NAV Facilities for Guernsey Funds: What's the noise about?

Briefing Summary: As late as 2022, the net asset value ("**NAV**") credit facility was seen as a relatively underutilised sector of the fund financing product offering. However, the interest and demand for NAV facilities has sharply increased with sponsor borrowers wishing to take advantage of the benefits that NAV facilities can offer in the current fund raising and M&A environment. Here, we highlight some of the key features of NAV facilities and the main advantages that can be gained from their use.

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What is a NAV facility?

A NAV credit facility is a type of term or revolving credit facility where one or more (i.e. they can be offered on both a bilateral or syndicated basis) banks or alternative lenders provide lending/credit to a fund or its subsidiaries, the LTV ratio and collateral requirements for which are based on the NAV of the fund's portfolio of investments. This contrasts with the more widely utilised subscription line or capital call facilities which look to the uncalled/undrawn commitments of the fund's investors as the collateral for the facility. Private capital funds will look to NAV credit facilities at the end or near the end of the fund's investment period when it has typically utilised/drawn down the majority of its investor capital commitments. In this scenario, funds are typically not able to access subscription line facilities because they do not have sufficient remaining uncalled capital commitments from investors to allow for either the requisite amount of borrowing or indeed the purpose of the borrowing does not meet lender criteria.

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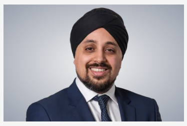

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Key distinction between NAV facilities and subscription line facilities

The key distinction between a NAV facility and a subscription line facility is that a NAV facility looks down the structure to the underlying investments of a fund and/or the associated distributions, cash flows or other amounts received from those investments, as the main collateral and risk basis for the credit facility, whereas a subscription line facility looks up to the uncalled capital commitments of investors in the fund. The investments of the fund are therefore seen as the primary source of repayment in a NAV facility in contrast to a subscription line facility where uncalled capital commitments of investors in the fund form the basis of the collateral.

The NAV facility market

The increased use of the NAV facility product is attributable, at least in part, to the recent macro-economic conditions (e.g. global occurrences such as the pandemic and regional conflicts) in which the ability to properly value and hence buy, and more importantly sell, assets has hampered exits for investment funds. This in turn has impacted the liquidity for their investors. The NAV facility market has accelerated as a result by providing a liquidity solution for sponsors needing or choosing to hold good quality assets for a longer than normal period, while awaiting a more favourable environment for exit opportunities.

NAV lenders have mainly been traditional bank lenders, but as the market has accelerated there has been increasing interest from a considerable number of alternative lenders such as private debt funds. The key points of difference between the two types of lenders, i.e. the sources of their debt financing capability, approaches to risk, and general comfort with and understanding of the collateral, has enabled borrowers to obtain financing solutions that are more bespoke to their specific needs. On the other hand, the advent of the rating of NAV loans has allowed access to a new asset class for debt funds with an institutional (and, in particular insurance, company and pension fund) investor base.

Key considerations of NAV facilities

While the NAV facility solution has become far more "*commoditised*" than previously perceived, the differing types of lenders, borrowers and underlying assets in the sector mean that there will inevitably be a variety of factors to consider when structuring and documenting a NAV facility. Some of these considerations include:

- Security package – the nature, breadth and form of the security package is a key component and will very much depend on the type of assets and how they are held by the borrower;
- Cash sweeps/repayments – how much of the cash flow/distributions from the collateral assets will be used to pay down the facility versus being available for distribution to the borrower's investors can vary;

- LTV - the maximum permitted LTV ratio is a key metric of a NAV facility and the nature and sensitivity of the LTV triggers will vary (depending on factors such as the lender and the ability to value relevant assets); and
- Portfolio concentration and holding structure – most lenders require a minimum number of assets/diversity in the portfolio, and that the assets are aggregated in a holding structure so as to allow a clear and easily accessible security package in an enforcement scenario.

NAV facility rationale

The rationale for using a NAV facility can be wide and varied, and ranging from the specific needs of the fund/sponsor in question relating to the life of the fund and the assets held by the fund to a specific need for liquidity. Examples of NAV facility usage include:

- Injecting liquidity into existing portfolio companies where other financing is not available or is only available on more onerous or expensive terms (which is particularly apparent in the current high interest rate environment).
- To finance add-on acquisitions and follow-ons, particularly near the end of a fund's life, in order to maintain and even enhance both individual asset and overall fund performance.
- To refinance more expensive existing asset-level debt.
- To provide some element of liquidity to a fund's investors in the context of elongated hold periods on high quality assets pending more favourable exit opportunities.
- Where private credit funds as lenders are attracted to the enhanced margins of NAV facilities and insurance companies are increasingly more willing to access the asset class as lenders as these are often term loans with longer tenors which can now be rated.

Summary

The investment fund world has been and continues to navigate considerable headwinds. the causes of which are wide ranging and much discussed. The resulting context is a current scenario of, on the one hand, more difficult and longer fund raising, and on the other, somewhat depressed M&A activity resulting in elongated hold periods on what are in a more "***normal***" economic environment high quality assets. NAV facilities have therefore come to the fore as a useful tool in dealing with some of these difficulties. The expansion of the pool of willing lenders (by the entry of alternative lenders) has provided not only the impetus for use but also the ability to tailor the offerings to the specific needs of a wider range of borrower funds.

Carey Olsen's expertise

- We have advised on numerous NAV financings in the last 12 months, acting for a mix of both sponsors and lenders. This experience has given us an understanding of the requirements and key considerations of both lenders and investment funds/sponsor borrowers and, as such, we are well placed to identify and help deal with any potential issues that may arise in NAV financings at an early stage and ensure the transaction runs smoothly.

- The strength of Carey Olsen's investment funds practice (Carey Olsen advise over 81% of the entire Guernsey-domiciled fund market by assets under management and nearly 74% by number of Guernsey-domiciled funds), has provided us with a unique insight into the interrelation between the fund and any financing solutions. We can advise funds at their formation stage on the potential future use of NAV financings and other fund finance solutions.
- Along with our experience on advising on NAV financings, we have advised on numerous continuation vehicles for globally recognised fund managers so can provide advice on whichever liquidity solution a fund requires, particularly in end of fund life type scenarios.