

Private Capital Solutions

# NAV facilities to private equity and private credit borrowers

## Common ground or different directions?

## Introduction

The pressures of the recent macro-economic environment and the desire of fund managers to use leverage to efficiently increase returns have driven demand for leverage solutions and liquidity alternatives.

Fund net asset value (NAV) – secured against the value of a fund's portfolio – is one such alternative that has garnered significant popularity in recent times as other sources of capital have become increasingly expensive.

We have advised on the structuring and negotiation of a diverse range of NAV facilities. NAV finance has seen various innovations and the boundaries around what we might consider NAV facilities constantly

shift to encompass lending as diverse as real estate back leverage and secondaries lending. Two common scenarios for NAV financings are those for private equity fund borrowers (**PE NAV**) and those for private credit fund borrowers (**PC NAV**). In this article, we examine common ground and potential differences between PE NAV and PC NAV.

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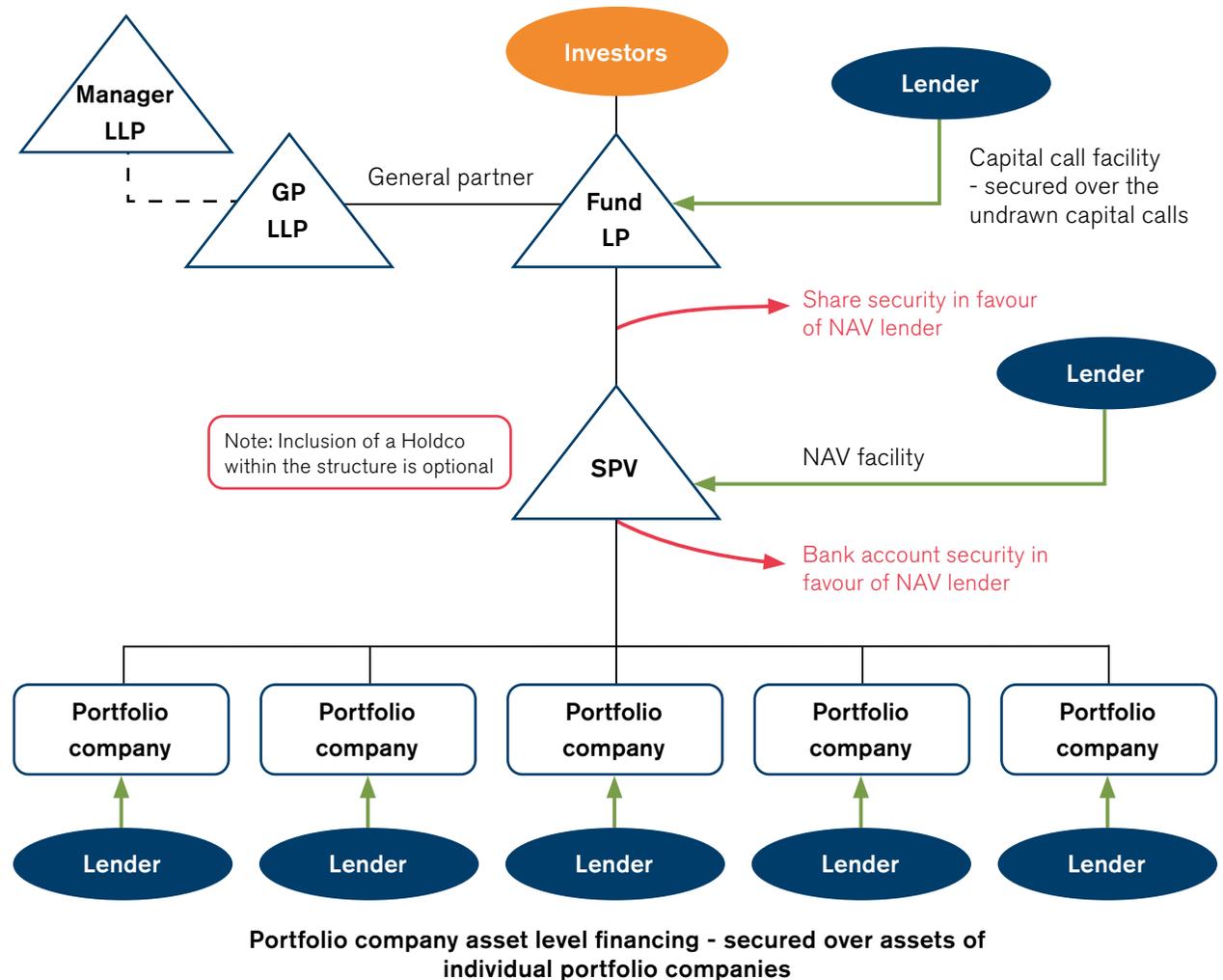
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# NAV facilities with private equity fund borrowers

NAV facilities to private equity fund borrowers seek to leverage the value of the fund's portfolio as a whole and utilise its overall value and the distributions flowing up from it to provide additional liquidity to the fund.

The NAV loan is often made available to a Holdco or SPV sitting between a fund and the portfolio assets. If the fund has not been structured with such a vehicle in place, it may be possible to restructure to provide it, albeit asset level loan agreements, shareholder agreements and other documentation must be scrutinised to ensure this will not cause any provisions (such as change of control) to be impacted.

Diagram 1: An example of a private equity fund with a NAV financing.



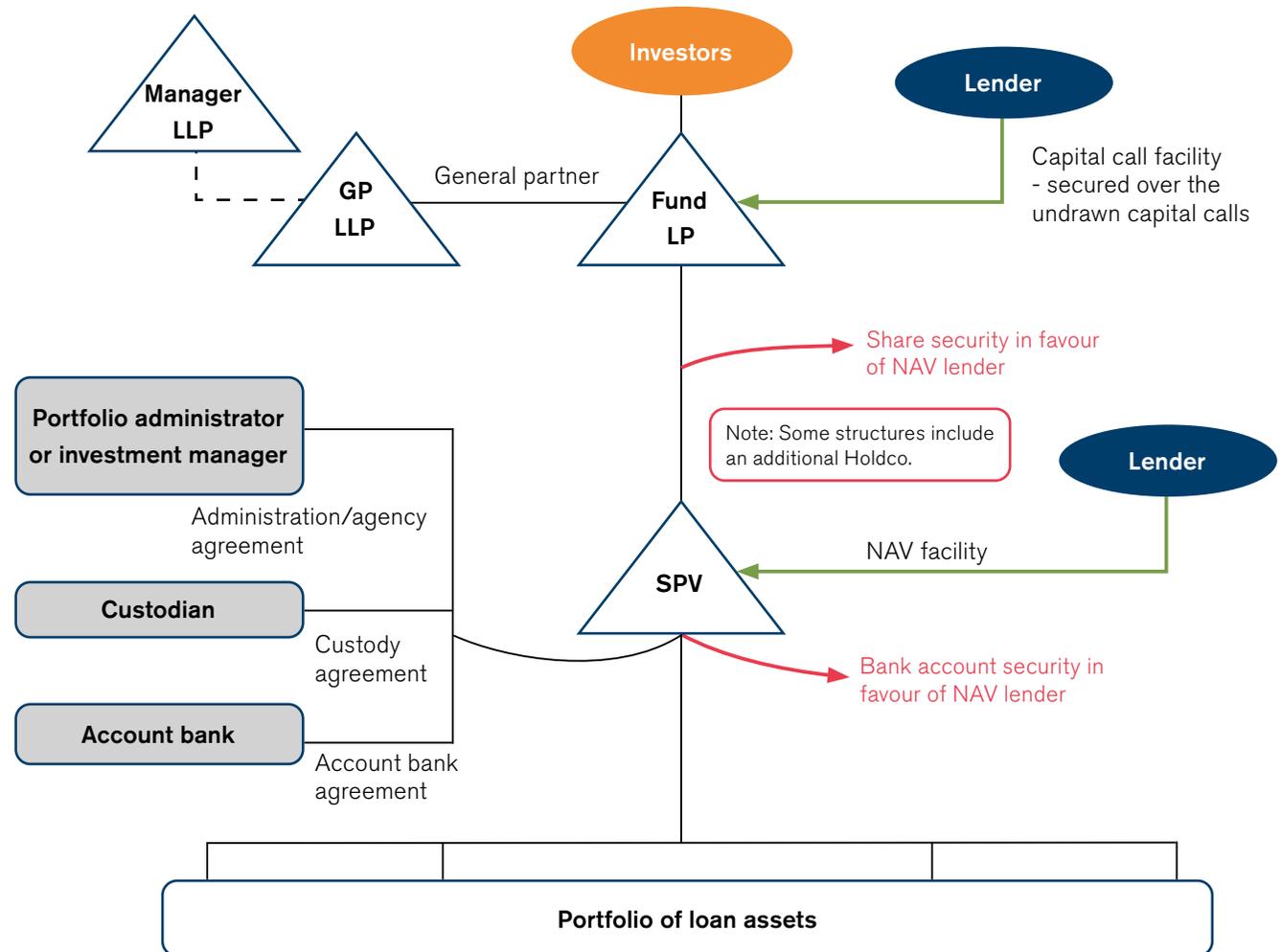
# NAV facilities with private credit fund borrowers

A new private credit fund or private equity fund will often be structured with a NAV facility in mind. For private credit funds NAV facilities will often be put in place during the early investment period of the fund, ready for when the increasing NAV of the portfolio allows for borrowing.

This type of fund leverage facility or asset backed lending facility, while qualifying as a NAV facility as it is secured against the value of the portfolio assets as a whole, has similarities with CLOs and other forms of asset backed lending secured against a collateral pool. It may use related concepts – for example including a payment waterfall for interest and principal collections on periodic dates. The borrowing base may be constructed using a complex set of eligibility criteria and concentration limits, depending on the size and diversity of the loan portfolio.

Both PE NAV and PC NAV facilities are based on the principle of borrowing against the NAV of a fund's portfolio in order to return maximum value to its investors. So, what similarities and differences are there between these types of facility in practice?

Diagram 2: An example of a private credit fund with a NAV financing.



# Common ground?

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## 1. Security

NAV facilities are often provided to funds with other types of financing in place. For example the capital call facilities shown in diagrams 1 and 2 above and, for PE NAV, financing at portfolio company level. Therefore, a question common to all NAV facilities is how to provide security without infringing on other ringfenced collateral.

Security structures are increasingly innovative but for both PE NAV and PC NAV they typically consist of one, or a combination, of (a) security over shares or other ownership interests of a holding company between the fund and the underlying assets that will often be the borrower of the NAV facility, and (b) security over the bank accounts into which distributions from portfolio companies are paid, effectively capturing the value to the fund of both the portfolio as a whole, and the cashflows up from the portfolio.

## 2. Diligence

Whatever the type of assets held by the fund, NAV lenders must diligence the portfolio assets and fund documentation and look carefully at distribution flows (with the aim of obtaining bank account security as near as possible to the source of the distributions themselves).

However, the level and type of diligence will differ greatly between, for example, a fund holding a few or only one asset and a fund holding a wide portfolio of possibly liquid/ traded debt instruments.

For a private equity fund borrower with existing assets, a lender will typically check shareholders agreements for transferability issues on an enforcement, and/or look into the amount and terms of leverage at portfolio level. A private credit fund borrower will typically put the NAV facility in place before loan assets are acquired, and the more extensive eligibility criteria

and concentration limits then function as a type of diligence, ensuring that assets which are unacceptable to the lender do not end up in the borrowing base.

## 3. Borrowing base

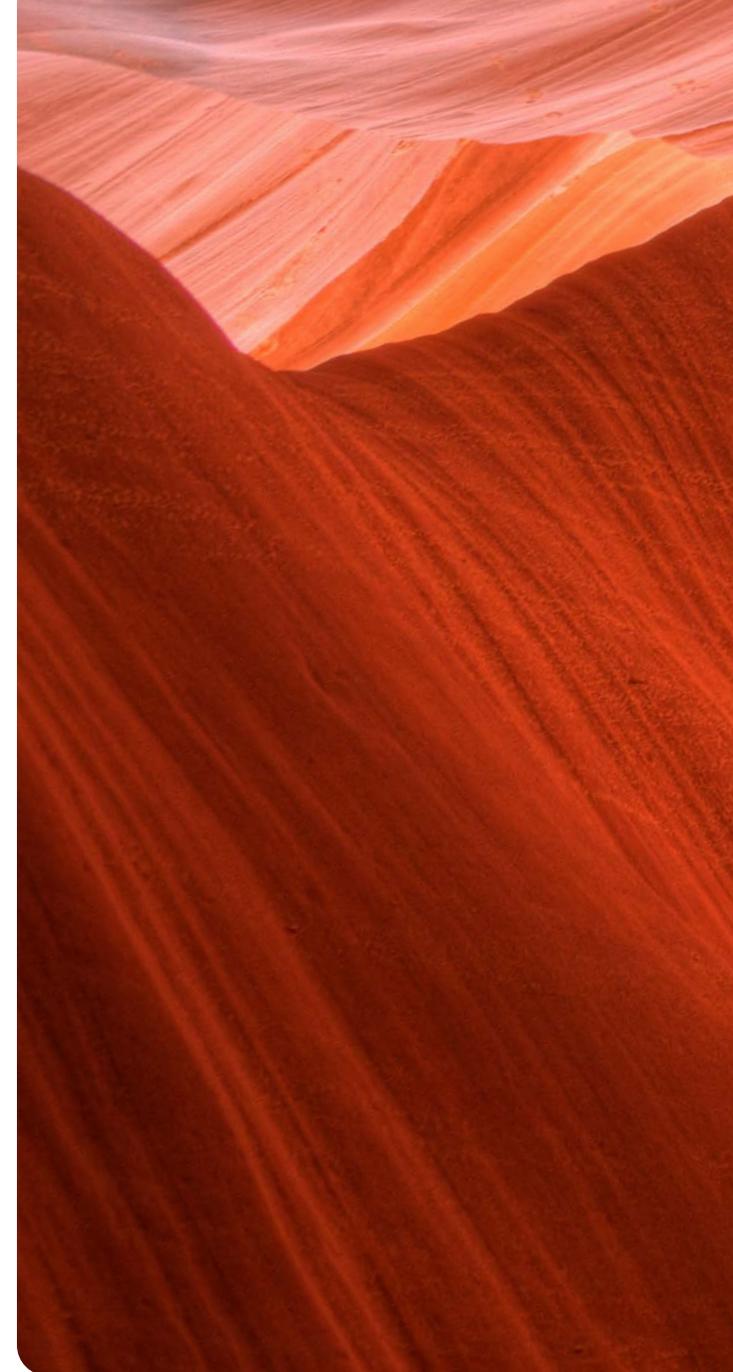
The value of the portfolio assets in both PE NAV and PC NAV operates as a borrowing base to determine the size of the NAV loan available. In both cases the lender will consider the type, number and liquidity of the portfolio assets to assess how the borrowing base should be calculated.

The borrowing base for PE NAV will usually consist of the aggregate NAV of eligible equity interests in the portfolio companies to which certain (limited) concentration limits apply and deducting the NAV of assets affected by certain defined events that result in them becoming ineligible. PC NAV borrowing bases will generally be a complex set of eligibility and concentration criteria. Cash in secured bank accounts is usually (but not always) included in the borrowing base.

## 4. LTV covenant

The LTV calculation will be a key metric for any NAV lender to check that the value of the portfolio as a whole is providing sufficient coverage for the amounts advanced under the NAV facility. A PE NAV facility will typically have an LTV covenant often calculated using the GP's own NAV valuation (with challenge rights if the lender believes this to be incorrect). In PC NAV there may not be an explicit LTV covenant at all, but if the outstanding loan amount is greater than the agreed borrowing base at any calculation date, there will be a requirement to repay the loan until it does not exceed this.

Broadly speaking, PE NAV generally has LTV covenants set at lower than 30%, whereas for PC NAV, with greater eligibility criteria and transferability of collateral assets, LTV can reach up to 70%.



# Different directions

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## 1. Purpose

The purpose of NAV lending can range widely. PE NAV facilities are used by private equity funds in a number of different ways, including to:

- make follow on or accretive investments;
- provide asset support to avoid a sale in ill-suited conditions, or refinance asset level debt where a NAV facility is more economically effective; or
- fund distributions to investors – it may be particularly advantageous to the fund to do this if investors will use distributions to invest in continuation or follow on funds in a difficult fundraising environment. For more on this, see our article [asset financing for credit funds on privatecapitalsolutions.com](https://www.privatecapitalsolutions.com).

PC NAV facilities are generally used by private credit funds as a long-term leverage approach to increase the returns obtained from portfolio assets and to allow the fund to originate a greater amount of generative assets.

## 2. Cash sweep

Although sometimes cited as one of the hallmarks of NAV fund financing, cash sweeps are not a universal feature, being much more common in PE NAV, where they can operate through the life of the NAV facility or be triggered when a certain LTV level is reached.

Where a PE NAV lender has agreed to provide a “concentrated” NAV facility – secured against a small portfolio of assets, usually when the fund is in its divestment stage – cash sweeps (along with more extensive information covenants about the assets) are usually mandatory, in an attempt to counterbalance the risk of lending against a less diversified portfolio.

In PC NAV the cash sweep generally only operates where the borrowing base test (i.e. borrowing base to outstanding loan amount (see page 5, section 3. Borrowing base)) has been exceeded, or during the amortisation period.

## 3. Covenants

In addition to the LTV controls (see page 5, section 4. LTV covenant), a PE NAV facility will often require a covenant relating to the number (and possibly diversity) of portfolio assets.

In PC NAV the mechanisms of the facility itself (primarily the eligibility criteria and concentration limits) control the assets which constitute the borrowing base. Bank lenders may require portfolio interest cover ratios, liquidity tests and certain other financial ratios depending on the portfolio/strategy of the fund. There are also diversity requirements that dictate the advance rate and a number of collateral quality tests (for example, the minimum weighted average spread of the portfolio).

# Issues and developments

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## 1. Investor views

The mid-market PE strategy of using NAV finance for follow on investments has become well understood and generally accepted, whereas its use to fund distributions to investors is more contentious. Many investors feel that this is not the type of return on their investment they want - particularly where PE NAV facilities are employed to finance callable distributions which can then artificially increase return figures. There is likely to be something of a reckoning with LPs as to whether this is a product that is generally accepted in the same way as subscription and capital call facilities were tested several years ago.

PC NAV does not suffer from the same tensions, as investors are likely to have sought and approved a levered strategy when deciding to invest in the particular private credit fund.

## 2. Continuing innovation

As PC NAV begins to mature, it is increasingly employed in innovative ways, in particular with its incorporation in evergreen/open-ended funds. For more on this see our article [Evergreen credit funds on privatecapitalsolutions.com](#).

## 3. Securitisation

An issue often faced is whether a particular NAV facility qualifies as a securitisation under the EU Securitisation Regulation (Regulation (EU) 2017/2402) and as onshored as part of the Brexit process to form part of UK securitisation regulations. This is unlikely to be a concern in PE NAV structures but in PC NAV lenders tend to want the transaction to qualify as a securitisation for their own regulatory capital purposes. It is important to ensure that the correct regulatory treatment is applied and that if qualifying as a securitisation, the fund is up to speed on the implications of and ongoing obligations arising from that qualification.

## 4. Confidentiality

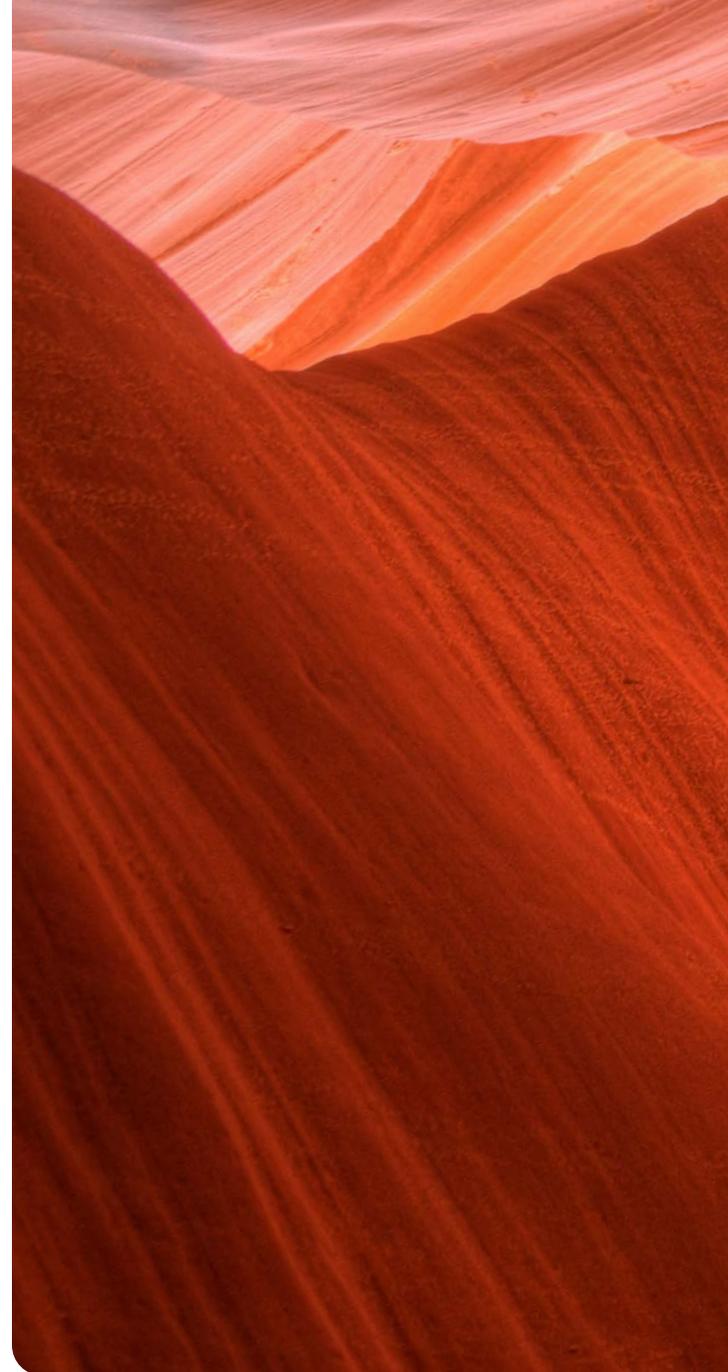
Both private equity fund and private credit fund borrowers are understandably reticent to share certain information such as portfolio performance and the identity of portfolio advisors with lenders who could possibly also be competitors. Accordingly there are usually tightly controlled transfer provisions in the facility agreement to ensure that the loan cannot be transferred to certain competitors without borrower consent.

## 5. Valuations and other regulatory focus

The private markets are increasingly an area of focus for regulators as they seek to better their understanding of this rapidly growing sector of the financial markets.

The second half of 2023 brought with it a wave of regulatory activity starting with the announcement by the Financial Stability Board of its review of the disciplines and governance around private market valuations. In the UK, the Financial Conduct Authority has announced that it will carry out a similar review. These reviews stem from a concern that existing market practice and governance procedures for private asset valuations may not be sufficiently robust, a concern shared by both the Bank of England and the Prudential Regulation Authority who have voiced that the unregulated private capital sector may pose potential risks to the regulated sector.

It is yet to be seen what the full impact of any resultant regulation or guidance will have on the private markets and the use by it of tools such as NAV facilities.



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