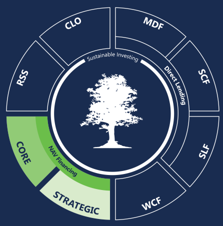


PEMBERTON

NAV Financing Offers Significant Benefits Beyond Dividend Recaps

October 2024

NAV lending has significant beneficial use cases beyond the headline-grabbing dividend recap trade, says Thomas Doyle, Partner and Head of NAV Financing at Pemberton Asset Management, a London-based private credit provider with 22 billion dollars under management.[1]

Over the past year or so, financial media have raised concerns that paying special dividends to liquidity-constrained limited partners (LPs) through NAV financing facilities may jeopardise the long-term prospects of fund entities by cross-collateralising risk and piling leverage upon leverage.

Our observations indicate dividend recaps are just one minority use case for NAV Financing, accounting for about 15% of the current growing NAV Financing market, with this percentage having decreased over time.

However, as the first direct lender in Europe to launch two dedicated strategies to provide NAV Financing and GP Solutions, we also believe that NAV Financing can provide significant value-accretive benefits to the private equity community.

Additional Fund Capacity

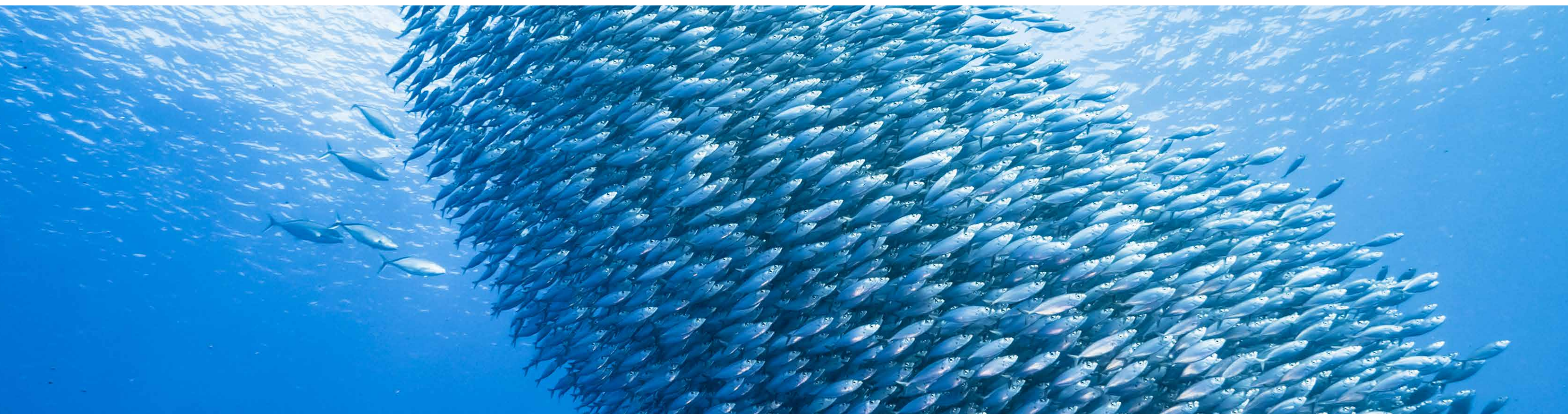
Prior to the end of a private equity fund's investment period, a sponsor might typically expect to have divested at least one portfolio asset, providing the manager additional capacity to either make an additional platform investment or to support the remaining portfolio investments thereafter.

But abnormal liquidity conditions, in the form of depressed buyout, IPO and M&A activity, are currently limiting exit options and the ability to realise early portfolio divestments. NAV Financing can address this by providing the sponsor with the flexible additional firepower it needs to enhance value within the portfolio.

Bolt-on Acquisitions

NAV Financing can also finance bolt-on acquisitions for portfolio companies. Without NAV Financing, a manager may have to delay or pass on a potentially accretive add-on portfolio company acquisition. That may hinder the growth strategy for a portfolio asset, potentially reducing future exit value.

1. Assets under management are defined as committed capital as of 30 June 2024.



Defensive Support

And while Pemberton avoids turnarounds, distressed situations and distressed portfolios, sometimes a good company needs support, for one of several reasons. Maybe it was acquired at an elevated valuation and needs time and capital to grow into those multiples. Perhaps it needs to refinance prohibitively expensive portfolio company debt that was put in place prior to the recent ramp-up in interest rates. Or a cyclical downturn could mean muted short-term trading.

NAV Financing can provide defensive support to get a fundamentally strong, well-managed, growing, EBITDA-positive and innovative business in a sector with secular tailwinds through a challenging period.

Conservative Criteria

Whatever the use case, strong credit selection and thorough underwriting are the keys to capital preservation and downside protection.

Pemberton has highly conservative NAV lending criteria, which includes re-underwriting the sponsor's NAV/collateral, taking into consideration sustainable through-the-cycle valuations and the appropriateness of both underlying portfolio company debt and fund leverage. As a result, NAV Financing is not a backdoor to unsustainable debt.

It is important to note that NAV Financing is not about creating unsustainable levels of leverage. Indeed, the impact on leverage as a result of a NAV facility is influenced by the use of proceeds. A NAV facility may result in look-through leverage increasing, remaining neutral or indeed reducing.

For example, if the proceeds of a transaction are used to refinance existing debt, insert equity into a business or finance a bolt-on acquisition, this would be leverage-neutral or potentially decrease leverage (while growing the underlying NAV pool).

Portfolio Protections

In addition, terms typically ensure that cross-collateralisation won't put the entire portfolio at risk in the unlikely event of a breach. Workout processes are extensively covered in lending agreements.

Since a portfolio is underpinned by significant equity levels, and typical NAV LTV metrics top out at levels that are unlikely to trigger default risk, an awful lot has to go wrong over a significant time period before a lender would even think about stepping in to assume control.

Clear Communication

We also believe it's an overstep to automatically paint dividend recaps with the "bad use case" brush. If handled correctly, dividend recaps can be valid, as LPs need and welcome liquidity, especially if the alternative is selling an asset in the secondary market at a depressed valuation, coupled with foregoing the equity upside. What frustrates LPs is poor communication by the GP.

In a 2023 paper[2], Pemberton advocated for transparent LP engagement about dividend recap transactions. We advocate that this should include disclosure about the rationale for the transaction, the deal process, the impact on IRR and other performance metrics, the structure of the NAV facility and its position in the capital stack, and the likely impact on a portfolio. As the ILPA recently outlined in its guidelines for NAV lending, good communication can help ensure LPs and GPs are aligned.

Valuable Toolset

NAV Financing can therefore meet numerous liquidity and capital needs and, in our view, is a valuable toolset that is here to stay. The current debate is reminiscent of the discussion around dividend recaps at an individual company level 15 years or more ago, and subsequently the conversation over the use of subscription lines. It's through such stress testing that NAV Financing will also be recognised as a beneficial part of the private equity manager's armory.

The concerns raised by a limited number of media outlets about the potential downside risk of one minority use case — dividend recaps — should not have a negative impact when thinking about the considerable benefits that can also accrue from other applications of this important source of credit capital.

2. https://pembertonam.com/research/navigator-series-a-guide-for-private-equity-stakeholder-engagement/

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