E X P E R T Q & A

Private equity chief financial officers are getting to grips with the power of NAV financing and GP solutions, says Peter Hutton, head of NAV financing at Arcmont Asset Management

The 'NAVs' and 'NAV nots': Understanding the financing toolkit

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Q Is NAV financing now an established part of the fund management toolkit for CFOs? What is driving demand?

Over the last five years, NAV financing has really exploded in popularity. Arcmont estimates that about 40 percent of mid-market private equity sponsors in Europe have already executed a NAV loan, with that number growing all the time.

In that same timeframe, the role of the private equity chief financial officer has evolved significantly. Whereas previously more focused on asset-by-asset returns and operations, today's PE CFOs are focusing more on whole-of-fund returns and strategy: managing the gross-to-net spread, fund liquidity and timing, mid-life fund management and value creation levers.

As the smorgasbord of fund secondary and liquidity management tools has increased, so has the requirement for CFOs to be fluent across all of those tools and their potential use cases. Sponsors do not have to be using all the tools available to them, but understanding them is a 'sine qua non' for the modern CFO, encompassing everything from subscription lines and NAV through to continuation vehicles, securitisations and GP stakes as well.

Specifically for NAV, we believe demand is being driven by several factors. The first is much more of an increased focus on value-accretive M&A at the asset level to enhance fund internal rates of return and manage fund J-curves as interest rates have risen and hold periods have lengthened.

Second, there is a growing desire for fundraising flexibility to allow sponsors to carry on investing in buying new platform assets much later into a fund's life versus traditionally having to pause or slow down dealmaking and wait for fundraising certainty. If, for example, a GP has not generated sufficient distributions or the fundraising climate is difficult, they can just do a NAV loan and carry on investing in platforms without the need to stall that activity.

The third driver is debt paydowns. Sponsors have realised that raising a NAV financing at the fund level backed by a diversified portfolio of assets at similar pricing to senior asset financing, but without the cash burden, is an attractive use case that can make a lot of sense.

So, NAV continues to evolve as a solution for increasingly sophisticated PE CFOs who require a strategic financing solution at the fund level.

Q How is the use case for NAV financing evolving over time?

Until five or six years ago, NAV was used for a mix of idiosyncratic reasons. The market was generally characterised as low demand and low supply, as well as relatively inefficient.

Today the vast majority of NAV loans are being used for M&A and to enhance value creation, squarely in line with the mandate from LPs. LPs have already got comfortable with subscription line facilities – recognising a fund return is more than a series of asset-level returns – and NAV is simply an extension of that paradigm.

LPs are certainly becoming more comfortable with some of these tools and knowledge of these facilities, and their use cases is an asset that can really drive value and fund returns.

Q What does the NAV decision-making process look like for sponsors? How does that vary according to their level of sophistication?

Typically sponsors that are first-time NAV users will think about using a NAV loan much more on a reactive basis, long after the end of the investment period when there is little to no dry powder remaining with a single targeted use case. Really, in these situations, GPs are just solving a capital need after every other option has been explored.

But for more experienced NAV users, and typically after a sponsor has done their first NAV loan and understand the product better, a NAV facility will be put in place on a much more proactive basis when the fund is around 70-75 percent invested for a wide range of use cases over a longer drawdown period. The earlier in the fund's life you are able to acquire additional equity returns, generating maybe 3x at a 1.2x-1.3x cost of capital, the more value accretive to the fund.

> *"NAV continues to evolve as a solution for increasingly sophisticated PE CFOs who require a strategic financing solution at the fund level"*

NAV is no longer just a capital need, but effective fund management with a strategic lens.

Q What should sponsors look for in a lending partner?

Really it comes down to four key points, the first of which is strong existing relationships. Between Arcmont in Europe and our sister firm Churchill Asset Management in the US, we have already executed a transaction with approximately 400 mid-market private equity firms. That results in trust, not only at the senior level within those organisations, but right down to the deal teams. Sponsors know that they are getting into bed with a brand that is already well trusted with a strong track record.

The second point is the 'one-stop-shop'. We increasingly see that sponsors want to deal with fewer partners. Arcmont, alongside Churchill, is part of Nuveen Private Capital. That is a $100 billion AUM mid-market private capital specialist and a one-stop-shop for sponsors.

There are really four key levels at which we operate: the LP level, making primary LP commitments; the GP level, providing GP financing; the fund level, providing financing for GP-led secondaries and NAV loans; and finally, the asset level, where we are known for providing both senior and junior debt financing, as well as equity co-invest.

Together, Arcmont and Churchill provide that full stack offering that allows us to drive synergies and better understand sponsors, their multiple strategies and the breadth of their financing needs.

The third area that sponsors look for is existing asset knowledge. If a lender knows the underlying collateral well, that should translate into more aggressive pricing. Alongside Churchill, we have already diligenced almost 18,000 of these companies globally. Typically, we have already diligenced 50-100 percent of the assets in any portfolio we have reviewed from an NAV perspective.

Finally, sponsors seek flexibility and scale. They want to partner with someone who has got staying power and has the ability to underwrite with the flexibility that they need.

Q What does the future look like for NAV financing, and where do you expect to see the market five years from now?

Five years from now, you will certainly see increased adoption. If adoption today stands at 40 percent in Europe and just under 30 percent in the US, I think that will reach 60-70 percent over the next five years. Given the network effect, we also think that rate of adoption will accelerate.

Secondly, I think we will see more global reach, so the US and Asia-Pacific will catch up with Europe in terms of adoption.

Third, we can expect to see more consistency in LPA language and in fund structures for NAV loans and NAV facilities, so there is a better link between fund formation lawyers and fund finance lawyers and between sponsors and lenders.

Finally, we can look forward to a proliferation of use cases and asset classes. We have only spoken about mid-market private equity, which is our focus, but we will see greater use of this tool in different asset classes and for different borrower types, not just for funds, but also for GPs, LPs, collateralised fund obligations and rated-note feeders.

There is certainly still a lot of room for growth in this market and we are only in the early innings. As we continue to educate the various stakeholders around the potential benefits of NAV facilities, we can expect to see activity levels continue to increase across the board, which is really exciting. ■

Q What are some of the typical issues that sponsors encounter when looking to NAV loans, and how can those be overcome?

It may be a soundbite, but it is really about education, education, education.

The number of stakeholders involved in a NAV loan is more than in a direct lending transaction, with varying levels of familiarity with NAV: internally, often a combination of the managing partner, C-suite, fund finance team, head of capital markets and head of investor relations can be involved.

Externally there are LPs and the LP advisory committee, which the sponsor will seek to help educate about the merits of the proposed transaction.

First, the lack of informed fund modelling and analysis can keep NAV a purely academic discussion. We believe the path to education, both internal and external, is found through analysis – where stakeholders are looking for answers to pre-/post-NAV fund metrics and sensitivity analyses.

A second issue that often arises is around use case, where there are multiple use cases on which we can educate sponsors, both at an asset-level, money in and in terms of money up for managing fund liquidity. That makes the use case for NAV loans much broader and more powerful.