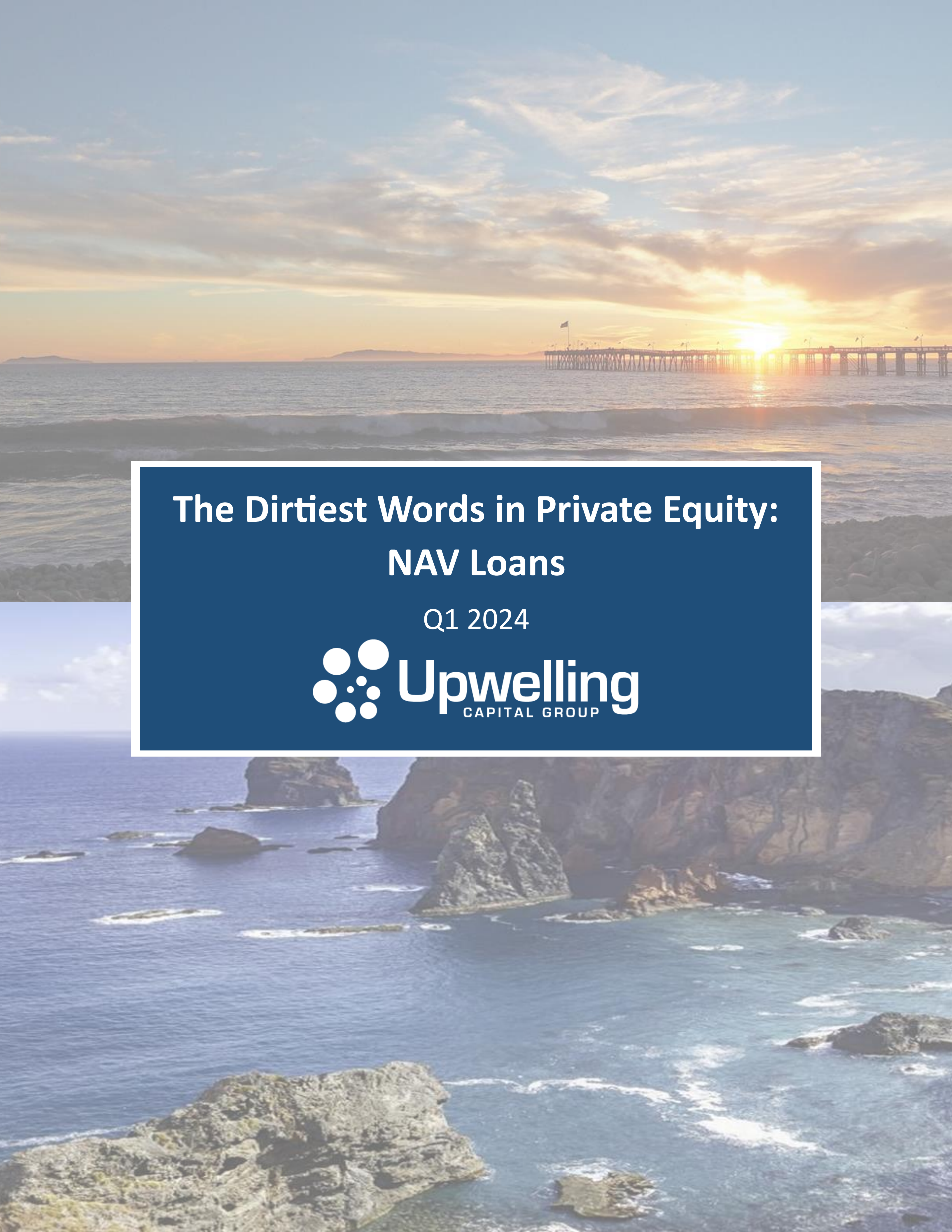


The Dirtiest Words in Private Equity: NAV Loans

Q1 2024

Upwelling
CAPITAL GROUP

The Dirtiest Words in Private Equity: NAV Loans

Q1, 2024

Overview

Over the last three years, average annual distributions for buyout funds between five and ten years old have dropped from 39% in 2021 to 13% in Q2 2023, the lowest distribution levels since 2009[1]. Decreased M&A activity, wide bid-ask spreads for secondary transactions, and increased financing cost for portfolio companies are the key reasons. Not surprisingly, private capital fundraising is down 14% year-over-year as of Q3 2023.[2] The confluence of these factors has led to a significant increase in fund level financings.

With these macroeconomic pressures restricting liquidity options, general partners ("GPs") are turning to NAV loans as an interim source of liquidity for limited partners ("LPs"). NAV loans are also used to refinance portfolio companies and to support existing portfolio companies with growth and acquisition initiatives.

With an estimated $80-$100 billion market value of NAV-based financings in 2023 and record volume of $35 billion in new deal flow for the first nine months of 2023, the private capital market is rapidly accelerating the adoption of NAV financings.[3] This growth is expected to continue, with projections estimating the NAV finance market could grow up to $700 billion by 2023.[4]

Stirring Up LP Sentiment

While many GPs see NAV loans as a valuable financial tool, there is a noticeable concern among LPs who believe that NAV loans can have a negative impact on the alignment of relationships between LPs and GPs. An estimated 54% of LPs see NAV financing and preferred equity as a poor way to generate liquidity.[5] As with all financial innovations, there are always skeptics:

"...it's just an effort to try and generate DPI…in my mind that's artificial"[6]

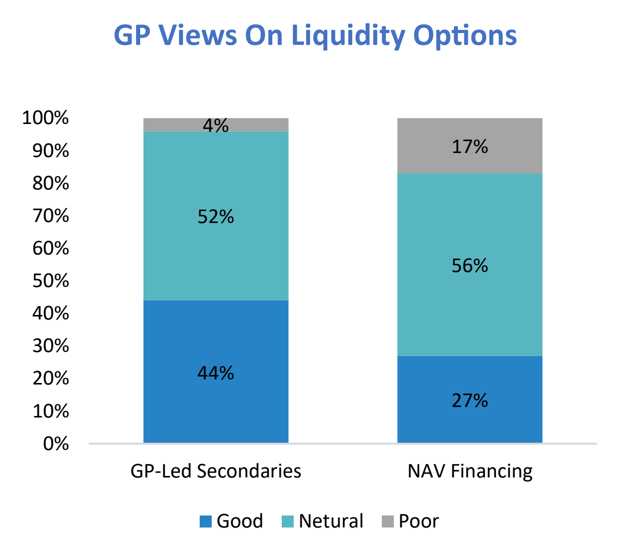
"…an oxygen tank for GPs…"[7]

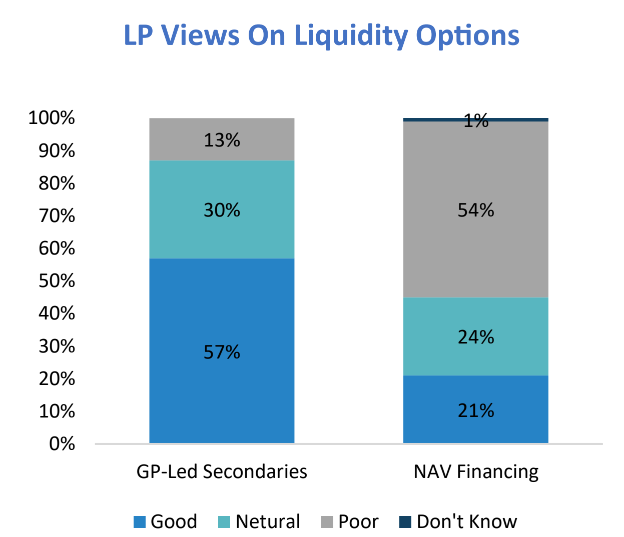
"Leverage on leverage"[8]

"…it feels like an unnecessary risk"[9]

[1] Pitchbook Data, Inc – Juliet Clemens, December 2023
[2] Pitchbook – "Q3 2023 Global Private Market Fundraising Report"
[3] Dave Philipp, as quoted by Amy Carroll, Private Funds CFO
[4] Greg Hardiman, as quoted by Amy Carroll, Private Funds CFO
[5] Capstone – Liquidity Solutions Survey 2023
[6] Secondaries Investor, September 2023
[7] Ana Marshall, as quoted by Capital Allocators, October 2023
[8] Andrea Auerback, as quoted in Institutional Investor, August 2023
[9] Greg Hardiman, as quoted by Amy Carroll, Private Funds CFO

Historically, subscription lines, originally used in real estate funds, were met with similar skepticism. Today, subscription lines are an industry norm. Despite the risks of additional leverage, subscription lines remain a prominent and viable financing option for GPs.[10] With regards to NAV loans, there are certainly alignment considerations to be evaluated, however these financings can be an effective solution during periods of illiquidity in the private equity market.





Source: Capstone Liquidity Solutions Survey 2023

What are NAV loans?

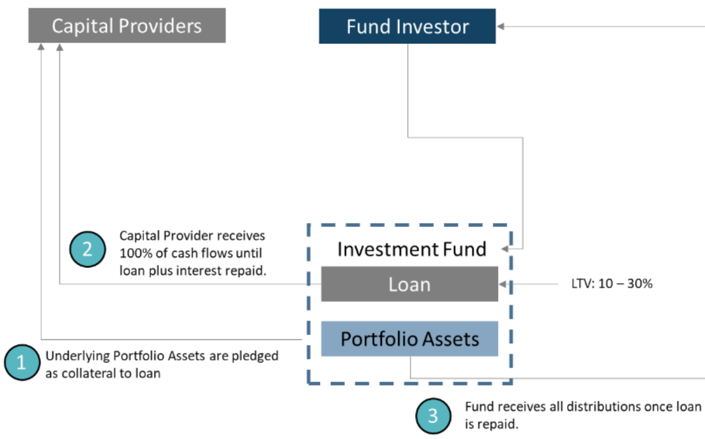
There are many words both profane and otherwise to describe fund-level debt, particularly NAV loans or preferred equity financings. Other types of fund-level financings include collateralized fund obligations (CFOs) and subscription lines. This paper will focus on NAV loans and preferred equity financings, which are typically used by GPs, with capital primarily provided by secondaries funds. It should be noted that many LPs provide commitments to these secondaries funds that are active participants in NAV loan financings.

	NAV Loans	Preferred Equity
Structure Type	Debt	Equity
Loan-To-Value Ratio	10% - 30%	30% – 50%
Term Length	3 years	5 years
Cost of Capital	SOFR + 4-7% PIK	10-15% PIK
Collateral	Secured	Unsecured
Minimum MOIC	1.2X - 1.3X	1.5X - 1.7X

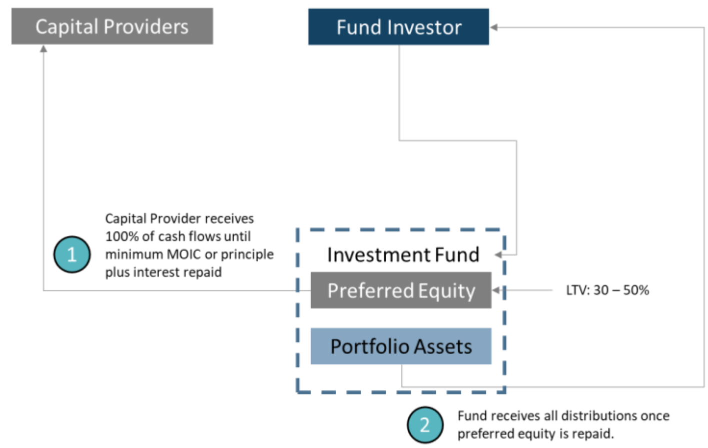
[10]Capital Allocators, October 2023

To protect against downside risk, NAV loans often have protective rights such as covenants, cash sweeps, LTV triggers, negative pledges, and veto rights. Preferred equity structures offer longer maturities and a higher advance rate with more flexibility, coupled with a greater cost of capital.

NAV Loans Structure



Preferred Equity Structure



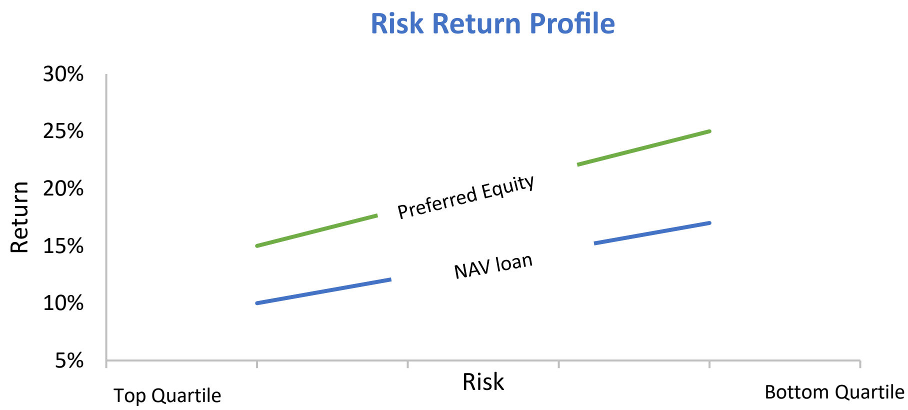
Performance engineering at its finest

Historically, NAV loans were used to improve returns for underperforming or tail-end funds by providing needed incremental capital. As the secondary market has grown, there has been increased specialization in certain strategies such as NAV loans. Accordingly, NAV loan investors have broadened their scope of capital deployment. In tandem with GP concerns about new fundraising, the NAV loan market has meaningfully increased in size, which has changed the characteristics of lending criterion.

Specifically, we believe that NAV loan providers today are focused on the following key criteria:

- Low Credit Risk – NAV loan providers focus mostly only on first and second quartile performing funds
- Diversification – Focus on larger capitalized funds with 15 or more portfolio companies
- Low Volatility – Focus on financing buyout funds which have generated more consistent cash flow (as opposed to Venture Capital)

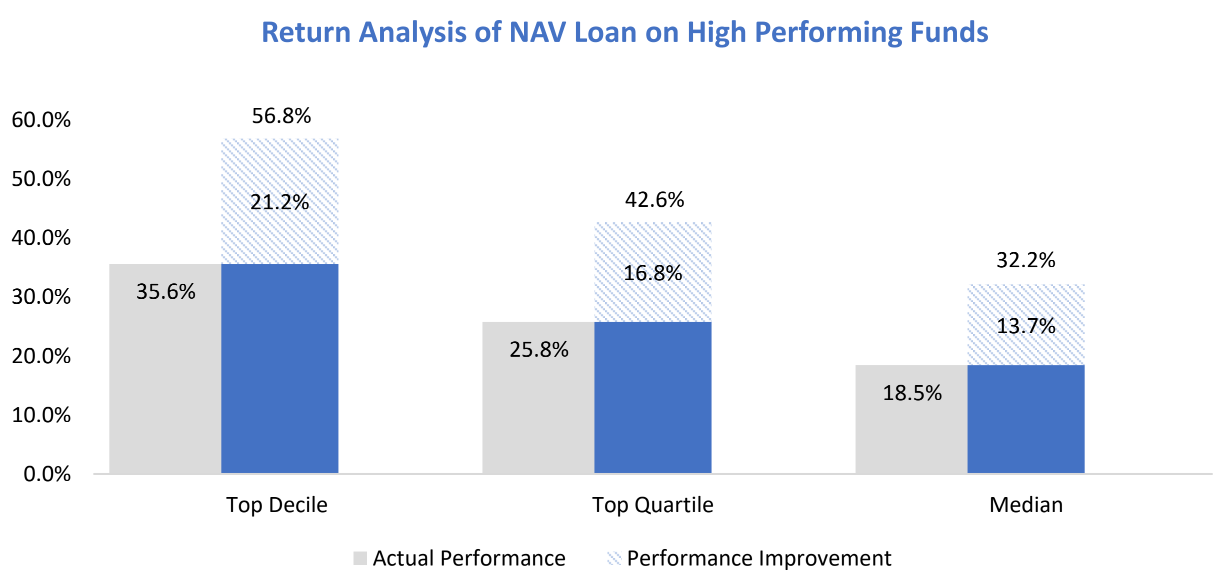
This has shifted NAV loan providers away from their historic focus of providing capital to tail end or underperforming funds as shown below:



Fund Performance Improvement

Why would a performing GP want or need to use a NAV loan?

As shown in the diagram below, a median GP can create returns that are almost top decile by utilizing a NAV loan financing. In a competitive fundraising environment, generating a top quartile track record has become critical.

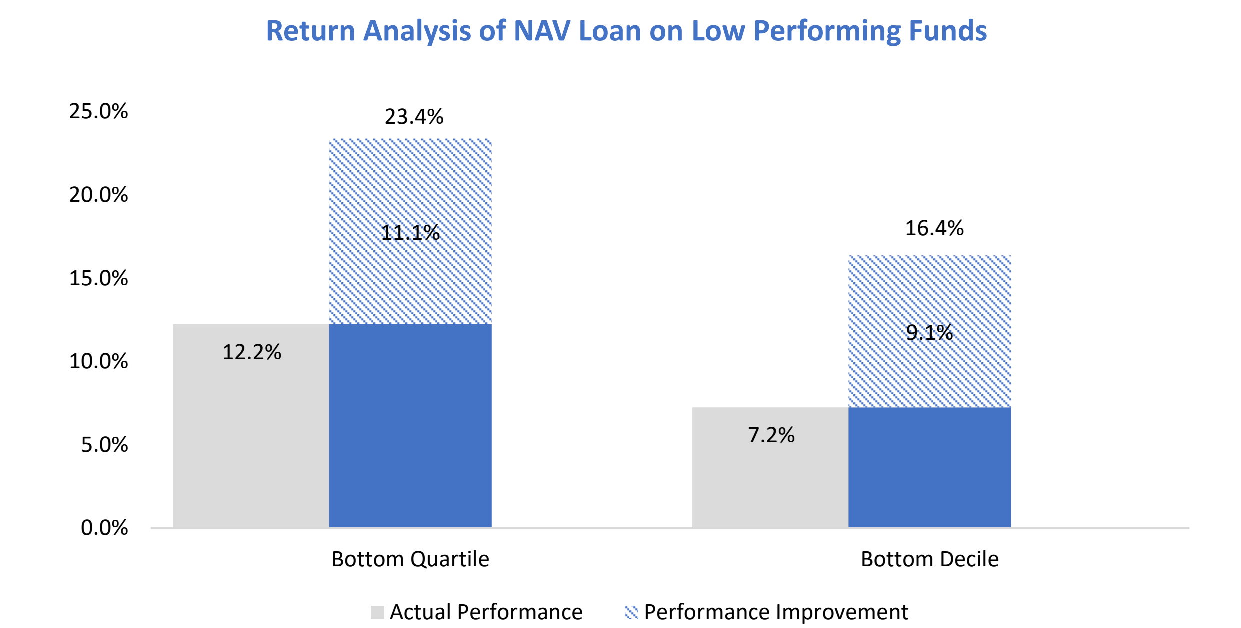


Upwelling estimates

Portfolio Performance Improvement

Are there any reasons why an LP would support the use of a NAV loan?

Used appropriately, NAV loan financings can enhance overall portfolio returns. As shown below, one can see why LPs benefit from NAV loans when utilized to support tail-end or underperforming funds. A bottom quartile fund's returns can be raised to a median performance as the cost of capital for NAV loan financing is meaningfully lower than the incremental return on new investments. It is unclear if LPs have any specific advantages other than higher returns when such structures are applied to median or top quartile GPs.



Upwelling estimates

Differing incentives create differing perspectives

NAV loans provide GPs with the flexibility to address the following:

- Provide additional investment capital either as follow-on investments in current portfolio companies or to make new acquisitions when there is no longer unfunded capital available
- Increase carried interest accruals or improve realized IRR track record through expedited distributions of capital to LPs (DPI)
- Provide liquidity to LPs without requiring the sale of underlying portfolio companies
- Operating capital for GPs who are in between fundraising cycles

LP Prospective

While the use of NAV loans by GPs has grown considerably in the last five years, many LPs have expressed skepticism at the use of these financings:

- Creates additional leverage risk beyond that at the portfolio company level
- Manipulation of performance through financial engineering at the fund level
- Lack of transparency – LPs have limited voice in the GPs' formation and use of NAV loans (LPAs generally allow for NAV loans to be used without LP consent)
- Cost of capital may exceed incremental returns
- NAV Loans may create misalignment with GPs
  - New investments beyond the original investment period may require fund life extension
  - New capital provider is senior to LPs; this may create misalignment if fund underperforms

Potential Benefits for LPs:

- Allows overcommitted or underfunded LPs to fund additional capital without having to sell assets on a secondary basis
- Generates interim liquidity for LPs interested in de-risking their original investment
- NAV loans have the ability to increase overall fund returns
- Does not force LPs to make an incremental investment outside their original fund commitment
- Avoids binary outcomes in situations where nonparticipation in follow-on round leads to substantive dilution

NAV loans continue to gain traction in the market. The adoption now extends beyond large, blue-chip sponsors and has trickled down to smaller managers and limited partners.

Best practices for NAV loans

For GPs:

To maintain a positive relationship with existing LPs and ensure a successful outcome, a GP should consider implementing the following best practices related to establishing NAV loans for their portfolios:

- Providing detailed rationale for the transaction in a timely manner
  - Proposed uses of capital
  - Whether executing an add-on or supporting an existing portfolio company with new capital, the GP should provide clear investment rationale on how the incremental investment upside demonstrably exceeds the cost of the NAV financing
- Ensuring an alignment of interest with LPs
  - Clarity on the NAV loan terms
  - Establish a budget for use of capital, with consent from the LPAC
  - No special economics to the GP from the NAV loan provider
  - GPs seeking NAV loans may consider establishing new LP-friendly carry waterfall
- Allow for LP feedback as a part of the NAV loan process
- Allow LPs to negotiate other changes to terms (i.e. limit extensions, ongoing management fees, other governance provisions if there have been interim changes in partnership)
- Track and disclose overall leverage at the fund and portfolio company levels

- Set reasonable term parameters:
    - Limit total leverage in the portfolio
    - Adhere to existing fund term (i.e., ten years), without elongating exit timing
    - Conservative advance ratios
- Track performance segmented on an unlevered and levered basis

For LPs:

- LPA should define the capacity of NAV loans and require certain consent rights, subject to specific factors
- Established limits related to the amount of NAV loan financing, perhaps in conjunction with overall fund leverage
- LPAC reporting and timely engagement as GP initiates NAV loan process

Separately, there has been a rise of LPs utilizing NAV loans to address their own liquidity challenges. These situations require a different approach, including structuring existing portfolio holdings into a collateral pool and have certain similarities to collateralized fund obligations (CFOs).

Ancillary Outcomes

With the increasing use of NAV loans and other forms of fund financings, the private capital industry would benefit from developing levered and unlevered set of performance benchmarks to account for the impact of these structures, which can materially impact quartile rankings.

If investors are uncomfortable with NAV loans, but there is a need for additional capital during the fund's life, perhaps continuation vehicles are a suitable alternative. CVs are generally unlevered vehicles and have evolved in their structures and formation protocols. This has been driven by investor feedback and new rules that are being established by the SEC. For instance, the regular use of independent third parties to advise on a CV formation process helps mitigate conflicts and improve investor transparency. Currently, LPs have more input in a CV process as compared to a NAV loan process. Consequently, we expect regulators will likely become more focused on NAV loans.

The Punchline

We do not expect NAV loans and other fund financings to fade away. Rather, consistent with the evolution of the private markets, GPs will continue to use such tools to enhance performance and create liquidity, particularly in more illiquid market environments. To improve market efficiency, it is important that solid ground rules are established in both the pursuit and execution of such transactions.

About Upwelling Capital Group

Founded in 2011, Upwelling Capital Group LLC ("Upwelling") is a registered investment adviser that provides customized strategies and solutions to enhance the overall returns for premier alternative investments. Upwelling specializes in providing secondary liquidity solutions across asset classes and capital structures. Principals have cumulatively overseen over $50 billion in global private equity commitments and have successfully managed over $5 billion in legacy, tail-end commitments, transfers, and workouts for leading institutional investors. Securities offered through BA Securities, LLC. Member FINRA / SIPC