EXPERT COMMENTARY

Market downturns caused by a tightening credit cycle should continue to boost demand for NAV lending, says Crestline's Dave Philipp

Fund finance in a downturn

How will an economic downturn affect NAV lending? What about rising interest rates? Understandably, there is an ongoing downturn debate in the fund finance industry. Economic downturns that stem primarily from an increase in interest rates and overall capital cost have different effects on market participants with access to dry powder, versus those that do not. This is true for companies, funds and LPs. Companies with access to dry powder are better positioned to source good acquisition opportunities and are more resilient during performance challenges.

Funds that have access to dry powder can grow their companies and make attractive investments, often at the expense of co-investors that don't have similar liquidity available. Meanwhile, LPs that have access to dry powder can take advantage of dislocations and potentially generate outsized returns.

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NAV loans can be thought of as dry powder generators for fully deployed funds that can borrow against current holdings. The value of this liquidity without having to sell existing assets is at its highest during economically challenging environments, whose intrinsic value benefits both borrowers and lenders.

Expanding opportunities

Identifiable market implications are driving demand and expanding the opportunities in NAV lending. Regulatory policies designed to combat inflation have direct implications on all aspects of the private equity market, driving increased demand for NAV lending against a wide use of cases.

1. **Economic downturns affect investment performance, depress M&A activity and extend holding periods**. During economic downturns, portfolio companies often experience lower or negative topline growth, higher employee turnover and less ability to grow through market expansion. This performance affects valuations, credit availability and the desire and ability for private capital to exit their investments. In turn, lower valuations slow M&A activity due to the value expectation gap that is created between business owners and potential buyers.

Meanwhile, extended hold periods at PE firms delay distributions to investors and reduce the amount of recyclable capital available to maximize value within their portfolio. NAV financings are being used to accelerate distributions to LPs and actively support and grow existing holdings.

2. **Difficult fundraising environment**. A pullback in public market valuations, alongside lagged PE valuations, is creating a denominator effect. This is compounded by the fact that while PE valuations remain elevated, asset sales and corresponding distributions are down, further limiting LPs' ability to commit to new funds. Sponsors have been historically active in borrowing capital from fund finance platforms to facilitate portfolio level recapitalizations and distributions to bridge this liquidity and enhance DPI.

   With the uptick in rates, the path to manufactured liquidity becoming less attractive. To complement or replace the recapitalization trade, we are seeing sponsors delaying fundraising and borrowing capital to continue investing out of existing vintages until the fundraising environment reverts to a friendlier climate.

3. **Painful refinancing environment**. The most direct and intentional implication of recent US Federal Reserve policy to hike interest rates is to reduce credit availability. This tightening credit environment is causing consternation with sponsors that are worried about potential terms, or even availability of credit, to refinance upcoming asset level debt. To counter this uncertainty, sponsors are borrowing capital at the fund level and downstreaming it to individual portfolio companies as new equity injections to placate lenders for better terms.

4. **Liquidity mismatch in private asset portfolios**. Many investors (fund of funds, foundations, family offices and others) built portfolios overweight in private assets to capture liquidity premiums and less correlated returns. Often, these portfolios are designed to satisfy capital calls from newer vintages with distributions from fully invested earlier vintages.

   Due to the lack of asset sales and realizations described above, portfolio managers are finding that capital calls are outpacing distributions. Rather than sell assets at depressed valuations, many groups are seeking bridge capital from fund finance platforms to meet their commitments.

As fund finance has evolved over the last decade, the market has gone from a niche product to a true portfolio management tool, essential to the operating business of sponsors.

Subscription lines of credit have long provided clarity in the cadence of capital calls while being accretive to the overall return profiles of the managers. NAV-based financings offer flexible capital with a varied use of proceeds that can provide stability during times of volatility and cost-effective leverage to grow business in a normalized investing environment. ■

Dave Philipp joined Crestline in 2013 and is a partner in the fund liquidity solutions group, a senior portfolio manager and a member of the ESG Committee

Additional considerations for lenders, borrowers and investors

Four best practices aimed at mitigating the risk of closing a NAV financing

Both fund finance borrowers and lenders must appreciate the current environment and acknowledge there could be greater than normal systemic risks, such as pricing volatility, as well as company-specific risks, such as refinancing risk.

Here are four key aspects to consider:

1. **Informed underwriting**. Working with a sponsor to understand any imbedded risks and thinking through structural protections and collaborative solutions is more important than ever.

2. **More syndicated deals**. The demise of SVB, FRB and Signature took almost everyone by surprise. Consequently, sponsors are proactively trying to build syndicates comprised of bank and non-bank lenders for greater surety of execution and stability of capital.

3. **Potential conflicts**. As more lenders enter the fund finance space, investors and borrowers need to remain vigilant around potential conflicts of interest, especially where the fund level lender is also lending to underlying portfolio companies or is an LP in the fund.

4. **Flexible structuring**. The most effective NAV loans are those that fill a very specific and highly accretive need and are beneficial to all stakeholders. This often requires a tailored transaction rather than a one-size-fits all solution.