KEYNOTE INTERVIEW

The north star for NAV financing

As NAV loans become increasingly popular, more lenders have entered the space, says Richard Wheelahan, co-founder of Fund Finance Partners

Q What are the key factors GPs should consider when looking at using a NAV loan?
They should keep in mind the extent to which their lender knows how to be a "NAV lender." This means knowing how to price risk properly, especially as it pertains to the borrower's asset class. It's one thing to be a domain expert in commercial real estate private equity or even, say, a knowledgeable real estate debt investor. It's something else entirely to be a valuable NAV lending partner for a commercial real estate private equity fund. And so that involves understanding who that lender is as it relates to NAV lending, what their view of the key negotiated points in any NAV loan are, even though the market is making room for new entrants.

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The differences include the lender's appreciation of asset-level diversity, how a security interest does or doesn't attach within different structural levels, and how all of those impact pricing. It's certainly a growing pie, so everyone can get a slice, but knowledge about NAV lending is tantamount to any other expertise the lender may have.

Q Are there some guidelines when GPs are initially considering NAV financing?
Any fund sponsor considering seeking a NAV loan for one of its funds or several of its funds should be clear-eyed and full-throated about the purpose of the loan. That can seem obvious, but NAV lenders appreciate that many fund sponsors seeking these loans do so based upon a defensive rationale, to raise additional capital quickly for a protective purpose. In the eyes of lenders, that is a perfectly permissible and valid reason to seek NAV financing. However, confusion about the purpose and use of proceeds is detrimental to any fund sponsor seeking NAV leverage, especially when dealing with savvy, veteran lenders in this space.

Equally important, fund sponsors should consider what is permitted with respect to NAV borrowing under the terms of their partnership agreement or governing documents. Not all funds are set up to permit NAV loans yet. But it's not the end of the world if a fund sponsor needs to approach their LPs or LPAC, in order to modify whatever term might prevent NAV financing.

But, on the other hand, there may be solutions within the realm of what's possible in the current partnership agreement that doesn't require a conversation with any LPs. And it's up to the sponsor's adviser in the process of securing this financing to help identify the possibilities and recommend the best route forward.

Beyond those fundamental issues, it matters a great deal whether the purpose is offensive (strategic) as opposed to defensive (protective), and whether that purpose necessitates a revolving vs term (with or without delayed draw) structure. I believe that buyout funds, in particular, will take advantage of NAV financing in order to finance a few extra tuck-in or follow-on investments in an effort to climb into the top quartile. The return enhancement NAV loans can offer has the potential to widen the gap between the "haves and have-nots."

Q In your expereince, are LPs supportive of NAV financing?

There's diversity of opinion among the limited partner base, and that has to do with the degree of sophistication, experience and scale of each respective limited partner or fund's LP profile. The NAV lending market, which includes all relevant constituents, including limited partners, has really taken a quantum leap forward in the last few years. And so thankfully, for the market's sake, if the sponsor is clear about the purpose of the NAV loan, institutional LPs are generally supportive, because it tends to align with doing the right thing in order to maximize returns and protect invested capital.

There are still some cases where, particularly for LPs who are new to the practice of NAV financing, where there's a bit of an education that needs to take place. Thankfully, there's plenty of material out there for investors who may not be as familiar with NAV lending to quickly get comfortable with it. And so we feel like it's becoming more and more feasible for fund sponsors to pursue NAV lending vis-à-vis their limited partners.

> *"The good news is most NAV lenders don't want to be in the business of liquidating borrowed portfolios"*

In fact, my co-founder Zac was recently quoted in one of your sibling publications, but approaching it from the perspective of LPs and subscription finance. I agree with Zac, that LPs look at NAV loans quite favorably, but I'll let his quotation speak for itself: "With sub lines the LPs' own balance sheet and credit rating are effectively the collateral, whereas with NAV lines the collateral is the assets themselves," he says. "I think they look at NAV financing more favourably because they don't feel that they are carrying the load."

Q Once they have LP approval, what are the key terms that need to be negotiated?

For starters, the fund's partnership agreement may already permit the NAV loan. In fact, fund formation counsel and GPs are increasingly forward-thinking in ensuring that the fund can install a NAV loan before the first commitments are made.

There are about five. First, everyone expects pricing to be one of them. And at the moment, the gap between a relatively expensive and a relatively inexpensive NAV loan is as wide as we've ever seen. So pricing is a key point.

The next most anticipated negotiated point is loan-to-NAV covenants. So a NAV lender that steps into a deal at a 30 percent loan-to-NAV is going have some trouble in a facility where the loan-to-NAV balloons to something that's 2X, that's 60 percent just based upon degradation of asset value, as opposed to the extension of additional credit. So loan-to-NAV covenants are always an essential point.

A separate but related issue is minimum eligible investments. So a NAV lender will view a potential credit facility with 15 individual portfolio investments as meaningfully less risky than one to a fund that has four investments in its portfolio.

The next issue is one we believe is critically important, and that's understanding the collateral package. Does the loan we're talking about involve a pledge of the actual equity interests in the portfolio investments, versus limiting that to a pledge of contractual cashflows and the accounts to which those cashflows are paid? There are more than likely going to be transfer restrictions at the level of individual investments against a fund sponsor's ability to actually pledge those investments as collateral. And so even though every NAV lender would like to have a pledge of actual portfolio investments, it may not be possible, and it certainly may be ill-advised.

And then finally, there's a question of what happens in the event of a default, say of the loan-to-NAV covenant, or minimum eligible investments. Does that result in a simple change of waterfall mechanics? It's a lot easier to divert more cash to a NAV lender to deleverage than to watch a NAV lender foreclose on collateral and actually seize investments or force the sale of them. The good news is most NAV lenders don't want to be in the business of liquidating borrowed portfolios. ■