Crestline Portfolio Finance

Is NAV Lending Good or Bad for GPs and LPs?

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Crestline Investors, Inc.

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Nav Lending Transaction Types, Use Cases and Key Considerations

As the material slowdown in private equity exit activity has thrust NAV lending further into the spotlight, the dynamics around this new point of leverage into the system has attracted new scrutiny. The concerns primarily circle around financial engineering (pouring more leverage into an already levered portfolio), issues of alignment between Limited and General Partners and potential conflicts between borrowers and lenders. While these are extremely valid concerns, NAV loans encompass a wide range of transactions with differing use cases and therefore should not all be viewed through the same reactionary lens. The use of proceeds, motivations of the borrower and affiliations between stakeholders should all be carefully considered.

Crestline has been an active NAV lender since 2015 and has led more than 50 financings to PE sponsors. During this time we have seen an incredible amount of market growth and evolution, but have also noticed three persistent transaction types defined by their respective use of proceeds. In our opinion these subsets of NAV loans should attract differing levels of scrutiny when participants are considering both financial engineering and alignment.

- **Type 1 – "Distribution Trades".** These are transactions designed to provide early distributions to LPs through a portfolio level recapitalization rather than through asset sales. Such trades are often the most difficult to calculate the net impact across stakeholders (due to each LP having their own desire for synthetic liquidity) and deserve the most scrutiny. Such trades clearly add new leverage on top of an existing portfolio, potentially provide more benefit to a GP (enhanced DPI metrics, better economics, capital that will be committed into a future fund) than to LPs, and possibly force some LPs to pay for a synthetic distribution whether they like it or not. Such transactions should be led by LPs, require a stringent consent process and possibly offer a structured solution or offsetting reinvestment option to neutralize the costs for LPs that don't want manufactured liquidity.

- **Type 2 – "Refinancing Trades".** The proceeds from such trades are used to refinance asset level debt and can act as a capital bridge for assets that need time to attract better financing terms due to company specific performance or general market conditions. These financings are generally not adding any new leverage into a portfolio but rather are shifting debt exposure from individual underlying assets up a level to the fund. These trades should be evaluated based on whether the fund level financing offers sufficient flexibility and pricing advantages to justify the cross collateralization inherent in a NAV loan. The economics and outcome of refinancing trades are shared much more equally between all parties and GPs should be in a position to identify and articulate the benefits to their LPs.

- **Type 3 – "Re-investment Trades".** NAV loans whose proceeds are used to support existing positions or acquire new assets do add more leverage to the portfolio, however, they also offer an increase in the equity value of the fund. In addition to financing new assets or bolt-on acquisitions, these trades can also include rescue financing or protective investments designed to salvage prior invested capital, or more complicated trades like buying back LP units or co-investors. Such transactions should be evaluated based on the expected net accretion to the fund over time (cost of the loan vs value uplift in portfolio value) and should also impact all of the stakeholders more fairly than a distribution trade.

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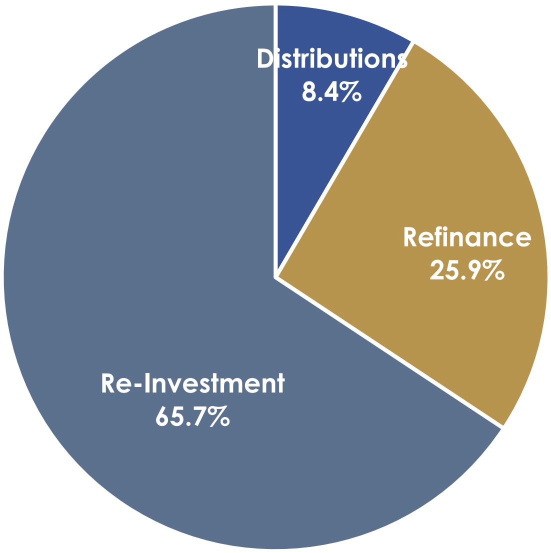
The chart below shows the Use of Proceeds for all the NAV financings completed by Crestline over the last 8 years:

Crestline Trades: Use of Proceeds[1]



In our opinion, bridge loans that deliver new capital for reinvestment into portfolio companies ("Re-Investment" or "Refinance" trades) add less "net" leverage into a fund and does not weaken GP/LP alignment. Such trades also offer the ability to add significant uplifts in portfolio value through accretive opportunities, but should be kept to relatively short-term exposures.

"Distribution Trades" offer more room for scrutiny around financial engineering and a breakdown of LP/GP alignment. Such trades represent less than 10% of Crestline's trades since inception of our NAV lending strategy and included additional uses embedded in a transaction and/or a reinvestment option for LPs that did not want to receive synthetic liquidity.

Potential conflict of interests with a NAV loan are also a valid concern. As new lenders enter the market from adjacent strategies, concern around the relationship between parties has also grown. This is particularly true when a potential NAV lender is also a Limited Partner (especially if they hold a role on the LPAC), an affiliate or minority owner of the sponsor or even an existing lender to one or more of the underlying portfolio companies. Potential conflicts can arise for both the LPs of the lending institution and the borrowing institutions if there are crossover relationships. Crestline believes that we are in a strong position to avoid conflicts of interest as we do not have a sister strategy that makes primary or secondary allocations to PE funds as an LP, we do not purchase stakes from sponsors, and we have not made a loan to a fund where we have exposure as a lender to an underlying company (nor have we made a loan to company in a portfolio where we have a fund level loan).

Much of NAV lending's appeal, and consequently its recent growth, is in its flexibility and wide range of potential applications. Like pretty much all forms of leverage, NAV loans can either help or hurt the outcome of an investment depending on how it is deployed. Paramount to the continued success of the NAV loan market is transparency and informed discussions with all stakeholders so they can properly evaluate an individual transaction in the context of the current environment and portfolio specific dynamics (needs and opportunities).

For more information on specific transactions that Crestline has led, please contact us directly.

[1]The Use of Proceeds data in the above pie chart is across 53 Crestline Portfolio Financing deals.