E X P E R T Q & A

NAV lending is a useful addition to investors' toolkits, say Andrew Bellis and Patrick Lee of Partners Group

Greater transparency set to fuel further NAV growth

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Q What are the main drivers of growth in the NAV lending market today?

Patrick Lee: There are really three key drivers of growth in the NAV lending market. First is the underlying private equity industry growth, whereby we have seen the industry expand rapidly in recent years, and it is expected to continue to grow for the foreseeable future. NAV financing represents only a small percentage of private equity assets under management today, indicating that there is further room for growth in the space.

Increased market adoption is the second driver of growth. As private equity sponsors continue to learn about and better understand how these solutions work, and with increased transparency around transaction rationale and how these financings impact LPs, we expect new users to come to market and existing ones to continue using NAV financings.

Another driver of growth is product innovation, which includes moving beyond NAV loans at the fund level into considering other solutions to support GPs as they continue to grow their platforms and LPs as they look for new financing tools. NAV financing will be used in new and creative ways as the market continues to develop.

Andrew Bellis: For me, transparency for LPs is a really important driver of the next stage of growth in this market. The negative headlines that we saw about NAV lending in the past have now largely dissipated because users of NAV facilities are being more open with their investors about the loans they are executing and how they are using those proceeds. As GPs engage more with their investors, there is an overall market education that takes place, and LPs build their understanding of these tools as a means to create value for all sides.

Q What role does it play in the broader financing toolkit for both GPs and LPs?

PL: Both GPs and LPs already have a number of financing options available

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ANDREW BELLIS

Q How can NAV lenders most effectively deliver attractive risk-adjusted returns?

PL: The underwriting process is a good place to start. A lot of time is spent underwriting the manager and the underlying assets of the portfolio on these transactions. It is critical for lenders to know how well established the manager is, that there is a strong and stable team in place, and that there is strong alignment with investors and team. It is also critical for them to understand and assess the quality of the assets, reviewing their financial performance, leverage levels, valuation and liquidity outlooks.

Although these aspects are a primary focus, structure is also important for reducing the risk for NAV lenders. This can be achieved not only through conservative attachment points, but by also including covenants such as max LTVs and designing cash sweeps typically governed by portfolio diversification, LTV levels and duration.

NAV lenders have generated attractive risk-adjusted returns with low volatility, and that is mainly from a combination of the diversification of the underlying portfolios, strong covenants, partnering with best-in-class managers and visibility of exits from a relatively more mature portfolio.

to them and NAV financing simply broadens the toolkit. These are facilities tailored for GPs and LPs' specific needs.

For GPs, not only does NAV financing provide liquidity while allowing them to maintain the equity upside in their underlying investments, it also gives them additional flexibility to manage their portfolios, such as increasing investment capacity for add-on acquisitions, platform investments, refinancing more expensive debt, and, in less frequent situations, accelerating liquidity to investors.

The period during which NAV loans are usually used is when the portfolio is relatively mature, which is when subscription facilities tend to become less available. NAV loans are most relevant during the value creation phase, which typically starts in year five of a fund's life.

GPs can also use these tools to help grow their management company through what is most commonly referred to as GP financing or management company financing. These facilities can be used to help grow the platform through strategic initiatives like M&A or to augment the GP commitment. GPs can use NAV financing to augment their commitments to their funds, creating stronger alignment with investors.

For LPs, on the other hand, NAV facilities can be used as an alternative to a secondary sale. When LPs are looking for a flexible solution to generate liquidity, to rebalance their portfolio or to commit more capital to their high conviction managers, NAV financing has proven to be a very useful tool.

Today, we are seeing strong growth in the GP financing part of the market as the private equity industry continues to scale even during challenging fundraising environments.

It is worth noting that this is a tool that can be relevant across market cycles, both offensively to provide additional dry powder to fund add-ons and defensively to support more troubled assets.

NAV loans are also a great way to allow GPs to maximise their fund

deployment. Several managers invest around 80 percent of their fund size, reserving the remaining 20 percent for additional capital to support portfolio companies, such as add-ons, and for management fees. NAV loans can be used for some of that additional capacity, allowing LPs' capital to be closer to fully invested.

AB: On both sides of the market, there is just a real appetite for flexibility. GPs have multiple tools to finance at the company level and tools to get liquidity at the GP level, but the latter often involve the sale of an equity stake. For LPs, the alternative is to sell a position to generate liquidity. A NAV loan is just a more flexible product because it is portfolio level financing that does not require the giving up of an ownership position. It allows both GPs and LPs to hold onto investments that they want to keep and borrow against them rather than having to exit positions they would like to stay in for longer.

Q How does NAV financing create alignment between borrower and lender?

PL: Overall, the goal is to not transact necessarily with sellers but rather to partner with counterparties that want to maintain ownership in their high conviction assets and benefit from the upside. Given its senior position, NAV lenders get repaid before the underlying investors or GPs. This would naturally create some sort of franchise risk for the counterparty.

If a manager is looking to raise capital either for an ownership transition or to grow the platform, this is a non-dilutive and non-permanent way of achieving that. It allows GPs to essentially have more skin in the game, strengthening the alignment between the GPs and their investors.

AB: There is a natural alignment built into these products, and here I would go back to the transparency point. A lot of LPs were perhaps cautious because they felt like there wasn't the transparency around these transactions and therefore didn't like them, but that lack of transparency did not translate to misalignment.

When people understand why this is a useful tool for the GP, they tend to view it as a positive from an alignment perspective.

Q What is the attraction of this strategy to investors, and what are LPs looking for when allocating to NAV lending strategies?

AB: The attraction to investors is about being able to deliver those attractive risk-adjusted returns. If an LP is allocating to private credit, whether it has a small or a broad allocation, it is all about where the most attractive risk-adjusted returns are to be found. That is why some investors are looking to NAV, because what it offers is strong on the returns side. You can argue that the low LTV, diversified portfolio exposure and shorter duration all create a meaningful pick-up against more traditional direct lending private credit assets.

This does not appeal to all investors – it is typically not cash-paying, which is not preferred by some LPs that require cash income, but it is important to note that this does not detract from the ultimate returns. Further, in more credit-like NAV loans, certain LPs, typically insurance companies, want a rating on the loans, and this could make it even more attractive for those constituents as an investment grade rating is often achievable.

In terms of what investors are looking for from managers, they are really focused on investing with someone that can underwrite the GPs, so a manager who knows the GP ecosystem well and has relationships and historic contacts across the market. They also want someone that can underwrite the underlying assets on a line-by-line basis. This is not like a traditional credit because the underlying exposures are equity exposures, so an ability to look through the portfolios properly is critical.

Finally, there is a focus on structuring, where this is very different to traditional direct lending. These loans are much more bespoke and require a lot more knowledgeable structuring, which means investors talking to managers about NAV lending really need to look across all three of those components.

Right now, we are witnessing a definite pick-up in interest from the investor base around these products. There has been a bit of a wait-and-see approach, but there is now much more appetite for either allocating into NAV strategies to get exposure to private credit, or for allocating a part of a broader private credit allocation to these kinds of loans. We haven't seen the kind of supply and demand imbalance here that has been evident in other parts of the private credit market, so those risk-adjusted returns are perhaps a bit stronger here right now, with the secular growth drivers providing strong tailwinds. ■

> *"For LPs, NAV facilities can be used as an alternative to a secondary sale"*
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> **PATRICK LEE**

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