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THE FUND FINANCE MAGAZINE

NON-BANK LENDERS AND NAV FACILITIES

ILPA NAV FACILITY GUIDELINES

INTERVIEW WITH SCOTT MCMUNN, CEO OF THE LMA

With contributions from

LMA
Reed Smith
Travers Smith

PRAXIO LAW&TAX

ABOUT THE AUTHOR

Michael Mbayi

Michael Mbayi is the Head of Banking & Finance at **Praxio Law & Tax**. **Michael** is one of the most experienced fund finance lawyers and advises leading financial institutions, private funds sponsors and alternative lenders on a wide variety of transactions including subscription facilities, hybrid/NAV facilities, as well as GP and Management fee facilities.

Michael was **awarded** in 2021 by **Fund Finance Association** for his contribution to the industry. **Michael** has been **recognised** in 2022 by "**The Drawdown**" as one of the most influential Fund Finance experts. **Michael** has been **quoted** by **Legal 500 EMEA 2022** as "very knowledgeable on Fund Finance matters", "responsive" and "particularly active on behalf of a lender-focused client base".

Michael is the author of various Fund Finance publications and a member of the Diversity Committee of the Fund Finance Association.

Beyond Fund Finance, **Michael** is involved in banking regulatory, structured finance and capital market transactions.

Editorial

Dear Friends,

This is with a great pleasure that we issue this second instalment of our Fund Finance Magazine.

The magazine starts with a discussion with **Scott McMunn**, CEO of the **Loan Market Association**.

Scott will share his views about the Fund Finance industry.

Leon Stephenson from **Reed Smith**, will introduce us to the nuances and the structuring solutions in relation with non-bank lenders and NAV finance.

Hannah Ramsey from **Travers Smith** will then introduce us to the ILPA guidelines on NAV facilities.

We hope that you will enjoy the reading of this second issue!

Michael Mbayi

Thanks for their contributions:

LMA Loan Market Association

ReedSmith

TRAVERS SMITH

CONTENT

ABOUT PRAXIO LAW & TAX

We are an independent multi-service law firm in Luxembourg. As corporate, finance, investment funds and tax attorneys, we service clients in all matters related to business law and both direct and indirect taxation. We are able to handle the most complex cross-border legal, regulatory and tax structuring matters, along with any commercial or business litigation. Our senior professionals have significant experience in advising private equity houses, multinationals, family offices and high-net worth individuals during their entire business and private estate life cycle from initial acquisition structuring and financing through restructuring and refinancing to exit, disposals and estate transmission.

We advise the leading financial institutions acting as lenders, in a wide range of fund finance, real estate finance, leverage finance and structure finance transactions.

Our legal teams have longstanding expertise in helping clients to structure private equity and venture capital transactions within regulated and non-regulated investment vehicles. This support includes negotiating the acquisition and financing, and subsequently drafting the relevant documents. We also assist with the drafting and tax structuring of management incentive arrangements and their implementation. Our clients appreciate us for our clarity, practical solutions, timeliness and efficiency.

The members of our firm have completed high-level academic training in the Luxembourg, French and Anglo-Saxon legal systems and are able to work in a trilingual environment. Our business lawyers work closely with fellow professionals in key foreign jurisdictions, enabling us to coordinate investment and structuring/restructuring projects in Luxembourg and abroad. We see ourselves as business partners and not solely as lawyers. We are committed to providing our clients with:

A full understanding of their business and culture;

A thorough focus on their objectives, both short-term and long-term;

An unwavering commitment to helping them solve their problems in the most efficient and cost-effective way. If something does not make commercial sense to our clients, it does not make sense to us.

Highly committed to the fund finance industry, Praxio's fund finance team, lead by our Head of Banking & Finance, Michael Mbayi, is involved in a wide range of transactions including subscription facilities, NAV facilities, hybrid facilities, and GP and management fee facilities.

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INTERVIEW WITH SCOTT MCMUNN CEO OF THE LOAN MARKET ASSOCIATION (LMA)

BY MICHAEL MBAYI | **HEAD OF BANKING & FINANCE (PRAXIO LAW & TAX)**

Fund finance over the years has become an asset class on its own. During our most recent Fund Finance Expert Talk, Scott McMunn, CEO of the LMA, shared with us his views of the industry.

The full interview, which has been recorded in November 2024, is accessible on our YouTube channel here: https://youtu.be/mZsOe94ersE?feature=shared

Michael: Can you please introduce in a nutshell the LMA?

Scott: The LMA is a respected authority to voice all the loan markets, including, notably, investment grade, high yield, leverage finance, real estate finance, fund finance, credit insurance risk, export credit, commodity and trade finance.

The LMA has more than 900 members, including large banks, law firms, and technology firms from 70 countries across Europe, Middle East and Africa.

The main purpose of the LMA is to enable liquidity, efficiency and transparency across the loan market.

Michael: You are the CEO of one of the main finance association active in Europe, Middle East and Africa. I would be interested to hear about some of the challenges that you faced during your career and about what you have learned from these challenges.

Scott: I would break it into two parts. The first is how firms handle changes and how firms handle difficulty, notably during a period of turmoil. Some of the positions that I had been holding, notably running risk and running business, have been through periods of turmoil (as for instance in the 1990's; in the early 2000's with the first technology bubble, or the GFC in 2008). I think that the challenges which arose from these events are very different but what is in common is that it is important to have access to liquidity, to stay ahead of perception and to build confidence.

The second part, on a personal level is, how do you consider your own career paths during these financial crises and how do you pivot and connect with mentors or leaders which have a clear vision and strategy to navigate beyond these challenges.

Concerning the LMA, some of the challenges are how do you engage members for contributing to working groups. How do you actually penetrate within the institution to have key stakeholders committed to contribute. People who are passionate to drive the cause, by contributing to working groups, by interacting with the regulators, or by using their own time to advise some of the junior members of the association.

The other interesting thing is the pace of change in the financial markets. We moved from a place where few people were talking about private credit to a place where private credit occupies a significant portion of the financial press.

Another point is, the significant emergence of fund finance. Fund finance has ben around from many years and we see a significant growth and innovation in this industry.

There are also interesting development in the technology space.

Michael: Why Fund Finance is in the LMA scope?

Scott: Many of our members are banks, and much of subscription finance historically has been provided by banks. Therefore, we have many members which have been providing subscription finance for a long time. Also, subscription finance is fundamentally a loan, so this is in the scope of the Loan Market Association.

On the other hand, the users of fund finance products are GPs and fund finance products are used to finance structures into which are investing LPs. At the GP level, our members range from the large sponsors like private equity firms, all the way to private credit firms, real estate and infrastructure funds. At the LP level, a lot of our members like insurance companies, asset allocators, and pension funds are LPs in some of those structures.

New providers of fund finance like credit funds are also members of the association.

This is a trillion dollar market, it is a significant market in terms of current size of financing. Given the size of the current private equity and the private credit market, it is going to get bigger and bigger.

Michael: I agree, when one talk about fund finance, there are generally two key words: growth and innovation. Growth because this is an industry which have been developing significantly over the years. Innovation because it has always been part of the DNA of fund finance, which is a blend between fund and finance technology. What are your thoughts about the fund finance industry?

Scott: Back in the nineties, I saw the first AAA rated CFO transaction, backed by subscription lines. So these structures exist for more than 30 years. What we are seeing is more visibility of an asset class and it now becoming into public sight.

Fund finance is now a significant part of the ecosystem and a significant part of finance. There is a significant volume there. It is a very exciting area in which to be involved at the moment.

In terms of product innovation, I think that you are exactly right. Almost like the early days of private credit and of leverage finance, there is a huge amount of flexibility and bespoke nature of what these agreements will look like, the types of leverage, and a lot of that supported by the inherent complexity in terms of GP domicile, pledge agreements, and the mix of the underlying assets. Therefore, all this requires smart people and really intelligent innovation.

And this is before, we even get into the delivery mechanism. The new delivery mechanism may be through securitisations. A lot of the channels to create further growth have been to credit risk insurance and trough some of the banks using portfolio management tools, to free up some capacity to do more.

On the actual demand side, you have GPs looking for more innovation and ingenuity to give themselves some more optionality. Certainly, private equity has seen a slowdown of exits, maybe that's back by the lack of an IPO market. In the venture capital markets, GPs are seeing less pops, less significant valuation rises,

so there is a need to create more flexibility and optionality to maintain and extract further value from some of the portfolio investments.

Also, you are seeing the rise of new forms of GPs / LPs structure, specifically, private credit, which again is interesting if you can add secured and lower risk types of optionality and leverage to create a little bit of extra return.

Michael: in your views what are the challenges and opportunities for the fund finance industry?

Scott: Starting on the challenges, a challenge is how you dispel some of the myths and negative press. In our blog, we have published articles which dispel these myths. Indeed, in fund finance, there is a real benefit for GPs and LPs. It gives more optionality to the GP and it permits to the GP to attract value in building a portfolio. We want to be a brand shield, a voice for the market so that we can dispel some of those myths.

The other challenge, and I think that it is a good challenge, is coming from the regulators. The regulators have been increasingly asking questions about private markets. Private markets create a broach church about what is included in that definition. But, ultimately, where you have private markets, the nature of the beast is that the definition says private. Private means that you have limited information, limited disclosure. So the challenge is how regulators assess the activity of private markets. So the work to be done in relation to private markets is education, information, and collecting data.

Michael: Coming back to the LMA, what are your members' expectations generally?

Scott: We have different type of members, so they want different type of things. An example is the LMA events. Our members like the content and the networking opportunities provided by the LMA branded events. Some other members want advocacy and us to be very strong on protecting and maintaining the integrity of an asset class. Fund finance is an example where the LMA may provide common language, common taxonomy and provide education to make sure people understand it more. For other members, a focus is what the LMA is doing in terms of technology and AI, and what the LMA does to increase the use of tokenization and the blockchain.

Michael: What would be your picture of success for 2025?

Scott: The easy measure of success would be increasing our membership. Another easy measure of success would be, how you are impactful on social media, like LinkedIn.

I like too softer objectives. I would like to look back at the end of 2025 and feel that we had a real support from our members through their contributions to our work.

I would like to feel at the end of 2025, that the global regulators and the national regulators, respect the voice of the LMA as an authority and as a knowledgeable and trustworthy source. Having us sitting one the table as part of the conversation around what should they do, to promote continuation of lending, economic growth through the loan markets, and continuation of sustainable finance to protect the planet and ensure that we are driving that in the right way.

Michael: What are the coming LMA events?

Scott: We always do events and one of our goal is to have events relative to what is happening in the market. We have a sustainable finance conference this week which will focus on blue finance.

We launched a program this year called future lend and it was aimed at the lenders of tomorrow both on buy side and sell side. It is almost like a future talent or like a young talent pool. The initiative is agnostic to the activity of the individual. It is more about giving the opportunity about this young talent pool about how to build a personal brand, how to look at their own personal career, and seek a mentor. We will do two of them a year.

We will work with a third party firm called Deal Catalyst, and do a fund finance event, which will be held in London in January 2025.

We will do a private markets event in Abu Dhabi in partnership with ADGM, Deal Catalyst and the LSTA in February 2025.

I am looking forward to doing small round tables with LPs in the Middle East to talk specifically about fund finance and NAV lending and provide that little bit of education.

We will also need to be in South Africa, in Kenya, in Nigeria, so we need to do Africa. We need to do the Middle East, Dubai, Riyad, and Abu Dhabi. I have got as well Scandinavia, Italy, and Spain. I think that it is about making sure that we are representing all of our members.

What I really like to do, in addition to the big events is small round tables, and have smaller groups share an impactful piece of work.

Finally, we would like to do a flagship technology conference.

Scott McMunn

Scott is the Chief Executive Officer of the **Loan Market Association**.

Scott has held a wide range of leadership roles in finance for nearly 30 years with institutions including Abbey National, Deutsche Bank, and the Royal Bank of Scotland where he was CEO of RBS Asset Management. His most recent roles have been as a principal in a private equity firm and as co-founder in a mortgage fintech.

LMA Loan Market Association

Michael Mbayi

Michael Mbayi is Head of Banking & Finance at **Praxio Law & Tax**. Michael has in depth knowledge of the Fund Finance market and a long-standing experience in Fund Finance. He advises financial institutions as lenders on a wide variety of transactions including subscription facilities, hybrid/NAV facilities, and other bespoke Fund Finance solutions. Beyond Fund Finance, **Michael** is involved in banking regulatory, structured finance and capital market transactions.

PRAXIO LAW & TAX

NON-BANK LENDERS AND NAV FACILITIES - THE NUANCES AND STRUCTURING SOLUTIONS

BY LEON STEPHENSON PARTNER (REED SMITH)

Introduction

There has been a significant increase in the number of NAV (Net Asset Value) facilities to private equity and other funds over several years and a large portion of that growth has come from non-bank lenders and credit funds providing these facilities. Non-bank lenders can provide agility and a certain amount of flexibility when structuring and executing NAV facilities. There are often less layers of internal approvals needed for credit and risk purposes and increased flexibility when it comes to the security package and other forms of recourse.

As demand for NAV facilities and the allocation by investors to private credit grows, it is likely that non-bank lenders will play an even greater role in providing liquidity to funds who require some sort of NAV based facility. These non-bank lenders may be well established direct lending funds who are now allocating a portion of their investments to NAV based lending.

We have also seen insurance companies set up designated teams within their businesses to focus on this type of lending. Finally, there are now several credit funds who have as their sole purpose allocating capital to fund financing facilities, usually in the form of NAV or GP/Coinvest facilities.

This article provides an insight into some of the nuances and structuring solutions we have implemented when working with our non-bank lender clients on NAV facilities.

Are there characteristics of NAV facilities provided by credit funds which are different from NAV facilities provided by banks?

Drawdowns

Most credit fund lenders will either need to draw down from investors or utilize a subscription line facility prior to advancing funds to a private equity fund borrower. If a subline is not in place, the credit fund lender will need to manage its obligations to the underlying borrower to fund a utilization by ensuring that there is a sufficient utilization period to allow it to drawdown from its investors. This means that sometimes a longer drawdown period is provided for in the NAV facility. (e.g. 10 or 12 Business Day

period) If the credit fund lender itself has a subscription line facility it can use, this drawdown period may be reduced to say 3 to 4 days of receiving a utilization from the NAV borrower.

Different pockets of capital

When a bank provides a facility, it is typically one single entity that will be the lender (unless it is a syndicated facility with different banks). When a credit fund or non-bank lender is funding, it may end up drawing from different pockets of capital managed by the same manager. Therefore, it is not surprising to see a number of different lenders, albeit managed by the same fund manager, be a lender of record when the facility closes. A syndicated form of facility is very often used that has as the facility agent, an entity controlled by the manager, or it may have a third party agent appointed.

Are all LMA and LSTA provisions required in the Facility?

There are several LMA or LSTA provisions in facility agreements that are really only there to protect regulated bank entities. Therefore, provisions such as Basle III, increased costs and Bank Levy provisions are not as relevant to a non-bank lender. Caution should be exercised when using a bank NAV form of facility agreement to document a NAV facility to be entered into by a non-bank lender, as alterations will need to be made.

Licensing in local jurisdictions and choice of lending vehicle

Some jurisdictions in Europe and elsewhere, require the lender to be licensed banking entity under their local regulations or European regulations. It is unusual for the non-bank lending vehicle to have any sort of bank license and so it is crucial prior to commencing any NAV financing that the licensing requirements are analyzed to ensure the right lending structure is in place to comply with the regulations.

Insurance money and ratings

Many non-bank lenders are relying on their source of funding from insurance companies and pension funds. For this lending to profitable it is often required to obtain a rating of the debt (either a public or private rating). An increasing number of banks are now also seeking to rate the debt, but the non-bank lenders have been investigating this now for a number of years. Borrowers and their counsel should ask their non-bank lenders upfront whether a rating of the debt will be sought.

Withholding Tax considerations

We work with many non-bank lenders whose lending vehicles are set up in the US (typically Delaware). The choice of jurisdiction of the lending vehicle and the withholding tax position between the borrower and the lender are all preliminary considerations that should be addressed up-front. There are many jurisdictions in Europe that do not have a withholding tax treaty with the US to neutralize any withholding tax hit. These lenders may often have to set up local European vehicles or lend to a borrower in a jurisdiction that does not have withholding tax or in a jurisdiction where there are withholding tax exemptions.

Bank Leverage to credit funds

We work on many transactions for lenders providing back leverage facilities to credit funds who have provided NAV facilities. It becomes very attractive to some lenders if a credit fund borrower has in its portfolio several NAV facilities with different borrowers. The back-leverage lender has good diversification as it will be lending against a pool of NAV facilities that themselves have diversification across different assets. Very often the back-leverage provider will itself be a bank. As the spreads that non-bank lenders obtain on NAV facilities tend to be higher and bank NAV facilities, it can make a credit fund more competitive when competing with bank lenders for NAV facilities to private equity borrowers.

Transfer of lenders rights

Any restrictions on a lenders right to transfer the loan will always be hotly negotiated and this is particularly the case when there is a non-bank lender under a NAV facility. The underlying borrowers will want to make sure that the details of the facility and other confidential information are not passed into the hands of the borrowers' competitors. However, the non-bank lender may need to securitize the loan, or offload exposure, particularly if the non-bank lender has some sort of open ended or evergreen structure. Most European facilities whether provided by banks or non-banks allow the lender to transfer to its affiliates or if there is an event of default continuing, however there may be other circumstances where a non-bank lender will require flexibility to transfer the loan.

Credit support alternatives for NAV facilities

It is quite usual for a bank NAV facility to provide the lender with security over the portfolio of the private equity borrower fund, either through an umbrella share pledge/charge or through share pledges over certain of the assets of the fund. We have seen NAV facilities to large and reputable sponsors where this "equity pledge" recourse is missing and the lender must rely only on security over a bank account into which distributions from underlying investments are swept. Where sponsors have difficulty providing these equity pledges, perhaps due to change of control provisions in shareholders agreements or due to the regulated nature of the private equity funds assets, non-bank lenders have sometimes accepted alternative recourse structures to mitigate the lack of an equity pledge.

Examples include the provision of an equity commitment letter signed by the fund over of the borrower agreeing to inject equity into the borrower if certain events occur. We have also seen an uncalled capital commitment minimum ratio inserted into the facility agreement, so there is always a minimum amount of undrawn capital in the borrower while the NAV facility debt is outstanding. Sometimes there is a fund level guarantee provided by the fund to the non-bank lender to support the NAV debt incurred by the holdco borrower.

If there is concern that monies may not be paid over by the topco's of each investment into a bank account controlled by the non-bank NAV lender, a deed of covenant could be sought, which will have various topcos agreeing to sweep any cash they receive to the designated bank account. Some of our non-bank lenders are even prepared to provide a preference share facility rather than a loan facility to some of their private equity fund borrowers if there are advantages to the borrower. This "Pref Facility" could be established by amending the share capital of the fund borrower or one of the aggregator entities in the fund borrowers equity structure, or through the parties entering into separate loan facility style document under which the parties contractually agree that the non-bank pref provider will be paid out first.

JV vehicles as lenders

Where multiple credit funds with different managers want to provide a NAV facility to the same borrower, we have also seen such credit funds set up a separate JV lending vehicle that they contribute capital to. This JV vehicle will be the lender of record on any underlying NAV facility provide, and the different credit funds who are providing the source of funding under the NAV facility can agree the commercial arrangements between them at the JV vehicle level. This has the advantage of limiting the underlying borrower's involvement or consent to the intercreditor arrangements.

Bad boy acts

Most of our credit fund clients want us to analyze upfront the bankruptcy risks associated with any given NAV structure and how these can be mitigated. We are very often called upon to write an enforcement memorandum that sets out the legal and practical steps needed on an enforcement to seek repayment of monies owed. A Bad boy guarantee is sometimes a protection that our non-bank lenders require. Broadly

speaking, this involves having another entity of substance such as the fund that sits above a NAV borrower or the regulated investment manager that manages the fund borrower, agreeing to guarantee the debt in the event a bad act is carried out (like fraud or willful misconduct). The idea is that this disincentivizes any fund manager from instructing any transfer of assets out of the portfolio in breach of the borrowers undertakings.

Interaction between a subscription line facility and NAV facility

It is important when providing a NAV facility below the fund to consider whether there is any consent needed from a subscription line lender at the fund level. A subscription line facility will typically prohibit any other debt at fund level, but it may not prohibit the giving of an equity commitment letter, insertion of NAV debt below the fund or the existence of covenants in the NAV facility relating to the amount of uncalled capital that is held back. ILPA has recently issued guidance to its investors on NAV facilities and certain disclosure requirements and recommendations. These should be considered by both bank and non-bank lenders prior to putting in place a NAV facility, so that the NAV lender is comfortable that relevant investor consents are in place for the financing.

Conclusion

We have seen the substantial growth of credit funds after global financial crisis in 2007/2008. Following last year's bank failures and a tightening in banking regulation, we are now seeing a new wave of growth in credit funds and a lot of these funds are focused on providing NAV facilities to private equity, secondary and other funds. The way in which these NAV facilities are provided by credit funds and other non-bank lenders need to be carefully thought about and certain nuances referred to above considered early in the life of the transaction to ensure speedy and efficient execution.

Leon Stephenson

Leon is a leading partner in **Reed Smith**'s fund finance team which is one of the market leading global funds finance practices. He works with bank and non-bank lenders, managers, general partners and limited partners on fund financing transactions with private equity, secondaries, real estate, direct lending and infrastructure funds. He is also an elected member of the firm's Executive Committee.

He has a great deal of experience advising on Net Asset Value (NAV)/asset-backed and hybrid facilities, secondary funds facilities, capital call facilities, co-investment and GP/manager support facilities and other types of liquidity facilities provided to funds; and also represents a large proportion of lenders that provide fund financing, as well as a number of private equity and other funds on complex fund finance transactions.

Leon is recognized as a "Leading Individual" in Fund Finance by Legal 500 UK 2024 and the team is recognized in Band 1 in Fund Finance by Legal 500 UK 2024 and Band 1 of Chambers and Partners 2024. **Leon** was also recognized as "Partner of the Year for Banking" at the Client Choice Awards 2017.

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PRAXIO'S FUND FINANCE SECURITY GUIDE

Download our Fund Finance Security Guide to discover the main aspects of the security package in the most common jurisdictions involved in fund finance transactions.

Our guide covers the following jurisdictions:

- Luxembourg
- Australia
- Cayman Islands
- England and Wales
- France
- Germany
- Guernsey
- Hong Kong
- Ireland
- Jersey
- Mauritius
- Scotland
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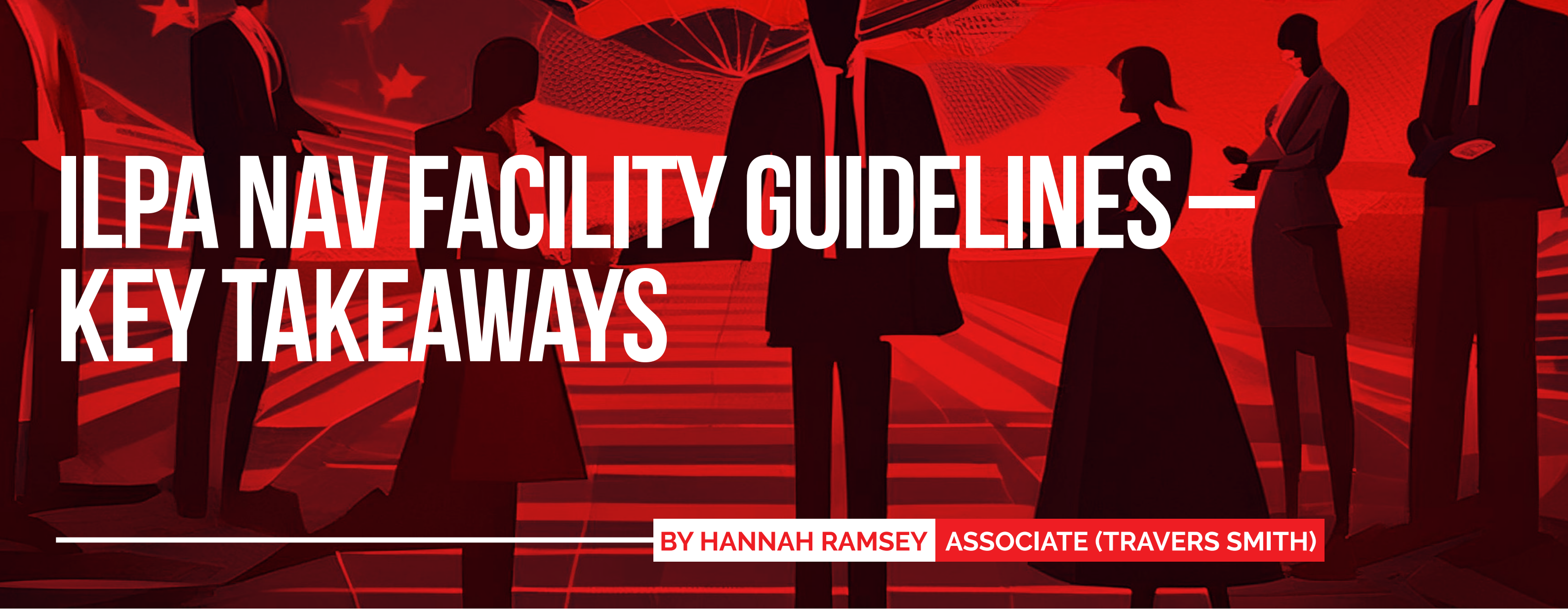

ILPA NAV FACILITY GUIDELINES – KEY TAKEAWAYS

BY HANNAH RAMSEY ASSOCIATE (TRAVERS SMITH)

On 25 July 2024 the Institutional Limited Partners Association ("ILPA"), the trade body for institutional limited partners in the private equity industry, issued its much-anticipated Guidance for Limited Partners and General Partners in respect of NAV-based facilities (the "Guidance").

As a very brief re-cap, net asset value ("NAV") based facilities are credit facilities made available directly to a fund (or, more typically, to a holding company immediately below the fund) which are backed by the value of the fund's investments. Lender recourse under a NAV facility is limited to those investments and their distributions and cashflows and NAV facilities therefore cross-collateralise the equity of multiple portfolio companies of the fund. Note that the Guidance only covers NAV facilities made available to private equity funds (as opposed to credit funds or secondaries funds etc).

NAV facilities have been used by secondaries, real estate and private credit funds for some time but their adoption by private equity and infrastructure funds has noticeably increased in the last few years and has attracted increased scrutiny from LPs, together with some negative attention from the press as a result. ILPA identifies LPs' main concerns (which often stem from a lack of understanding of, and familiarity with the product rather than specific issues with it) broadly as being:

1. a general lack of transparency and disclosure from GPs where they are using NAV facilities, and the associated lack of governance; and
2. specifically where NAV facilities are used to make early distributions to LPs, that this artificially enhances the "Distributions to Paid in Capital" ("DPI") ratio and IRR, and hence there's an inherent conflict of interest between GPs and LPs where NAV facilities are used for this purpose.

To address these concerns the Guidance (1) calls for improved transparency and greater disclosure from GPs around the usage of NAV facilities, (2) recommends that, going forward, funds' LPAs contain specific parameters around NAV facility usage and a requirement for limited partner advisory committee ("LPAC") consent in certain circumstances, and (3) sets out standardised disclosures that ILPA recommends GPs deliver to their LPs once a NAV facility is put in place.

The key takeaway from the Guidance is that, whilst there might be a very good reason for the fund to use a NAV facility, in the absence of proper communication from GPs, LPs will draw their own conclusions as to the rationale (and that conclusion might well be a negative one and at odds with the reality). Increased transparency, disclosure and, where applicable, LP/LPAC consent rights should therefore benefit both LPs and GPs.

Key takeaway - LP concerns

Many LPAs (particularly older ones) are silent as to the use of NAV facilities – on the one hand, there is unlikely to be an express provision permitting NAV facilities and, on the other, there are typically no express restrictions on NAV facilities (LPAs will impose restrictions on fund-level leverage, but because NAV facilities are very often borrowed at an SPV or master holdco level directly below the fund, GPs have historically tended to interpret those leverage restrictions as not applying to the SPV / master holdco and therefore as not restricting NAV facilities). As a consequence, LPs feel they have limited insight as to when NAV facilities are being used, and that there's a general lack of governance or parameters around their use set out in the LPA.

The conflict of interest point is a more interesting one and appears to be the key LP concern. The Guidance states that, because the uptick in use of NAV facilities has coincided with very challenging fundraising and M&A markets, there is a concern among LPs – where NAV facility usage is not communicated to them by the GP – that they are being used (whether explicitly or indirectly) to make distributions to LPs and thereby to artificially enhance the DPI. Both DPI and IRR will be improved by returning capital to LPs early and they are both important metrics by which a fund's performance is judged – there is therefore a concern among LPs that GPs could use NAV facilities to artificially inflate both DPI and IRR in order to encourage LPs to commit to their next fund. That LP concern is exacerbated by the cost of NAV facilities (particularly the ongoing interest expense) and the fact that any so-called "synthetic" distributions will very often be recallable. ILPA also notes that LPs are facing increasing questions and scrutiny from their own stakeholders, which can be difficult for these LPs to address in the absence of guidance and information.

Whilst ILPA's main concern appears to be where NAV facilities are used to fund distributions, the Guidance makes it clear that LPs also have concerns where NAV facilities are used to support the portfolio (e.g. to fund working capital and bolt-on acquisitions) – the main concerns being (1) that the fund has not retained sufficient capital reserves beyond the expiry of the investment period and is therefore being poorly managed and (2) a perceived risk that a GP that is struggling to fundraise might use a NAV facility to increase its assets under management under its existing fund (and therefore increase its management fees if the management fee is calculated on cost).

Key takeaway - increased transparency and disclosure

To address the above concerns the Guidance recommends that unless an LPA explicitly permits a NAV facility, that GPs seek LPAC consent, and explicitly communicate certain information about such facility (and in relation to which ILPA proposes a set of standardised disclosures) including key economic terms, rationale and use of proceeds and any LP obligations (including whether any distributions funded by a NAV facility would be recallable).

The Guidance also recommends that where (as is often the case) an LPA is silent on the use of NAV facilities and where leverage restrictions under the LPA are expressed to apply to the fund only, that LPs proactively ask their GPs how they

have interpreted those provisions and whether they view the leverage restrictions as applying to the fund only.

Going forward, the Guidance recommends that newer LPAs "address NAV-based facilities to ensure a shared set of expectations and guardrails around permissible uses" and include clearly defined limits as to the amount of leverage that a GP may incur through NAV facilities throughout the life of the fund.

The Guidance also recommends that LPAs require GPs to seek LPAC and/or LP approval for all conflicts of interest associated with NAV facilities. Where a facility is to fund distributions, it recommends that LPAC consent be sought prior to that facility being put in place, regardless of whether the GP has received prior LPAC or LPA consent to use a NAV facility generally.

What are we seeing?

The Guidance has been anticipated for some time and its focus on increased transparency and disclosure was widely expected and has been largely welcomed by GPs and LPs alike.

We suspect however that for most funds, concerns around NAV facility usage are overstated. For well managed GPs NAV facilities remain a very useful device in the liquidity toolkit to help them maximise value from a fund's investments. Moreover, given only a relatively small percentage of NAV facilities in the market are used to fund distributions the particular emphasis on this concern seems overblown. There are also of course plenty of LPs in the market who are looking for liquidity and who welcome earlier distributions funded by NAV facilities, particularly given that any such distribution will be made at NAV (as opposed to a sale by the LP of its interest in the secondary market, which would typically be made at a discount to NAV).

We have started to see NAV facility provisions built-in to new fund LPAs, particularly over the last six to twelve months, as well as more standardised due diligence requests from LPs on the intended use of any NAV facilities throughout the life of the fund. The Guidance is likely to accelerate that trend and we expect an increasing prevalence of NAV facility provisions in new fund LPAs as a result, with an increased role for LPs and LPACs before a NAV facility is put in place. How standardised those provisions become remains to be seen.

We do anticipate a degree of resistance among some GPs regarding the recommendations for LPAC or LP consent (particularly in relation to the use of NAV facilities to fund distributions where an LPA already expressly permits the use by the fund of NAV facilities in general) and the suggestion that leverage limitations in the LPA which apply to the fund should be interpreted so as to apply to any NAV facility borrowings at a level below the fund. It will be interesting to see whether these recommendations soften in time as the market in general (and LP community in particular) becomes more familiar with NAV facilities.

Hannah Ramsey

Hannah is an associate in the **Travers Smith** Finance Group. **Hannah** works across a range of financing matters for clients that include banks and other non-bank financial institutions, private equity funds, and corporates. She has particular experience of fund finance. Hannah trained in-house at a global investment management firm following several years working in the asset management industry.

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