Private Funds CFO

NAV loan due diligence: Recent trends and what to expect when requesting a loan

From lenders' due diligence basics to new processes resulting from increased caution among some lenders, Private Funds CFO outlines what you should expect when taking out a NAV loan.

By
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Lenders' due diligence processes for NAV loans are typically intensive, but as **demand for the product is said to continue to far outpace supply**, lenders are retaining a cautious approach. In some cases, they're getting even more thorough, say market participants.

In part, that may be due **to a fraud perpetrated in 2021 against subscription line lenders**, in which the borrower, one Elliot Smerling and his firm JES Global Capital, fabricated LP commitments.

The NAV loan is a very different type of instrument from subscription credit lines. The latter are backed by investors' uncalled capital. NAV loans can be secured by portfolio assets or unsecured, and provide lenders with various ways to handle defaults or covenant triggers.

There have been no known fraud cases in the NAV market thus far, but lenders are still anecdotally asking for more information from their borrowers. The due diligence process and structuring process in this highly bespoke market is already relatively intensive, and typically takes much longer to complete than sub lines.

But the fraud was enough of a shock to the industry to cause the entirety of it to take stock.

Lenders review processes

Emad Shahin, partner and general counsel at private equity portfolio financing provider 17Capital, says the firm did review its practices in the wake of that scandal, despite already having what he says is a robust due diligence procedure.

“It would have been remiss of us not to take stock of our processes to see if there are any lessons that could be learnt” despite the fact the fraud occurred in a different asset class, he says.

He adds that due diligence is generally robust in NAV loans, and often includes a review of the documents relating to the fund’s underlying investments, the organizational documents for the borrower, and, depending on the nature of the fund’s investments, a collateral audit and on-site inspections of the fund sponsor and the fund’s portfolio companies.

Dave Philipp, a partner in Crestline Investors’ Fund Liquidity Solutions Group, says the firm also reviewed its practices after the JES fraud came to light, though he adds that the firm continuously refines its processes as it learns from experience. He says Crestline has started looking more closely at borrowers' underlying LP bases, assessing whether existing LPs could step up with additional capital to protect the assets, if needed. He adds, however, that "our legal reviews have always done a thorough analysis of chain of custody for the underlying assets."

Onsite portfolio company visits

Anastasia Kaup, partner and managing director at advisory firm Fund Finance Partners, notes that some lenders are going deeper into traditional, high-level measures of borrower assessment, like historic or projected asset value or performance. Now, they want detailed info on asset performance or portfolio company historic operations, for example, and are asking more questions of sponsor and portfolio company management than they did pre-JES, Kaup says.

And lenders now sometimes want to talk directly to management at the portfolio companies in assess their qualifications and skill, and that they have the wherewithal to operate the company successfully.

"This was not as common, in my experience, prior to the JES incident" Kaup observes.

"The vast majority of transactions used to be executed without onsite visits," Kaup says. "Post JES, we've been seeing NAV lenders want to go and meet the sponsor/management physically at their office, as part of their diligence process."

17Capital's Shahin adds that onsite visits have always been the practice for 17Capital because they "help foster the strong and long-term partnerships we are looking to develop with sponsors."

Crestline's Philipp says that when his firm talks to the management of the portfolio companies, they are trying to form an independent view of the business.

"Our conversations and diligence range from business model, customers, competition, financial analysis, exit strategy etc," he explains.

Shahin says, "We take a bottom-up approach to the underlying portfolio… These assets have often been held for some time by the managers and the purpose of the NAV financing is to add further value in the portfolio for the benefit of their investors."

Asset-level due diligence

But asset-level due diligence isn't completely new. Crestline's Philipp notes that about 90 percent of the firm's due diligence is focused on the assets themselves.

The intensity of a lender's due diligence will often depend on various factors, including the sectors of assets in the pool and the resulting sector concentration, as well as loan-to-value of the requested loan to the pool's NAV.

"For example, if there are only three companies that they are underwriting, they are going to look at those assets much more closely," FFP's Kaup explains. "If there are more assets, the lender may not look as closely at all of them but focus on doing a deeper dive on the larger or more valuable assets."

What borrowers are seeing

During due diligence on potential borrowers, NAV lenders typically focus on gaining a deep understanding of the firm as a whole, the makeup of the portfolio that the loan would be based on, and management's future plans for that portfolio.

"I would say they were looking at the bigger picture," one private equity CFO says. "It wasn't just about 'how much do you want and why do you want it,' but whether we know how to manage the assets we have, our fund management history, and if our portfolio companies' management had the right experience to run their business."

An alternatives manager CEO says the lender on her firm's most recent NAV facility spent significant time looking at the firm, the fund and the fund portfolio companies even though there was a pre-existing relationship with the lender in other areas of business.

"They were pretty thorough even though we've taken loans out with them before," she explains. "But this was our first NAV loan with them, and they had a 'better safe than sorry' attitude."

"It didn't matter that we worked with them before [on other financing products]; they were more interested in drilling down on changes at the firm and making sure the people making investment decisions had the experience to be investing in the assets they were," she added.

NAV lenders say they have always looked at fund sponsors during due diligence, even when there is a pre-existing relationship. Crestline's Philipp explains that familiarity with the firm, its documentation, and companies and industries in which it invests is helpful but doesn't change the fact that the firm still looks at these things when making a lending decision.

More important to lenders is that GPs have fund commitments themselves. Philipp says his firm spends a lot of time looking at alignment between the GP, the fund and its investors. Good alignment illustrates that everyone is invested in the success of the fund – critical for successfully borrowing a NAV loan.

Shahin adds that alignment shows the GP is interested in the long-term success of the firm.

“When we discuss NAV financing with a manager, we want to know that their plans for their portfolio companies are consistent with the use of our facilities. We want to support successful managers looking to create value for their investors,” Shahin explains.

Lenders are increasingly asking for additional detail on a funds’ documentation, including subscription documents, market participants say. They are also looking closely at LPAs and returning to borrowers with more questions than was typical pre-JES.

“All of our legal review ties back to an ownership component. We make sure the company is real, and that the company is owned by the fund,” Crestline’s Philipp explains.

And they are frequently taking a closer look at relevant documents to assess whether the underlying borrower can make good on the equity pledges it makes when those are part of the loan’s collateral package.

“Lenders like to see a clear and explicit permission for the entities that will be entering into the financing to do so. If the NAV financing is secured, do the entities have the ability to pledge assets to secure the debt? Any lender is going to want comfort that the transaction they are proposing to enter into is permitted,” Kaup says.

An alternatives manager CEO says that in her experience, there is a big focus by lenders on verifying the owners of the underlying assets, and reviewing the firm's service providers, like outside legal counsel and third-party fund administrators, to give them a sense of how "institutional" the borrower is.

Spotting the red flags

Of course, all lenders look for red flags that cause them to walk away from a potential borrower.

Philipp notes that Crestline would refuse a loan to a prospective borrower if they had insufficient collateral or insufficient diversification, if there were reputation risks, potential conflicts, lack of transparency, documentation restrictions or opposition from investors.

"If the managers are being really optimistic around valuations and timeframes, that would be a red flag," Philipp adds. "We like to really understand what the use of the proceeds are going to be and validate that they are accretive. So, if the sponsor doesn't know what they want to use the capital for or they don't have any idea how they are going to repay us that is a definite red flag. If they can't be well-articulated or their arguments don't seem to hold water, those are some red flags.

Other red flags include issues in the fund documentation that would either govern a consent process or would restrict borrowing.

17Capital's Shahin says the firm wants to see managers that have been able to grow their firm organizationally along with AUM.

"We don't want to work with managers that are not investing in their business. We want to work with managers that are looking to hire new partners, to grow and succeed in the future."