NAV LENDING TO CREDIT FUNDS[1]

By Alexander Short

The "NAV Lending to Credit Funds" panel covered questions relating to the net asset value financing market.

- **What are the different approaches to lending to private debt funds?** There are three main differences: (1) a much more homogenous portfolio; (2); a lot more granularity for the underlying eligibility of assets; and (3) the structure is going to be a securitization type structure with different tranches. Private equity strategies are more opportunistic (end of life for example). Credit funds on the other hand expand the size of the fund and enhance returns, and are more all-encompassing in terms of security over all assets.

- **Pros and cons?** Yield is higher, and the advance rate is higher, so funds can maximize leverage. Cost – they are cheap for lenders, so they can lend more at a higher rate of return. Tenor – 5yrs or longer means certainty of capital. Hedging – multicurrency facilities so naturally hedge the debt creating IRR benefits. One main con is that if assets diverge from expectations, there are issues around edge-cases which might require lots of analysis regarding concertation limits for example, which requires resources. On the whole it is an intense facility requiring lots of reporting on the assets. Lots of documents must be provided and reviewed, and reporting needs to be done on time and constantly updated. Finally, an approval based approach means lenders can reject assets with wide discretion, which can be difficult for borrowers.

- **What different strategies are we seeing?** The general view was that the lender process was still very non-standardized and bespoke. There are a lot more non-bank lenders moving into the market and transaction sizes are increasing. The assumption is mark to market and fully recourse, but borrowers/lenders are sensitive to marking methodologies that are unilateral. A lot of the product development for funds of this type has been to find the right balance for delivering valuing methodologies that is linked to underlying credit principle. Many ideas are being borrowed from other markets, e.g. securitizations. Finally, lenders are seeing a growth in lending to funds where security is just limited to rights to distributions to assets rather than a locked box structure, so ultimately less secured. This may be made up for by diversification requirements and modest LTVs. It is crucial to have a good trusting relationship between borrower and lenders in this market.

[1] Panelists included Emma Russell (Haynes Boone); Jons Lehmann (Fried Frank); Pierre-Henry Quantin (Corinthia); Thomas Speller (KBRA); Marco Unti (Deutsche Bank); and Ramesh Yesodharan (Sumitomo Mitsui Trust Bank).

- **Performance of fund – how does structure impact?** Under the typical fund five year tenor, ramping up is an issue – a borrower needs a good diversification score for large lenders so it can't have much leverage day one, meaning there's a need to have a subline or hybrid for this ramping period (and there's a similar issue at the tail end). Once capital is deployed, borrower is obligated to make lots of repayments to lenders ahead of itself.

- **Regulations impact?** Given these products are effectively securitizations, they always need to be analysed for securitization regulations (including risk retentions). The lender analysis of capital treatment is essential as it impacts pricing to a huge degree, as well as impacting which investors can invest in funds that have securitizations. When considering AIFMD II, concentration/leverage limitations on funds need to be borne in mind. This means all parties need substantial operating teams, credit monitoring and examining aggregated exposures.

Conclusions? From the borrower perspective, it is an attractive product, but the key is to knowing who to partner with. Some of the biggest challenges include the ability to deploy capital given funding rates remain high. The sector has modest defaults, trending very low in private credit, and elevated interest rates still hasn't caused too much difficulty. If interest rates stay high then more disciplined and larger manager will start to outperform.

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