# E X P E R T Q & A

*Contrary to some assumptions, NAV financing is not all about private equity buyouts. Matt Hansford, head of Europe, portfolio finance at Barings, examines the broad and less known opportunity set*

# A broad and overlooked opportunity in portfolio financing

SPONSOR
**BARINGS**

**Q What does the NAV financing market look like today? How would you describe the breadth of products on offer?**

When people think about NAV financing, they often focus on lending to private equity buyout funds. But the market is much wider than that. In fact, the other less talked about and less understood areas are more established – and have been in existence for over a decade.

For instance, there is private credit portfolio financing for corporate and real estate credit, among other asset classes. Those deals involve financing a cross-collateralised portfolio of private credit assets and represent a pretty defensive strategy because lenders are the most senior in the capital stack.

Then there is secondary portfolio financing, lending against a portfolio of secondary investments or a fund, which typically involves a number of LP stakes and allows lenders to benefit from a huge diversity of underlying assets. Again, that is cross-collateralised so the lender benefits from the upside if an underlying asset increases in value, counteracting some of the downside potential in others.

Finally, there is GP financing, which is a source of liquidity capital for GPs and is being talked about a lot in the context of GP stakes equity. In an environment where GPs are growing and consolidating, having the option to introduce debt as well as equity into their capital structures is a valuable tool.

**Q What are the tailwinds driving market growth?**

Fundamentally, there is going to be a supply-demand imbalance without institutional capital for NAV financing. On the supply side, portfolio finance has historically been funded by banks. However, private markets are growing by 9 percent per annum, which is unlikely to slow, but bank balance sheets are growing at only 4 percent per annum. With regulation constraining banks' ability to lend, institutional capital is the natural source to fill this growing funding gap.

There are also a number of long-term structural demand drivers. In secondaries, for instance, the market is growing massively and the growth looks set to continue. There is still only a fraction of the trading in private equity assets that you see in normal liquid markets and, at the same time, fundraising is struggling to keep up. As a result, a capital shortfall is emerging.

If you look at a diversified portfolio of LP interests, the most senior part of that is comfortably investment grade, which means you can create an access point for credit capital. There is a natural balance of credit and equity capital that can come together to provide the liquidity that will be needed to keep up with deal volume growth.

In credit NAV financing, the driver is the tailoring of portfolios to meet the specific needs of investors. In today's market, where fundraising is difficult, if an LP can write a really large cheque it will often look for a tailored mandate via a separately managed account or similar. An LP may like the strategy but want different returns, and one way of doing that is with the introduction of financing. Again, the most senior part of a diversified pool of credit investments is typically investment grade, making it a natural fit for credit capital in the form of portfolio finance.

Within GP financing, GPs face a lot of demand for liquidity and we know that LPs want to do more with the GPs they have strong relationships with. Raising larger funds, new strategies, evergreen funds and continuation vehicles are all putting strain on GPs liquidity. If we think of GPs as much more long-term businesses with the same capital structures seen elsewhere, it makes sense to bring in debt as well as equity to solve the growing need for capital.

There are also natural growth drivers for NAV lending to private equity buyout funds, where GPs are holding assets for longer, creating more opportunities to invest follow-on capital. We know that creating private equity returns is now more about enhancing value, so having NAV financing available allows GPs to continue to invest and then exit at the right time to optimise value.

## Q What makes the strategy so appealing to institutional capital?

Because of the diversification, the cross collateralisation and the seniority of these facilities, these portfolio financing strategies are rated investment grade in terms of risk. At the same time, they offer a spread pick-up in comparison to public investment-grade opportunities. This creates a compelling opportunity for institutional investors.

Most institutions have a lot of public investment-grade credit that is liquid. Swapping some of that out for private investment-grade credit, such as portfolio finance, can earn an illiquidity premium. This is an appealing strategy for pension funds, sovereign wealth funds and insurers as they do not need daily liquidity across their entire investment-grade credit book.

For insurers particularly, this is very capital efficient, enabling them to be more competitive in their own policy pricing. For others, the asset class is defensive, low volatility, with characteristics that support an absolute return within their portfolio.

## Q How do you see the convergence of capital formation and financing driving demand?

This is all about insurance capital coming into private markets. Private market investors want to invest more with trusted GPs and the creation of insurance-friendly structures enables those groups to access another product from a GP while in turn allowing the GP to create financing solutions to support secondaries deals, the creation of SMAs for large investors, and so on.

So, if you create the financing in a way that suits insurance, you are creating a capital efficient product for your insurance investors allowing you to tap into the largest part of their investment accounts.

## Q Are there any hurdles for the market to overcome as it scales?

The challenges are about education, expertise and access. We know institutional investors are often challenged to run very lean teams, so for an institution to access this exposure that fits well on their balance sheet and benefits their policyholders, they need to find a way that makes sense and is well controlled.

Therefore, they need to be educated and they need expertise. That is challenging when they are running lean teams, which means they need well defined access points to help them capture the opportunity.

## Q Finally, where do you see the NAV lending space five years from now?

The breadth of NAV financing is going to be a core part of investors' investment-grade allocations. There are going to be choices for investors across asset classes and across risk profiles and those risk-return choices will be increasingly well understood. They will be able to select from those different elements and create allocations that really work for them.

The last piece of that jigsaw will be duration, because for investors that require some element of asset liability matching, that is really important. The ability to tailor across those three axes of risk, duration and asset class will be well developed in five years' time as this private investment-grade credit asset class continues to scale. ■