



Houlihan Lokey

# NAV Lending Market Update and Valuation Considerations

December 2023

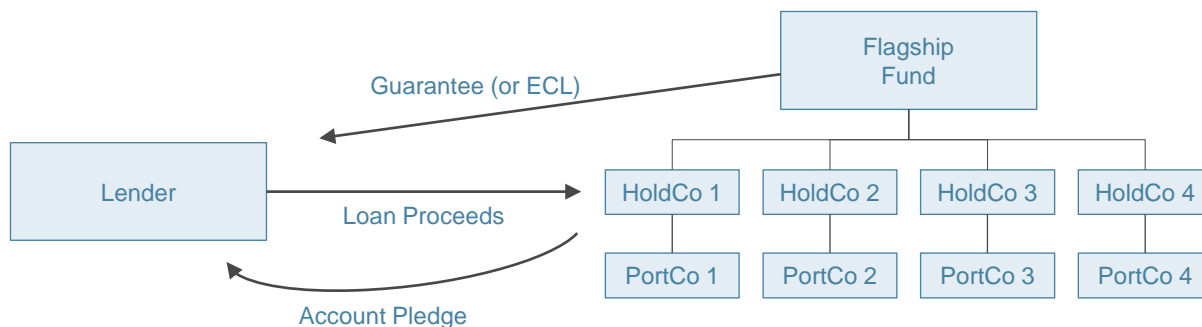


# Overview of NAV Lending

## NAV Loans

Net asset value (NAV) loans have increased in relevance since the public capital markets seized up in the spring of 2022, thus limiting the opportunity for fund managers to profitably exit illiquid investments. NAV loans are a form of fund-level debt financing where one or more lenders provide senior secured debt capital up to a specified loan-to-value (LTV) ratio against a portfolio of cash-flowing private asset interests or receivables. NAV loan structures are tailored to the funds' objectives. They can be privately rated and placed privately with banks, asset management arms of insurance companies, pension funds, sovereign wealth funds, and alternative credit managers. Achieving an investment grade rating is possible subject to asset diversity, asset cover tests, and other structural components. There is typically room to structure around the specific investment portfolio based on the general partner's (GP's) objectives. These objectives can range from financing a limited partner (LP) distribution to increasing distribution to paid-in capital (DPI) or financing follow-on investments into strongly performing portfolio companies or other forms of investments.

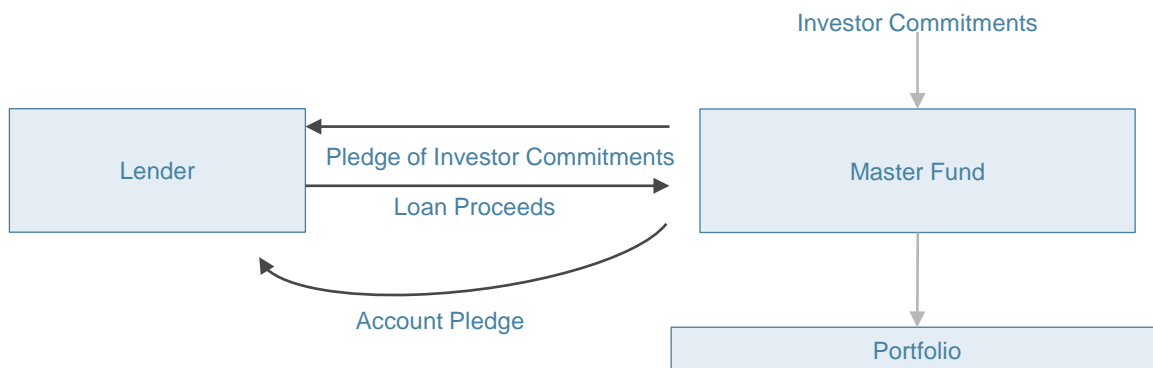
## NAV Loan Structure



## Subscription Lines

Subscription lines are another form of fund-level financing. A subscription line or "capital call line" is a form of financing that is secured by the uncalled equity capital commitments of the LP investors in a fund, not by the investments. Historically, this instrument has been used as a "bridge" that allowed GPs to delay capital calls to equity investors, hence increasing IRRs. Because these forms of financing were offered by large commercial banks for one- or two-year terms, their costs were very low; however, some banks required (and some still require) periodic "clean downs" of called commitments. Bank-provided subscription lines have highly standardized structures anchored around a single LTV test. At any point in time, the facility needs to be borrowing-base-compliant, as determined by the static LTV test, or repayment is "accelerated" to de-risk the lender. The subscription line market underwent a fundamental change in the past 18 months as base rates increased. This caused pressure on the commercial banking sector, leading banks to limit capital to their largest client relationships. At the same time, nonbank lenders, including insurance companies, have increasingly expressed an appetite to participate in such facilities—sometimes for longer tenors—on a fixed rate basis and offer more flexibility to managers than banks can offer. Some rating agencies have released methodologies for rating subscription lines, allowing insurance companies to optimize capital charges associated with such loans and optimize pricing terms.

## Subscription Line Structure



## Overview of NAV Lending (cont.)

Separately from the senior secured debt instruments mentioned on the previous page, different tools are being used in the fund finance market to help managers raise junior capital, which is more flexible but more costly than the aforementioned debt instruments. Junior capital instruments include preferred equity, feeder funds, and collateralized fund obligations.

### Preferred Equity

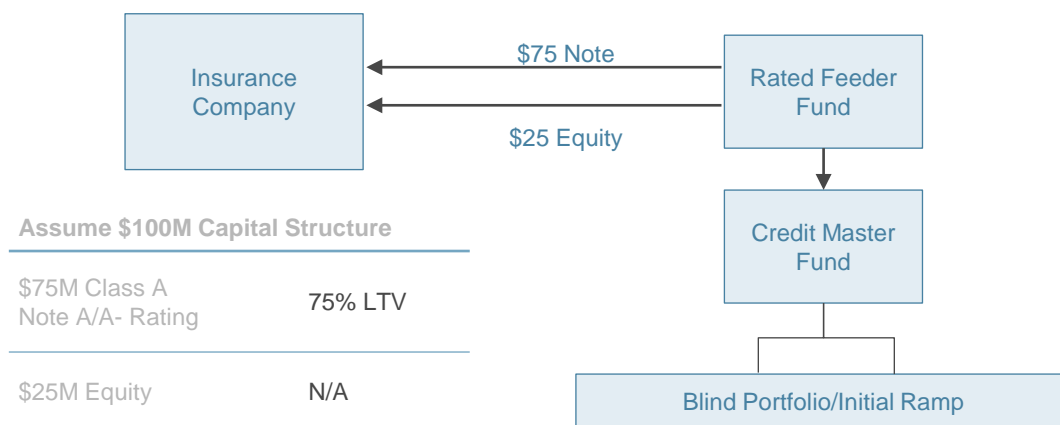
Preferred equity instruments involve the issuance of equity capital (rather than debt) and provide investors with ownership rights, unlike the collateral-based structure of NAV loans and subscription lines. Preferred equity investors typically receive a stake in the fund, and the investment yields a fixed dividend percentage or a percentage of realizations from all or a subset of the fund's portfolio during a period of time driven up to the point where a specific threshold return is met, rather than an interest rate during a fixed tenor. Preferred equity offers greater capital flexibility around maturity and interest payments and does not require the same degree of collateral pledges and related pledge consents often required by lenders. Offsetting this greater flexibility is at least a temporary dilution in the fund's ownership structure and greater cost of financing.

### Rated Feeder Funds and Collateralized Fund Obligations

Rated feeder funds and collateralized fund obligations (CFOs) allow GPs and LPs to generate liquidity out of existing and/or future equity interests in one or several funds. These structures are said to be "LP-led" when they are established to generate liquidity for an LP or a group of LPs.

Both rated feeders and CFOs issue debt and equity tranches. The debt tranches are rated by a nationally recognized statistical rating organization (NRSRO) to enable insurance company investments in a rated feeder fund or CFO on a capital-efficient basis. Other investors with higher risk-adjusted return objectives will typically participate in mezzanine and equity tranches issued by these vehicles. The capital instruments issued by the rated feeder or CFOs finance the purchase of equity interests, which collateralize them on a senior, mezzanine, or junior basis. Depending on regulatory treatment, insurance companies will invest in the debt or a "vertical slice" of both the debt and equity.

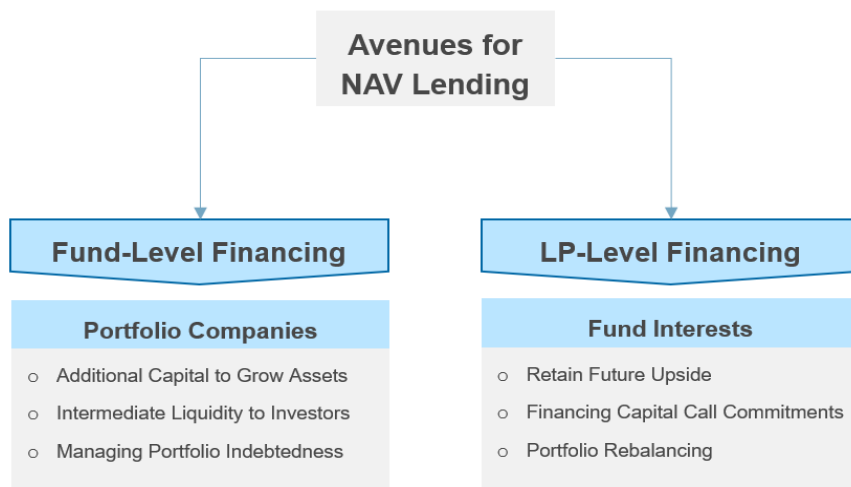
### Rated Feeder Fund Structure



## Valuation Methodology

Houlihan Lokey's teams have seen an increasing number of inquiries for valuation expertise on this new and growing asset class. Distinct valuation considerations arise in fund-level financing, often requiring an evaluation or appraisal of LP interest collateral. Although Houlihan Lokey has extensive experience advising on LP interest valuations, sales, and acquisitions, this publication will focus on valuation considerations related to fund-level financing, which we consider to be debt financing incurred by a private investment fund that is primarily backed by the fund's investment portfolio.

### NAV Lending Types



Typically, NAV lenders are seeking the valuation of a NAV loan or the valuation of collateral supporting the NAV loan. The valuation of a NAV loan is needed when the lender needs to record the value of the NAV loan at fair value or when the borrower needs to record the NAV loan liability at fair value. The valuation of collateral is often required to satisfy provisions in the NAV loan credit agreement related to the auditing or testing of collateral values or to calculate or test borrowing base calculations.

The valuation of a NAV loan requires an understanding of the underlying collateral, particularly its composition (private equity investments, private debt investments, venture investments, real estate investments, etc.) and how the collateral is valued by the fund that is fair value or nonfair value (e.g., cost, accrued cost, etc.). If the collateral is reported at fair value, the amount of additional work to establish collateral coverage for the NAV loan may be reduced; however, the date of the fair value reporting relative to the valuation date of the subject security should be considered. If there is considerable time between the date the collateral was last valued and the valuation date, adjustments may be needed to account for potential changes in value during that time. Certain market benchmarks can aid in determining the appropriate adjustment. If the underlying collateral for a NAV loan is not reported at fair value, then more detailed work may be required to establish whether there is sufficient collateral coverage.

#### Valuation of Performing NAV Loans

When an enterprise value analysis or asset collateral analysis indicates there is sufficient value coverage through the subject debt security, the discounted cash flow approach is generally employed to estimate fair value whereby the security's projected cash flows are discounted to present value, utilizing a discount rate that aligns with the risk associated with achieving these cash flows. The discount rate used in this analysis can be derived by considering the rate of return implied by the original transaction and then calibrating that rate to account for changes in market spreads and credit-specific factors.

#### Valuation of Nonperforming NAV Loans

When a subject security faces nonperformance or the loan is unlikely to be fully recovered under its repayment terms, the net recovery approach or liquidation approach may be appropriate. The specifics of each approach are outside the scope of this publication, but generally, these approaches are used to estimate the expected recovery amount for the subject security in the event of financial distress. The determination of the collateral value and expected amount and timing of cash flows is critical in this scenario.

## Valuation Methodology (cont.)

### Benchmark Rate Selection for NAV Loans

For the valuation of a NAV loan, the selection of appropriate market benchmarks is an important step. Depending on the assets within the portfolio, various market rates of returns such as loan indices, corporate credits, collateralized loan obligations (CLOs), and business development company (BDC) bonds can be utilized as benchmark rates. In selecting these benchmarks, it is important to understand similarities and differences between the subject security being valued and the selected benchmark security, including differences in seniority, security, structural provisions, liquidity, and collateral type, among others.

### Debt Valuation—Debt Investment Collateral

For the valuation of debt investment collateral, which may consist of debt investments such as a portfolio of middle-market loans, one can consider qualitative factors, including the timing of the investment relative to the valuation date and the financial performance of the company since the investment date, as well as quantitative factors such as the changes in market benchmarks such as high-yield bond indices, loan indices, and corporate credits we deem comparable to the investment.

- For performing debt collateral, we employ a discounted cash flow approach explained in the “Valuation of Performing NAV Loans” section.
- For nonperforming debt collateral, we employ a net recovery or liquidation approach explained in the “Valuation of Nonperforming NAV Loans” section.

### Equity Valuation—Equity Investment Collateral

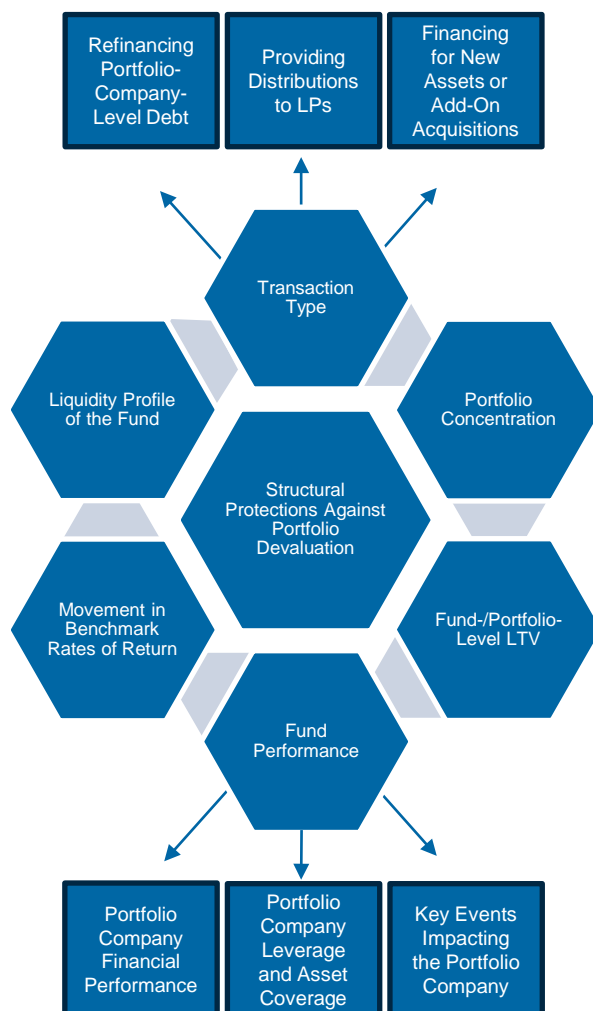
For the valuation of equity investment collateral, we first determine the fair value of the underlying portfolio company. We consider the market approach and/or income approach to estimate enterprise value. Then, we subtract the net debt to arrive at the NAV or equity for each portfolio company.

The market approach provides value indications for a company through a comparison of the company with the guideline public companies (GPC) method or guideline transactions method (GTM). The market approach entails selecting relevant financial information of the subject company and capitalizing those amounts using valuation multiples that are based on the observed multiples for the guideline public companies and guideline transactions.

A valuation multiple is an expression of what investors—in the aggregate—believe to be a reasonable valuation for a company relative to a measure of financial information, such as revenues, earnings, or cash flows. The multiple incorporates expectations of growth as well as risk.

A form of the income approach is the discounted cash flow (DCF) method. This method estimates the value of a company as the present value of the projected net cash flows to be generated by the company, and theoretically available (though not necessarily paid) to its various capital providers. The discount rate used in the DCF method is intended to reflect all risks associated with realizing the stream of projected net cash flows. It can also be interpreted as the rate of return that would be required by providers of capital to a company to compensate them for the risk-adjusted time value of their money. Unlike the valuation multiple, however, the discount rate contains no implicit expectations of growth for the net cash flows. Instead, such growth expectations are contained within the projected net cash flows and terminal value assumptions.

### NAV Loan Valuation Considerations



## Conclusion

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NAV lending is becoming an increasingly valuable tool for fund managers and the growth in this asset class is part of the natural evolution of financial markets. NAV loans are often used at the fund level to accelerate distributions to investors, increase investment capacity, manage portfolio indebtedness, and enhance the return profile of a fund. As the market for NAV lending grows, so does the need for trusted advisors such as Houlihan Lokey to help navigate the complexities of these transactions and the valuation requirements that come along with them.

## About the Capital Markets Group and the GP Advisory Group

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Houlihan Lokey's Capital Markets team has in-depth expertise in structuring and placing bespoke fund-level financing instruments, including on a rated basis, to source and compete flexible and cost-efficient financing proposals from market participants. Our team of 90+ professionals globally, with expertise across products and geographic markets, enables differentiated placement of bespoke financing instruments and selective access to the most constructive lenders for a given client need. We partner with the GP Advisory team within the Private Funds Group, a leading advisor to GPs with significant market share globally, to identify and address GP-level considerations, and, where needed, we partner with our Financial and Valuation Advisory partners to significantly enhance our overall value proposition to sponsor clients. Contact names of key individuals involved can be found at the end of this publication.

## About Portfolio Valuation and Fund Advisory Services

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Houlihan Lokey's Portfolio Valuation and Fund Advisory Services practice is a leading advisor to many of the world's largest asset managers who rely on our (i) strong reputation with regulators, auditors, and investors; (ii) private company, structured product, and derivative valuation experience; and (iii) independent voice. We rapidly mobilize the right team for the job, drawing on our expertise in a wide variety of asset classes and industries, along with our real-world transaction experience and market knowledge, from our dedicated global Financial and Valuation Advisory business.

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