conventionally placed is more usefully analysed by focussing, not on their differences when compared, as is traditional, with subscription lines secured on uncalled commitments, but rather on the varied challenges faced by fund managers for whom NAV facilities may provide solutions.

One reason for the surge in popularity of NAV facilities is the increasingly innovative use of such lines by fund managers to meet an expanding range of portfolio and liquidity management requirements across almost all strategies and asset classes as they search for higher value and increased returns. Placing value at the centre of our thinking, one way of distinguishing the ever-expanding spectrum of NAV facilities is to divide their underlying purpose into one or more of the following: (1) value creation; (2) value protection; (3) value release; and (4) value extension.

VALUE CREATION

(1) Secondaries financings

Often thought of as the 'original' NAV facility is acquisition financing made available to secondaries or fund of funds managers seeking to purchase a portfolio of (traditionally distressed) limited partner interests in the secondary market. Large private equity secondary acquisitions now consistently feature leverage in some form. The secondaries market itself is buoyant, moving from (largely) distressed or regulatory-driven sales in the aftermath of the GFC to a circa. $20bn highly sophisticated global market of secondary managers now seeking to dynamically calibrate both their performing and non-performing portfolios and provide liquidity solutions to their investors.

Average fund sizes in this space have increased significantly[1] and the number of large portfolio sales has also risen dramatically, with both of these trends predictably being coupled with upward pressure on prices to

[1] Preqin note that no less than 30 secondary funds raised an aggregate of $37bn in 2017.

frequently above par levels[2]. With the use of debt financing, buyers are able to position themselves strongly in increasingly competitive auction scenarios[3]. Leverage in the structure enables large portfolios to be acquired in their entirety at the higher price levels sought by vendors. It further mitigates execution risk and timing concerns and alleviates the need for large elements of deferred consideration. Depending on the level of diversification and vintage of the acquired portfolio, lenders in this space are likely to focus on cash sweep mechanics and scope for re-investment, agreed amortisation profiles and eligibility criteria.

(2) Co-investment and concentrated NAV deals

In an alternative asset climate of increasingly sophisticated investors, returns compression and a keen focus by limited partners on management fees[4], the desire for more co-investment and single managed account (SMA) opportunities looks set to stay[5] . Whilst the mainstream, increasingly commoditised secondaries sphere touched on above may now be viewed as characterised by mega-funds and sales of large, highly diversified portfolios, another contrasting focus for managers is the need to offer bespoke deal opportunities to their largest investors. Providing only modest, concentrated limited partner commitments in a co-investment or SMA vehicle as collateral will often seriously constrain or rule out capital call style financings for these structures. As such, once again there is a role for tailored NAV facilities in providing a financing-led solution to aid the search for additional value.

As the NAV financing market has evolved, providers have become increasingly comfortable with financing more concentrated portfolios of primary or secondary assets by deploying additional asset-level diligence capabilities and selecting transactions with clear near to medium term exit or recapitalisation horizons. Facility documentation seeks to ensure that these exits/recaps become reality via the inclusion of bespoke facility step-downs and LTV-linked margin ratchets. Even in a particularly concentrated portfolio, the combination of credit support from modest or decreasing investor commitments, when looked at together with the NAV of the investments, may mean that a hybrid facility is a viable solution. In the context of a highly competitive subscription facility market, with downwards pressure on pricing, some fund finance providers (both new and established) are proving to be open to more heavily structured deals such as these as they potentially yield higher, longer-term returns and provide a means of building relationships with target fund clients.

VALUE PROTECTION

(1) Asset restructuring solutions

So far our focus has been on NAV facilities which are deployed in expansionary or value accretive contexts. In contrast to this is a developing trend for such facilities to also be used in a more defensive or protective fashion where the overriding commercial aim for managers is to de-risk, or protect existing value within, a portfolio or specific asset. Examples of this strategy include the use of (usually modest) leverage, secured on existing assets and related cashflows, where the debt is used to effect an asset-level financing covenant cure, or otherwise to fund assets in need of a restructuring before asset-level financing or refinancing can be obtained. In contrast to financings of large secondary portfolio acquisitions, cash sweeps contained in more concentrated NAV lends such as these are likely to be event-driven rather than being characterised by fixed amortisation and even greater scrutiny of, and controls on, underlying asset performance and valuations will likely be required.

[2] Triago cite that average pricing reached 98% of NAV in 2018, up from 91% in 2012. They also cite that post 2012 vintages with upside remaining often trade at a premium.
[3] Asset valuations and competition for assets cited as the top two challenges for return generation in 2019 (source: Preqin Fund Manager and Investor Survey Nov 2018).
[4] 2 out of 3 limited partners see management fees as the most important term to be negotiated. This is up from 40% and 54% in 2014 and 2015 (source: Preqin 2017 Private Capital Fund Terms Advisor).
[5] 64% of fund managers were offering co-investments in 2017 compared to 52% in 2015. Similarly over 300 of surveyed funds offered SMAs in 2017 compared to just 140 in 2012 (source: Preqin Fund Manager and Investor Survey Nov 2018).

(2) Portfolio Management & GP-led restructurings

Active portfolio management is an important part of any sophisticated limited partner's or secondary or fund of fund manager's role in seeking to preserve the value of their investment portfolio[6] . The increased availability of leverage in the secondary market has facilitated their ability to divest themselves of assets which no longer fit their core strategy - whether in terms of asset class, geography, manager, vintage or other investment criteria.

GP-led restructurings have also proliferated over the last three years[7] . GPs have sought to actively manage their investor bases, whether as a means of aligning investor sentiment with a longer-term strategy for their assets, returning value to investors in line with their required return profiles or in the context of a key-person succession. Driven by strong asset prices in the secondary market and a movement away from the association of the sale of LP interests with underperforming portfolios or so-called 'zombie-funds', GP-led transactions, supported by availability of leverage for purchasers, look likely to become an increasingly popular phenomenon and one which potentially spans across all of the categories considered in this article. Indeed, The Institutional Limited Partners Association (ILPA) itself has recently issued guidance for limited and general partners in the form of "general parameters for a well-run General Partner led process" in which they too acknowledge that such transactions "are becoming more common in the private equity industry, and more oriented towards solutions, such as providing liquidity for limited partners or securing a pre-emptive extension of the fund term to maximize the value of a fund’s assets"[8] .

VALUE RELEASE

(1) Dividend recaps & bridges to exit

Unlocking value in a fund's portfolio at the most opportune time represents a constant challenge for managers. Accelerating distributions to investors can aid IRRs and money multiples and can also be used tactically ahead of fundraising for a successor fund. Facilitating earlier distributions may also allow a manager to access recallable commitments ahead of their expiry where they may otherwise lapse. The use of NAV facilities to fund dividend recaps or bridges to an exit are now a common tool considered by managers, particularly where a clear distributions or exit profile for the funded assets can be presented to a debt provider to support relatively swift deleveraging via regular and/or event-driven cash sweeps. In turn, fund finance providers' willingness and capabilities to understand and closely diligence the funded assets have expanded in line with the growth of NAV facilities in this context, putting those providers with the ability to tap into sector and asset class expertise more widely across their organisations in pole position.

(2) Over-equitised portfolios

The combination of asset level funders insisting on higher equity cheques and providing lower leverage multiples[9] has led some managers to regard their portfolios as generally 'over-equitised', particularly in the context of the permitted leverage caps contemplated in their fund documentation. In response, some managers are exploring the use of portfolio-wide NAV facilities to bring their overall leverage levels more in line with investor expectations and to provide required liquidity for planned value-enhancing asset level spending. Depending on the maturity of the relevant portfolio and desired liquidity requirements, lenders will likely focus on permitted loan to value multiples, means of funding cash-pay interest, controls on the ability of the borrower to acquire and sell assets and related eligibility and valuation criteria.

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[6] Evercore estimate that 66% of LP sales in 2017 were made as part of an active portfolio management strategy.

[7] Market data suggests that more than 35% of market value in the secondary market is driven by GP-led solutions (source: Greenhill presentation Sep 2018).

[8] GP-led Secondary Fund Restructurings – Considerations for Limited and General Partners (The Institutional Limited Partners Association, April 2019).

[9] Preqin cite the average ratio from 2013 to 2018 as being 75/25 compared to an average of 85/15 pre 2008.

Whether viewed as a bespoke solution for a particular asset where an exit is not on the immediate horizon or as a portfolio-wide strategy to manage overall leverage and liquidity levels, a NAV facility can offer a nuanced means of releasing value which can be tailored to the expected distribution and exit profile of a portfolio.

VALUE EXTENSION

(1) Life beyond the investment period – follow-ons & capex

Average fund life has risen in the last five years with funds increasingly holding on to assets for longer[10]. Sometimes this is attributable to a challenging exit environment – whether market-wide or asset/sector specific – but increasingly it is reflective of managers seeking to work assets harder and for longer in the search for enhanced returns. In this context, for managers the expiry of the investment period does not necessarily represent a bright line transition into harvesting mode and significant cashflows may still be required to fund follow-ons, follow-ups and capital expenditure[11]. At this stage in a fund's life, investor commitments may well be significantly depleted or otherwise committed which will constrain a manager's ability to tap into the subscription facility market to provide requisite funding for opportunistic, value-enhancing strategies for existing assets.

In this scenario, borrowing against the assets in the ground is an obvious solution to ease these cashflow concerns. NAV facilities of this type at an advanced stage in the fund lifecycle may well also appeal to providers with expertise in the relevant asset class who are attracted by the non-blind pool exposure. Depending on the relevant asset class, a focus for lenders in this context will be visibility on the true look-through leverage position of the portfolio and a clear understanding of the liquidity of the relevant underlying assets.

(2) Fund restructurings

Perhaps in response to the combined trends of the fixed 10 + 1 + 1 model for fund life being perceived as potentially outdated[12], increased investor appetite for opportunistic co-investing with GPs and (as discussed earlier) the growing willingness of GPs to actively manage their investor bases, a trend for shifting older vintage assets into newly formed structures, with optional rollovers (stapled and non-stapled) for existing limited partners to participate, has emerged. This is attractive to GPs and managers where such assets are perceived to hold additional untapped value which can be better realised after the scheduled wind-down of an existing fund.

A revitalised investor base with a belief in the GP's strategy for the remaining assets, often coupled with re-aligned incentives for the GP, is also potentially very appealing for GPs and investors alike, particularly if viewed as an alternative to shifting assets into a successor fund with related conflicts challenges. With the support of a NAV facility, the GP is able to design such structures with sufficient cashflows to work the transferred assets through to an extended maturity, ultimately with the aim of achieving superior exit multiples. A full understanding of the rollover and acquisition arrangements will be key to funders successfully putting in place such NAV lines, together with a detailed grasp of the future strategy for the transferred assets.

CONCLUDING THOUGHTS

The above represents only a small selection of the scenarios in which NAV facilities, where appropriately deployed, can provide an attractive, flexible tool for meeting a fund's liquidity and portfolio management demands. What is apparent, however, is the adaptability of such lines to respond not only to specific challenges faced by managers in their particular portfolio, but also for the umbrella of NAV lines to extend its reach into supporting, or even driving, new types of structures which can be used to respond to shifting market and macro

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[10] For deal sizes over €250m, average months to exit has increased to nearly 80 for 2018 from just under 70 in 2015 (source: The Centre for Management Buy-Out Research).
[11] Four out of five GPs expect to make follow-on investments after the investment period has ended (source: Investec GP Trends Report 2018/19).
[12] 31% of respondents are contemplating launching a product with longer duration (source: Investec GP trends Report 2018/19).

trends. In a strong fundraising environment[13] with the prospect of a large proportion of such funds being deployed at a time when we are at the top of the cycle[14] , flexibility and the scope to tailor facilities to each fund's individual needs is likely to continue to be attractive to managers.

With increased capital consolidation by virtue of the trend for fewer, larger managers and the increased competition for assets[15] , the pressure on fund managers to differentiate themselves is intensifying. Appropriate and tactical use of leverage, at the right times in a fund's life, may prove an increasingly useful means of promoting value in all its forms for investors and one such means of out-performing peers. From the other end of the lens, with the subscription line market becoming increasingly crowded, fund finance providers may find that the ability to provide financing solutions of this nature also gives them a valuable competitive edge.

Senior Associate Katie McMenamin authored this briefing note and spoke on a panel on the topic at the 9th Annual Global Fund Finance Symposium earlier this year.

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[13] Preqin estimate that over $800bn of aggregate private capital was raised in 2018 with dry powder exceeding $2tn. They predict alternative assets growth to continue reaching $14tn by 2023.
[14] 61% of surveyed managers view us as currently being at the peak of the current equity market cycle (source: Preqin Fund Manager and Investor Survey Nov 2018).
[15] Preqin report that at the start of 2019 there were over 3750 private equity funds seeking $977bn – the five largest funds combined are aiming to raise $219bn.