NAV Lending for Institutional Portfolios with Lisa Larsson

Michael Venne (MV): [00:00:00] Net asset value or NAV lending is one of the latest trends in private markets. PitchBook, the Financial Times and other outlets have issued reports on this type of debt within the last few months. Yet, despite attention from the media, relatively little is known about it. That's because most NAV lending structures are privately offered to large institutional investors. Interest in debt structures has renewed in part due to the so-called denominator effect. With many investors allocations to private markets bumping up against or [00:00:30] even surpassing their policy limits, limited partners are exploring alternatives to maintain their commitment targets. Here with me to discuss the re-emergence of NAV lending is Lisa Larsson, a managing director on our portfolio management team. Lisa, welcome to RPM.

Lisa Larsson (LL): [00:00:46] Thanks, Michael. Delighted to be here.

MV: [00:00:48] So Lisa, let's start at the top. NAV lending or NAV based lending is one of those broad ambiguous terms that can take on multiple meanings. What flavor of NAV lending are we [00:01:00] talking about?

LL: [00:01:01] That's a great question. Debt is such a rich area, and generally here we're exploring how institutional investors can think about adding leverage to their private-market portfolios and importantly, why they would want to do that. You know, what portfolio construction puzzles does it solve? So specifically, I'll discuss adding asset-backed term debt. Yeah, that's a bit of a mouthful to a diversified [00:01:30] portfolio of private funds and private assets. And to put this in perspective, if you think of a typical line of credit which most investors have experienced with, each dollar that's borrowed needs to be paid back rather quickly—a year, six months, a quarter these are kind of typical repayment timelines, and they're almost always backed by the credit quality of the investor. So, the asset back term debt [00:02:00] is essentially exactly the opposite of a line of credit. So, it's longer duration and it has more interesting collateral. And what I mean by term debt is simply that it can be outstanding for several years. And NAV lending has already kind of indicated that we'll be exploring asset backed lending, in particular using a portfolio's existing private markets, funds and assets as the collateral to support the leverage. So [00:02:30] in a nutshell, this is the corner of the NAV lending world that we'll home in on here.

MV: [00:02:36] Lisa why now? I mean, these sorts of securities have been around for about 20 years, but only in the last few years has interest returned. Could you talk to our listeners about what dynamics are at play here?

LL: [00:02:50] Yeah, sure. So some investors that have been regularly active in this market were kind of plain and simple, looking for higher return potential [00:03:00] on higher quality portfolios they had curated. So when you think about leverage, hunting for outsized return is certainly one of the first use cases to come to mind. However, given the market environment last year, in 2022, as well as the outlook this year, investors now have a few other use cases for leverage structures, and these are basically to help them maintain their allocation [00:03:30] and liquidity targets. So you already mentioned the denominator effect. We've all heard it mentioned quite a bit over the last six months. And if your portfolio has 25% allocation to PE but your target is 20%, you need to trim that 5% to get back on plan. And we all know that one way to trim allocation is through selling fund interests in the secondary market. But discounts [00:04:00] right now are little bit painful. So this option is less attractive. And so leverage has risen as a second option. And so taking debt out on your portfolio generates cash that solves the overall allocation problem. Another challenge facing investors is liquidity. So distributions in 2022, they were much higher than the GFC. I mean, it wasn’t a crisis scenario in [00:04:30] private markets, but they were certainly lower than expected. And so this left investors with potentially less capital to meet upcoming capital calls.

LL: [00:04:39] And one flavor of leverage that actually allows investors to add leverage along the way is particularly relevant here. So basically when a capital call comes, the debt holder would be part of the capital call, the investor would meet the other part. And so your overall [00:05:00] unfunded burden is lower and it makes planning around unfunded simpler. And so if two challenges weren't enough, there is also a third and this can be caused by the denominator effect, liquidity challenges or combination and concretely is, you know, investors are facing constrained commitment budgets this year. And so they're basically facing the challenge that re-upping with their preferred managers in the near term [00:05:30] is difficult. So from the academic literature vintages that came just after a downturn, so 2002 after the tech bubble in

2009, after the GFC, they tend to outperform. So here term debt can be used to generate the day-one liquidity or to help meet capital calls from the new commitments. And this would allow investors to maintain their relationships and their vintage year diversification plans. [00:06:00] So I think in the past returns are really a key reason to use leverage and at the moment it's shifted to allocation and liquidity planning. And this is really driving a lot more questions from investors about NAV lending options.

MV: [00:06:15] It's really interesting. So when I hear about structures like this, I think of collateralized mortgage offerings or, you know, other and other CDOs, which, you know, depend on some level of diversification to minimize [00:06:30] risk, how large does a portfolio need to be?

LL: [00:06:35] The answer is all structural elements are a discussion. There's a high level of customization that's possible in these structures to meet investor needs. But at the end of the day, there are two parties that need to be happy and satisfied with the structuring, and one is the investor who holds the portfolio and the other is the party offering the debt financing. And [00:07:00] generally speaking, yes, the portfolio needs to be large and diversified, so a typical portfolio will be sized kind of at or above 250 million. The good mix of managers and no significant tail end exposure. 20 to 30 funds is a common number. More is possible; less is tricky. Again, all a discussion. So I don't think if you have 19 funds you need to sit on the sidelines. And then smaller investors, [00:07:30] you know, for whom like the 250 million is a large kind of prohibitive number. You know, they can try to combine efforts with other small investors to reach those target sizes and diversification requirements as well.

MV: [00:07:48] Next, let's talk about another hot topic, interest rates. How has the heightened rate environment affected performance of these structures?

LL: [00:07:59] Yeah, so the [00:08:00] current interest rate environment generates a lot of questions. And I think the punchline is that if your portfolio's unlevered, go forward return is higher than the interest costs, then leverage helps performance. So, if your unlevered return is, you know, a 10%, then your levered return will be higher than that. And so the opposite is equally true. Leverage has both effects. [00:08:30] So levering up something that's above the interest costs is good; levering up something that is below the interest costs will lead to underperformance. And so you really need to look at that go forward, return expectation, compare it to prevailing interest rates and make a decision based on that. And so within our portfolio management team, we've actually run a number of historical and forward looking simulations. So like we said, every structure [00:09:00] is a little different, has its own waterfall, but you can get some information about how the cash flows look over time by running it on historical portfolios that are similar or building kind of a go forward model as well. And so even if you start with a portfolio that has a modest TVM expectation, so maybe 1.4, 1.5 X go-forward return, and you use kind of 50% leverage and an 8% blended interest [00:09:30] rate. The levered TVM is attractive. So higher unlevered performance, will just amplify that. So if you're kind of if your portfolio that you're putting behind this is super charged, then then you'll do even better in terms of the levered performance. And so portfolio composition is really the key here. And in that sense, it's important to work with partners that can evaluate the funds, vintages, managers to make [00:10:00] the structure work. And I think that basically sums up the interest rate environment. It's even when interest rates were lower, you wouldn't want to lever up just any portfolio. And so really doing a careful analysis in terms of the quality and the cash flows is key.

MV: [00:10:17] So the data here are sparse, right? These are privately negotiated transactions, but do we have any sense of how active the market is currently?

LL: [00:10:27] Yeah, so these are currently happening. [00:10:30] So there are a number of these structures issued last year. Among them, for example, a $370 million portfolio with 50 fund interests and 65% LTV. And we work with a number of investment banks who specialize in placing the debt. So they they've kind of shown us their active pipelines in 2023. And definitely, LPs are pursuing these kinds of structures.

MV: [00:10:58] Lisa, we've spent a lot of time [00:11:00] talking about sellers. So for my last question, I'd like to talk about the buyers. How do potential buyers get comfortable enough to take part in one of these transactions?

LL: [00:11:10] So I mentioned earlier in passing that there are two parties that need to be satisfied for this structure to work. And we focused on the investor who holds the private portfolio. There's also the party or parties that offer the debt financing. And so for them, getting

[00:11:30] comfortable with the debt means that they are certain that the downside protections are robust. For example, even in an adverse market for private equity, the debt holder will still receive their contractual interest payments. And so, I mean, how concretely would they get this certainty? I think the main way that they do it is by relying on rating agencies to perform stress tests as well as baseline analyses [00:12:00] of the portfolio and the waterfall structure and the rating that they come up with and reflects kind of how robust the portfolio is through the cycle. And notably, rated structures like this have endured the GFC, which had relatively low distributions compared to the market average. And so at Stepstone we are deeply committed to tracking data and using [00:12:30] data in all corners of our business. And in this case we track the underlying holdings on thousands of funds quarterly. And this company by Company View allows the debt investors additional detailed health check on the portfolio.

MV: [00:12:47] Meaning that they can evaluate the managers and then the underlying companies, right?

LL: [00:12:51] Exactly. Exactly. So, I mean, the rating agency there is kind of there are these portfolio level [00:13:00] kind of scenario analyses. But if you really want to go line by line, this the Stepstone data is really helpful there.

MV: [00:13:08] Lisa, is there anything that we missed that you want that you want to talk about?

LL: [00:13:12] I think this is probably enough to get people started. I hesitate to say, you know, anything more about asset backed term debt, which is a mouthful in this short session, but we're more than happy to discuss more of the details [00:13:30] and some case studies and examples as needed and as interested.

MV: [00:13:35] Lisa, thanks so much for joining us today. Be well and hope to see you again soon.

LL: [00:13:39] Thanks, Mike.

MV: [00:13:40] That does it for this episode of RPM. To learn more about our NAV lending solutions, contact any one of us here at StepStone. Rpm is available on Apple Podcasts, Spotify, Stitcher and other podcast platforms.