Jon Moulton's Diary

Are NAV loans a smart piece of financial engineering or do they repeat the mistakes of the Great Financial Crisis?

Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

Net Asset Loans: are they clever or too clever? I'm talking about loans made secured against the net assets of a fund (Net Asset Value loans). For those who remember the Global Financial Crisis, if you substitute "NAV loans" for "sub-prime housing" then much that happened in sub-prime lending could happen in the world of NAV loans.

NAV comes in a wide variety of structures. The bulk of the money in these structures is where a loan is made to the fund secured against the value of the assets of the fund and the proceeds of the loan are then distributed to the investors (LPs) in the fund. There is generally no recourse to those LPs if the ultimate proceeds of selling the fund's assets fail to repay the loan and interest.

These loans have been running at tens of billions of dollars a year in recent times. Again, many of the tools of sub-prime lending are in use. The loan providers are not always banks – structures such as CLOs (Collateralised Loan Obligations – highly structured tiered loan structures) are in use providing leverage galore!

Take a portfolio of leveraged buyouts – perhaps levered two-parts debt to one-part equity. Then you add in an NAV lender which could be a bank or a CLO with 10 to one leverage. And then someone will reuse the CLO squared from 2008 (a CLO of CLOs – mindboggling complexity) to fund the CLOs – end to end leverage literally in the 100 to one range is possible. Large NAV loans are structured to fit CLOs.

You can see a "credit" or "special opportunities" fund managed by a general partner investing in the NAV loan made to another of its funds.

Concerns and risks

Should investors be concerned?

If you are a super highly credit rated LP in a fund, your own borrowing (if any) probably comes at a lower interest cost than the NAV loan can get. The loan would therefore be against the financial interests of the LP.

If on the other hand, you are an LP with a weak credit rating, then your main concern would be that the portfolio investments do not grow in value at a rate noticeably higher than the interest on the loan. If they don't you would end up worse off.

And you should be concerned where there are obvious conflicts that can be abused – and for all recorded history leverage has been often abused. Some of the same firms that gave us the sub-prime crisis are active in NAV lending.

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NAV loans clearly add risk if the portfolio falls in value. Breaches of covenant could occur causing poorly timed forced exits and/or a rate hike. Possibly even putting the fund into the hands of the insolvency profession – not a group known for value maximisation.

A simple risk is that many NAV loans are floating rate instruments. A rise in interest rates could generate risk at a time when portfolio LBOs could be struggling with their own interest bills.

Fixed repayment schedules also carry their own risks of forcing untimely and sub-optimal portfolio exits.

Many flavours of NAV

There are all kinds of other considerations – loans come in many flavours. Adverse terms might include early repayment fees, a lender's right to hire an external valuer at the fund's expense, guarantees from GPs, varied levels of security, "sweeps" on portfolio company sales – or not, and quite a few other points including taxation. Only a careful read of the terms will show what is really happening.

There are other smaller volume forms of NAV loan – an investor can borrow against their own investments if they need liquidity – these loans are smaller and vary a lot in terms.

NAV loans have some arguably good use in providing fresh equity for portfolio companies (rather than funding distributions to LPs) when a fund is running out of money. Clearly this comes with risks and potential downsides.

The collapse of Silicon Valley Bank was in part due to its exposure to NAV loans (mostly smaller facilities to venture funds it seems). Credit standards seem to have risen since then and interest rates (together with other costs) have risen to pushing 10%. Loan to value ratios have tightened – at least one large NAV loan had been done at 100% before SVB fell over. But deals are still happening.

Investors and regulators need to be wide awake.

The industry needs to be vigilant about NAV loans because they contributed in part to the collapse of the Silicon Valley Bank

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