E X P E R T Q & A

Evergreen vehicles are attracting retail investors to private debt but the big LPs need more convincing, says Barings' Tyler Gately

Evergreen structures remain a work in progress

Q What are the main fund structures being adopted by private credit managers?
Today, the market within private credit is dominated by two types of fund structures – the traditional closed-end drawdown structure and the evergreen, or open-end, fund. The latter is a new frontier within private markets and is still finding its feet.

The majority of capital is still going into traditional structures, with only around 15-20 percent of the funds in the market today evergreen. Many of these more open-end structures are focused on introducing retail investors to the asset class by incorporating quarterly liquidity, so the shift is driven by a new investor base rather than limited partners.

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Q How have these evolved in recent years, and why?
The financial crisis was an important inflection point for private credit. Before that, the majority of capital was on-balance-sheet lending with banks and insurers. As banks retreated in the wake of the global financial crisis, institutional capital filled the void – largely in the form of the traditional GP/LP drawdown structures.

In recent years, the introduction of these semi-liquid, evergreen structures has opened the private markets to retail investors. Although liquidity is one clear benefit, investors are also drawn to other features including the ability to be fully invested on day one, and the simplicity of gaining a single more permanent allocation (rather than having to re-up into future vintages).

As the advantages of evergreen funds become better understood, we expect to see increased institutional participation in evergreen structures, particularly from smaller, less well-resourced institutions. Some of these investors target the evergreen solution for the simplicity mentioned; others see it as a potentially tactical solution within a broader private credit allocation. For instance, institutional investors use evergreen structures as a bridge into a more permanent allocation to a traditional vehicle, or to provide more liquidity in an illiquid asset class.

Q What are some of the key risks at the fund structure level in today's market?

Evergreen vehicles have become popular both due to the efficiency they bring to investing in private debt and, more importantly, the democratisation – they provide retail investors with access to the asset class. However, over the last couple of years, retail investors have had mixed experiences with private debt investing, which is heightening regulatory pressure. This has also brought into focus the importance of education – especially given that these vehicles, although they provide some level of liquidity, are ultimately investing into an illiquid asset class.

Another challenge for evergreen vehicles is around valuations as investors enter and exit the funds at NAV. There is greater focus on a manager's ability to transparently and accurately value the underlying assets that do not have public marks. There is no perfect solution, and institutional allocators are acutely focused on such governance aspects.

Fund level leverage is another structural feature that warrants attention.

The financing landscape has changed quite a bit in recent years, with implications for how managers operate traditional and evergreen vehicles. Funds have accessed leverage in different ways. Pre-GFC, one-year rolling facilities were common with one-year cliffs for times when market activity waned. That has evolved to liability matching, with three- to five-year structures more common, and some managers taking advantage of CLO-type structures.

We have also seen more structural changes in the leveraged market, with the collapse of Silicon Valley Bank and Signature Bank impacting capital call facility markets, in particular. More broadly, we have seen Tier 1 providers of capital trimming their GP rosters to focus on a smaller number of top-tier players. All of that has limited GP access to leverage, and consequently, the leverage structure, pricing, how a fund will perform through a cycle and the rights of lenders are all areas of heightened focus today.

"We expect to see increased institutional participation"

Q How will investor bases differ across structures?

There is likely to be a continued focus on the retail market as it is an area of tremendous growth potential for alternatives managers. At the same time, the market will continue to develop to become more suitable for institutional investors over time. We have seen evergreen GP/LP structures enter the market, but with different types of liquidity mechanisms attached, and that will continue to evolve. One example is the run-off sleeve, where institutional investors can redeem their allocation (or a portion of it) and see their investment put into a run-off sleeve, whereby liquidity is returned to investors as and when the loans repay.

We would expect to see more complexity as managers and investors explore different solutions. Our platform, for example, has 30-odd vehicles on it, and you will probably see even more optionality introduced for investors before we consolidate to fewer common structures. But overall, we do expect to see an ongoing adoption of evergreen vehicles by institutional investors.

Q What is the most appropriate fund structure for institutional investors in an illiquid asset class?

Ultimately, the illiquidity of the underlying asset class needs to be respected, and in the various structures available today, managers have done just that – after all, it was born of a liquidity mismatch in the banking system.

But within that important illiquidity constraint, every investor has their own world view and tolerance for different types of risks, whether those are structural or underlying deal risks. If you are solving for a targeted 14 percent return, you can take on more asset-level risk and less leverage risk, or vice versa. So, you can solve for the same thing in different ways, and that is the same with the actual fund structures.

If you want exposure to a certain vintage, you are going to do your drawdown style and get exposure to assets over the next 18 months. But others would say that is inefficient from a capital standpoint and would want to put more money to work right away.

We are seeing optionality increase and there is no one appropriate fund structure – it is about meeting an investor's end goals in the most appropriate way.

Q How do you see private credit fund structures evolving through 2024 and beyond?

Probably to having more optionality, greater flexibility and ultimately more structural choice for investors. Right now, we are in the exploration phase and new concepts need to be viewed with some caution, given their complexity, as well as uncertainty about how they will perform through cycles. Some evergreen funds have already had to put up gates and shut down redemptions (albeit within the guidelines of those funds), but we do not know what happens in the face of more widespread issues.

It is also a slippery slope for GPs to be wholly beholden to retail investors, as institutional capital tends to have a longer time horizon and be more committed. These issues, combined with the regulatory risk and governance questions, mean there is still a long way to go before evergreen structures become the preferred option for LPs. ■

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