EXPERT Q&A

Lending against net asset values, or NAV, is proving a valuable source of liquidity and capital to private equity funds as they near the end of their investment period and move into the harvest period, says Pemberton's Thomas Doyle

Why LPs are warming to NAV financing

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Q What are the current use cases for NAV financing at fund level?

NAV financing is not new and has been applied to many asset classes. However, the focus has now turned to NAV financing for private equity buyouts, always secured on a diversified portfolio of performing companies. NAV financing is an incredibly flexible financing tool and can be applied to solve a myriad of liquidity and capital needs at the fund or management company level.

Examples of growth-orientated applications include the provision of financing in support of portfolio company bolt-on acquisitions at the fund level or at the management company level, financing to support a new strategic initiative or supporting GPs to increase their commitments in future fundraises.

Defensive applications may include the proactive optimisation of portfolio company debt, which is particularly pertinent today, given the recent rise in interest rates, to ensure a fund's portfolio companies have sustainable debt obligations and, as such, are able to operate effectively, with management teams left to focus on driving growth rather than diverting cash to service debt.

$100bn
Estimated size of current NAV financing market

Q What is the outlook for NAV financing and what are the key growth drivers?

We believe the outlook is incredibly exciting, not least as growth is underpinned by robust drivers, which can be grouped into four broad buckets: firstly, growth in underlying collateral pools is driven by the well-documented growth in the private equity buyout market – increased fundraising both in its velocity and in the size of funds – this capital has now been deployed or is being deployed and post seasoning, will yield significant financing opportunities; secondly, as the NAV financing market matures, a broadening array of NAV financing applications are being applied; thirdly, we see increased adoption by funds and GPs, as the asset class becomes increasingly mainstream; and finally, and by no means least, the growth in demand is being serviced by the growth in supply of capital as dedicated providers like Pemberton enter the market to service the pent-up demand.

NAV financing is currently estimated to be around $100 billion in volume. We certainly see this as becoming larger than the sub-line business, which is now worth over $500 billion globally – and that is just for buyouts. NAV financing is an all-weather solution, and we expect adoption to keep accelerating as it becomes clearly designated as a private debt product with private debt structures, covenants, and instruments. NAV financing is relevant across market conditions in both up- and down-market cycles. We therefore believe that NAV financing is poised to become an integral part of the private equity financing ecosystem.

Q How does NAV financing compare to other asset classes for institutional investors?

Structured appropriately, NAV financing solutions provide institutional investors with access to a new, large, fixed income, investment grade asset pool, that benefits from reduced volatility, and meaningful premia relative to public market equivalents.

The asset class compares favourably and represents a valuable addition to investors' alternative credit portfolio. NAV financing can operate across the risk paradigm, from the comparable single B-rated risk found across direct lending portfolios through to investment grade financing solutions. In each case it provides attractive relative risk-adjusted returns.

Compared to secondaries, that market is currently 85 or 90 cents on the dollar, so NAV financing offers good relative value, with a better risk-adjusted exposure to the similar underlying portfolio risk at 30-40 percent loan-to-value. There is a real relative value opportunity in the space because of the significant equity cushion on seasoned assets, the relatively more structured

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Q What is the case for NAV financing in the current economic climate, from an investor perspective?

There are numerous factors that substantiate the growing popularity of NAV financing with investors. The fact that all these transactions are secured against a portfolio of assets means there are multiple sources of repayment, which in itself is very attractive. This is further reinforced by ensuring these portfolios are diversified by end sector and geography, providing additional resilience to the asset class.

The increasing adoption of these transactions by successful sponsors, where the underlying companies have been operated and owned by the existing sponsor for several years, provides asset seasoning, a further risk mitigant and makes the NAV/valuations inherently more stable.

Finally, the low, absolute, LTV attachment points, together with more robust underwriting of valuations by experienced credit organisations, make this a very attractive alternative asset class and complements existing allocations.

and covenanted nature of transactions, and the greater alignment with the borrower, who remains the owner of the assets.

Q What do LPs think of these financing structures?

LP acceptance of NAV financing is critical to the growth and longevity of the asset class. We have always championed strong engagement to ensure structures align the interests of LPs with those of GPs. In recent transactions we have seen managers benefiting alongside LPs who have seen upside in liquidity.

It is important for GPs to explain the purpose and benefits of the transaction. This enables a win-win when applied to the right situations.

These win-win situations are becoming increasingly prevalent, as NAV facilities are being adopted by proactive, successful GPs who are not looking to utilise facilities to artificially enhance returns, but rather drive accretive growth for their seasoned portfolio assets or conversely preserve the value they have created to date. This is particularly pertinent given the uncertain economic climate, which is yielding unforeseen extended hold periods, where capital and liquidity reserves may not be available to the fund without access to NAV facilities.

Q Is NAV financing leverage on leverage? Why should an investor be comfortable with NAV from a risk perspective?

NAV financing is not about creating unsustainable levels of leverage. In many situations these transactions are leverage neutral or may ultimately help reduce leverage as they facilitate growth. For instance, the proceeds of a NAV financing transaction can be used to refinance existing debt or finance transformational bolt-on acquisitions. Equally, as discussed, a NAV solution remains an efficient tool for optimising leverage across a fund. That said, ensuring that look-through leverage remains appropriate is a key credit consideration for both the lender and borrower and should remain an important data point reported to investors.

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Q What is the competitive landscape like for NAV financing providers?

We think there is huge growth potential here and so inevitably there will be more competitors coming into the market. Right now, there are very few dedicated players, although a number of firms are doing this using side pockets or commingled funds.

We welcome new entrants to this asset class as it supports the growth of the market, which holds extensive opportunities for innovation as supply and demand increase.

Q What are Pemberton's USPs in this space?

Pemberton, with our extensive direct lending business developed over the past 10-plus years, has created an extremely strong origination platform. Our large office network across key European economies enables a continuous dialogue with sponsors and gives us first-hand insight and knowledge of local markets. NAV financing as an additional product is incredibly relevant to these sponsors.

There are very few firms with a dedicated NAV financing product that have invested in a large credit team. With 18 credit analysts, who have assessed close to 3,000 private equity-owned companies in recent years, we feel we are uniquely placed to make informed investment decisions – which is the DNA of Pemberton.

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Finally, core to our strategy is our independence. We are a dedicated lender to the European middle market and do not have a competing private equity, loan-to-own, or distressed lending offering on a direct or indirect basis. That makes us an ideal partner for the sponsor community. ■

Thomas Doyle is partner and head of NAV financing at Pemberton Asset Management