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Private credit funds — structures and recent trends

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In recent years, the alternative investment space has grown in size and significance as a result of a period of low interest rates, favorable monetary policy and financial conditions. The hunt for yield and diversification provided further comfort to institutional investors seeking to gain exposure to this burgeoning industry. In particular, buyout[1] and infrastructure[2] focused strategies have received media attention while credit funds served as sources of financing to fill in gaps at times when banks reduced lending post financial crisis.

But recent strategic moves by fund managers, such as TPG's acquisition of Angelo Gordon in May 2023,[3] and Wall Street financial institutions, such as DWS Group (of Deutsche Bank AG), Fidelity International and T Rowe Price, buying or building out a private credit franchise, may have shifted focus to private credit,[4] which is already developing as the premier frontier of alternative investing, achieving a fundraising record in 2022 and standing alone as the sole category of alternative investing to exceed fundraising levels set in 2021.[5]

As the credit fund space continues to evolve with established players consolidating and new entrants emerging, we anticipate that the terms governing credit funds will continue to deviate from those of traditional private equity funds and hedge funds.

Nature of credit investments

Credit assets are hybrid. Some are freely tradable and have a readily available market value, while others are illiquid "level 3" assets that may be hard to value.

Generally, there are three categories of credit investments:

- *Liquid debt instruments:* Loans and bonds of companies that trade like equities, typically in increments larger than stocks.
- *Direct lending:* Loans directly to companies with bespoke terms for maturity, interest, collateral and seniority.
- *Distressed debt:* Loans or bonds that are in distress and often thinly traded.

Investors find credit investments appealing due to current yield, often floating rates, and relative insulation (via their senior position in the capital stack) from declining valuations, which is even more relevant in the context of the current interest hiking cycle.

Depending on the investment strategy of the particular fund and the composition of the underlying credit assets, credit funds can be organized based on an open-end structure (with more limited liquidity than traditional hedge funds) or a closed-end structure (with modified terms when compared to traditional private equity funds).

> *The level of portfolio transparency for investors may vary depending on the strategy of a credit fund.*

To add a layer of complexity, funds may have a diversified portfolio spanning the spectrum of credit investment types (from mark to market to mark to model), further warranting a structure that deviates from traditional models.

Closed-end credit funds

Depending on the nature and composition of the underlying credit portfolio (for example, liquidity and maturity), there can be wide variations in fund terms, even across closed-end vehicles. For instance, with respect to the investment period (i.e., the time during which the fund can actively invest its capital before entering into a "harvest period"), a credit fund can resemble that of a traditional buyout fund and expire on the fifth anniversary of the final closing date. However, it is common to encounter credit funds with shorter investment periods ranging from the second, third or fourth anniversary of the final closing date.

Correspondingly, the total term of the relevant fund (for example, the period from launch until the date on which the fund begins the dissolution process) is also shorter than the typical eight or (in case of an extension) ten year term of a traditional private equity fund, with the dissolution process commencing as early as the fifth, sixth, seventh or eighth year anniversary of the final closing date.

As a rule of thumb, the fund term will equal the investment period plus the average maturity (three, four or five years) of the loans in the fund's portfolio. And just like in a typical private equity fund, there is often the ability to extend the term by a year or two (sometimes requiring the consent of an investor advisory board or investor majority vote).

Furthermore, the nature of credit funds and their underlying investments may warrant some flexibility as to when capital can be deployed in the first place. Certain credit managers have incorporated recycling/reinvestment provisions that closely resemble the recycling mechanisms in traditional buyout funds (for example, permitting recycling only during the investment period and applying a limitation set as a percentage of capital commitments), while others have taken a more flexible approach, for example, by more freely allowing recycling after the end of the investment period for follow-on investments.

Moreover, the level of portfolio transparency for investors may vary depending on the strategy of a credit fund, such that more liquid bonds or loans strategies may not elicit detailed diligence queries, while a portfolio of tailored loans directly to companies may result in requests for transparency as it relates to the obligors and the terms of such loans (for example, collateral and order of priority).

Investors seeking liquidity and long-term convenience have recently pushed for open-end credit funds.

To the extent investors have policies in place that forbid their exposure to certain investments (for example, particular jurisdictions or industry sectors (weapons, tobacco, etc.)), credit managers can choose to include limited excuse provisions to assist such investors.

However, credit fund managers may try to resist and argue that their typically highly diversified portfolio of loans would make an opt-out right administratively burdensome or that the fund's exposure to the business of its borrowers is not comparable to a relationship between a traditional private equity fund and its portfolio companies.

In terms of fees, the calculation of management fees and carried interest may deviate from that of a traditional private equity fund. In particular, some credit managers may charge management fees as a percentage of capital commitments prior to the expiration of the investment period (as is the case in private equity), though we commonly encounter hybrid calculations where the management fee base reflects the value of the underlying credit investments themselves.

Alternatively, the management fee base can start with the capital contributions allocable to investments (invested capital/cost) and then be adjusted to reflect, among others, (i) net unrealized losses, (ii) distributions of investment proceeds, (iii) current income and/or (iv) interest income.

Alternatively, for credit funds with a loan portfolio that has a readily available market value, management fees can be calculated as a percentage of the portfolio's net asset value, in a way similar to open-end funds.

Further, credit managers may choose to charge a fund certain fees in addition to the management fee, by removing, for example, loan origination, loan/collateral administration or other credit-related fees from the otherwise applicable management fee offset mechanism. As such fees may be payable to an affiliate of the credit manager, it is important to ensure that affiliated service providers are engaged in accordance with the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act").

Specifically, the U.S. Securities and Exchange Commission (the "SEC") has expressed concerns regarding the inherent conflict of interest with respect to compensation paid to affiliated service providers — namely the sufficiency of disclosures and reporting to investors in respect of such compensation.[6]

With respect to carried interest, the terms of the distribution waterfall may vary to reflect the nature of the investment strategy and portfolio. For instance, credit managers may elect to treat the current income stream (derived from interest payments or other fees) through a separate waterfall mechanism that charges a carried interest already after a preferred return payment (but before return of capital), while having a traditional waterfall for proceeds that result from principal repayment, refinancing or disposition of a loan.[7]

Alternatively, a fund may elect to distribute current income, for example, quarterly without going through any waterfall at all (i.e., with no carried interest charge). The preferred return percentage in credit funds also varies and can fall below the traditional 8% figure that is traditionally seen in the buyout context, often ranging from 4% to 8% (on a compounded basis).

Lastly, despite the generally closed-end nature of these fund structures, credit managers have explored the possibility of providing liquidity for their investors in a similar manner as their private equity manager counterparts do.

For instance, credit managers may create continuation fund vehicles to house instruments that have not yet approached maturity, thereby offering investors the election to either exit the investment for cash or stay with the investment through a continuation vehicle.

Credit managers may also create a Delaware "series" fund or an offshore "segregated portfolio company" with sub-funds, where each series / sub-fund is closed-end in nature but, upon the end of the term of a series / sub-fund, provides investors with the option to carry over investments to a subsequent series / sub-fund.

Open-end credit funds

While statistically, in terms of fund launches and assets under management, credit fund managers tend to utilize closed-end fund structures, investors seeking liquidity and long-term convenience have recently pushed for open-end credit funds.[8] And indeed, there are a number of ways in which credit managers can structure their funds as open-ended.

Depending on the composition of the target investment portfolio, a credit manager may find an open-end structure to be more suitable for the execution of the investment strategy.

For example, if the underlying assets are more liquid in nature and have a readily available market value, such as the "liquid debt instruments" described above, a credit manager could prefer to freely invest and divest such securities, in a continued fashion, rather than be restricted by recycling limitations (after the end of an investment period) or have to distribute certain sources of income on a quarterly basis, each as is typical in closed-end structures.

Investors may similarly prefer investing long-term in a single open-end fund as it precludes the need to conduct diligence or to go through an investment-committee approval processes that would have been required of an investment in a successor closed-end fund.

At the same time, if a manager wishes to diversify its portfolio by investing in credit instruments that are more illiquid in nature (i.e., "direct lending" or "distressed debt" as described above), there are various mechanisms by which the manager may retain exposure to such investments without triggering a liquidity crisis or shortfall.

In particular, a prominent means of maintaining liquidity is the utilization of a gate mechanism, which can either be applied on a "fund-level" basis or an "investor-level" basis. If applied at the fund level, withdrawals are capped at a set percentage of the net asset value of the fund and would often be structured to match the maturity of the underlying loans (for example, 5% of the fund's net asset value may be withdrawn in the aggregate on a quarterly basis, to align with a loan portfolio that has an average 5-year maturity).

Although a fund-level gate may trigger a "run on the fund" by encouraging investors to try to withdraw before the gate is imposed or as soon as it is lifted, phrasing such mechanism as an automatic gate that is not subject to the manager's discretion alleviates the manager from the difficult decision of raising or lifting a gate in a moment of high withdrawal requests.

An automatic implementation of a fund-level gate may also not be perceived by the market as a situation of distress for the fund (which would often trigger even more withdrawals), as would be the typical negative reception of the "last-resort" decision of a manager to suspend withdrawal rights.

An automatic fund-level gate of, for example, 5% could also be combined with a much less restrictive investor-level gate (for example, quarterly 25%, 33% or 50% to permit withdrawals within four, three or two quarters) or no investor-level gate at all, thereby maintaining from the individual investor's perspective the fund's characteristic of a fairly liquid open-end investment product. This works particularly well for funds of a certain size so that reaching the fund-level gate threshold (for example, of 5% of the fund's net asset value) may be unlikely (absent a situation of distress).

At the same time, it is generally prudent to require sufficiently advance notice for each withdrawal request (for example, not less than 90 calendar days) to allow the manager to meet liquidity demands in the ordinary course.

In addition to gates and potentially lock-up periods,[9] credit funds may include side pocket mechanics to deal with liquidity challenges. Side pockets could be particularly advantageous if a fund may end up owning inadvertently a large portion of illiquid assets (for example, former collateral for loans) as a result of one or more borrower defaults.

However, in a situation of numerous defaults due to market distress, side pockets may be of little help because investors often demand caps on side pockets (for example, 10% or 20% of the fund's net asset value) to keep the nature of the fund open-end and liquid, and these caps may fill up quickly.

Also, while the inclusion of side pockets in credit fund documents has a convincing rationale for a private credit fund that expects to face the unintended ownership of large illiquid assets after a default, certain investors still remember the difficulties to withdraw from supposedly open-end funds during the 2008 financial crisis and therefore generally may shy away from private funds with side pockets.

Given the various structuring alternatives for private credit fund, the nature of the underlying credit assets will always result in bespoke credit fund terms.

The alternative could be for the fund to adhere to strict concentration limits, so that absent unforeseen market distress, it can reduce the risk of owning large chunks of illiquid collateral assets.

As an alternative, fund sponsors may consider implementing a "fast pay/slow pay" mechanism where investors withdrawing as of the same date are moved to a "withdrawal class" that represents a vertical slice of the fund's entire portfolio, which is then liquidated (and proceeds distributed) in the ordinary course. This mechanism ensures investors receiving distributions from liquid credit assets relatively promptly (as they can be disposed), while retaining interests in illiquid credit assets until the relevant loan is repaid or otherwise realized in the ordinary course.

The fund documents contemplating these mechanics must clearly disclose that the illiquid portion of a portfolio attributable to a withdrawal class remains at risk of fluctuations in value during the withdrawal period. There are also important practical considerations that may advocate against the use of a pay/slow pay mechanics in a credit fund, including the administrative burden and costs associated with slicing large portfolios of loans into withdrawal classes on each withdrawal date.

As a third option, managers may create sidecar vehicles that are closed-end in nature and hold concentrated or illiquid credit positions. Sidecars often invest alongside an open-end fund in the same borrower (issuer) but at a different capital structure level. This approach works well for one-off, special situation investment opportunities where the investors in the main open-end fund and other co-investors can affirmatively elect to participate in the opportunity.

With respect to the economics of open-end funds, fund managers are typically entitled to two income streams, the management fee and the incentive allocation. Management fees of open-end credit funds are traditionally calculated as a percentage of the capital account balance or net asset value of the relevant shares, which includes cash balance amounts.

In the event investors are uneasy with fees being charged on cash held, managers may elect to incorporate a commitment facility/drawdown mechanism so that capital is called only when needed to invest and fees would be payable only on called amounts.[10]

Incentive allocations are typically calculated at the end of each fiscal year (or upon withdrawal by an investor) and would be calculated by taking a certain percentage of the net capital appreciation of the relevant capital account or shares. With credit funds in particular, such capital accounts balances would include current income as well.

There can be some variations in the way managers elect to calculate the incentive allocation, such as incorporating a hurdle rate. To calculate the management fee or incentive allocation for an investor's capital account or shares, the asset valuation should reflect the "market" value of the underlying credit instruments. Many closed-end credit funds utilize cost of the capital as a base of such valuation, which would not consider market fluctuations in credit instrument valuations (thereby ignoring unrealized gains or losses).

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Given the various structuring alternatives for private credit fund, the nature of the underlying credit assets will always result in bespoke credit fund terms. In fact, the same credit strategy can often be offered either through an open-end or closed-end fund using at least some of the features described above and reflecting the manager's and its investors' preferences.

Not uncommon are also private credit funds with various classes of interests or shares that are a mix of these features and aim to meet the expectations of different investors. Managers may also offer investments in the same strategy through parallel funds, one being open-end the other closed-end.

Thus credit funds, which both incorporate, and deviate from, various aspects and mechanics of the traditional private equity and hedge fund worlds, appear to continue evolving into a unique class of its own.

Notes

[1] https://bit.ly/3XrHd35.

[2] https://bloom.bg/3CR5m9z.

[3] https://bit.ly/3ra2DFC.

[4] https://bit.ly/3pz1Z42.

[5] McKinsey Global Private Markets Review 2023.

[6] "Private Fund Managers Must Prepare For Greater Scrutiny and Transparency Regarding Affiliated Service Provider Arrangements" by KKWC dated June 13, 2023.

[7] A general partner clawback obligation becomes more relevant in case of such bifurcated waterfall.

[8] https://bit.ly/3NxwfnW.

[9] While not uncommon, lockups, whether hard or soft (i.e., requiring an early withdrawal charge), actually do not really solve the liquidity challenges of an open-end credit fund because after the lock-up expires, investors can withdraw.

[10] That management fee calculation model deviates from a traditional private equity fund that charges the fee based on commitments.

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