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LENDING STRATEGIES

Forming Private Credit Funds: Key Differences in Fund Lifecycle and the Use of Subscription Facilities Versus PE Funds (Part One of Two)

By Rorie A. Norton, *Private Equity Law Report*

Private credit funds are often established as closed-end, PE-style vehicles because of issues associated with the relative illiquidity of the funds' assets. PE and private credit assets are not equally illiquid, however, and the differences trickle through to meaningful variations in the fund documents for each strategy. Therefore, a PE sponsor needs to understand how the comparative liquidity of the underlying assets affects the terms and management of a private credit fund before launching one as an additional strategy.

This first article in a two-part series details the abbreviated lifecycle of a private credit fund compared to a PE fund; describes how asset liquidity elevates the importance of economic considerations when admitting subsequent investors to the fund; and examines the heightened significance of subscription facilities in managing the liquidity of a private credit fund. The second article will contrast the structure and rates of management fees and carried interest charged in private credit funds relative to PE, while also detailing key friction points in negotiations surrounding recycled proceeds.

See our two-part series on direct lending funds: "Structural Approaches to Address Liquidity Considerations and Ensure Regulatory Compliance" (Dec. 3, 2019); and "Five Structures to Mitigate Tax Burdens for Various Investor Types" (Dec. 10, 2019).

Fund Lifecycle

As a baseline, it helps to identify the fundamental timeline and arc of a PE fund as a byproduct of the liquidity of its assets relative to private credit funds.

Between the initial closing and subsequent closings, fundraising periods for PE funds tend to last for 18 months, said Schulte Roth partner Stephanie R. Breslow. "PE then tends to have a 3-5 year investment period that is followed by a 5-year harvest period, with maybe 1-2 year-long extensions after that," she observed. "That means a PE fund's arc lasts over 12 years, and sometimes even longer."

The lifecycle is different in private credit, however, because of the quicker turnaround and reduced complexity of the underlying transactions. "We think of them as 'PE-lite' approaches, where most things are the same as PE funds, except that the whole investment cycle and fund term are shortened," noted Breslow.

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Beyond the theoretical, that can manifest in real differences between PE and private credit funds. For example, private credit funds often have investment periods as short as 3 years and fund terms of only 6 years – materially shorter than the 5 years and 10-12 years for PE funds, said Akin Gump partner Ann E. Tadajweski.

Despite the shorter time periods, private credit managers still retain many of the accompanying fund mechanics available to PE sponsors, noted Akin Gump partner Dennis P. Pereira. "The periods can often be extended in the GP's discretion, with further extensions thereafter with consent from LPs or the LP advisory committee."

See "LPAC by Design: Six Recommendations for GPs to Define LPAC Features During Fund Formation" (Feb. 25, 2020); and "Evolution of LPACs: Trends Toward Robust Procedures and Accountability for LPAC Members (Part One of Two)" (Oct. 8, 2019).

The distinctions between asset classes begin to fade, however, as managers and investors grapple with the perpetual fundraising environment prompted by the condensed private credit fund cycles, posited Ropes & Gray partner Jessica Taylor O'Mary. "The level of negotiation with investors and structural complexities of private credit funds can make them just as expensive to raise as a PE-style fund with a term life, but with lower returns than in PE," she reasoned. "Some investors prefer to be continuously invested instead of engaging in the expensive process of underwriting totally new checks every 18 months or 2 years."

"In turn, we have begun to see interest among managers and investors in elongating the periods a little bit, and for managers to raise larger private credit vehicles to avoid going to market quite as frequently," observed O'Mary. "The market is still figuring out how to make those changes work," she clarified, "but those types of changes are the natural result of private credit funds having inherently shorter cycles."

Subsequent Closings

It is common for a private fund to have multiple rounds of closings where investors join the fund during the fundraising period. PE and private credit funds often operate similarly in that respect, as both require any investor joining the fund after the initial closing date to pay a "catchup payment" to the initial investors, said Pereira. The amount of the payment can differ, however, depending on how subsequent investors are treated, which is where PE and private credit funds may deviate.

Closed-end PE funds often allow subsequent investors to benefit from the economics and income earned from investments made since the initial closing date, said Kirkland & Ellis partner Stephanie W. Berdik. In exchange for that right, subsequent PE investors often pay initial investors premiums equal to the amounts they would have paid to invest at the initial closing plus additional interest to make the initial investors whole for fronting the costs of any investments made to date.

That approach is logical for closed-end PE funds because the ramp-up period for making investments can be quite slow, reasoned Berdik. "With traditional buyout PE funds, the goal is to buy a company, hold it, improve its value and then sell it. In that context, it is rare during the one-year fundraising period to have a meaningful income stream, assuming any deals were even made during the fundraising period," she explained.

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Private credit is often quite different, however, as it is common for income-generating investments to be made during the fundraising period, noted Berdik. "Private credit funds are often off to the races very soon after getting capital in the initial closing, with income generated from those investments right away in the form of arranger, upfront or commitment; original issue discount; amortization payments; interest payments; etc.," she summarized.

When coupled with that steady, early income stream, the lack of a consistent approach across the private credit sector can cause the issue to land at the relative forefront of negotiations between sponsors and LPs during the fundraising process, concluded Berdik. The following are ways private credit sponsors can handle the predicament, with accompanying pros and cons of each approach.

See our two-part series: "What Must a PE Sponsor Consider Before Launching a Private Credit Strategy?" (Feb. 4, 2020); and "Four Common Fund Structures to Mitigate ECI Risks When a PE Sponsor Launches a Private Credit Strategy" (Feb. 11, 2020).

Benefit From All Investments

The primary approach for handling subsequent investors is to use the closed-end PE fund model, which is administratively straightforward for private credit sponsors. "Subsequent investors are adjusted back as if they entered the fund from day one, so they receive pro rata pieces of all investments made and resulting income generated before they joined," summarized Berdik.

Similar to PE funds, subsequent investors to private credit funds structured in that manner end up making catch-up payments to the existing investors of the fund for fronting the cost of the early investments. "One proxy that can be used for what that interest payment should be is an amount equal to the preferred return for the fund," noted Berdik.

There are downsides to that approach, however, as it could disincentivize investors from committing on the initial closing date. Instead, investors could arbitrage the situation by waiting to evaluate the fund's portfolio – and the return it generates – before committing. For example, if the fund has an 8% catch-up payment for subsequent investors but has accrued 10% interest rate returns to date, then that investor could earn the 2% difference before risking any capital.

For coverage of regulatory arbitrage opportunities, see "Key Factors When Deciding Between Offshore Domiciles for Establishing Shari'a-Compliant PE Funds" (Feb. 18, 2020); and "Broadening the Scope of MiFIR Intervention Powers: ESMA Demands Direct Supervisory Authority to Limit 'Top-Up' Management Activities and Reduce Regulatory Arbitrage" (Jun. 1, 2017).

Although that possible arbitrage opportunity exists, there is skepticism as to whether it is actually a motivating factor behind why investors wait to join private credit funds. "I don't think LPs are out to game the system," suggested Berdik. "Rather, for certain LPs it's a matter of when the fund fits in their particular calendar schedule – for example, maybe an LP's 2020 allocation is full, so it needs to wait until 2021 to commit.

If a sponsor worries the disincentives are too stark, however, then it can pull other levers to induce investors to commit early to a fund, noted Steven Schwab, director of legal and

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chief compliance officer at Thoma Bravo. Economic incentives are the most common way to encourage investors, with fee discounts often ranging from 15-30 basis points, said Pereira.

Echoing the above point, Tadajweski added that "first-close discounts can be layered with size-based discounts to produce substantial discounts – particularly for credit funds that only charge fees on contributed capital, rather than committed amounts."

In addition, there are other intrinsic benefits that inure to investors that join a private credit fund in the initial closing. One example is the ability to have a more substantial role in negotiating the fund documents, which is important to certain investors. "Once the terms of the fund documents are set, then the sponsor has a little bit more wind at its back to push back when negotiating with subsequent close investors," noted Berdik.

Receive Pre-Close Investments, Not Income

Another approach is to allow subsequent investors to receive income earned from investments only after the dates they enter the fund, summarized Berdik. "Investors simply participate from their closing dates forward and do not receive the coupon collected before being admitted to the fund, but they do take part in the investments from that point forward," explained Schwab. "It is a middle-of-the-road, market approach that many feel is equitable," he opined.

Private credit sponsors find the approach appealing because it contains a built-in incentive to induce investors to join the fund in the initial closing during the fundraising period, suggested Berdik. To equalize the arrangement, subsequent investors still make catch-up payments to the initial investors, noted Schwab. "There can be an interest charge or even an interest charge plus some other charge (*i.e.*, a carrying charge)," he continued.

In light of that, investors may find it compelling to join a fund in the initial closing because it enables them to avoid the catch-up payment while also allowing them to receive the early coupon payments, suggested Schwab. The relative allure of that inducement depends on each individual investor. "Some may find it sufficiently compelling to cause them to commit sooner," posited Berdik, "while others may not consider it a meaningful enough amount of money to drive their behavior."

Sponsors only receive the benefit of that potential investor inducement at the expense of some administrative burdens on the back end, noted Tadajweski. Although that factor can deter some sponsors from the approach, Schwab suggested that it does not present insurmountable difficulties. "The sponsor's finance team would need to put proper controls in place to track each LP's account when they've joined the fund. If you put those controls in place, however, it really shouldn't be too great of a burden."

For more on managing other operational tasks, see "Peter Tsirigotis of Brown Brothers Harriman Discusses the Operational Challenges Posed by Side Letters" (Feb. 14, 2013).

No Benefit of Pre-Close Investments

The least-common approach is for subsequent investors to be precluded entirely from earning any income from investments made before they joined the fund, even if the income is

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earned after that date. In exchange for that concession, subsequent investors can make smaller catch-up payments to the initial investors upon joining the fund, noted Berdik. "The first-close LPs are not carrying as much water because they actually get to keep their percentage ownership and the resulting interest from before the subsequent investors joined the fund," she explained.

Although it is an option that sponsors can choose, that approach is far less common in practice. The most notable factor stifling its popularity is the administrative burden it imposes on sponsors, as "there would be different investment streams for each set of investors if distinctions were made based on their closing date," said Schwab. "Sponsors need to track income streams on distributions of interest payments, determine the variable participation percentages and the ratios on which investors participate on a long-term basis," added Tadajweski.

The result is a heavy burden on a sponsor's back office, both in the complications and challenges it would introduce. "Every LP is almost in its own sub-partnership from day one, which is just complicated from a back office, accounting and reporting perspective," noted Berdik.

Use of Subscription Credit Facilities

The rapid ascent of private credit as an asset class since the 2008 financial crisis has coincided with the widespread adoption of subscription credit facilities by fund managers over the same period of time. To date, subscription facilities are largely ubiquitous among PE and private credit funds in the industry. That does not mean, however, that issues and considerations with using the facilities are the same between the asset classes.

See our two-part series on trends in the use of subscription credit facilities: "Advantages for PE Investors and Sponsors Have Led to Adoption by Some Hedge Funds and Credit Funds" (Jan. 24, 2019); and "Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions" (Feb. 7, 2019).

Although subscription facilities are convenient for PE sponsors to smooth out capital calls from LPs, they may not be strictly necessary. "PE deals are very spaced out and can have very long lead times to enable sponsors to give investors notice for capital calls," observed O'Mary. The rapid pace of private credit investing, however, makes subscription facilities critical features for funds, she argued.

"The amount of time between when a private credit sponsor commits to an investment and actually consummates the transaction is much shorter than in PE," explained O'Mary. "Subscription facilities then become really important for managing a fund's liquidity. Not only do institutional investors want to avoid constant capital calls, but in some cases they may not be able to fund in the brief amount of time needed for a credit investment," she explained. "In addition, many credit funds make larger numbers of investments than PE funds, so a few 'bunched' capital calls are less of a burden on investors."

In addition, there are much different expectations among investors about the use of leverage to enhance a fund's returns. As PE investors are less comfortable with leveraged funds, the Institutional Limited Partners Association (ILPA) and other large institutional investors

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have been vocal about curbing unpermitted uses of subscription facilities. That scrutiny has driven PE sponsors to, among other things, keep borrowings outstanding for short time periods and to advertise separate fund returns with and without leverage.

See "Distorting Alpha: How Fund Management Practices Affect IRR Figures (Part Two of Three)" (Sep. 17, 2019); and "SEC Examination Topic Trends: Outside Business Activity Disclosure, Subscription Credit Facility Use and Cybersecurity Policies (Part One of Two)" (Mar. 19, 2019).

Conversely, private credit investors tend to be much more comfortable with using leverage from subscription facilities and net asset value (NAV) facilities to enhance their overall returns, noted O'Mary. Private credit sponsors accomplish that by keeping borrowings outstanding for much longer durations – sometimes over a year – than in the PE context. "Therefore, a lot of ILPA's commentary doesn't actually make sense in the credit space because the limitations they're pushing for are inconsistent with levered strategies," she explained.

With that said, there are certainly private credit investors that do not expect or desire levered returns, O'Mary clarified. To accommodate that desire, some private credit sponsors launch parallel funds for the same strategy: one offering levered returns and another that is unlevered. "In that case, some sponsors will use subscription facility borrowings for unlevered private credit funds in a way that more closely mirrors the PE approach."

See our two-part series on avoiding parallel fund conflicts: "New SBAI Standards and Case Study Provide Guidance for Mitigating Conflicts" (May 5, 2020); and "Avoiding Parallel Fund Conflicts: Specific PE, Real Estate and Private Credit Issues and Mitigation Tips (Part Two of Two)" (May 12, 2020).

Finally, subscription facilities serve a unique purpose in the private credit context because of their interplay with a fund's NAV facility, which is a financing option supported by a fund's actual assets. NAV facilities are far more common for private credit funds than for PE funds, which rely almost exclusively on subscription facilities for fund-level leverage.

One problem, however, is that sponsors are unable to have NAV facilities in place on day one of a private credit fund's launch, noted Schwab. "Early on in a credit fund's lifecycle, sponsors need to build a large enough basket of the right mix of investments before they can deploy the back-leverage facility (*i.e.*, NAV facility), which is the fund's more permanent leverage facility," he explained. "Most people do not have asset bases to support NAV facilities until well into their investment periods – perhaps as much as a year or more," added O'Mary.

In light of that, a subscription facility is a really important tool for sponsors to manage the liquidity of their private credit funds until a NAV facility is available, summarized O'Mary. "You'll often see the subscription line serve that purpose of bridging from a launch date so sponsors can construct a portfolio to put an asset-backed line in place when it's time."

For more on NAV facilities, see our two-part series: "Common Structures, Applications and Trends in the Use of NAV Facilities by Secondary Funds" (Mar. 17, 2020); and "Five Obstacles When Negotiating NAV Facilities and Potential Ways to Overcome Them" (Mar. 24, 2020).

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LENDING STRATEGIES

Forming Private Credit Funds: How Material Variations in Fee Structures and Recycled Proceeds Compare to PE Funds (Part Two of Two)

By Rorie A. Norton, *Private Equity Law Report*

Sponsors well-versed in operating PE funds are accustomed to certain risk/return profiles when evaluating investment opportunities and negotiating fees with prospective investors. That background can make it jarring when they seek to enter the world of private credit, where comparatively liquid assets with flatter projected returns create a very different negotiation dynamic with investors. In addition, distribution waterfalls and the treatment of proceeds are also affected in ways that are important to consider when forming a private credit fund.

This second article in a two-part series highlights differences in how management fees and carried interest for private credit funds are structured compared to PE, while also describing the enhanced importance of recycling provisions in negotiations with LPs. The first article examined how the liquidity of most private credit assets manifests in abbreviated fund lifecycles and new issues when admitting subsequent investors to the fund, as well as why subscription facilities play a more critical role for managing private credit funds than PE funds.

See our two-part series: "What Must a PE Sponsor Consider Before Launching a Private Credit Strategy?" (Feb. 4, 2020); and "Four Common Fund Structures to Mitigate ECI Risks When a PE Sponsor Launches a Private Credit Strategy" (Feb. 11, 2020).

Fee Amounts and Structures

Private credit strategies are often appealing to PE sponsors because they offer diversified sources of revenue relative to equity investments. To fully appreciate that reality, however, PE sponsors need to understand that private credit offers very different economics than PE, noted Ropes & Gray partner Jessica Taylor O'Mary.

When coupled with different approaches to fee calculations because of the liquidity of the asset class, it means that PE sponsors have a meaningful learning curve when entering the private credit space. "The returns on private credit are generally lower, the fees are lower and the expense burden can be a problem if you are charging the same level of expenses as with PE funds," asserted O'Mary.

Management Fees

As alluded to previously, the management fees for all but a handful of private credit sub-classes (*e.g.*, distressed debt) tend to fall short

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of the typical 2% charged by PE funds. Depending on the return profile of the type of debt held by a fund, the management fees often begin at 1.5% and can be discounted from there, said Akin Gump partner Ann E. Tadajweski.

See "Trends in PE Funds' Core Economic Terms and Adoption of Recent ILPA Recommendations" (Sep. 24, 2019).

The fee rate is only the tip of the iceberg, as there is a broader disparity as to what capital is included as the base when calculating management fees. The standard approach in PE is for the management fee to be charged on capital committed to the fund by LPs during the investment period, said Schulte Roth partner Stephanie R. Breslow. "That incentivizes a GP to buy a vintage of assets across different years by evaluating opportunities in a measured manner, instead of rushing all the money out the door in year one," she explained.

Comparatively, some private credit funds charge a portion of management fees on committed capital during the investment period, while others only receive the fee on invested amounts. Further, there is a disparity in how "invested capital" is defined – and how certain issues are handled – when charging management fees. Parsing those differences is critical for managers to effectively launch private credit strategies.

Treatment of Committed Capital

The most common approach in the private credit industry is for the management fee to be charged only on invested capital. LPs often prefer that approach conceptually because it motivates GPs to be active at putting money to work, rather than collecting fees on dry powder, noted Breslow. "Investors take the stance that 'your job as the sponsor is to deploy, so when you deploy, you can take a fee on that deployed capital,'" echoed Steven Schwab, director of legal and CCO at Thoma Bravo.

The approach is most suitable when a private credit fund will be investing in fairly liquid forms of debt (*e.g.*, bonds). "Because investments in the credit space are generally realized more quickly than PE investments, a fund can use its reinvestment powers to take advantage of opportunities over multiple years even if it makes its initial capital deployment early."

GPs may be unwilling to acquiesce, however, if their private credit strategies are more similar – in terms of liquidity and tactics – to PE strategies, noted Tadajweski. "For example, it takes longer to source distressed debt investments, and they often require a lot of management. Thus, managers may want management fees similar to PE."

To that end, in some limited circumstances, a manager can negotiate a PE-like blended approach where management fees are charged on both committed and invested capital. A manager will often agree to a smaller number on the unfunded portion (*i.e.*, below 1.5%), with stratification based on the size and timing of the commitment, said Tadajweski.

There is not, however, an industrywide approach to how fees on committed capital are structured. "For example, I would say the fee rate for more retail-like investors (*i.e.*, smaller high net worth investors) is often the same on unfunded amounts as for funded amounts. Thus, it would effectively replicate them just charging one committed amount," observed Tadajweski. "In addition, I've seen more substantial size-based discounts on the fee rate on unfunded capital as an easier giveaway by managers expecting to invest the funds quickly."

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See "PE Expectations for 2020: Fee Arrangements, Fund Terms and the Secondary Market (Part Two of Two)" (Jan. 14, 2020).

Definition of Invested Capital

Aside from the issue of committed capital, PE sponsors launching private credit strategies will likely confront other considerations regarding earning management fees. "There is a tension when negotiating the defined term 'invested capital' and the associated management fee," observed Schulte Roth partner Daniel F. Hunter.

The first issue is whether the underlying assets on which the management fee is calculated should be valued at their cost basis or on their net asset value (NAV), said Breslow. "Where the calculation ratchets to the value of the remaining credit instruments after the investment period using the NAV approach, it can potentially produce a higher management fee base," she cautioned.

See "Distorting Alpha: How Fund Management Practices Affect IRR Figures (Part Two of Three)" (Sep. 17, 2019).

There are a couple of ways LPs will negotiate the management fee calculations to mitigate the potential harm of using NAV approach to value assets. "Some investors negotiate for management fees to be calculated on the lower of the cost basis and the NAV of those credit instruments," suggested Breslow. "Another approach," she continued, "is for the fee to be based on the assets' NAV, but not to exceed the investors' original commitments to the fund."

Another consideration is how recycled proceeds – where the GP reinvests investment proceeds, rather than distributing them to LPs – factor into the management fee. There is clear logic for why GPs should earn management fees on those recycled proceeds. "If GPs are paid to manage and monitor investments, then that wouldn't change if the deployed capital were from recycled proceeds or original investor commitments," reasoned Schwab.

See "Distorting Alpha: How Omitted Inputs and Deferred Carry Can Inflate IRR Calculations (Part One of Three)" (Sep. 10, 2019); and "ILPA Issues 'Principles 3.0': PE Economics and Related Fund Provisions (Part One of Two)" (Jul. 30, 2019).

Instead, negotiations in the private credit context are focused on how recycled proceeds are used. That aligns the parties' expectations and can also address LP concerns that GPs will use recycled proceeds to drive up their management fees, noted Hunter. "The amount of recycled capital, how fast it goes back, whether there was a coupon straight out, etc. – those negotiations have indirect effects, of course, on how much management fee the GP takes."

Finally, negotiations occur about whether management fees can be charged on borrowings under fund financing facilities. Subscription credit facilities are the first friction point, as they are nearly ubiquitous in the industry as a way for sponsors to bridge the time period – often broadly from 30-360 days – between purchasing an investment and receiving called capital from LPs.

See our two-part series on trends in the use of subscription credit facilities: "Advantages for PE Investors and Sponsors Have Led to Adoption by Some Hedge Funds and Credit Funds" (Jan. 24, 2019); and "Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions" (Feb. 7, 2019).

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The issue is whether a manager can receive a management fee on draws from a subscription line, or only when it actually calls capital from LPs. "Sponsors can typically charge management fees on subscription facility borrowings, but they are usually tailored very closely," noted Tadajweski. Negotiations also occur on more nuanced issues, including whether management fees charged on amounts borrowed under subscription lines can be capped, Schwab added.

In addition, negotiations occur around whether management fees can be charged on draws under back-leverage facilities (*i.e.*, NAV facilities) supported by fund assets. "A lot of credit funds have levered and unlevered sleeves to suit the preferences of their investors, so charging fees on the levered product is not uncommon or inappropriate provided it is properly disclosed," said Schwab.

For more on NAV facilities, see our two-part series: "Common Structures, Applications and Trends in the Use of NAV Facilities by Secondary Funds" (Mar. 17, 2020); and "Five Obstacles When Negotiating NAV Facilities and Potential Ways to Overcome Them" (Mar. 24, 2020).

Where appropriately disclosed and negotiated with LPs, management fees on a levered product could just be charged on deployed capital with a cap of up to X amount – *i.e.*, 1x, 1.5x, etc. – permitted to be drawn under the back-leverage facility, explained Schwab. As management fees in that scenario are on the gross value of the assets, Breslow noted that "this approach would presumably push the sponsor's management fee rate lower."

"The interplay between the leverage facilities and the fee base, and how you calculate the fees, is an interesting topic that firms need to be thoughtful about in terms of how those fees are calculated, avoiding potential conflicts and ensuring their LPs understand how the fees work," said Schwab.

Carried Interest

Consistent with the theme on fees generally, the carried interest earned by private credit sponsors tends to be lower than the 20% rate that is common for PE funds. The carried interest rate often ranges from 10-15%, which is attributable to the comparatively limited volatility of the underlying assets of private credit funds, said Akin Gump partner Dennis P. Pereira. "You are targeting, in some of these strategies, high single-digit or low double-digit returns, so the carried interest rate tends to be reduced accordingly."

See "Investors Demand Variations to PE Management Fees and Distribution Waterfalls (Part One of Two)" (Apr. 16, 2019).

With that said, the carried interest rate can be closer to 17.5-20% for more aggressive assets with return profiles similar to PE assets (*i.e.*, special situations and distressed debt), observed Pereira. Similar adjustments also tend to be reflected in the hurdle rate to be met before a sponsor collects carried interest, added Breslow. "A mezzanine fund, for example, would probably not have an 8% hurdle rate, whereas a distressed credit fund might have a hurdle rate closer to what's typical for PE," she explained.

Aside from fee and hurdle rates, another material difference between PE and private credit is reflected in the waterfall distributions typical of each asset class. PE funds typically have an American waterfall (*i.e.*, deal-by-deal carry), which enables GPs to collect carried

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interest after returning contributed capital to LPs that is specifically attributable to the realized investment, said Tadajweski. Among other reasons, one potential factor for that approach is that it is operationally easier to track the proceeds from PE investments given that there are fewer than in the private credit context.

Conversely, it is far more common for a private credit fund to use a European waterfall that requires all contributed capital to be returned to investors before the GP earns carried interest through the preferred return, noted Tadajweski. "Credit strategies that involve active trading on the public markets or secondary markets end up with a European-style waterfall because investment activity with a lot of churn makes it impractical to use an American waterfall," added Breslow.

For more on the different waterfall structures, see "ILPA Model LPA Attempts to Redistribute Economic Risk From LPs to GPs (Part Two of Three)" (Dec. 17, 2019); and "How Different Waterfalls Affect GP Receipt of Carried Interest (Part One of Two)" (Jun. 4, 2019).

The lines of demarcation are not rigid, however, as private credit funds can support American-style waterfalls in certain contexts, such as where they issue a limited number of private loans. The benefits of an American-style waterfall may be offset, however, by other LP protections negotiated in the underlying fund documents. "If investors agree to an American-style waterfall but insist that the GP escrow money or provide personal guarantees, then as a practical matter there's not much of a benefit to the waterfall because that money is sitting on the side anyway," reasoned Breslow.

Recycling Proceeds

A common feature of PE and private credit fund documents is a recycling provision permitting a GP to reinvest proceeds from investments sold within a specified period of time – often up to 24 months – from the initial investment date. Practically speaking, the GP recycles the proceeds by adding the amount to an investors' remaining uncalled capital commitment during the period in question.

Differences Between PE and Private Credit

There are primarily three fronts where recycling provisions in the private credit context are distinguishable from those in PE. The first relates to the duration of a fund's reinvestment period relative to its investment period and whether recycling is even permitted, as is often not the case with PE funds. "In PE, if you hit an early home run, the idea is that you would distribute those proceeds to LPs," observed Tadajweski.

Where PE funds permit recycling, the length of time permitted for recycling can actually be quite similar as for private credit funds. There is a marked difference, however, in that amount of time relative to the duration of each asset classes' respective investment periods. Pereira explained the issue using a hypothetical involving private credit and PE funds with three- and six-year investment periods, respectively. "The reinvestment period for the private credit fund isn't reduced from 24 months to 12 months just because its investment period is shorter. It remains at 24 months."

That relates to the second difference, which is the frequency with which recycling occurs in each asset class. PE funds often have longer investment cycles and comparatively infrequent

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recycling because it takes much longer to source, close, harvest and then exit illiquid investments. In fact, the fickle and complicated M&A arc associated with selling portfolio company stakes often forces PE sponsors to hold investments longer than anticipated and to resort to various methods for extending their funds' terms on that basis.

See "ACA Program Examines Sponsor-Led Secondary Market: Themes, Issues and Solutions (Part One of Two)" (Oct. 8, 2019); and "How Fund Managers Can Address End-of-Life Issues in Closed-End Funds" (Mar. 19, 2019).

The opposite is true for private credit, however, because of the liquidity of the asset class. "Credit funds that expect a lot of recycling during the investment period have, in some instances, very limited drawdown periods – for example, only one year – to call capital from investors to invest," noted Tadajweski. "But, once that capital is drawn, they can often reinvest the proceeds for an additional two years," she explained. "That incentivizes managers to put capital to work very quickly."

The final distinction is the portion of proceeds that are eligible for reinvestment. Where recycling is permitted, PE funds often limit recycling to the portion of proceeds representing the principle of the original investment, said Breslow. "PE typically allows reinvestment of the cost of that investment, and that's it."

Conversely, the private credit sector tends to have a more flexible and expansive approach, as sponsors often retain the ability to reinvest both profits and interest from investments, said Tadajweski. Echoing the point, Breslow explained that "credit funds often don't try to tease apart whether proceeds are an interest payment or principle payment. All proceeds are subject to recycling, which may be capped at the amount of capital that the investors put in."

For more on the effect recycling proceeds can have on a fund's performance reporting, see "Distorting Alpha: How Omitted Inputs and Deferred Carry Can Inflate IRR Calculations (Part One of Three)" (Sep. 10, 2019).

Exception to the Rule

Although those differences reflect the typical dynamic between PE and private credit, there can be exceptions where the two asset classes are more closely aligned. For example, sometimes the recycling provisions of private credit funds mirror those of PE funds based on investors' preferences. "Some products are put in place with an expectation that investments will throw off significant interest income to be regularly distributed to LPs," observed Tadajweski.

In addition, some private credit asset types share similar illiquidity and transactional barriers with PE assets such that recycling becomes more limited and difficult. "For example, a private credit fund directly issuing private loans may be holding those assets for years before the principle is repaid, so there is no obvious reason why it should be recycling any more regularly than a classic PE fund," reasoned Breslow.

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