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What Ted's Thinking

NAV Loans: Canary or the Gold Mine?

Financial market participants tend to stretch at the end of a cycle in ways that look silly in retrospect. In 2000, public companies with millions of "clicks" (and minimal revenue) held market caps in the billions of dollars. In 2008, structured products that sliced and diced subprime mortgages professed to spin junk credit straw into AAA gold. After their fall from grace, dot.coms became dot.bombs, and the only sighting of precious metal attached to defaulted mortgages was on the "silver" screen.[1]

The New New Thing in private lending is NAV loans.[2] In its most common form, a private equity sponsor takes on senior debt at the Fund level using its portfolio or a subset of the portfolio as collateral. The portfolio loan differs from the standard practice of borrowing only at the individual company level.

Private credit managers see NAV loans as the latest gold mine. Accustomed to providing leverage to individual companies, lenders can now issue 12-14% senior paper at 10-20% LTV backed by a diversified portfolio of companies. The risk of these loans seems minimal, and the rewards are outstanding.

Private equity managers look at NAV loans as a solution to problems created by today's difficult environment. For those struggling, NAV loans may help generate distributions to LPs or provide capital for new deals. GPs with stronger hands use NAV loans as a portfolio management tool to access lower-cost debt than otherwise available.

Allocators are raising alarm bells over NAV loans. In her soon-to-be-released book, The Climb to Investment Excellence, Ana Marshall, CIO at the Hewlett Foundation, compares investing to climbing a mountain. At Capital Allocators University, she called NAV loans "an oxygen tank for GPs," implying that those accepting NAV loans might be running out of air.

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[1] *The Big Short*, based on the 2010 book by Michael Lewis.
[2] Another hat tip to Michael Lewis, *The New New Thing: A Silicon Valley Story, 2008.*

The different perspectives across the food chain of capital are an interesting dynamic to unpack.

Case Study – Vista and Finastra

In a recently publicized NAV loan transaction, Vista Equity Partners took a $1 billion NAV loan to complete a $5 billion refinancing for portfolio company Finastra.[3] According to investors familiar with the situation, the Vista fund that owns the business has $10 billion in assets and is performing extremely well. This example has me thinking about the choices Vista faced in refinancing Finastra's debt.

1. Provide more capital. Vista could have added $1 billion of equity, structured equity, or credit from their different pools of capital.

2. Pay more interest. Vista could have accepted a higher coupon to refinance Finastra's junior debt. Credit may not have been available at the rates Vista liked, but it still could have refinanced and maintained the independence of collateral.

3. Wait for market conditions to improve. Vista could have waited to see if the recent spike in interest rates settled down before testing the market.

4. Take a NAV loan. Vista could have used the lowest cost of capital available.

By choosing a NAV loan to fund Finastra, Vista decided to not add equity to the deal. It eschewed traditional junior debt financing and consummated a transaction in advance of a debt maturity. In past cycles, Vista would have had to choose among the first three options.

Use Cases for NAV Loans – Private Equity Manager Perspective

Private equity managers use NAV loans for refinancing in a tough environment, distributing capital to its investors, or buying time to continue doing deals.

1. Lower cost debt. By providing a diversified portfolio as collateral, sponsors can access cheaper credit for their companies. Business cash flow projections based on the prior interest rate regime may not hold up in the current environment. But a 12-14% NAV loan allows the model to work if the company exceeds its cost of capital.

2. Refinancing portfolio companies. The purse strings of private lenders are tightening. If a private equity firm cannot access funding for its companies, a NAV loan can fill the funding gap.

[3] https://www.ft.com/content/be9e095f-71b8-402f-a404-1172d6df1fb7?shareType=nongift.

3. Return of capital. As dealmaking has slowed, some GPs are using the proceeds from NAV loans to return capital to LPs. The act is especially useful when LPs are overallocated to private equity and need distributions to create capacity for future commitments. Carlyle, HG Capital, and Softbank reportedly used NAV loans to distribute capital this year.[4]

4. Dealmaking. GPs out of dry powder can buy time for the fundraising environment to improve by taking a NAV loan and using the proceeds to add a deal or two to its existing fund.

Problems with NAV Loans – LP Perspective

While private credit managers are enthusiastically offering NAV loans and private equity firms are increasingly accepting them, investors in private equity funds are concerned about the risk and misalignment of interest they create.

1. NAV loans introduce equity risk. A portfolio of options is more valuable than an option on a portfolio. One of the attractive features of private equity is the absence of cross-collateralization of debt across portfolio companies. NAV loans take away that benefit. The risk of a low LTV NAV loan to LPs is low - until it isn't.

2. Leveraged capital structures. NAV loans allow GPs to apply more leverage to an individual company than lenders deem appropriate. Creditors and sponsors have not seen eye-to-eye on the future cash flows of buyouts for a while. Using the software industry as an example, private equity multiples were a lot less ten or twenty years ago. A deal back then might have transacted at 10x EBITDA with 6x leverage. Today, that same deal might sell for 18x EBITDA, carrying a similar 6x leverage. Private equity managers believe that growing future cash flows will justify higher valuations, but lenders have not been willing to extend a proportional amount of debt.

   If the sponsors are right and their portfolio companies can handle the debt, everyone wins. If the lenders are right and the businesses can't support more debt through a cycle, problems will surface. Only one of the participants will be correct.

3. Expensive dividend recap. Why does a sponsor think that borrowing at 12% to return capital will help an LP whose cost of capital is 8-10%? If an LP wanted liquidity from its private equity portfolio, most could borrow against their interests more cheaply than a single private equity fund could. A dividend recap of a private equity portfolio seems like a gimmick to juice distributions (DPI) and IRR so the GP can ask for a commitment to its next fund. In fact, NAV lenders are pitching this concept to GPs as part of the value proposition for accepting a loan.

[4] https://www.ft.com/content/f23d9cd9-2650-4943-a9ac-eb262414e772.

4. Borrowing to do more deals is the ultimate misalignment of interest. If a GP is out of dry powder and unable to raise money, the market has told the GP that it is not supportive of their future deal-making ability. Their response of using more debt to reload is like pulling the goalie at the end of a hockey game or throwing a Hail Mary at the end of a football game. It rarely reverses the outcome.

5. Zero-sum game. The LPs providing capital to private equity funds are the same ones who invest in private credit funds making NAV loans. One investor's attractive return on a NAV loan is another's price paid in a private equity fund. In the case where an LP invests in a NAV lending fund that extends a loan to one of their private equity funds, the investor loses by the fees it pays to both sides, just like Jack Bogle's critique of active management in public equities.

6. Complexity and communications. Private equity managers have the discretion to manage the capital structure of their portfolio companies. In a high-performing fund, the GP is likely to communicate their rationale for a NAV loan in advance. In an act of desperation, the LP may not know about the loan until it's too late. Further, the structure of every NAV loan is different. Only clear communication in advance by the GP can help ease LP scrutiny.

Canary or Gold?

Gold Mine. I can tell two stories that suggest that NAV loans are a win-win-win for investors, fund managers, and creditors. The first is when incremental leverage carries little risk, creates a better capital structure, and the loan fills a funding gap between lender and sponsor expectations. This dynamic could have played out in the software industry over the last decade; buyouts worked, but they have not been *leveraged* buyouts. Vista's NAV loan exemplifies this story.

The second story is that a NAV loan is a new portfolio management tool for a mature portfolio, where the sponsor can replace higher-cost debt in a more difficult borrowing environment. Capitalizing businesses fund-by-fund instead of deal-by-deal resembles a holding company in which the sponsor can efficiently acquire and allocate financing. It's a bit like Warren Buffett's centralized capital allocation at Berkshire Hathaway.[5] With long track records of low losses at the portfolio level, maybe all sponsors would generate higher returns by exchanging cross-collateralization for a lower cost of capital.

Canary. While both stories have some merit, they also have flaws. In the first story about funding gaps, the late stage of an economic cycle is a bad time to decide that previously

[5] Described in Berkshire Hathaway's Annual Letter in 2014 commemorating 50-years of Warren Buffett's tenure. www.berkshirehathaway.com/2014ar/2014ar.pdf, page 30.

undercapitalized deals can be improved with more leverage. Lightly leveraged loans may not have much risk, but, as Buffett says, what the wise man does in the beginning, the fool does in the end. I've already seen presentations from lenders offering NAV loans for up to 50% of a private equity portfolio value. That amount of leverage poses a substantial risk in a downturn.

In the second story about portfolio management, I scratch my head again thinking about why this innovation is taking hold now. Private equity firms could have accessed cheaper debt this way any time in the past, and it's unlikely the entire industry left easy money on the table. The massive growth of private equity over the last fifteen years coincided with low rates and readily available financing. Maybe now is the first time in the modern era that the titans of industry need to sharpen their pencils.

Other use cases of NAV loans are more pernicious. A GP struggling to maintain its business might take out a NAV loan to make a distribution, thinking that LPs will return the money with a new commitment. The GP boosts its IRR but lowers its MOIC in exchange. Worse, GPs out of dry powder can take NAV loans to conduct additional deals. Both of these pit the interest of the GP against those of its LPs.

We've Seen This Before; Let's Not Again

NAV loans strike me as a canary in the coal mine signaling the end of the private equity boom. According to Preqin, 645 firms have not raised a new vehicle since 2015.[6] With interest rates higher and the fundraising environment tighter, credit is scarce. NAV loans feel like the "extend and pretend" activity we saw after the GFC. For every Vista NAV loan, there are probably ten used to cure the woes of a GP.

This isn't the first structural innovation in finance, and most have unintended consequences. In private equity, subscription lines started as a red-headed stepchild, became an expected business practice, and then led to instances of abuse including excessive leverage, inflated IRRs, and opacity.

Continuation funds started as an idea for GPs to hold great businesses longer and LPs to save fees from fewer sponsor-to-sponsor transactions. The pristine concept didn't last long. Continuation funds are controversial today. Many LPs are concerned about valuation challenges, incentive misalignment, questionable business selection, and zombie fund extensions.

In many ways, NAV loans resemble the AAA tranches of subprime CDOs fifteen years ago. Real estate prices across the U.S. had never previously declined simultaneously, and the super senior portion of securitizations held the same credit rating as U.S. Treasuries. Between portfolio company debt, NAV loans, and credit facilities, potentially three layers of leverage sit above

[6] https://www.bloomberg.com/news/features/2023-09-24/private-equity-zombie-firms-leave-pension-funds-with-hard-choices?sref=oaOFfGYY. .

private equity assets. I can't think of a reason why private equity-owned businesses would default on low LTV portfolio loans, but markets experience hundred-year floods far more than once a century.

No matter how you look at it, NAV loans are a late-cycle response to the higher cost of debt and slowing fund flows that will bring uncompensated risk to LPs. Whenever a GP takes a NAV loan, LPs must assess whether the additional debt is a wise capital allocation decision or an early warning sign of problems at the firm.

Ana suggested that anyone hearing about a NAV loan should shout out a warning from the mountaintop. She is right – you've now heard my call.