Private Credit Fund Structures and Matching Assets and Liabilities

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Over the last few years, the landscape for private credit fund structures has changed due to the increasing focus on private credit investing from an expanding investor base looking for yield. I thought it would be worthwhile to discuss this shift in fund structure and one innovative solution in more depth. The key challenge in private credit fund structuring is aligning investor liquidity expectations with the duration and liquidity profile of the underlying assets.

Post-financial crisis, many private credit investors have become comfortable investing in a more traditional private equity closed-end structure. Over time, as the private credit investor universe has expanded, other investors, namely family offices and the wealth management community, have expressed a desire for evergreen or open-ended structures for operational reasons. Some of the operational challenges cited include managing capital commitments, executing subscription documents for subsequent investments and/or rollover investments and subsequent fund diligence, among others. However, earlier attempts at evergreen or open-ended structures used for private credit investing were flawed and many created a significant asset-liability mismatch.

Closed-End vs Open-End

Closed-End Fund: A fund that has a closed-ended structure will have a finite life, and the amount of capital raised is capped by either the passage of a defined amount of time or upon meeting the capital raise target. Under this structure, the life of the fund is generally known and does not continue on indefinitely. Most closed-ended private credit funds will be structured as a private equity or a hybrid private equity structure with clearly defined capital raise, investment and harvest periods. Most have some type of capital commitment and call feature. The life of these funds usually ranges from 4 to 7+ years in order to correspond to the life of the underlying investments. This directly addresses the concerns of fund asset-liability mismatch. Generally, there are no redemption provisions in a closed-ended fund; once the capital is deployed, it will only be returned to investors once the underlying transactions monetize. In this structure, all investors are on equal footing with respect to the distribution of capital.

Open-End Fund: A fund that has an open-ended structure, or what some refer to as an “evergreen” fund, has no maturity and can raise capital indefinitely. Most evergreen funds have monthly or quarterly capital raise periods based on a closing NAV. Historically, most private credit funds established as evergreen funds had redemption features that would allow investors to exit the fund prior to the underlying investments monetizing. Those features generally included meeting some type of “lockup” period, i.e., a one-year investment horizon. Once the lockup period was satisfied, an investor could redeem their capital on a monthly or quarterly basis. When the underlying fund investments are illiquid with a multi-year maturity, as frequently seen in private credit, using a traditional evergreen structure proved to be problematic. The flaw in the traditional structure is a mismatch created between the time investments can be monetized and the time required to satisfy a redeeming investor, commonly referred to as a fund asset and liability mismatch. When those two elements are misaligned, investors may face gates, delayed liquidity, or value erosion caused by forced asset sales. As any veteran of the financial crisis can attest, this mismatch can quickly place managers in the unenviable position of becoming forced sellers of illiquid assets. In this case, the manager may find it difficult to liquidate positions at favorable prices or may even have to dump well-performing positions in order to generate liquidity. To make matters worse, private credit investors in a true evergreen fund structure can find themselves at the back of the line in terms of distribution of capital as investors are redeemed on a first-come, first-redeemed basis. The priority of paying redemptions and the mismatch of assets and liabilities described above resulted in many funds that focused on illiquid investments being “gated” when redemption requests overwhelmed the available capital.

The Evergreen Fund 2.0

At SR Alternative Credit, we spoke to our investors and thought long and hard about the fund structures used for our asset-based lending strategy. Additionally, because our investors desired the ability to receive quarterly income distributions, we focused on structuring deals that generated cash payments of coupon and fees that could be distributed to our investors. Our prior funds were structured as a variant of the traditional closed-end fund, which most private credit investors were comfortable with. These funds were constructed with three components: a capital raise period, an investment period, and a harvest period. Altogether, the investment time horizon from start to finish could be viewed as a five-year hold. Once the fund concluded its capital raise and investment periods, it entered the harvest period, where the focus shifted from investing to monetizing investments and allowing capital to be returned to investors.

Post-financial crisis, most private credit funds were structured as closed-end funds. However, there was a segment of investors, mainly family offices and members of the wealth management community, that desired a different structure. Over the last several years, some innovative hybrid evergreen structures have been created that address one of the biggest flaws of a traditional private credit evergreen structure: asset-liability match. The birth of the “Evergreen Fund 2.0,” or as we call it, a hybrid evergreen structure, has created an opportunity for us as a manager to offer certain investors the ability to invest in private credit in a fund without a maturity date, thereby eliminating the investors’ need to go through the subscription process of a new fund every few years while at the same time addressing one of the biggest flaws of a traditional evergreen structure used in private credit investing.

The hybrid evergreen structure that we applied to our OHPC fund allows capital to be raised on a monthly basis at NAV and provides for two forms of liquidity: optional quarterly distributions of income and redemption of principal. The income distribution option is an important structural feature for many of our investors searching for yield in our ABL strategy. A more interesting structural feature is the flexibility given to investors to redeem their investment while at the same time addressing the alignment of fund assets and liabilities for the remaining fund investors. This is accomplished by creating an initial hold, or a lockup period of one year, after which the investor may make quarterly redemption requests. However, the key difference in this structure versus a more traditional evergreen structure is that when a redemption request is granted, the manager creates a pro-rata distribution of the existing portfolio (at the then NAV) and places it in a liquidating account for each redeeming investor. As the investments in the liquidating account monetize, which could occur over a few years, the redeeming investor receives the proceeds in line with the natural liquidity of the investments. This monetization process is very similar to the process that occurs during the normal harvest period of a traditional closed-end fund. Thus, this structure shifts the decision of when the harvest process begins from the manager to the investor. At the same time, it avoids forced sales of illiquid investments to satisfy a redemption and ultimately aligns fund assets and liabilities. Investors now have the flexibility to invest in a private credit fund for one or more years before starting the harvest process. The decision as to when to begin the harvest period is in their own hands.

In order to capture the illiquidity premium inherent in an asset-based lending strategy, investors should consider a hybrid evergreen fund, such as that offered by SR Alternative Credit. This type of structure is open-ended and attempts to match the underlying transaction duration with investor capital commitment periods while at the same time giving investors flexibility to influence the investment time horizon. While this structure does not provide immediate liquidity in the traditional sense, it seeks to align investor redemption rights with the natural realization profile of the underlying investments.

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