The Rising Popularity of NAV Loans

The current economic environment has called for partial liquidity alternatives that provide value for private equity firms and other fund managers. One of those alternatives, the net asset value (NAV) loan, is becoming increasingly popular as it offers flexibility and liquidity at a competitive cost of capital and is non-dilutive.

In this perspective, Lincoln International will explore what NAV loans are—including their structure, use cases and why they are a beneficial solution for both borrowers and lenders—as well as how they are valued.

NAV LOAN OVERVIEW & BENEFITS

At the fund level, NAV loans leverage the collective net asset value of a fund's portfolio as collateral and are an avenue to achieve liquidity in lieu of premature investment exits. NAV loans are repaid through asset exits, meaning when the fund sells investments, the proceeds are utilized to repay the NAV loan facility.

Structure

- **Amount** Lenders typically provide the commitment amount based on a percentage of a fund's net asset value. Terms including pricing will vary depending on the risk and diversity of the portfolio, manager track record and reputation, the leverage of the facility relative to the underlying NAV, etc. with loan-to-value (LTV) ranging from 10% to 20%.

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- **Margins** NAV loan margin rates can be either variable or fixed and are typically guided by market conditions, fund creditworthiness as well as other negotiated terms. The margin can be capitalized into the loan or paid periodically.

- **Terms** Terms vary and are influenced by market conditions and fund needs. The average term is three to five years, with several one-year extension options typically included as a structural feature.

- **Covenants** Covenants, or the restrictions and conditions outlined in the governing loan agreement, often include financial performance metrics (typically based on LTV), limits on additional indebtedness and additional terms that protect lender interests.

- **Margin calls** Many loan agreements include margin call provisions such that if a fund's portfolio doesn't meet covenants, the lender requires the fund to repay part of the loan or provide additional collateral.

- **Collateral and security** As the NAV loan collateral is the fund's portfolio, the lender takes a security interest in the portfolio to mitigate risk with additional protection often included in the form of a corporate or personal guarantee from the fund manager.

- **Purpose** The loan agreement will outline the intended use of the proceeds which include, but are not limited to, growth capital, bolt-on acquisitions, or distributions to limited partners.

Borrower Benefits

1. Access capital without selling investments, enabling more time for managers to enhance portfolio values.
2. Maintain investment strategy and avoid forced liquidation.
3. More flexibility and can be utilized for a variety of purposes, outlined in the use cases below.
4. Mitigate the potential negative impact of selling in an uncertain market with potentially unfavorable returns.

Lender Benefits

1. Offer security in the form of a perfected right to collateral.
2. Diversify collateral base beyond typical assets.
3. Ability to liquidate and quickly recover investment.
4. Increased flexibility in loan terms.
5. Receive regular, stable income from interest payments.

Borrower Use Cases

1. Finance a portfolio company refinancing or bolt-on acquisition.
2. Enhance fund internal rate of return.
3. Bridge an investment to a liquidity event.
4. Support investments with negative cash flow by creating additional runway to enhance value.
5. Offer liquidity to limited partners (LPs) through distributions.

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VALUING NAV LOANS

When ascribing the fair value for NAV loans, Lincoln conducts a qualitative and quantitative analysis of the collateral structure, as outlined below.

General Investment Considerations	<u>Fundamental analysis:</u> • Review investment thesis, risk factors, strategic initiatives and management outlook, ongoing borrower and collateral reporting • Assess relevant industry information, including pertinent research reports for the collateral <u>Investment specific analysis:</u> • Analyze relevant documents, including credit agreements, trust agreements and prospectuses etc., to develop an understanding of the rights and economics of each instrument • Examine performance history of the underlying collateral pool as well as other similar collateral to inform key assumptions • Evaluate whether the investment is performing and is sufficiently covered by collateral • Assess the collateralization and enhancement levels within each structure using the most recently available data
Collateral Forecasting	<u>For performing collateral:</u> • Forecast collateral cash flows and expected compliance and triggering events, as applicable, based on the underlying collateral and latest, most reliable information available <u>For special situations / impaired investments:</u> • Project collateral cash flows utilizing a scenario-based approach considering multiple outcomes and market participant solutions • Consider proforma restructuring or take-outs, as applicable
Discount Rate Considerations	• Evaluate transaction implied discount rate, using market participant assumptions for collateral performance and private insights from Lincoln's proprietary database • Adjust for observed changes in both general market inputs as well as investment-specific aspects of the discount rate build-up, with consideration given for debt to capitalization of the business, additional perceived risk of the asset as well as any other applicable considerations • Modify for changes in performance relative to expectations and other similar instruments • Consider relative pricing to public asset-backed security transactions using market color collected from new issuance pricing, bid wanted in competition activity, dealer offering sheets and research • Assess the reasonableness of the overall discount rate implied by analysis relative to rates on comparable instruments

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Lincoln Perspective

While NAV loans are a favorable alternative solution, it is important to structure and value them soundly and consider the associated credit risk of both the collateral and the borrower when pricing and constructing the proper bumpers in the form of covenants.

Working with a trusted advisor, such as Lincoln International, is crucial when navigating this alternative as properly structured NAV loans can create value and benefit all parties.

LEARN MORE

If you would like to learn more about NAV loans and whether you are well-positioned to access this alternative, please contact a member of our capital solutions team (listed below), which is supported by our Capital Advisory, Private Funds Advisory and Valuations & Opinions Groups.

For other perspectives, visit us at www.lincolninternational.com/perspectives.

Get to know Lincoln's Capital Advisory Group at
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