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A borrower's guide to NAVigating the globe: An international overview of net asset value facilities

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Introduction

While subscription facilities ("Subscription Facilities" or "Subscription Financings"), which are backed by a fund's uncalled capital commitments, have been a long-standing financing strategy for investment funds, net asset value facilities ("NAV Facilities" or "NAV Financings") and hybrid financing arrangements, which are partially or solely backed by a fund's investments, have grown in popularity among private equity and alternative investment funds across the globe in their pursuit of additional liquidity solutions.

Historically, NAV Financings had been employed by credit and secondaries funds (or "funds of funds"). More recently, both NAV Financings and hybrid financings have been adopted by investment funds in Europe, the United States ("U.S.") and Asia-Pacific ("APAC") across different strategies, including private equity, infrastructure, real estate and open-ended funds. This worldwide expansion is driven by a willingness of fund sponsors and lenders to find alternative liquidity solutions that address a combination of factors, including: (i) individual asset-level financings becoming more expensive (or, at times, unavailable) in a high interest rate environment; (ii) longer holding periods for investments due to decreased M&A activity; (iii) a desire to support underperforming assets; and (iv) the natural progression of the market, as lenders, fund sponsors and investors collectively become more comfortable with NAV-linked financing arrangements.

This chapter reflects a collaboration among Simpson Thacher's global fund finance practitioners and aims to provide fund sponsors with an international overview of the key legal and practical issues that arise when considering a NAV Financing. We will first review common features of NAV Financings, followed by a deep-dive into the two most critical and unique components thereof: (a) "bankability" due diligence with respect to the governing documents and structure of a fund and its subsidiaries, including impact on collateral and liability structuring for the facility; and (b) the net asset value ("NAV") calculation and loan-to-value ("LTV") metrics for purposes of the facility documents. Each topic will be discussed through the lens of jurisdictional similarities and variations among the European, U.S. and APAC fund finance markets. We conclude our thoughts with a preview of future trends for fund sponsors in 2024 and thereafter.

Overview of NAV Facilities

At a high level, NAV Facilities "look down" to the value of a fund's investments. Conversely, Subscription Facilities "look up" to investors' uncalled capital commitments. A "Hybrid Facility" combines features of both, wherein a fund supplements Subscription Facility collateral by pledging its interests in underlying investments and/or the economics with respect thereto. A further subset of NAV Facilities are "Private Margin Loans" or "Single-Asset NAV Facilities", which "look down" to the value of a single investment, as compared to multiple investments or an entire portfolio. This chapter focuses on NAV Facilities for multiple or fund-wide investments.

NAV Facilities are typically:

- implemented after a fund has made a number of underlying investments and has accrued sufficient value;
- used for a range of purposes, such as additional working capital, replacement of asset-level financing, making follow-on investments or distributions to limited partners;
- incurred at the fund level or at one or more special purpose vehicles below the fund; and
- secured by a variable and highly negotiated collateral package, ranging from "collateral lite" (i.e., pledge of distribution accounts only) to fully secured (i.e., pledge of interests in investments, rights to receive distributions, and distribution accounts) or a combination of the foregoing.

Globally, there is no "one-size-fits-all" approach for NAV Facilities. Their terms and structure are guided by a variety of factors, including the permissions and restrictions under the fund documentation, investor expectations, tax and regulatory considerations, the composition of the investment portfolio and the fund's structure, including how investments are held and any underlying deal limitations.

Bankability Due Diligence Part I – Fund Documentation and Investor Considerations

<u>LPA permissions and limitations</u>

Fund limited partnership agreements ("LPAs") have long been a focal point for Subscription Facilities. Over time, the global market has generally settled on the language that should be included in an LPA for it to be considered "bankable" for Subscription Facility purposes. The same cannot yet be said for NAV Financings, and a threshold issue for any fund considering a NAV Financing is whether such a facility is permitted (or not restricted) by its LPA. Depending on the LPA terms, a fund sponsor may need to structure the debt to fit within the negotiated parameters of the existing fund documentation, in particular, with respect to collateral packages, debt limitations and tenor restrictions.

While most fund sponsors have ensured that their LPAs permit Subscription Facilities, many have only considered NAV Facilities on an "as needed" basis after the fund documentation has been executed. As a result, the LPAs may not have robust flexibility to permit a range of NAV Financings or may be silent on the issue. For example, an LPA's pledging provisions may not expressly permit the granting of a security interest over the assets that a NAV lender may prefer, such as a fund's portfolio investments (or a subset thereof) or its rights to receive distributions or proceeds relating to such investments.

Aside from the collateral package, LPAs and other fund documentation may restrict debt at the fund level as well as below the fund. As a key diligence matter, a fund sponsor should consider whether NAV Facility borrowings or guarantees provided by a fund thereunder constitute fund-level indebtedness or are otherwise subject to any debt limits under a fund's governing documentation. For example, even if the fund is not a borrower under the NAV Facility, the borrower may be deemed an alter ego of the fund for purposes of this LPA analysis. Further, if fund-level debt cannot exceed uncalled capital commitments, a fund-level NAV Financing may be severely limited later in a fund's life when there is little unfunded capital, even if there is substantial asset value. In addition, depending on the language in the fund's LPA or Subscription Facility, a NAV Facility, if considered fund-level debt, may reduce (rather than supplement) the fund's borrowing capacity under its

Subscription Facility. Some LPAs separately specify whether fund-level debt secured by uncalled capital commitments is expressly included or excluded from the debt limits. In such cases, a fund will need to discern whether borrowings under a Hybrid Facility count towards that limit. As such, it is critical for fund sponsors to fully understand how a NAV Facility fits into the overall leverage profile of the fund.

Tenor limitations for fund-level debt may also be prescribed in the LPA. While LPAs in the European market sometimes limit short-term borrowings to 364 days, tenor restrictions have historically been most common in the APAC market. Tenor restrictions that capture NAV Financing indebtedness can limit the potential utility thereof for a fund sponsor. One benefit of a NAV Financing is that it facilitates holding an investment until the optimal time to maximise its return. In such cases, a fund may borrow under the NAV Financing so that investors may realise an early return on an investment in advance of it being sold. A fund does not necessarily control when it receives distributions or sells investments, and may be relying thereon to repay its NAV Financing loans. Therefore, a fund may need flexibility for such loans to remain outstanding for longer periods than initially contemplated under its LPA.

Structuring borrower liability

When there is more than one borrower under a NAV Facility, lenders may require that such borrowers be jointly and severally liable for their obligations. This results in each borrower being liable for the full amount of loans outstanding under a NAV Financing, regardless of which borrower incurred any given loan. Joint and several liability allows for a single LTV ratio that is calculated by reference to all of the borrowers' investments. From a fund perspective, one potential concern is that certain borrowers may have significantly less asset value than others, which can render such borrowers insolvent (or in violation of debt limits in their organisational documents) simply by having such borrowers jointly and severally liable with others. To mitigate this result, fund sponsors should insist on including savings language to limit the liability of each borrower to the maximum amount that may be incurred without rendering such borrower insolvent (or in violation of its organisational documents). In addition to considering the relative size of borrowers, fund sponsors should consider whether the proposed liability arrangement undercuts any aspects of the fund structure, including the separateness of the relevant fund vehicles.

A common fund structure includes alternative investment vehicles ("AIVs"), which may be utilised for tax or other regulatory purposes. When implementing a NAV Financing, fund sponsors should be mindful of any impact on the fund's overall tax structure resulting from joint and several liability, cross-collateralisation or cross-guaranteeing of debt between AIV(s) and the main fund.

Investor disclosure and expectations

As interest in NAV Financings has increased, so too has investor scrutiny thereof. Many investors are becoming increasingly knowledgeable as to the range of possible fund financing solutions, and expect fund sponsors to disclose and explain their leverage strategies. At a minimum, disclosures to investors should include whether the fund has the ability to enter into a NAV Financing. Further, investors should be notified when the fund actually enters into such a financing arrangement. Similar to Subscription Facilities, fund sponsors should be prepared for targeted information requests from investors, particularly the purposes for which NAV Financings are being used and how their usage may impact a fund's performance. To provide some examples, NAV Financings may be relied upon in the following scenarios:

1. *meeting working capital or refinancing needs of portfolio companies* – where traditional financing options at the portfolio company level are either unavailable or not affordable;

2. *follow-on investments* – where the fund is near the end of its investment period and has limited unfunded capital commitments and/or limited availability under a Subscription Financing; and
3. *making recallable distributions to investors* – given the subdued M&A and initial public offering markets globally, this use has gained some traction among European fund finance borrowers, while APAC and U.S. fund sponsors still tend to be more restrained.

Fund sponsors should ensure that there is a compelling business purpose to justify any incurrence of debt, including NAV Financings, and would do well to communicate their financing strategy to investors to help assuage any concerns. In an ever-competitive fundraising environment, the importance of strong investor relationships and communication will continue to be a critical consideration for fund sponsors.

Bankability Due Diligence Part II – Structuring

In addition to reviewing the fund documentation and investor disclosures, fund sponsors will have to consider the structure of the fund and its investments in order to determine the appropriate NAV borrower(s) and guarantee/collateral package.

<u>Investment portfolio diligence</u>

Fund sponsors will need to conduct legal due diligence to determine whether the proposed credit support for a NAV Financing can be implemented in light of the existing financing and shareholder arrangements at the investment level. Such diligence will be more comprehensive and time-consuming if a NAV Facility is not "collateral lite". Pledges of equity, whether direct or indirect, or limited solely to economic rights, may implicate change of control ("CoC") or transfer provisions or restrictions on encumbrances at the investment or holding company levels. Even a negative pledge of the fund's direct or indirect interests in investments may be deemed an indirect pledge that is prohibited by the underlying investment documentation. This analysis will impact the identity of the NAV borrowers and the breadth of the collateral package.

With respect to CoC or transfer provisions, the analysis is similar to typical M&A diligence. Fund sponsors should evaluate the following:

1. A CoC or a breach of a transfer restriction under an asset-level financing, customer or vendor contract or shareholder arrangement could result in a default thereunder and permit the relevant counterparty to enforce on the collateral (in the case of a secured asset-level financing) or to terminate such contract or arrangement. This would not be beneficial for the fund sponsor or the NAV lender since the value of the investment would be eroded.
2. Regulatory approvals or filings in certain jurisdictions may need to be obtained or made if there is an ownership change resulting from the enforcement of an equity pledge or if the investment is restructured to accommodate the NAV Financing collateral package. There have been cases where pledging the right to receive distributions triggers such regulatory approval, although this is more likely where the underlying asset is in a regulated industry. Understanding the different regulatory implications tends to be most complex for Pan-Asia and European funds, as APAC and Europe have a wider variety of regulatory restrictions as compared to the U.S.
3. Tax consequences can also arise from a direct or indirect CoC resulting from the enforcement of an equity pledge. For example, if a fund holds German real estate, the German Real Estate Transfer Tax may be triggered by a change of shareholder, even if indirect.

Given the prevalence of indirect CoC provisions and transfer restrictions, fund sponsors should note that the above analysis is not necessarily avoided by pledging equity in an aggregator vehicle only. In such cases, diligence may still be required with respect to all of the investments held by such aggregator vehicle.

Even where a fund sponsor and lenders are comfortable with the consequences of enforcement of an equity pledge (given the remote likelihood thereof or otherwise), the existence of the pledge itself may be problematic. The above-described restrictions may be triggered by granting a security interest, or permitting an encumbrance, on the equity interest. Such restrictions are often found in shareholder agreements, which tend to broadly define "transfer" to include any pledge or encumbrance.

The limitations contained in the underlying investment documents will largely shape the negotiations regarding the collateral and the related covenants. However, a fund sponsor should also consider how the investments are held.

<u>Co-investors and separately managed accounts ("SMAs")</u>

Including investments with co-investment vehicles or SMAs within the scope of a NAV Financing can be challenging, since the fund sponsor owes a fiduciary duty to such co-investment vehicles and SMAs, as well as the fund, and is required to act in their respective best interests, in addition to complying with any contractual obligations. While it may be in the best interest of the fund, as a whole, to sell an asset in order to repay its NAV loans, it may not be in the individual best interest of the co-investment vehicle or SMA. To help mitigate these issues, when negotiating the governing documents for any co-investment vehicle or SMA, a fund sponsor might consider including certain carve-outs to provisions regarding investment dispositions. If no such carve-outs are included, co-investor consents may need to be obtained, which will extend the time period to put in place a NAV Facility. Depending on the nature of the investments and a lender's credit requirements, *in lieu* of undertaking extensive due diligence and/or obtaining co-investor consents, the parties may agree to exclude certain investments (or portions thereof) from the scope of the collateral.

<u>Regulatory considerations</u>

A fund sponsor should consider whether the composition of the investment portfolio or collateral impacts the regulatory treatment of the NAV Facility. For example, under U.S. margin loan regulations, if more than 25% of the borrowers' assets consist of margin stock, and the NAV Facility includes a negative pledge with respect to the borrowers' interests in such investments, there may be U.S. securities law or other regulatory implications. In this circumstance, if loan proceeds are used to purchase margin stock, the NAV Facility may be deemed indirectly secured by margin stock (even if not actually secured thereby), triggering certain requirements under Regulation U. Similarly, if the collateral under a NAV Facility includes any margin stock and the loan proceeds thereunder will be used to purchase margin stock, the fund sponsor should consult with regulatory counsel, as Regulation U requirements will likely apply.

If the fund manager is licensed in the United Kingdom or a Member State of the European Union, or the fund is registered for marketing to investors in any of those jurisdictions, the fund will need to assess whether utilisation of a NAV Facility will impact its leverage status for purposes of the Alternative Investment Fund Managers Directive ("AIFMD"). If the leverage status for AIFMD purposes changes as a result of the incurrence of NAV Facility debt, additional regulatory filings or additional disclosures may be required.

Collateral package

Borrowers and lenders will need to work with funds, tax, regulatory and local counsel to formulate a collateral package based on the results of the diligence discussed above. There are primarily two approaches to structuring NAV Facility collateral as detailed below.

From a borrower's perspective, a "collateral lite" approach is most preferred. However, such an approach must be considered in the context of the overall terms of the financing and pricing implications, particularly in the European market. A "collateral lite" NAV Facility solely involves pledging the borrowers' bank accounts into which distributions from underlying investments are received. In the U.S., account control agreements are also required. A "collateral lite" package has a number of advantages for fund sponsors, including:

1. efficiency from a time and cost perspective, given the limited diligence with respect to investment-level documentation and narrower scope of security documentation;
2. less ongoing collateral management; and
3. reduction of potential legal and regulatory complications.

Lenders may be more comfortable with a "collateral lite" approach when dealing with a large and diversified investment portfolio, but are likely to push for additional collateral or other protections when dealing with a small or highly concentrated investment portfolio. "Collateral lite" is common in the U.S. market, and offered by certain lenders in the European market. However, regardless of jurisdiction, certain lenders may be unable to offer a "collateral lite" NAV Facility due to their individual underwriting requirements.

The second approach, found in each of the APAC, European and U.S. markets, involves pledging the equity interests in a fund's underlying investment vehicles (or holding company vehicles) and/or the fund's rights to receive distributions with respect thereto. This approach is most prevalent in APAC and is also common in Europe. As summarised above, the primary hurdles with respect to this structuring are conducting the requisite diligence and addressing any limitations in the underlying investment documents.

An equity pledge can also be challenging if an investment vehicle is structured as a partnership and the general partner thereof is required to pledge its interest in order for a lender to assert control over the vehicle in an enforcement scenario. Pledging the general partner's interest has to be weighed against the general partner's fiduciary duty to act in the best interests of the limited partners. This often poses an issue for APAC funds that use different holding structures across jurisdictions (for example, in Japan and Korea, where investments are often held via limited partnerships). This is also a point of negotiation and discussion in the European market. In these cases, fund sponsors and lenders must be collaborative when negotiating the collateral package and broader terms, since limited partnership investments may need to be carved out of the collateral package.

If a lender determines that the quality of the investment portfolio is too weak to support a NAV Facility (for example, if the investment portfolio is highly concentrated in jurisdictions or sectors that are less favoured by lenders), a fund sponsor may provide credit enhancements to ensure that the NAV Facility is "bankable". These can range from "bad boy" guarantees (which are contingent obligations of the fund to step in and make payments if the borrower or fund commits one of a pre-agreed list of "bad acts") to a full fund-level guaranty. These options will be influenced by tax and regulatory considerations as well as fund documentation limitations.

Ensuring satisfactory bankability of the overall fund and investment structure is a critical first step for fund sponsors. Any deficiencies will need to be addressed before negotiating the NAV Financing legal documentation. Once all parties have agreed on the structure, the lender will turn its attention to the fund's investment valuation policy and methodology, with a view to negotiating how the NAV will be calculated and monitored for purposes of the loan documents.

NAV calculation and LTV metrics

Calculation and reporting of NAV

Across all jurisdictions, the extent of negotiations with respect to calculating and reporting the fund's NAV will vary depending on the fund's strategy. Across the private equity and infrastructure sectors, the majority of investments tend to be illiquid without a publicly available price. The starting point for fund sponsors in these sectors is to simply apply the NAV that is calculated in accordance with the LPA. Lenders are usually comfortable with this approach, so long as the NAV Facility includes a covenant restricting adjustments to the fund's valuation methodology and lenders have ample opportunity to review the valuation methodology as part of their diligence process.

Real estate funds, in contrast, can point to valuations delivered by reputable third-party evaluators that are accepted at the asset financing level, where there is often an established market for the asset (for example, commercial real estate within a wider commercial district). Regardless of the fund's strategy, lenders will require assurance that the NAV calculation takes into account debt and credit support arrangements incurred at the asset level and any holding companies through which investments are held. A fund sponsor will want to ensure, to the maximum extent possible, that the NAV that is calculated and reported to investors pursuant to the fund documents is the same as that which is calculated and reported to the lenders pursuant to the financing documents.

Similar to Subscription Facilities (where lenders assess the creditworthiness of each investor to determine which are eligible for inclusion in the borrowing base), NAV lenders may only count "eligible investments" when calculating aggregate NAV. What constitutes an eligible investment is negotiated on a deal-by-deal basis. Borrowers across the globe will push for any follow-on or follow-up investment to an existing eligible investment to be automatically included. Across jurisdictions, a baseline requirement for an investment to be considered eligible is that there is no insolvency or acceleration event with respect to any material debt attributable to such investment. Funds may also be required to maintain a minimum number of eligible investments (for example, four to five) under the facility at any time, to ensure that there is a diverse underlying portfolio. This threshold should be set following an analysis of the fund's divestment schedule, to ensure that the financing does not have to be repaid earlier than expected.

In APAC and, to some extent, the U.S. and European fund finance markets, more specific geographical diversification is common, as each lender may have a different risk appetite for a particular jurisdiction. Depending on the portfolio's characteristics, eligibility under U.S. NAV Financings may also be subject to minimum credit ratings (which are not required in APAC and less common in Europe), or concentration limits based on each investment's rating (if any), jurisdiction and/or sector.

Valuations and lender challenge rights

Funds typically report the NAV of their investments to investors on a regular basis (often quarterly). One of the key concerns from a lender perspective is the time delay in receiving up-to-date valuations, which may range from 60 to 120 days following the date of valuation. As a result, lenders may seek more frequent valuations, including in connection with the occurrence of any exclusion event or other "write-down" event that negatively impacts an investment's value. Lender concerns must be weighed against the practicality and cost of producing valuations within the requested timeframes. Any exclusion or "write-down" events should be limited to strike a balance between the lenders' and the borrowers' interests, and ideally should allow adjustments in the event that the valuation improves. This can be particularly helpful for fund strategies where one or more investments exit through an initial public offering.

Valuation challenges and third-party appraisal rights may also be agreed where the lender is of the reasonable view that there are material inaccuracies in the fund's valuation, but only under certain circumstances and subject to agreed parameters. In particular, strong borrowers in the private equity and infrastructure sectors will insist that the scope of any challenge is limited to a review of the application of the valuation methodology, rather than a review of the data underlying the valuation or the choice of methodology itself. Where third-party appraisal rights are agreed, borrowers and lenders may agree to a list of acceptable evaluators, as well as the allocation of and/or cap on costs, with some borrowers pushing for these to be borne by the lenders in the absence of a material variation in NAV (usually in excess of a specified percentage). Borrowers should also consider limiting how frequently a lender can request a third-party appraisal. While third-party appraisal rights are typically a focus for traditional lenders, some private credit funds (particularly in the European market) may be willing to forego such rights in certain transactions, seeing themselves as closely aligned with the fund's investors.

LTV covenant

The principal covenant in a NAV Facility is the LTV ratio, which measures the ratio of borrowings under the facility against the NAV of eligible investments. "Day 1 LTV", or "Target LTV", regulates the amount that can initially be borrowed. For traditional bank providers across the global market, this typically ranges between 10% and 20%, but may be higher for non-bank lenders. Borrowers should note that LTV thresholds can vary based on various factors, in particular, the fund sponsor's reputation, the nature of the investments and diversification of the portfolio (including jurisdictional and sector-specific diversification). The NAV will fluctuate during the life of the fund, which will, in turn, impact the LTV. When the LTV exceeds one of the pre-agreed thresholds, consequences can include a mandatory prepayment, cash sweep, pricing increase, implementation of a cure plan or, in some cases, acceleration or a forced sale process.

In contrast to Subscription Financings, where borrowers can call capital from investors to repay the debt, borrowers may not have cash readily available to make a mandatory prepayment under a NAV Financing. As a result, a breach of the "Cash Sweep LTV" threshold will not always require an immediate prepayment. Instead, a cash sweep ordinarily applies when proceeds are realised from underlying investments. This typically requires 100% of the net proceeds (subject to certain exceptions) to be applied to outstanding loans to the extent necessary to bring the LTV ratio back down to an agreed threshold. Assuming a diversified pool of investments, the Cash Sweep LTV trigger can range from 12.5% to 30%, or ratchet to different thresholds depending on the number of investments held by the fund at any given time. The structure of the cash sweep can also be driven by the fund's strategy. Given the illiquid nature of real estate and infrastructure investments, for example, borrowers in those sectors may negotiate for a longer timeframe to make a prepayment.

A breach of the "Forced Sale LTV" or "Acceleration LTV" threshold will typically trigger a sale process or (particularly in the U.S. market) the requirement for the fund to prepare a repayment plan, which may or may not include selling investments. The Forced Sale LTV or Acceleration LTV threshold is typically no less than 30%. A forced sale may address any diligence deficiencies discussed earlier, where a borrower is prohibited from pledging equity in specific investments. Rather than going through the complex process of enforcing collateral and taking ownership of one or more investments and their related holding companies, this mechanic allows the fund sponsor to run a formal M&A process in order to extract maximum value from the investments and apply the proceeds to repay the NAV loans. Fund sponsors are often best placed to run a sale process, given their inherent knowledge of the underlying asset, while NAV lenders benefit from a reduced enforcement workload with the comfort that the LTV threshold is set at a level that leaves a sufficient buffer for recovery.

While forced sales are a common feature of bank-led deals, practice varies when dealing with private credit funds that are more closely aligned with a fund's investors in their credit analysis. In any event, fund sponsors should try to maintain as much flexibility as possible so as to avoid a forced sale, or prolong the cash sweep period prior to enforcement, or else they may be obligated to sell investments during sub-optimal market conditions. Submission of a repayment plan, which must be approved by the agent and/or a threshold of lenders, may be preferred over a forced sale. The repayment plan will usually include an end date by which the LTV deficit must be cured; if not cured by such date, NAV Facility borrowings may be accelerated.

Given the complexity of the above negotiations, together with the wide-ranging diligence necessary to execute a NAV Financing, fund sponsors should be conscious of the lead time to implementation, and ensure that the relevant legal, regulatory, tax and accounting teams are engaged as early as possible.

Market trends

As we move into 2024 and beyond, our fund finance practitioners across the globe anticipate continued focus from lenders and fund sponsors on finding innovative approaches to structure NAV Financings. In particular, we note the following market trends.

NAV Financing providers

Since NAV Financings require disclosure of extensive confidential fund-level information to lenders, fund sponsors have tended to first approach their relationship lenders before private credit funds with private equity arms that may be considered competitors. Given these confidentiality concerns, we do not expect NAV Financings to become widely syndicated products across the globe in the near future. This trend is pronounced in the APAC market, where NAV Financings are currently a bank-dominated and relationship-driven product.

In light of fluctuating liquidity in the U.S. and European fund finance markets, we are seeing an increasing number of private credit and specialist NAV Financing providers growing market share. These non-bank institutions can often move quickly and deliver more tailored solutions, with the combination of NAV Financing and preferred equity arrangements being a strategy that we expect to continue to develop in the coming years as fund sponsors push for multifaceted financing solutions. Subject to their ability to compete on pricing, we expect to see alternative credit providers boost their presence in APAC's NAV Financing market, with a focus on sponsors operating in the mid-market.

The type of NAV Facility lender a fund sponsor selects will also be influenced by whether a fund prefers a term loan *versus* a revolving facility. Whereas traditional banks can often provide more flexibility for revolving facilities and delayed draw term loans, private credit funds have historically required an immediate drawdown (although this is starting to change in the European market). As the NAV Financing market matures, there is increasing interest in accessing insurance capital. We expect to see more insurance companies in the U.S. and Europe providing NAV Financings, which will likely be structured as term loans, given their longer tenor.

Use of proceeds and the continuing evolution of NAV Financings

While the popularity of NAV Financings through 2023 may have been fuelled by market dislocation, NAV Financings have proven to be more than a seasonal trend. We expect to see the purpose of NAV Financings evolve over time, especially as M&A and initial public offering markets normalise. In addition to the recent trend of using NAV borrowings to make distributions, (i) portfolio companies will continue to have growth and capital expenditure needs, (ii) there will continue to be distressed investments requiring liquidity, and (iii) with rates remaining higher for longer, there will continue to be difficulties executing asset-level refinancings in a cost-efficient manner. These drivers will continue to make NAV Financings (and hybrid financings) a critical portfolio management solution that fund sponsors should consider early in a fund's life.

Front-loading the structuring for NAV Financings

With their increasing popularity, we are seeing more fund sponsors start to front-load the structuring of NAV Financings at a fund's inception. Sponsors going to market with their latest funds may update their LPA form language to seek explicit permission for NAV Financings. As a structural matter, some funds may establish additional special purpose vehicles or aggregators between the fund and asset level, attempting to minimise interference with asset-level financing arrangements and other agreements and ease the diligence burden to be undertaken later in the fund's life (as discussed above). We expect this theme to continue across the globe, as fund sponsors learn from experience while implementing NAV Financings for their existing vintages of funds and seek to streamline some of the structuring complexities.

Conclusion

While there are certain nuances and trends distinguishing the U.S., APAC and European markets from one another, it is evident that the key considerations and challenges in these jurisdictions are more alike than not. Although not yet as ubiquitous as Subscription Facilities, NAV Facilities are becoming increasingly essential to meet fund sponsors' liquidity needs and are consequently gaining prominence on a global scale. We expect that fund sponsors and lenders in all jurisdictions will continue to embrace NAV Facilities, especially as market participants gain a deeper understanding as to their potential benefits and role within a fund's overall investment strategy.

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