NEUBERGER | BERMAN

PETER VON LEHE
Head of Investment Solutions and Strategy

ELIZABETH TRAXLER
Managing Director

JUSTIN WELFELD
Associate

A Perspective on Private Equity NAV Loans

From the financial press to Limited Partner Advisory Boards, Net Asset Value ("NAV") loans have captured popular interest across the Private Equity universe. While time has illuminated the merits and considerations of most portfolio-level financing tools used by managers or General Partners ("GPs") and led to the convergence of sentiment among investors or Limited Partners ("LPs"), we continue to hear animated debate around NAV loans.

Neuberger Berman has over 35 years of experience as an active primary fund investor and is currently a member of over 390 Limited Partner Advisory Committees.[1] As a highly engaged market participant, we believe—in our capacity as both an investor and a manager—that NAV loans are not inherently good or bad, but rather a financial tool that can be used appropriately or less appropriately depending on the facts and circumstances of each transaction.

In this piece, we explore key fact patterns and considerations around NAV loans and ultimately offer a framework for GPs and LPs to analyze these instruments accordingly.

[1] As of September 30, 2023.

Background

NAV loans are a portfolio-level financing tool for managers of, and investors in, private markets assets. Although implementation can vary across the Private Equity value chain, a NAV loan is debt advanced at a prescribed loan-to-value ("LTV") ratio and collateralized by the net asset value of a diversified pool of assets. Since NAV loans are a form of asset-backed borrowing, they are often implemented later in the life of a portfolio, when it has achieved a sufficiently large and diverse borrowing base.

Generally, NAV loans can be divided into three categories by the identity of the Borrower:

1. **Asset-Owner as Borrower:** Generally institutional LPs seeking to decrease private markets exposure, generate liquidity, or achieve a leverage effect.
2. **Asset-Manager as Borrower:** Generally multi-fund managers seeking to unlock liquidity at the management company level.
3. **Fund as Borrower:** Generally Private Credit or Private Equity funds seeking to raise debt collateralized by the net asset value of underlying portfolio investments.

Since there are many flavors of NAV lending across the Private Equity universe, this piece will focus on the Fund as Borrower category—specifically, on NAV loans executed by Private Equity managers and collateralized by equity interests in the underlying companies of a direct Private Equity fund. Within this category, capital call lines are another common portfolio-level financing tool. NAV loans are differentiated from capital call lines, which are collateralized by uncalled capital commitments from LPs and typically implemented earlier in a fund's life.

Structure Profile

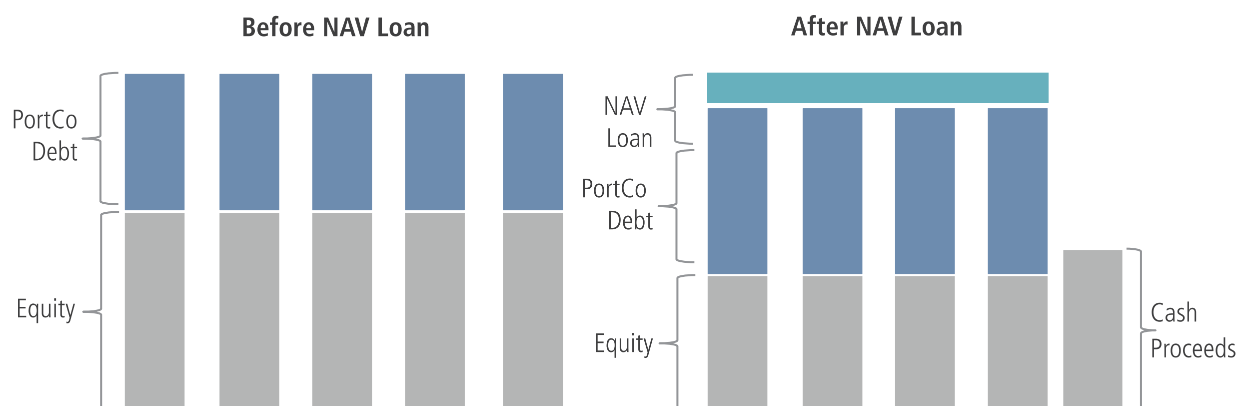
As with all debt products, the terms and covenants of a NAV loan play a critical role in its potential impact on a portfolio. Most NAV loans are secured by a fund's equity interests in its underlying portfolio companies. Covenants generally include a minimum diversity requirement which triggers a 100% cash flow sweep ("cash turbo") as well as a maximum loan-to-value ratio which, if uncured, triggers an Event of Default. While pricing of fund-level facilities is generally cheaper than company-level borrowing, the tighter spread comes at a cost: cross-collateralization.

Common Concerns

While NAV loans are a financial tool with the capacity to improve potential return outcomes, imprudent use of leverage can negatively impact returns and lead to total loss of value in extreme scenarios. Market participants critical of NAV loans often argue that these tools add "leverage on leverage" and enable companies to achieve higher turns of debt than they would otherwise be able to access on their own. These are legitimate points of concern, but we believe that the most significant risk introduced by NAV lending is the systemic risk of cross-collateralization.

Although Private Equity is no stranger to leverage, this leverage is fundamentally *different*. Use of leverage by Private Equity has not historically caused significant risk issues because debt has generally been limited to the portfolio company ("PortCo") level. This has meant that an idiosyncratic credit issue at one portfolio company would not impact the other companies in a fund. NAV loans introduce an additional layer of systemic risk to a fund since they are cross-collateralized across portfolio companies.

FIGURE 1: ILLUSTRATIVE IMPACT OF FUND-LEVEL LEVERAGE[2]



Risk Mitigants

Given this notable risk, it is critical for all parties to focus on mitigants—first of which is asset quality. A substantial borrowing base of quality, performing businesses is critical to supporting the cash flow and return requirements of a more levered capital structure. Flexible loan terms and other structural considerations are also important for mitigating leverage risk. Key terms for addressing this risk include but are not limited to lower initial LTVs, buffer to LTV triggers, conservative sweep levels, cash flow vs. asset-secured collateral packages, optional extensions, and option to PIK, among others.

Ultimately, a NAV loan is only as effective as the value it unlocks from the use of borrowed funds. As such, focusing on use cases that augment a fund's investment portfolio and improve expected outcomes for both GPs and LPs is a key component of risk mitigation.

Common Use Cases

NAV loans to Private Equity funds can generally be divided into three sub-categories by their use case:

1. **Acquisition Financing:** Proceeds used to finance platform investments and/or follow-on M&A at one or more portfolio companies.
2. **Capital Infusion:** Proceeds used to support organic growth, shore up balance sheets, de-lever capital structures, or act as bridge financing until long-term financing is arranged at one or more portfolio companies.
3. **Accelerated Distributions:** Proceeds distributed to investors.

Often, a single NAV facility can achieve multiple use cases. In the first two cases, a NAV loan is used in place of calling funds from investors because it is more capital-efficient or because additional investor capital is not available. For funds with expected acquisition activity as well as potential growth capital needs across several portfolio companies, a fund-level facility provides managers with flexibility to deploy capital faster and more efficiently. This benefit is especially great for funds anticipating a high level of activity or capital requirements across a range of companies, but with low visibility into which specific companies will be involved.

[3] For illustrative and discussion purposes.

The following table provides a few examples of generally positive / neutral / negative fact patterns around transaction set-up and implementation.

Figure 2: Generally Positive / Neutral / Negative Fact Patterns[3]

	Acquisition Financing
Generally Positive	Proceeds secured to support a large pipeline of M&A across multiple portfolio companies
Generally Neutral	Proceeds used to fund the equity purchase price of a platform investment or refinance a capital call line at the end of a fund's investment period
Generally Negative	Proceeds employed to leverage a fund's commitment to a single company that otherwise could not support the debt at the company level

	Capital Infusion
Generally Positive	Proceeds used to support growth at one or more portfolio companies
Generally Neutral	Proceeds used to send cash to company balance sheets, de-lever synthetically through M&A, or otherwise bridge a cash flow mismatch
Generally Negative	Proceeds injected as bailout capital to de-lever a company by paying down expensive company-level debt, with no line-of-sight to recovery or exit

	Accelerated Distributions
Generally Positive	Proceeds distributed to investors to enable the manager to hold high performing companies longer and drive additional value creation
Generally Neutral	Proceeds distributed as a non-recallable distribution with no material impact to carry waterfall (fund well-in carry or well-under carry)
Generally Negative	Proceeds distributed to achieve the preferred return hurdle and pay carry to the GP and/or proceeds distributed as a recallable distribution

Market conditions influence not only the propensity for managers to pursue NAV loans, but also the relative mix of use cases for those being pursued—some relevant factors that govern this balance include company hold periods, fund distribution levels, and interest rates/cost of borrowing. In consideration of how and when they are implemented, NAV loans have the capacity to be accretive or dilutive based on the return target of each LP as well as the facts and circumstances of each transaction. Since NAV loans can materially impact the economic profile of a fund investment, it is essential for investors to understand the inherent risk-return attributes of each use case and how the conditions of each transaction may impact LP outcomes.

[3] For illustrative and discussion purposes.

Recommendations for General and Limited Partners

For GPs, clear and open communication with LPs around a prospective NAV financing is critical to achieving long-term success. This transparency is expected not only in fund LPAs and other formation documents, but also in real-time candor around the origination process from exploratory discussions through final stages—a few LPs may not support a NAV loan, but no LPs like being told about one after the fact. In these discussions, be sure to explain the "what" and "why" of the transaction and affirm manager-investor alignment (if articulating this point is difficult, it may be worth reconsidering the deal). Additionally, it is important to include all LPs in these communications, not just those required for approval on Limited Partner Advisory Boards. On the execution front, consider the cost of financing relative to both company-level debt and expected prospective return on equity—assuming reasonable coverage here, it often makes sense to emphasize flexibility over incremental pricing.

For LPs, we suggest listening to the GP's rationale and measuring if it is consistent with the strategy of the fund and reasonable in the context of the transaction. In the analysis, consider manager-investor alignment, the risk profile of the trade (i.e., high LTV/high cost vs. low LTV/low cost), and underlying liquidity (i.e., ability to generate full or partial liquidity as determined by marketability of, and governance rights over, holdings). If relevant, update capital pacing accordingly to reflect the expected impact to capital call/distribution activity as well as to portfolio NAV. When conducting diligence on managers that use NAV loans, consider how these instruments may impact traditional performance metrics and seek to assess historical returns on an absolute basis.

Looking Ahead

NAV-based lending is highly dependent on macroeconomic factors including but not limited to M&A/exit activity, fund distribution levels, interest rates and credit spreads. As such, GPs and LPs can benefit from recognizing current and potential market conditions that not only impact the propensity of NAV loans, but also make them more or less effective. While NAV loans are a multi-tool for achieving a wide range of investment objectives, they introduce a layer of systemic risk to a fund which is mitigated first and foremost by a substantial asset base of quality, performing companies. The terms and conditions of a NAV loan are also critically important factors for mitigating risk.

Given the importance of these factors, openness and transparency is crucial for maintaining positive alignment and ensuring that use of proceeds is accretive to investor outcomes. As with all portfolio-level financing instruments, NAV loans should be analyzed on a case-by-case basis, in consideration of each opportunity's unique macroeconomic conditions, investment contents and transactions terms.

This material is provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice. This material is general in nature and is not directed to any category of investors and should not be regarded as individualized, a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. Investment decisions and the appropriateness of this material should be made based on an investor's individual objectives and circumstances and in consultation with his or her advisors. Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. All information is current as of the date of this material and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole. Neuberger Berman products and services may not be available in all jurisdictions or to all client types.

Investing entails risks, including possible loss of principal. Investments in hedge funds and private equity are speculative and involve a higher degree of risk than more traditional investments. Investments in hedge funds and private equity are intended for sophisticated investors only. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

This material is being issued on a limited basis through various global subsidiaries and affiliates of Neuberger Berman Group LLC. Please visit www.nb.com/disclosure-global-communications for the specific entities and jurisdictional limitations and restrictions.

The "Neuberger Berman" name and logo are registered service marks of Neuberger Berman Group LLC.

NEUBERGER | BERMAN

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com

Z0379 02/24 1666255 ©2024 Neuberger Berman Group LLC. All rights reserved.