Building an Evergreen Credit Platform

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Proskauer

Introduction

Given the challenges in fund raising for successive closed-end credit funds due to the speed in which managers go back to the market and the complexity in tax structuring, managers are seeking "evergreen" solutions for their direct lending strategies as well as other credit-related strategies.

Such an "evergreen" platform may be structured in a number of ways based on a variety of considerations:

1. **Open-End Fund Structure** that allows for continuous fundraising with specified liquidity rights
2. **Hybrid Fund Structure** that borrows from open-end and close-end architecture. Such funds often have a traditional waterfall structure and may be segmented into "vintages"

Permanent capital structures can also be used, but those are bespoke in nature and generally would not offer an exit except on certain liquidity event triggers

Drivers of Structure Choice

There are many drivers to the choice of structure in creating an evergreen platform. **Such considerations include:**

Types of loans
Senior secured, junior, subordinated and distressed and whether equity interests or other assets are considered

Valuation process
All evergreen structures will have a valuation component in accepting new capital commitments/contributions into the fund vehicles. Furthermore, certain options may also need valuation on exits (*i.e.*, redemptions) and for management fees/performance compensation. Certainty of the valuation process can influence structure choice

Current Income
Investors seeking current income distributions can influence terms as this can affect recycling features and waterfall/incentive allocation structuring

Management Fee and Performance Calculations
Net Asset Value ("NAV") based vs. invested capital/waterfall structure

Expected investor base
Non-U.S. and tax-exempt investors (if the platform will use leverage) will need appropriate tax planning

Open-End Fund Structure

General Attributes

- Continuous offering of interests to investors
- Capital contributions typically in lieu of capital commitments
- Mark-to-market accounting
- Management Fees generally paid on NAV, but could be based on invested capital
- Annual mark-to-market incentive allocation, generally subject to a high water mark
- Generally reinvestment of all income
- Periodic redemption available to investors

Open-End Fund Structure (*cont'd*)

Advantages of Open-End Structure

- Can continuously fund raise and recycle proceeds into new investments
- Management fees can take into account any unrealized appreciation in assets (*e.g.*, any equity kickers)
- Annual incentive allocation will provide quicker payouts to investment team as opposed to a traditional "back-end" carry
- Structure can appeal to a broad audience who may need liquidity that can be obtained through redemption
- Avoids need to go back to investors for re-ups as is required in closed-end regime

Disadvantages of Open-End Structure

- Fund will be classified as a "hedge fund" for regulatory purposes with different (more enhanced) regulatory compliance
- Capital contribution model will mean that deal flow should be readily available so there is no drag on returns with uninvested cash. This issue can be solved with a commitment structure if needed, but buy-ins on calls will be based on NAV
- Robust valuation process is important as it impacts in-flows, outflows and management fees/incentive allocations (valuation is an area that often is subject to significant scrutiny).
- Generally an open-end model does not provide for periodic (*e.g.*, quarterly) distributions. If investors require this feature, it can be implemented, but distributions may cause crystallization of incentive allocations more frequently and additional operational complexity
- Open-end fund structure is difficult to structure as a "treaty fund" to address ECI as the inflows and outflows can affect treaty availability. Other structuring alternatives may need to be considered.

Open-End Structure (*cont'd*)

Specific Term Features

Liquidity terms vary widely and can be structured with a number of features to protect the fund and non-redeeming investors, including:

- Terms relating to frequency of redemptions—quarterly, semi-annually, annually or less frequent
- Initial lock-ups before a right to liquidity can be linked to an investor's initial investment or each contribution/commitment made by an investor (the former being a feature in a commitment structure)
- Overall fund level gate, limiting the total percentage of NAV that may be redeemed out of the fund (can be measured at any redemption date or over calendar year or rolling 12-month period)
- Investor level gate limiting the amount an investor can redeem of its own investment at any redemption opening (*e.g.,* 25% investor level gate for a fund that has quarterly liquidity would mean it takes four calendar quarters to redeem)
- Ability to side pocket illiquid investments (*e.g.,* for assets acquired on foreclosure)
- Fast pay/slow pay models can also be used as liquidity features
- In-kind distributions in the event there is significant illiquidity resulting in the need to redeem through a liquidating trust or SPV

Incentive Allocation Arrangements:

- For long initial fund lock-ups (two to three years), incentive allocation can be offered over a multi-year period
- Incentive allocations can be structured with a hurdle rate, benchmark rate and with or without catch-up provisions
- Incentive allocation rates often in the range of 15% to 20%

Capital Contributions vs. Capital Commitments:

- Capital contribution structure is typical for open-end fund and if target investors include high net worth investors, will be easier for such investors to participate
- Capital contribution structure will mean that the manager will need a robust deal flow to put capital to work
- Capital commitment structure can also be made available
- Capital commitment structure will have calls coming in at NAV with mark-to-market accounting

Hybrid Model

General Attributes

- Capital commitments made to the fund, and drawn down pro rata to allow earlier investors to be fully called first
- As capital calls are made, valuation and book capital accounts are kept much like in an open-end fund
- Management fees paid on either invested capital or NAV
- Vintages may be established to give investors an opportunity to continue to invest or “roll” into the next vintage; a typical cycle is three years
- Incentive compensation is typically structured as a back-ended carry with a waterfall being established at each vintage and run-off
- Current income distributions may be provided and allow for “carry” on current income
- Full re-cycling generally permitted

Hybrid Model (*cont'd*)

Advantages of Hybrid Structure

- Less pressure on valuations since management fees and carry can be determined without reference to valuation; however, fund ownership when accepting new capital contributions will be NAV based
- Carry on current income distributions can provide earlier compensation to investment team
- Structure may be more appealing to traditional close-end fund investors
- Fund likely not classified as a hedge fund for regulatory purposes

Disadvantages of Hybrid Structure

- Robust valuation process is important as it impacts in-flows and capital account maintenance
- There can be cross-liability risks across vintages—SPVs can be used to reduce risk
- For investors electing to "stop" investing and be run-off, distributable income related to that vintage's investments would be allocated on a capital account basis and then between the investor and the general partner
- There will be complexity on tracking rolled distributions to any new vintage
- There can be complexity on performance reporting

Hybrid Model (*cont'd*)

Specific Term Features:

Liquidity Terms/Carry Structure:

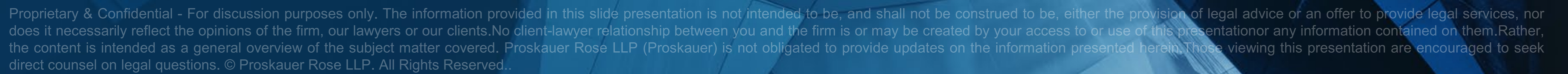
- Typically structured as a European styled (back-end) waterfall structure
- Initial lock-ups before an option to seek a run-off of investments. This can be combined into, for example, three-year investment cycles ("vintages") where an investor can elect to continue to invest, and therefore roll to the next vintage, or investor can elect to be run-off
- Periodic estimated carry calculations may need to be made when an investor is allowed to roll-over to the next vintage to crystallize performance; this can be combined with a potential clawback arrangement
- Carried Interest rates generally between 15% to 20%
- Preferred return rates between 6%-7%. For credit funds that invest in other opportunistic investments or distressed, the preferred return is often 8%.
- Periodic distributions may be permitted and subject to a separate waterfall for the manager; this may or may not be aggregated with main waterfall
- "Vintages" may allow easier reporting of performance during different market environments

Management Fees:

- For levered credit funds, generally invested capital (which will count investments made with leverage) will be more advantageous than NAV (which would be net of leverage)
- Consider whether and to what extent other income will offset management fees, including loan servicing fees, administration fees, and agency fees.

Subsequent Closing Mechanics:

- Use of separate vintages may permit a cost + model for subsequent closers within a vintage. Valuation will need to be made for "rolling investors" and new investors admitted into assets rolled from a previous vintage.
- NAV model can also be used for subsequent investors in which new capital commitments/contributions are accepted based on the NAV of the fund. Distributions for NAV based funds would be made under the waterfall based on the relative capital account balances of investors as adjusted for the realized and unrealized appreciation of the fund.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