PEMBERTON

NAVIGATOR SERIES 2023

NAV Financing

A GUIDE FOR PRIVATE EQUITY STAKEHOLDER ENGAGEMENT

The history

Net Asset Value ("NAV") Financing has been a commonplace activity in banks for decades. The financing of the NAV of fund portfolios has been applied to all manner of liquid and illiquid asset classes for many years, including but not limited to 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 more recently single private equity funds in the buyout space.

The place of NAV facilities in lifecycle of PE funds

NAV facilities represent a natural evolution in the life of the private equity fund. In the same way that subscription lines originally answered the organic need to bridge the gap between the time of cash deployment following the origination of the asset and the receipt of cash from a capital call, the NAV facility was conceived to support residual financing needs of the fund post investment period. Over time, the use cases, the users, and the financial instrument used evolved to serve an ever wider set of needs.

The advent of this kind of financing in the private equity buyout space has led to increased dialogue between stakeholders (lenders, General Partners ("GPs") and Limited Partners ("LPs")) as the practice has gained increasing popularity and adoption in recent years.

When is NAV Financing used?

Growth-orientated Applications

- **Finance** transformational/bolt-on portfolio acquisitions.
- **Speed and certainty** of execution (relative to exposure to public/capital markets).
- **Proactive optimisation of fund level** and portfolio company leverage.

Defensive Applications

- **Protect** against dilution of **equity interest.**
- **Liquidity** to support portfolio investments.
- **Facilitate dividend recap** – lock in performance returns.
- **Fundraising:** proactively **support limited partners** to manage their private equity exposure / free up capital for latest fundraise or meet future capital calls.

Does a GP have to get LP consent for NAV Financing?

In many cases a transaction does not require explicit approval from the Limited Partner Advisory Committee/LPs.

It is important to remember, however, that when LPs invest in a fund they accept many risks due to the skill and integrity of the GP. The LPA and accompanying fund documentation govern and help drive this interaction but cannot hope to capture all eventualities, how the parties to the agreement interpret their obligations in terms of their level of service and depth of engagement. There therefore needs to be an inherent degree of trust that governs the beginning and maintenance of a LP/GP relationship.

As such, whether or not explicit consent is required to implement a NAV facility, it is important for parties to clearly communicate the motivation for the transaction and the financing need being solved.

GP/LP engagement - common points to consider

NAV Financing is a very bespoke instrument. A well-designed facility can be an incredibly useful tool for all involved but the importance of the communication cannot be overstated.

As we look at the development of this market the following set of topics should provide a good outline for GP/LP interactions:

- **Transaction Rationale:** Establish the purpose and motivation of the transaction and its associated merits relative to other solutions – be that defensive, accretive or supportive. Important consideration should be given to ensure alignment of interest between stakeholders is maintained.
- **Transaction Process:** As these transactions are contemplated a significant amount of work takes place between the GP and the fund's formation lawyers, as well as between the GP and the NAV provider. These conversations often develop over a number of months and are rarely short term. The timing of engagement between GP/LPs is therefore likely to be bespoke. Furthermore, in a similar manner to an individual company acquisition, there may be sensitive market or portfolio information that needs to be protected to preserve the integrity of the transaction, which will influence the timing and content of communications.
- **Impact on KPI Performance:** metrics (IRR, MOIC, DPI) before and after the transaction.
- **Portfolio implications:** Pre and post portfolio leverage. There is often a misconception that these transactions are 'leverage on leverage'. In many cases, the transaction may be contemplated to optimise leverage for underlying companies that are seasoned and may have de-levered accordingly (below an optimal level). Equally the transaction may facilitate an acquisition which could result in a reduction in leverage on a pro forma basis. Consideration should also be given to pre and post debt/equity split (portfolio company debt plus fund level debt to fund equity) and the appropriateness and sustainability of the debt in this capital structure.
- **Structure of the transaction:** Rationale for the proposed structure, scope of collateral/security pool, collateral enforcement rights, cash-flow sweeps/waterfall and risks emanating from the transaction. Most transactions will be structured by way of an SPV borrower. The use of SPVs are akin to the use of SPVs for the purchase of underlying companies. In a like manner, the SPV of these company purchases are ringfenced from the fund and allow for the judgement of the GP in determining the capital structure of any given company and to create the appropriate security package.
- **Legal Amendments:** Any additional legal implications for consideration – preferential claims/covenants, any fund restructuring that needs to be undertaken to facilitate the transaction etc.
- **Finance Counterparty:** Finance providers' identity and if appropriate whether or not the provider of the facility is an investor in the fund or is coinvesting in the transaction directly or through syndication. This can impact alignment of incentives and is a topic worthy of discussion between LPs and GP. Consideration should also be given to their knowledge of corporate credit, which should be helpful to gauge their understanding of the transaction, their appetite to take appropriate terms and conditions and their ability to work constructively in stressed conditions.
- **Explicit Consents (if any):** Identification of any explicit consent requirements from the affected stakeholders (these will be established through the facilities' legal due diligence process).

All for one and one for all

LPs do need to consider that they are part of a limited partnership and not the only investor in the fund. Accordingly, while any decision that a GP makes may not entirely suit any one of a number of investors, there is a fiduciary responsibility for the GP to act in the interests of all the LPs.

Market outlook

NAV Financing is flexible and can be applied to solve a myriad of liquidity and capital needs. We believe it is here to stay. In the same way as we have seen the development, evolution and acceptance of the subscription line, the NAV facility is poised to become an integral part of the private equity financing ecosystem.

It has been successfully adopted across many alternative asset classes and awareness and application by private equity firms is growing significantly, driven by the liquidity and capital demands that arose during the Covid crisis and that are further exacerbated by the volatile economic climate the industry is navigating today.

Summary

The practice, communication and application of the NAV Financing product will improve and become a central feature of the discussion between LPs and GPs.

Pemberton are very much advocates of this approach. We would welcome the opportunity to work with stakeholders to enhance their knowledge of the market and discuss NAV Financing applications and how they may be applied or may influence their private equity exposure.

Contact Us

Thomas Doyle
Partner | Head of NAV Financing
thomas.doyle@pembertonam.com
T: +44 (0)20 3994 7954
M: +44 (0)77 06338295

Matthew Kirsch
Managing Director | NAV Financing
matthew.kirsch@pembertonam.com
T: +44 (0)20 3841 8359
M: +44 0770 6338 300

Pavol Popp
Managing Director | NAV Financing
pavol.popp@pembertonam.com
T: +44 (0)20 8057 9236
M: +44 (0)759 6865 068

General Enquiries
info@pembertonam.com
T: +44 (0)20 7993 9300
www.pembertonam.com