PEMBERTON

NAV Financing

- Evolution within Fund Financing

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Preface

Net Asset Value (NAV) Financing refers to a form of lending that takes the NAV of the assets of a fund as collateral (in other words, lending which is secured against the underlying assets in the fund's portfolio). Although some LPs might believe that NAV Financing is a new asset class which has only emerged recently, it has existed for several years. Taking the NAV of various types of funds in different asset classes as collateral, banks have been lending to a variety of funds for decades. The recent evolution is that NAV Financing is now starting to move away from the traditional banks and is being replaced by institutional capital via funds. Another evolution is that funds started to provide more flexible solutions (e.g., providing preferred equity vs senior secured loans) which banks traditionally didn't provide. This is a similar trend that has been seen within the European Direct Lending market, where banks are also gradually pulling out of the market due to regulatory constraints and are being replaced by Direct Lending funds.

This paper aims to address key questions that LPs might have on NAV Financing, which is starting to evolve rapidly as an asset class which institutional investors can access more widely via funds focused on this space. In doing so, we will look at comparisons with Direct Lending, which many LPs are more familiar with and which has both similarities and differences with NAV Financing.

Pemberton offers 2 sub-strategies under the NAV Financing product suite – 'NAV Core' and 'NAV Strategic'. While 'NAV Core' is more conservative of the 2 sub-strategies which mainly provides senior secured loans at low LTV levels, 'NAV Strategic' have the flexibility to provide other instruments (PIK, cov-lite, preferred equity, etc.) and/or providing financing at higher LTV levels. Although the main themes are consistent across both 2 sub-strategies, for the purpose of comparing NAV Financing to Direct Lending strategies, several of the content inside this report is more focused on 'NAV Core'.

What is NAV Financing?

Definition of NAV Financing

The general definition of NAV Financing is "a form of lending which takes the NAV of the underlying assets of a fund as collateral". NAV Financing can be applied towards different types of fund portfolios in multiple asset classes. These include both liquid and illiquid investment products cutting across equity funds, credit funds (bond or loan), macro funds, commodity funds, funds of hedge funds, single hedge funds, funds of private equity funds, secondaries transactions and the focus of this paper, single private equity funds in the buyout space.

Within the wide spectrum of assets to which NAV Financing techniques might be applied, the narrower definition of NAV Financing is lending that takes the NAV of a PE buyout portfolio as collateral and this paper will focus on this part of the NAV Financing market. Pemberton's NAV Financing product suite is focused on buyout funds and not on venture capital, growth, real estate funds, or other types of investment strategies.

Similarities and differences with Direct Lending

Given that Direct Lending funds (including Direct Lending funds managed by Pemberton) often provide loans to companies which the PE sponsors are acquiring, Direct Lending and NAV Financing are closely interrelated within the 'PE buyout ecosystem/PE life cycle'. Both Direct Lending funds and NAV Financing funds are funds investing in loans secured against the equity of the companies in which PE buyout funds invest.

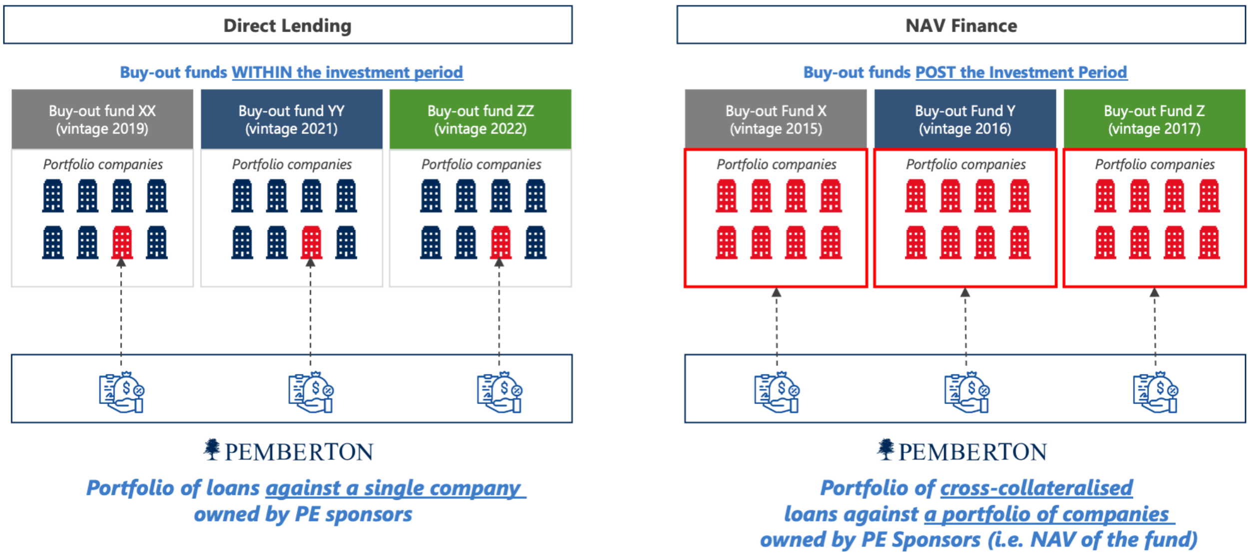
However, there are also differences. Above all, the fundamental difference between Direct Lending and NAV Financing is whether it is 'single credit lending' or 'multi-credit/portfolio lending'. While Direct Lending provides a loan against one single company (so 'single credit lending'), NAV Financing provides a loan against a portfolio of companies (so lending against a portfolio or pool of companies – 'multi-credit/portfolio lending').

Also, there are differences on the timing of the PE sponsors' investment into these companies in terms of the investment cycle. Direct Lending provides loans to companies which the PE fund is about to purchase and Direct Lending is therefore often a lending solution for PE funds within the investment/re-investment period.

On the other hand, NAV Financing provides loans against seasoned portfolios of companies in which the PE fund is already invested and which they may already have owned for several years. For this reason, NAV Financing is often a solution for PE funds beyond the investment/re-investment period. For example, a PE portfolio which is in the fund's 'harvest period' (after the investment/re-investment period) may have 10 assets remaining. NAV Financing provides a single loan against the combined NAV of all the 10 companies, with full information on how those companies have performed under the ownership of the PE sponsor over the past few years and what the remaining equity story or exit plan is for each underlying portfolio company.

Since the collateral of NAV Financing is a pool of companies, the loan is 'cross-collateralised' against multiple companies within the PE portfolio. For this reason, as the difference between 'single credit lending' and 'multi-credit/portfolio lending' suggests, NAV Financing is never exposed to a single asset within the portfolio whereas Direct Lending is always exposed to single assets. Along with the generally low LTV of the loans provided by NAV Financing funds (10-30% of the NAV), this cross-collateralised nature of NAV Financing is the reason why NAV Financing loans can be rated investment grade by third party rating agencies but can offer the return of an alternative asset class similar to Direct Lending funds.

Exhibit 1: Illustration of Direct lending and NAV Financing



For illustrative purposes only.

Why is NAV Financing growing?

Evolution of the NAV Financing market

As previously explained, NAV Financing has existed for many years. Taking the NAV of various funds in various asset classes as collateral, banks have been lending to a range of funds for decades. Even within the narrow definition of NAV Financing ("lending against a PE portfolio"), although it is still relatively limited to a small number of banks, some banks have been active in this space for some time.

NAV Financing is a natural evolution within the banks' fund financing business built around the 'PE buyout ecosystem/ PE life cycle'. Banks have been providing (or arranging) leverage financing to PE funds for their buyout activities for the past few decades. Based on this relationship with GPs (not just PE sponsors but in general), to support the funds' need to bridge the timing difference between cash deployment post investment and the receipt of funds via a capital call from LPs, banks first started providing subscription lines – taking the unutilised commitment from LPs as a collateral in earlier stages of the funds' investment period (when funds have ample unutilised LP commitments but few assets which they can use as collateral).

Subsequently, as a solution tailored to support the PE funds' residual financing needs post the investment period (when funds do not have unutilised LP commitments, but they do have assets which they may be able to use as collateral), NAV Financing evolved.

Growth expectation of the NAV Financing market

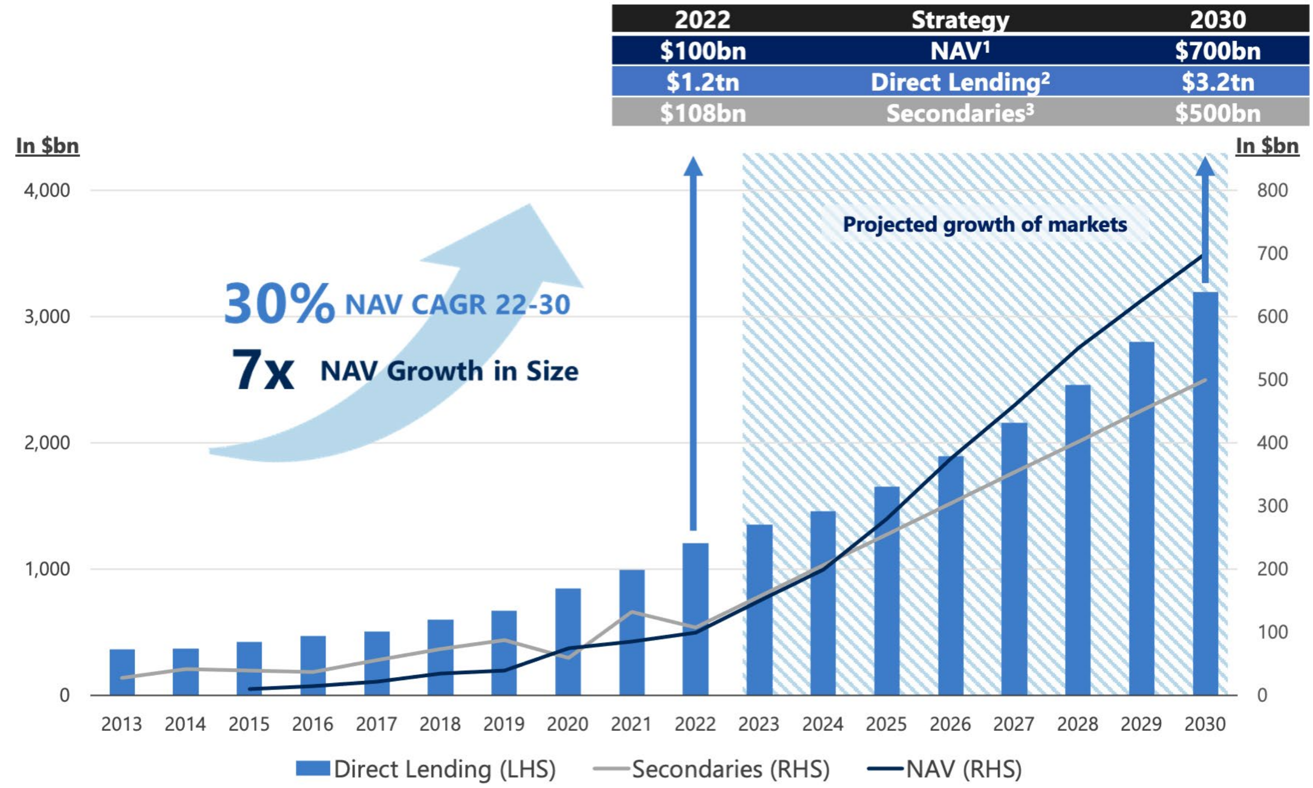
The evolution of NAV Financing is still ongoing, solving ever wider sets of needs (use cases, instruments, structures, etc.) and being adopted by an expanding range of users. Partially since the market definition of 'NAV Financing' can vary by player, it is hard to accurately assess the current market size and its potential size in the future. However, various sources indicates that the current market size of NAV Financing is somewhere between $80-$100bn in 2022 and can potentially reach $700bn by 2030[2]. This would represent 7x growth in market size and c.30% CAGR over 8 years, which is much faster than the growth of other asset classes such as Direct Lending or Secondaries.

Similar projections on the future trajectory of NAV Financing growth can be found through comparison of the growth of the NAV Financing market to that of the subscription line (subline) market. Independent private equity fundraising advisory firm, Rede Partners, wrote in a report published in May 2023 that the adoption of NAV Financing by PE funds might reach 90%, following a similar path of the adoption of subscription lines by PE funds over the past decade[3].

"The arc of development for these types of transactions can be compared to that of the Subscription Credit Line market. Only a decade ago, this market was in its nascent stages and subscription lines were often viewed as an aggressive fund management technique. Now, sublines are a prevalent feature in almost 90% of all private equity funds, and GPs failing to make use of them may have to face probing LP questions as to the reasons for their absence. It is Rede's view that the NAV financing market is on track to see similar levels of adoption within private equity funds by 2030."

[1] Significant majority of loans invested by Pemberton's NAV Financing Core Strategy will be rated by external rating agencies.
[2] Critical questions about NAV: How big could NAV Finance Get? (Private Funds CFO, PEI Group, 08/01/2023)
[3] Rede Partners, NAV Financing Market Report 2022/2023, May 2023

Exhibit 2: Growth projection of NAV Financing Market



For illustrative purposes only. Please note that forecasts are not a reliable indicator of future performance. Source: [1] White & Case, 2022. [2] Preqin, 2022. [3] Coller Capital, 2022

NAV Financing as an alternative to PE Secondary

The PE Secondary market has grown rapidly over the past decade – matching the needs of the sellers (GP or LP) who need to exit positions with buyers who are willing to take on the exposure at a certain discount. Although the PE Secondary market will continue to exist and grow, given the large discount (often 20-30% of NAV) that the seller needs to give up, it is natural for some sellers to consider borrowing money via NAV Financing (thus retaining the upside of the portfolio) rather than selling for a discount and giving up the upside of the portfolio.

This is particularly true for secondary sellers which are selling more for short-term liquidity or capital reasons as opposed to a permanent decision to exit the position or the asset class. Selling a PE exposure that has been an attractive investment might be more of a last-resort option for those sellers with temporary liquidity or capital needs. In a similar way, if you are a homeowner with some short-term liquidity needs, using the house as collateral to get a mortgage is probably something you would consider before you consider selling the house and moving out permanently.

From this perspective, NAV Financing can act as an alternative to the PE Secondary market. This aspect of NAV Financing is another reason why we expect the NAV Financing market to grow rapidly in the next few years, in line with a similar trajectory of the PE Secondary market over the past decade and into the future.

Why banks are becoming less active in NAV Financing

Given this growth potential of the NAV Financing market, a natural question is why the business is coming out of the banks' balance sheet at this point in time? Why will banks not continue to expand their position in a growing market (or other new banks enter this market) as opposed to giving market share away to credit funds and/or NAV Financing funds? To answer this, we will look at the NAV Financing solution offered by banks and the limitations they face in keeping up with this growth of the market.

In terms of their respective offerings, there is a significant difference between what banks can provide versus what funds (including NAV Financing funds) can provide. The difference between a 'bank solution' and a 'fund solution' can be caused by various factors such as 1) the balance sheet constraints of banks and 2) structural limitations on what banks can offer (in terms of long maturity facilities, delayed drawn facilities, preferred equity, and so on).

Even for those banks who are active in this field, they have a limit on how much further they can grow their NAV Financing books. As the market has expanded, their NAV Financing lending books have grown quite rapidly over recent years, but it is unlikely that they will be able to keep on growing their books in line with the market's continued growth (given that the expected growth rate is 30% p.a.). The NAV Financing market is inevitably growing beyond what banks can support – hence the emergence of funds backed by institutional capital to fill this gap between the supply and the demand of these financing needs.

Structural limitations can also be seen in various parts of the 'bank solution'. One example is the maturity of the NAV Financing facility. Banks often prefer to keep the maturity of NAV Financing to 3-4 years and 5 years is generally the maximum they can provide due to the uncertainty of the regulatory situation (including regulatory capital requirements) in the future. As we have seen in the progression from Basel I to Basel IV today, capital requirements for banks change over time. Not being able to fully predict how regulation and capital requirements may evolve further, banks are generally hesitant to commit to a facility with a long maturity. However, borrowers (especially PE sponsors) often prefer longer terms so as to retain flexibility, placing value on their ability to extend the hold period of assets in the current uncertain market environment.

Another example of a structural limitation within the 'bank solution' is facilities with DDTL (delayed draw term loan) structures. Since the undrawn portion of a delayed draw NAV Financing facility will still require banks to hold capital against any undrawn amount, it is extremely capital-inefficient for banks to hold or provide this type of DDTL structure. Similar limitations exist for subordinated / preferred equity structures (vs senior loans) which is extremely punitive for banks to hold. On the other hand, borrowers such as PE sponsors will often prefer to have this kind of structure due to the nature and purpose of the NAV Financing facility. Given that NAV Financing is a loan against a PE Fund post the re-investment period (on a cross-collateralised portfolio), there are several situations where the borrower might not need to draw the full facility on day one and potentially prefer a subordinated / preferred equity structure. While banks are not keen on such structures, NAV Financing funds generally have no problems with providing them.

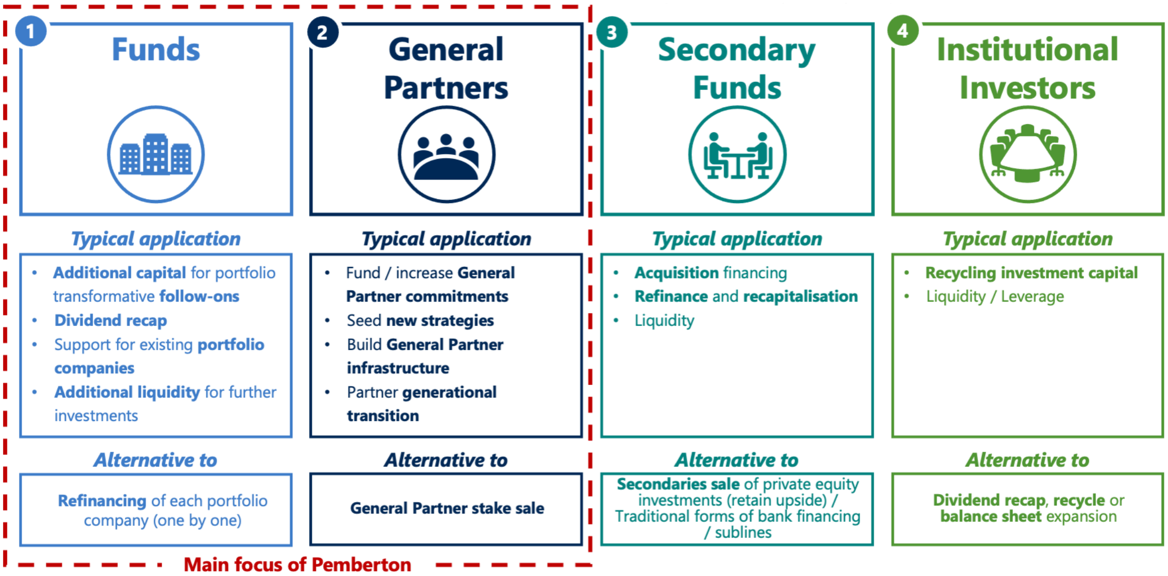
Even for LPs already active in investing in NAV Financing loans, loans originated by banks and loans originated by funds can often have certain differences. The NAV Financing solution which banks have traditionally offered can have different incentives versus what a pure-play NAV Financing fund will provide. Often these bank loans can be considered as a 'relationship trade' where banks lend to PE sponsors not necessarily on the basis of the economics of that specific deal but more as a way to enhance the relationship with the sponsor and generate profit elsewhere (for instance doing a NAV Financing deal for a global buyout fund so as to generate more M&A advisory fee revenue for the bank's investment banking division). Hence, for LPs that do not stand to benefit from these ancillary businesses which the banks are able to exploit, participating in NAV Financing loans originated by banks might represent a good risk for a good PE fund but maybe not one that offers the right price for investors.

Banks will continue to be active in certain sub-segments of the NAV Financing industry despite these limitations, but we expect that more and more of the future growth of the NAV Financing industry will be captured by institutional capital via NAV Financing funds. For the right price, funds can provide size, speed and certainty of execution, as well as the flexibility that sponsors also require. This is similar to the trend we have seen in the Direct Lending market where banks have continued to pull out. While banks are still active in certain parts of the leverage finance market, an ever-greater proportion of leverage finance transactions are now being done by Direct Lending funds.

What is NAV Financing?

NAV Financing Applications

Exhibit 3: Different applications of NAV Financing



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Although the key fundamental concept of "lending against a seasoned PE portfolio" is broadly consistent across all applications, there are at least 4 different applications of NAV Financing.

The most mainstream application is to lend to a specific PE fund at the fund level (i.e., lending to Sponsor ABC's Buyout Fund X), taking the NAV of the fund as collateral. Funds borrowing such capital can use the proceeds either 1) into the portfolio (e.g., financing a bolt-on acquisition for a company inside the portfolio) or 2) out of the portfolio (e.g., facilitating a dividend recap to provide distribution to LPs). Due to the macro environment and the economic uncertainty, the hold period of PE assets is getting longer, and more PE funds may likely require financing post the investment period.

The second application is to lend to the GP of a PE Fund (i.e., lending to Sponsor ABC). The typical use case is when a GP wants to finance its GP commitment to a new vintage fund, but is lacking the required capital since its earlier vintages have not redeemed and the GP commitment in those earlier vintages is still trapped. In this situation, NAV Financing funds can lend capital to the GP by taking the GP commitment in the early vintages as collateral, and it can be used as an alternative to GP-led PE Secondary sales.

Along with the hold period of PE assets getting longer, and with the significant change in the fund-raising cycle (with fund sizes becoming larger and larger, the interval between vintages getting shorter and shorter, etc.), demand for GP financing is also increasing.

The third application is to lend to secondary funds when they acquire a PE Secondary portfolio, taking the assets they acquired as a collateral. Secondary funds can use NAV Financing to finance a portion of their equity investments to boost returns.

The final application is lending to an investor who holds a PE portfolio, taking its LP stake as collateral. This is similar to a repo on the LP stake, providing a liquidity solution for investors. Again, this can be a strong alternative to LP-led PE Secondary sales as, in the case of NAV Financing, the LPs will be able to retain exposure to the upside of the PE portfolio.

What are the capabilities required to do NAV Financing?

Different approaches to NAV Financing underwriting - ‘Credit approach’ (‘bottom-up’) vs a ‘Secondary Approach’ (‘top-down’)

Several NAV Financing players come from a PE Secondary background. This is partially due to the previously mentioned close relationship between the NAV Financing and PE Secondary markets. It has been a natural adjacency for people with PE Secondary backgrounds to move into NAV Financing – given that rather than buying the PE portfolio in a Secondary, the provider finances the portfolio with loans or equity-like instruments in a NAV Financing. Due to the nature of the investment approach taken in PE Secondary, the underwriting stance taken by these Secondary background players can often be more ‘top-down’, with stronger focus on the GP name, the historical track record of the GP/vintage, and the LTV level (i.e. how much to lend to the provided NAV).

By contrast, NAV Financing done by providers with a credit background can be slightly different. The DNA and core capability of credit firms are the skillset to look at individual assets inside the portfolio on a one-by-one basis. For this reason, the approach often taken by the credit background players is more ‘bottom-up. Along with the GP name and historical track record of the GP/vintage, credit funds go into each asset inside the PE portfolio individually and assess the true NAV of each asset and its future projection as a way to calculate the LTV.

Requirements to do NAV Financing/ Barriers to entry

There are several capabilities that investors should look for when assessing a NAV Financing fund. In this section, we aim to discuss the core capabilities required and briefly explain why Pemberton’s NAV Financing strategy has a competitive advantage. To do so, we break the NAV Financing fund’s investment abilities into the following 4 steps – 1) Capital raising capability, 2) Deal sourcing capability, 3) Deal underwriting capability, and 4) post investment monitoring (and/or enforcement) capability.

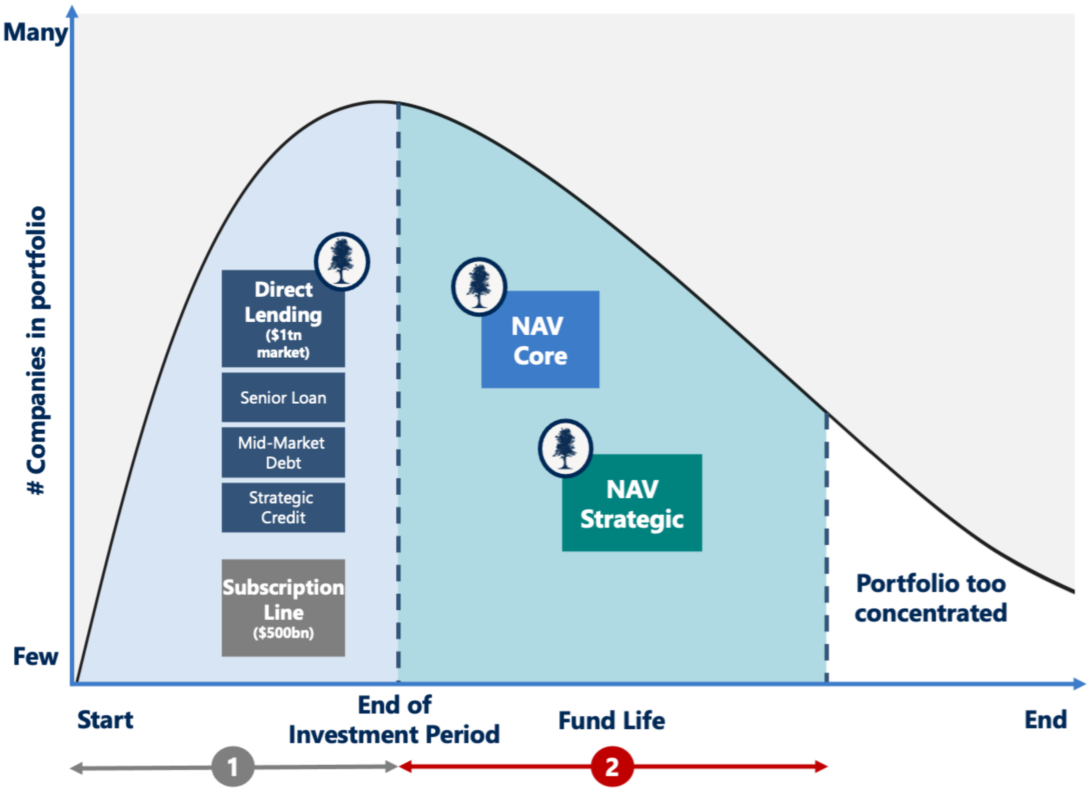
In order to be successful in NAV Financing, lenders will need all these capabilities and these requirements act as an entry barrier prohibiting new players from entering the market easily and protecting the competitive advantage of those already in the market.

1. Capital raising capability
   The first thing any fund requires is the capability to raise capital. Superior investment skills will not have a value if a fund does not have the dry powder to showcase that capability. Pemberton has regular dialogue with c. 1,000 LPs and already manages capital for c.200 LPs around the world. Clearly, along with the capability to raise capital from LPs, the ability to support LPs post their investment (for instance with reporting) is also a critical factor when selecting a NAV Financing fund provider.

2. Ability to source deals
   In addition to having the necessary capital, a provider needs to be able to source deals and to see as much opportunity as possible to pick the best transactions in the market for LPs. As NAV Financing involves lending against a PE portfolio, having the relationships and the network with PE sponsors is key.

Pemberton proactively covers c. 200 PE sponsors and has already financed more than c.70 PE sponsors on their portfolio companies through our Direct Lending Strategy. Rather than having to build the relationship with PE sponsors from scratch, our NAV Financing solution represents another addition to the solution we can provide to the PE sponsors we already work with. Similar to how banks expanded their product/service offering to PE sponsors from leverage finance to sublines to NAV Financing, it is a natural extension for Pemberton to move into NAV Financing to support the PE sponsors – not just to provide company level financing during the investment period via our Direct Lending platform, but also to provide portfolio level financing post the PE sponsors’ investment period via our NAV Financing platform. With 3 direct lending strategies with clearly defined mandates, Pemberton is already a ‘must call manager’ for multiple PE Sponsors. With NAV Financing, our relevance and importance to sponsors will only increase.

Exhibit 4: Direct Lending and NAV Financing serving different phases of the life cycle of PE Funds



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Furthermore, the fact that Pemberton is a pure private debt platform is also key in deal sourcing. When a NAV Financing lender underwrites a NAV Financing deal, it will require all key information of all the underlying assets within the PE portfolio to be disclosed (not just the NAV but the financials, historical performance, future business plans and so on). Since such information is very sensitive and mission-critical, PE sponsors are very cautious as to who they are willing to provide this kind of information to. Understandably PE sponsors are not keen to share such sensitive information with any party which could potentially use it in a way that might work against the sponsor. For this reason, they will often not share such information with an entity or a group that might have a competing business with the PE sponsor (resulting in PE Sponsors avoiding NAV Financing platforms that also have a PE business). In this context, being a pure credit platform without any private equity or distressed/'loan-to-own' businesses, Pemberton is positioned as a NAV Financing lender with no competing interests.

3. Deal underwriting capability

In terms of deal underwriting, having started as a direct lending platform, Pemberton clearly takes the 'Credit approach' ('bottom-up'). Similar to deal sourcing, Pemberton's Direct Lending business provides a significant synergy to the underwriting of NAV Financing. Being one of the top Direct Lending firms in Europe, it is highly likely that we will have seen several of the portfolio companies within the PE fund when the company was originally acquired by the PE sponsor. Considering that NAV Financing is lending to PE funds post the investment period, the actual investment in those companies has already happened. At that point of the investment, PE sponsors will often have sought a Direct Lending solution to finance their acquisition. In such situations, if Pemberton has seen the transaction in the Direct Lending side of the business, we already have knowledge about those companies. We can see how the company has performed under the PE ownership since investment and can leverage this information when we perform the 'bottom-up' assessment of the underlying assets.

This information advantage applies not just for the companies that we have financed through our Direct Lending business (30-50 companies p.a.) but also for those companies which we reviewed but ultimately did not finance (c. 700+ deals p.a.). Pemberton's Direct Lending platform has reviewed c.3,000 companies since 2019 and those transactions which occurred within the past 4-5 years are now often inside the portfolios of PE funds that are now past the investment period.

4. Post investment monitoring (and enforcement) capability
   The 'Credit approach' ('bottom-up') clearly plays a role in this respect as well. Along with the fund level information of the PE portfolio that we are financing (quarterly / annual reporting, AGM access, access to fund accounts, etc.), similar to how we underwrite, we have the capability to dig deep into the asset level when we need to. In the same way as we underwrite and monitor for our assets in the direct lending funds, we can review the performance at the asset level, monitor the true NAV we calculate, and take early actions if there are signs of underperformance. In the worst-case scenario, especially if the NAV Financing was provided as a senior secured loan, we have the right to exercise our enforcement rights to access the collateral pool.

Closing

Although NAV Financing might appear to be new, it is an asset class which has existed for a long time. Following a similar trend seen in the European Direct Lending market, we observe that banks have limitations on what they can and cannot do, and the market is gradually shifting towards institutional capital. NAV Financing is an adjacent asset class that is closely linked to Direct Lending since it is servicing PE sponsors at a slightly different stage of the PE funds' life cycle. In line with how the subscription line market and the PE secondary market have grown, we expect NAV Financing to follow a similar path, being adopted by more and more PE sponsors and becoming a critical asset class for investors around the world. With several synergies with our Direct Lending businesses, we can provide investors with superior access to this unique, highly attractive, and rapidly growing market within the private credit space.

Pemberton's NAV Financing Team

Thomas Doyle
Partner | Head of NAV Financing Strategy

He joined Pemberton in 2022. He was previously a partner at 17Capital in London, where he was head of credit, and a member of the investment committee for both the credit and preferred equity strategies.

Tom has over 25 years' experience in banking and private debt, with experience in building and creating successful fund financing businesses in Europe and the US, including at JP Morgan where he established and led the fund financing business in EMEA and at KBC Financial Products, where he was global head of fund derivatives.

Tom is a CFA Charterholder from the CFA Institute and holds a Bachelor of Commerce from University College, Dublin.

Pavol Popp
Managing Director | Portfolio Manager of NAV Financing Strategy

He joined Pemberton in 2022. Pavol has over 23 years of experience in finance and banking. Prior to joining Pemberton, Pavol was a Managing Director at J.P. Morgan, where he established the structured financing business in EMEA and was Global Co-head of the Financing Solutions team with a direct responsibility for all structured lending business outside of US & Canada.

Pavol holds a Master's Degree in Finance from London Business School and MA in International Business from University of Economics, Bratislava.

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