NAV financing: How managers can leverage private credit flexibility

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1. Market conditions aren't easing, so investment managers need more tools to better manage their portfolios

2. NAV financing allows managers to effectively manage the cash flow requirements for their funds

3. It delivers liquidity and flexibility advantages, but these need to be balanced with risks

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NAV financing and private credit once lived in relative obscurity. However, ongoing geopolitical and market uncertainty means fundraising has remained difficult, leading fund managers and investors to find innovative solutions. This has been instrumental in thrusting NAV financing and private credit firmly into the spotlight. Francesca Raffa explains why.

Challenging market conditions generally mean fund managers and investors need flexibility to deal with any liquidity issues which may arise. Step forward NAV financing, which has grown significantly over the last few years and become a vitally important tool for private market fund managers.

So, what exactly is NAV financing?

In simple terms 'net asset value' or NAV financing allows private equity managers to take out loans secured against the underlying assets in their portfolios, which can be especially useful in efficiently managing the cash flow requirements of the fund.

Private equity firms can lean on NAV financing to provide cash injections to struggling portfolio companies – something that became particularly helpful during the Covid-19 pandemic, when other areas of liquidity dried up. NAV financing can also be used to bankroll portfolio company growth opportunities or to enable distributions to investors.

As market participants have battled against dogged high inflation, spiking debts costs and large falls in fundraising, NAV lending has stepped forward as a vital tool for sponsors and investors, becoming an agile stopgap.

Why is it being used more within private credit?

The answer to that lies more within the spectacular growth of the private credit market, which has ballooned over the last 20 years, particularly in the aftermath of the global financial crisis (GFC).

In the wake of the GFC, banks curtailed their lending to repair their own balance sheets, allowing non-bank lenders to step in and fill the funding gap that was left behind. The result has been a formidable spike in private credit assets, with the latest figures from EY and Preqin showing the market will almost double in size from what it was at the end of 2022, to $2.8tn by 2028.

As the private credit market has grown, so too has its reliance on NAV financing, which has proven to be a very handy and useful tool for investment managers.

What are the benefits of NAV financing?

In both Europe and the U.S. there has been an uptick in the use of NAV financing facilities by general partners (GPs) as other sources of capital have become harder to access.

Those other sources of capital, which include loans from banks, can also prove more expensive depending on how a loan is structured and can lack the flexibility of terms that an investment manager wants or needs.

A number of factors have increased market volatility, among them being Covid-19 pandemic aftershocks, higher inflation leading to higher interest rates, a slowdown in the Chinese economy, Brexit, election surprises as well as geopolitical instability with the conflicts in the Middle East and Ukraine as well as elsewhere.

To manage the market volatility that these factors create, investment managers need to be equipped and have the flexibility at the ready to capitalise on growth opportunities and deliver on investors' liquidity needs as and when they arrive.

However, NAV lending has its risks. It obviously increases leverage in the fund and alters the way in which risk needs to be assessed. Also, if a fund were to run into trouble and was wound up — which is rare — investors are paid out after NAV lenders, which are higher up in the capital structure.

In summary NAV financing offers benefits in two main areas: liquidity and flexibility.

Liquidity

- There has been a tightening of lending standards by banks to defend their liquidity positions and this pullback is an opportunity for private lenders. Fund managers do not want to call money from investors too early or too often, so a bespoke NAV financing loan allows the manager to give money back to investors without compromising investments that are not ready to be liquidated.
- NAV loans are also a quicker route to liquidity as they are easier and speedier to execute than a traditional secondaries sale. Transferring a book of 25 to 50 LP (limited partner) interests can easily take months to complete but, with a NAV loan, transactions can be completed in six to eight weeks.

Flexibility

- NAV financing can be leaned on to protect portfolio company positions, where asset-level financing is not available. NAV financing delivers options for GPs and LPs in tough fundraising environments as well as when markets are unpredictable.
- The loans can be used for follow-on investments, investment restructuring or for liquidity where other forms of debt-financing have less attractive terms.

It's an exciting time for NAV financing, which has moved on rapidly from being a concept that private equity managers were once just talking about, to something they are now readily using. Indeed, 17Capital have projected that NAV financing volumes will rise from $100bn to $700bn by 2030, while private credit lenders see it as a strategy to lend to their private equity colleagues.

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