KEYNOTE INTERVIEW

Funding a growing market

NAV finance has been around for over a decade, but the past few years have seen this corner of the market expand substantially, says 17Capital's Augustin Duhamel

As the private equity industry develops and becomes more sophisticated, firms are increasingly looking for ways to finance growth, both in their portfolio companies and on their own account – into new strategies or geographies, for example. According to eFront, average holding periods are also lengthening, standing at a record high of 5.4 years in 2020 versus 3.8 years a decade ago. Because of this, firms are increasingly seeking ways of offering their LPs liquidity options.

As with so much else, the pandemic has only accelerated many of these trends. One of the areas that has benefitted is net asset value finance, or portfolio finance, which has experienced rapid growth over the past few years. *Private Equity International* caught up with Augustin Duhamel, managing partner and co-founder of 17Capital, to discuss new trends in the market.

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Q What types of NAV financing are currently available?

NAV finance is essentially funding against a portfolio of private equity assets. In the context of private equity funds, it is typically used after the investment period when investor capital has been deployed. While there is no remaining uncalled capital, there is an asset base that can be financed.

NAV finance is most often used to put more funding into portfolios for acquisitions or expansion purposes, or to accelerate portfolio liquidity ahead of an exit, or sometimes both. There are applications across the private equity industry, for funds, investors and private equity firms.

There is a range of financing options, and these depend on certain factors. The primary one is how well diversified a portfolio is, but also what the borrower is trying to achieve – the loan to value ratio and/or the flexibility they are seeking.

At one end of the spectrum, there are NAV-based loans; at the other end, where the borrower is looking for higher LTV on a more concentrated portfolio or where they want more flexibility, preferred equity can be a solution. We offer both at 17Capital.

Q How has the market developed in recent months and years?

We've provided this type of finance since 2008, which means we were there at the market's creation and we've seen it evolve. It has grown significantly; today, we are seeing an acceleration of that growth.

The market started out offering finance to LPs on the basis that they have very diversified portfolios to lend against, and it then moved into the secondaries market, where players also have diversified portfolios. NAV finance is now available to single funds, which are, by definition, more concentrated, and it is offered at both GP and fund level.

The demand is clearly there: we have raised $8.5 billion since we started, including $4.5 billion in 2021 alone for our fifth-generation preferred equity vehicle, co-investment and separately managed accounts. And we're finding that the more we raise, the more demand there is for NAV finance. Our addressable market is growing – there is approximately $4.5 trillion of unrealised assets held by private equity firms globally, and that figure is expanding by around 10 percent a year. It's a trend that we expect to continue as the private equity fund life span stretches out. For example, it is increasingly becoming the norm for funds to run for 15 years.

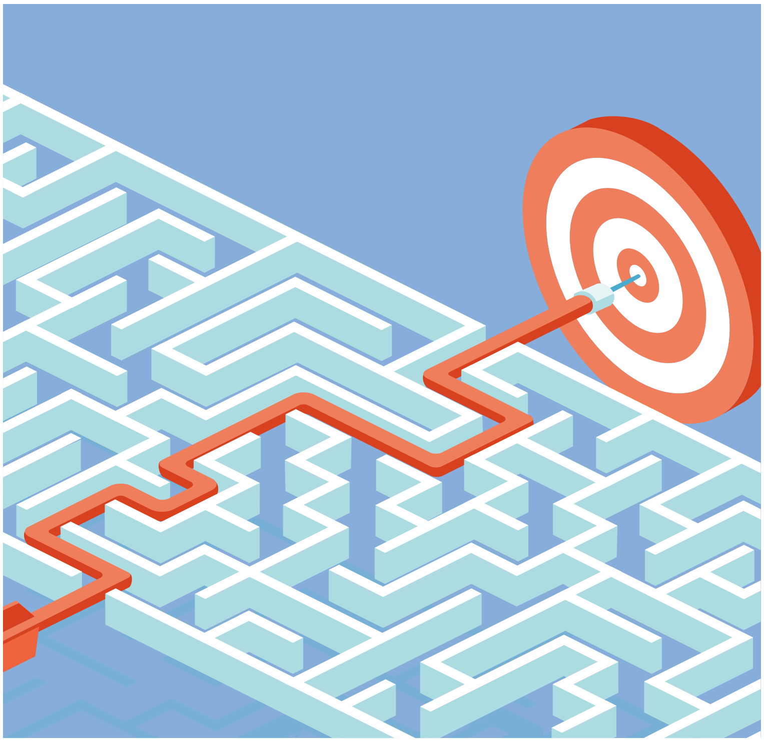
Q What new uses and trends are you seeing in NAV finance at present?

There will always be new applications for this type of finance because it offers a lot of flexibility, and new situations will arise. One example is if a fund has to suddenly increase its investment pace and then needs capital before its next fundraise – in that situation, how does a GP address dealflow and investment opportunities?

NAV finance could be a solution. It could allow new investments to be added to existing funds or provide warehoused finance to fund the next investments. These kinds of special situations have come up recently.

Another way of deploying NAV finance that we are seeing is where a GP has the opportunity to reorganise the shareholding structure of the management company. NAV finance could allow some of the partners to buy out other shareholders to support succession or where existing shareholders are seeking to exit.

We are currently seeing a race to grow with the market and increase in size. Some firms are looking to add new strategies or expand geographically. NAV finance can be an alternative to raising equity for the management company.



Q What type of firms are using this finance?

Our target market is US and European buyout funds, and we're seeing greater adoption of this finance there. This is particularly the case in the larger funds. In 2021, 80 percent of our deals were with the top 100 GPs by size, including two deals closed with top 10 managers. These are firms with dedicated teams that review the market for new sources of capital and are, by nature, opportunistic. NAV finance particularly suits large players in the market that target larger transactions and where firms are in the volume business, although mid-market firms can use it as well. We are seeing repeat business across the spectrum.

There could be other segments of the private equity space to go for, though. We focus on European and US buyouts because these are already large markets and there is less volatility than in some other areas, but growth equity firms, for example, could benefit from this type of finance. Infrastructure funds could be another interesting area because of the long duration of the funds – NAV finance could help to accelerate liquidity for LPs.

Q How are these firms using NAV finance?

In a variety of ways. Some managers, for example, use this funding to help them grow in tandem with the boom in private capital markets. Until now, managers have tended to fund this through equity, by attracting investors to take stakes in the management company. Now, they have the option to use NAV finance, which doesn't dilute their equity stakes – that's very attractive to many managers. Others are also using it to differentiate their returns in a very competitive market. NAV finance can be a tool to manage cashflows better and optimise fund performance.

And, of course, NAV finance can be used when a fund is fully invested but the GP needs further capital to continue growing its portfolio companies. The finance offers a cheaper cost of capital than equity or co-investment, and is also used to accelerate liquidity as an alternative to selling – especially for early winners in a portfolio, allowing GPs to hold on to these for longer. But there are new uses that are emerging all the time.

Q How does this fit with GP-led deals, which also allow for longer holds on attractive portfolio companies?

It really depends on what a GP is trying to achieve. GP-leds are very well suited to tail-end transactions. At the other end of the spectrum, you might have GP-leds motivated by a need to invest more capital in one or two portfolio companies to grow them further. NAV financing is another solution to the latter situation. It provides further optionality to the market, and we may start to see a hybrid that combines NAV financing and GP-led deals in the future.

> *"NAV finance can be a tool to manage cashflows better and to optimise fund performance"*

> *"Some managers [use NAV finance] to help them grow in tandem with the boom in private capital markets"*

Q How competitive is the market? Are you seeing new entrants?

We've not yet seen a proliferation of providers, although interest is increasing in some corners. There is a lot of activity at the low LTV part of the market, although in the space between 10 percent and 25 percent LTV the cost of capital means there are far fewer participants. In the preferred equity area, we are seeing some secondaries players entering or approaching the market, while some credit funds are also looking at it, so there are some existing players looking to extend their offer. But there are very few pure-play participants.

Q How do you see the market developing?

If we look at what we've seen so far, we expect there to be a further acceleration of growth. The market has become more mainstream over the past 12 months as larger GPs globally have adopted this type of finance. Once you have one or two leading GPs using it, the others follow. I see this trickling through to other parts of the private equity market. I expect that NAV finance will become used as much as subscription lines of credit are today and as a follow-on to this type of finance, once commitments are fully called.

We see private equity firms increasingly recognising that they can use this type of financing to optimise their fund cashflows and their internal rate of return to LPs. That will increase the bifurcation we already see in the market between the haves and the have-nots; between those benefitting from the growth of the market and those that aren't. This finance works best for firms with good returns, so you will see a bigger gap between the best performing managers and the rest. There will be a greater differential between the top quartile funds and the others. ■

Augustin Duhamel is managing partner and co-founder of 17Capital