

NAV FINANCING

A Deep Dive in Fund Finance

What is NAV Financing?

NAV financing is **a borrowing facility that allows funds, especially private equity funds, to raise capital using their Fund Net Asset Value (NAV) as collateral**, unlike subscription lines, which are secured against uncalled investor commitments.

This approach **provides fund managers with liquidity once most capital is deployed**, enabling them to meet cash needs or pursue new opportunities.

Fund managers may also use NAV financing when a fund is underperforming, **deploying borrowed capital to support struggling investments or chase returns**.

However, adding this "leverage on leverage" can increase systemic risk, potentially overleveraging the fund's structure and affecting limited partners' interests.

While NAV financing offers flexibility, it also brings risks. Regulators have voiced **concerns about transparency and financial stability** when funds, particularly those under stress, rely heavily on this strategy.

How Does NAV Financing Work? (I)

01 THE STRUCTURE OF NAV LOANS

NAV loans are secured by a fund's portfolio assets, offering funds liquidity options as they approach later stages in their lifecycle.

These loans are structured to provide flexibility through two main formats:

- **Revolving Credit Facilities:** Enable funds to borrow, repay, and re-borrow as needed, allowing for flexible cash flow management.
- **Term Loans:** Provide a specific loan amount that is borrowed once and repaid over a set period.

Additional features of NAV loans:

- **Interest Rates:** Typically floating, meaning they fluctuate with market conditions, though fixed-rate options may also be available.
- **Repayment Flexibility:** Funds can repay NAV loans through various mechanisms, such as:
 - Dividend recaps
 - Asset sales
 - Other liquidity events within the portfolio

How Does NAV Financing Work? (II)

02 NAV FACILITIES AND THEIR COMPONENTS

NAV facilities generally include several key components that determine borrowing capacity and terms:

- **Loan Amount:** Based on the Net Asset Value (NAV) of the portfolio and subject to an LTV (loan-to-value) ratio.
 - Example: With a 20% LTV ratio, a fund with \$200 million NAV can borrow up to \$40 million.
- **LTV Ratio:** Governs the maximum loan amount as a percentage of the portfolio's NAV, ensuring a controlled level of leverage.
- **Interest Rate:** Typically pegged to a benchmark rate (e.g. LIBOR or SOFR) plus a spread
- **Covenants:** Lenders may impose specific conditions, such as:
 - Maintaining a minimum NAV level
 - Restricting certain asset sales without lender consent
- **Maturity Date:** NAV loans are shorter-term compared to traditional loans, generally maturing within one to five years, fitting the needs of funds seeking temporary liquidity without long-term debt obligations.

Comparing NAV Financing Options

NAV financing comes in different forms, and **fund managers must choose the most suitable option based on their objectives**. Here’s a comparison between two main types of NAV financing:

TYPE	DESCRIPTION	USE CASE
NAV Term Loan	A lump sum loan repaid over a fixed period	Ideal for specific funding needs such as recapitalizations or distributions to investors
NAV Revolver	A revolving credit facility that allows for flexible borrowing and repayment	Suitable for ongoing liquidity needs or unforeseen expenses

Each option has distinct benefits, and fund managers need to assess the flexibility, cost, and risks involved in each to make an informed decision.

What Are the Benefits of NAV Loans?

NAV financing provides **several advantages** for funds seeking liquidity solutions, **particularly when other funding avenues may be exhausted**. Some of these benefits include:

LIQUIDITY ADVANTAGES

NAV loans provide **immediate liquidity without forcing asset sales**, allowing funds to meet short-term needs while preserving long-term growth. This liquidity supports portfolio firms, follow-on investments, or capital returns to investors.

BOOSTING IRR

NAV loans provide liquidity to PE funds despite long lock-up periods. They bridge cash flow gaps, allowing **smooth distributions, pursue growth, and enhance IRR**. This enables timely capital returns, supporting investor satisfaction while maximizing long-term value.

IMPACT ON FUND STRUCTURE AND DISTRIBUTION

NAV financing can affect a fund's structure and distribution schedule by enabling **earlier returns to investors through loan proceeds** instead of waiting for exits. This flexibility boosts investor confidence and can lead to increased future capital commitments.

Additionally, NAV financing **allows managers to diversify their funding sources**, strengthening the fund's overall financial structure. However, it is crucial to balance the advantages of liquidity with the risks associated with leverage.

What are the Risks of NAV Financing?

Market Trends Affecting NAV Loans

NAV loans are influenced by market conditions - a drop in portfolio valuations can reduce a fund's NAV and borrowing capacity. In severe cases, this may trigger loan covenants or require early repayment of the loan. Additionally, **variable interest rates can increase debt servicing costs**, especially during periods of rising rates, which is a significant risk amid tightening monetary policies aimed at controlling inflation.

Understanding the LTV Ratio in NAV Financing

A key risk in NAV financing is associated with the **Loan-to-Value (LTV) ratio**. If asset values decline due to poor portfolio performance or market factors, **the LTV ratio may become misaligned**, forcing the fund to reduce borrowing or repay parts of the loan, which can strain liquidity. Additionally, **lenders often include margin calls in agreements**, requiring funds to provide more collateral or reduce loan balances if NAV falls below a certain threshold, further stressing cash flow in volatile markets.

Due Diligence: What NAV Lenders Look For

Before extending a NAV loan, **lenders assess the fund's risk profile** by evaluating asset quality, diversification, performance history, and exit opportunities. They also **review the management team's experience** and may request financial reports and stress tests to evaluate portfolio performance. Fund managers can enhance their chances of securing favorable loan terms by **being transparent and proactive**, as building a strong, trust-based relationship with lenders is vital for ongoing access to NAV financing.

How to Execute NAV Financings?

Successfully managing NAV financing requires **careful planning, a clear understanding of risks, and strategic decision-making**. Here are some key considerations for fund managers looking to leverage NAV credit facilities.

FUND SPONSORS

Fund sponsors must **develop a clear strategy** by aligning loan structures with investment goals and timing borrowings with expected liquidity events. **Keeping a buffer in the LTV ratio** is crucial to avoid margin calls, and proactive risk management through stress testing can help ensure solvency in challenging market conditions.

NAV CREDIT FACILITIES

NAV loans offer flexibility but should be used wisely. Fund managers must **avoid over-leveraging and focus on enhancing returns** at critical moments, like funding follow-on investments or returning capital to investors. These loans can also provide necessary bridge financing for short-term liquidity without requiring asset sales.

COMMON PITFALLS IN NAV LENDING

A common pitfall in NAV financing is **neglecting interest rate risks** with floating-rate loans, which can increase servicing costs. Funds should consider hedging strategies to mitigate this risk.

Overestimating asset values can lead to unrealistic NAV calculations. Funds must use **conservative valuations that reflect current market conditions**, as lenders will stress-test these values during due diligence.

Current Market Trends in NAV Financing

01 NEW DEVELOPMENTS IN FUND DOCUMENTATION

Fund documentation is evolving to accommodate the rising prevalence of NAV financing in private equity. Traditionally focused on subscription lines, **fund documents now include provisions for NAV loans**, such as flexible collateral arrangements and asset performance covenants. New funds should draft documentation that anticipates NAV financing needs to ensure operational flexibility.

02 CHANGES IN BORROWING PRACTICES

Private equity funds are increasingly shifting from subscription lines to NAV loans, allowing them to leverage portfolio value without making new capital calls. This trend is **particularly pronounced in funds further along in their lifecycle**, as NAV loans provide liquidity and align with limited partners' preferences for quicker returns through distributions.

03 INSIGHTS FROM PRIVATE FUNDS CFOS

CFOs of private funds see NAV financing as a way to **enhance liquidity and manage cash flow**, helping to address cash shortfalls in uncertain markets. Many recognize the risks of leverage ratios and interest rate exposure, leading to the adoption of sophisticated risk management strategies, including interest rate hedges and conservative LTV ratios. Building **strong lender relationships** is also emphasized, as funds with clear investment theses and strong governance are more likely to secure favorable terms.

To Wrap up...

NAV financing is a **valuable tool for funds that have deployed most of their capital and need additional liquidity**. By borrowing against their Net Asset Value, private equity funds can unlock value without prematurely liquidating assets. **However, this leverage carries risks**, including market volatility, interest rate exposure, and potential covenant breaches.

Fund managers must tackle these risks by **structuring loans to align with broader strategies and maintaining clear communication with lenders**. With the right approach, NAV loans can enhance liquidity, improve cash flow and drive stronger returns for investors.

As the NAV financing market grows, fund managers should **stay updated on trends in documentation, borrowing practices, and risk management strategies** to ensure NAV financing remains an effective tool for optimizing liquidity and fund performance in a complex financial landscape.



Enjoyed this read?

As a team, we are stronger.

Please repost to help us
grow!



@PRIVATEEQUITYBRO.COM