INVESTMENT FUNDS

Recent trends in credit funds

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The world of private fund formation is commonly divided into two buckets; private equity and hedge funds. Pursuant to this simplistic paradigm, private equity involves illiquid investments in a limited number of private companies or other illiquid assets to be held for some years while operational improvements are attempted followed by an exit through a strategic sale or initial public offering. Accordingly, funds have fixed terms and investors are locked in while assets are acquired, the strategy has time to be effected and exit is achieved. Hedge funds, in contrast, offer investors periodic liquidity on demand and therefore involve investments in marketable instruments that can be readily valued and sold and in which the fund sponsor will not engage actively with the business itself.

However, there are certain strategies that are not a perfect match for either the private equity or hedge fund paradigm. Many of these strategies involve credit instruments. We have seen a material increase in the number of credit funds recently, of which there are many types employing different structures and strategies. Leveraged loan funds buy or originate bank loans and then lever the bank loan portfolio, often on swap. Special situations funds have a broad focus and may buy a wide range of fixed income opportunities, seeking higher yields with "equity like" returns. Direct lending funds originate loans rather than purchasing from the secondary market and often focus on senior secured loans with floating rate interest charges. These commonly-unlevered funds may have lower yields and be made to buyout borrowers as part of a leveraged buyout. Finally, distressed debt funds invest in impaired credits, including acquiring or refinancing the obligations of companies that have filed for bankruptcy or will most likely file for bankruptcy in the near future.

Hybrid structures gained popularity after the credit crisis of 2008, when a significant number of hedge funds experienced redemptions in an illiquid credit market. Going forward, many credit-focused general partners who traditionally utilized a hedge fund structure moved towards "hybrid" fund structures that combine the flexibility of the open-ended hedge approach with attractive features of the closed-ended structure. The terms adopted from each vary, and credit funds are often bespoke. Some examples of hybridization include: drawdown features rather than full upfront contribution from investors (so that general partners have runway to draw down capital and invest in a more measured manner without suffering the drag of dry powder); redemption rights for investors similar to those offered in hedge, but with longer lockups with less frequent liquidity (so that general partners do not find themselves in the position of having to fire-sale assets or suspend redemptions, as many did in 2009); adjustment of carry waterfalls, capital call mechanics and reinvestment mechanics to address the likelihood of active trading of at least some portions of the portfolio; and revision of the private equity concept of an investment period followed by a harvest period to instead permit certain types of trading throughout the fund's life. Hybrid structures enable general partners to pursue a variety of liquid and illiquid credit strategies within the same vehicle.

EXPERIENCE WITH CREDIT FUNDS IN PARTICULAR ... IS CRITICAL TO NAVIGATING THIS LANDSCAPE

While credit funds borrow from both traditional private equity and hedge fund structures, there are several aspects that do not translate to credit funds. For instance, the shorter path to liquidity for debt instruments (through periodic payments and eventual maturity) means that even funds that originate or invest in debt instruments that do not have an active secondary market can offer more liquidity than traditional private equity funds. Since investments produce returns more rapidly, general partners are likely to

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want the ability to reinvest often both returns of capital and profits. One will often see credit funds where the ability to reinvest mirrors the ability to call capital (potentially extending to fund dissolution), while recycling is much more limited in private equity. The fact that investments throw off cash regularly also means that credit funds will likely make distributions of current income to investors and employ a back-ended "European-style" waterfall structure, where investors receive a return of all capital plus a preferred return before the general partner takes carry so that it is not necessary to track, in real time, which investments have generated the proceeds.

Credit funds may hold debt instruments that have a readily assessable market value. As a result, the private equity fund model of dealing with investors who come into private equity funds at subsequent closings may not be a good fit. Instead of allowing subsequent investors to participate in subsequent closings based on cost of investments plus an interest factor, a hedge-fund style approach, in which investors participate based on the current value of the portfolio, may be more equitable.

Hybrid credit fund terms also have key differences from the terms of more liquid funds. Because of the types of assets that many credit funds hold, valuation presents a difficult issue; general partners must decide when to use in-house valuation or assign this task to third-party valuation firms and how often they will conduct the valuation of the portfolio. Credit funds that allow periodic redemptions may need to include side pocket or slow pay features to address the possibility that portions of the portfolio will be, or become, illiquid and difficult to value.

Hybrid terms can be used to reduce the risk that a credit fund general partner will be forced to sell assets that do not have an active secondary market in order to meet redemptions, as would be necessary in a fund using more traditional hedge fund terms. If the hybrid fund has a fixed term rather than offering redemption rights, the general partner can hold the portfolio through its natural timeline to liquidity.

Tax and conflicts of interest must also be considered. For example, funds that originate loans or lead workouts may generate effectively connected income, which requires special structuring. One must also consider potential conflicts of interest with affiliated businesses and funds. Credit fund general partners must decide in advance how they will allocate trades among their various funds, as well as how to resolve conflicts when investing in different parts of the capital structure of a given portfolio company. The current trend has been for larger fund sponsors to run multiple funds and managed accounts, often with partially overlapping investment objectives. These arrangements create the possibility that some investors would be exposed to senior debt, others to subordinate layers and others to equity, creating fiduciary quandaries for the general partner when these layers develop opposing interests. Clarity on how these issues will be resolved is key.

Over the past ten years, there has been a material increase in the number of credit funds. One asset management firm predicts that the credit fund market will reach $1 trillion in assets under management by 2020. This is largely attributed to their flexibility and ability to employ complex investment strategies by borrowing terms from both liquid and illiquid strategies. Long-standing credit fund general partners continue to launch new vintages of credit funds and are pursuing new strategies, and new general partners are entering the credit space. According to one survey, a key trend in credit has been the continued growth of the institutional lending landscape, with numerous funds being raised globally and increasing interest in private lending strategies by investors globally.

The fund sponsors who navigate these trends most successfully are those who understand the optimal mix of fund terms that meet all objectives: attracting and retaining capital, matching liquidity to the realities of the investment program, and structuring funds that align the interests of sponsors and investors with tax efficiency. Experience with credit funds in particular, rather than experience with hedge or private equity funds in general, is critical to navigating this landscape.

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