Schulte Roth & Zabel

SRZ INSIGHT

Midyear Update — Trends in Credit Funds

"Credit fund," like "hedge fund," is a term that embraces many distinguishable investment strategies — among them capital preservation strategies such as those employed by mezzanine and direct lending funds, return-maximizing strategies such as those employed by distressed debt, corporate credit and opportunistic/special situations funds, and specialty finance or other niche strategies. Credit funds can be structured as hedge funds, a private-equity style funds or a combination of both — also referred to as a "hybrid fund." Often, managers will run multiple credit funds side-by-side.

Lots of Dry Powder, but Is the Opportunity There?

We have previously reported that our clients attracted strong demand for their private debt and special situations funds in the second and third quarters of 2020, and this continued through year end. However, aside from the very largest firms,[1] the fundraising explosion that some predicted would occur in this space in the wake of COVID-19 was muted by the effect of government stimulus on the opportunity set and competition for opportunities from managers of hedge, private equity and hybrid funds, many of whom already had significant dry powder going into 2020.

That said, U.S. institutional investors, including retirement plans, appear to be increasing their allocations to private credit, with the private credit assets of the largest 200 U.S. retirement plans nearly doubling in the year through September 2020. Each of New York State Common Retirement Fund, Pennsylvania Public School Employees' Retirement System, Los Angeles Fire & Police Pensions, and Ohio School Employees Retirement System has recently announced larger allocations.[2]

In our October 2020 report, we said that while it remained unclear whether governmental action would lead to less opportunity than originally expected, there would be distressed investing opportunities for managers that were willing to be industry-agnostic, and we described a number of fund structures and terms that could be employed to bring blind pools or single-investment/co-investment vehicles to the market quickly. More recently, other commentators such as iCapital have expressed the view that, even despite governmental action and the larger number of funds pursuing these opportunity, "the global opportunity set [is] nearly 2.5x larger than the capital targeting it." Moreover, iCapital points out, investors can take heart from the fact that distressed funds that were raised during previous market dislocations have delivered high returns. Companies left out of the governmental stimulus packages,

[1] 2020 was a strong fundraising year for the very largest private credit fund managers. For example, the 10 largest private credit funds accounted for some 39% of the total capital raised in that space during 2020, with a notable move by such firms into the origination of even the largest corporate loans. *See*, for example, "Asset owners turn to private credit in quest for returns," *Pensions & Investments*, Feb. 8, 2021, available here.

[2] *See*, for example, "Private credit managers supersizing their loans," *Pensions & Investments*, March 8, 2021, available here.

according to iCapital, form the bulk of the distressed opportunity, which threatens to be driven by a deep, long-term "solvency crisis."[3]

Dislocation funds

Prior to the COVID-19 outbreak, with many credit managers anticipating an end to the benign economic climate and investors cognizant of the success of some of such funds in the years following the end of the Global Financial Crisis, a number of credit managers had built and accepted commitments to funds where the committed capital is not drawn until certain trigger events occur (e.g., a certain high yield spread is reached). Such funds are often referred to as "dislocation funds." Post-COVID-19, some dislocation funds were put into play, and the raising of new dislocation funds has continued into 2021.[4]

Hybrid Credit Structures

Because certain private credit strategies are not a perfect match for either a traditional open-end hedge fund or traditional closed-end private equity fund structure, "hybrid funds" have been popular in the credit space for some time. Examples of hybridization include:

1. The use of commitment features rather than full upfront subscriptions, so that sponsors have time to draw capital and invest in a measured manner without suffering the drag of dry powder;
2. Redemption rights similar to those offered in hedge funds, but with longer lock-up periods and less frequent redemption opportunities, so that sponsors do not have to fire-sell assets or suspend redemptions;[5]
3. The ability for investors to choose to terminate reinvestment provisions in respect of their capital so as to be paid out their capital as it naturally matures or is harvested without causing the sponsor to modify its realization strategy to meet requests for withdrawal;
4. Adjustments to carry waterfalls, capital call mechanics and reinvestment mechanics to address the likelihood that at least some portions of the portfolio will be actively traded; and
5. Variations on the private equity concept of an investment period followed by a harvesting period so as to permit certain types of trading throughout the fund's life, although the credit funds that apply these "hybrid" variations typically still have shorter investment and harvesting periods than a traditional private equity fund.

Since investments in debt instruments tend to produce returns rapidly, sponsors often want the ability to reinvest proceeds representing both returns of capital and profits. We therefore often build hybrid credit funds where the ability to reinvest mirrors the ability to call capital. In contrast, recycling is much more limited in private equity.

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[3] *See*, for example, "Is it Too Late for Distressed?," *iCapital Network*, available here.

[4] *See*, for example, "Dislocation Funds that have Emerged from Chaos," *Private Equity International*, available here.

[5] Usually, the shorter path to liquidity for debt instruments (through periodic payments and eventual maturity) means that even the 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. However, if the hybrid fund has a fixed term rather than offering redemption rights, the sponsor can hold the portfolio through its natural timeline to liquidity.

The fact that investments throw off proceeds regularly also means that hybrid credit funds that have carried interest terms 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 (lately 6 — 7% has become more common for credit funds that are not distressed strategies, down from 8%) before the sponsor takes carry. This avoids the need to track in real time which investments have generated the proceeds. More established credit sponsors are sometimes able to incorporate a current income waterfall in addition to a traditional waterfall, allowing the sponsor to earn carry purely because current income exceeds a hurdle.

The rate of carried interest itself will usually be a function of the expected returns of the program. There may also be a lower management fee, and the management fee may be based on invested capital from day one, as opposed to committed capital during the investment period as is common in private equity funds. (Not as big a concession as it sounds, as credit fund managers often call capital more rapidly than private equity managers and private equity sponsors sometimes grant a fee holiday to early investors.) Funds focusing on distressed debt will often have rates that are close to traditional private equity rates.

As these credit funds may hold debt instruments that have a readily assessable market value, the private equity fund model of dealing with investors who come into private equity funds at subsequent closings is not always a good fit. Allowing late closers to participate based on the cost of investments plus an interest factor can allow late closers an arbitrage opportunity that disadvantages early closers and creates a potential disincentive to early commitments. As such, a hedge-fund style approach, in which investors participate based on the current portfolio value, may be more equitable.

Due to the types of assets that many credit funds hold, valuation presents a difficult issue; sponsors 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.

If you have any questions concerning this *Insight*, please contact your attorney at Schulte Roth & Zabel.

SRZ lawyers regularly author articles, alerts and publications, providing their updated, timely views of the market trends affecting private funds and drawing on SRZ's decades of experience as the market-leading law firm serving the alternative investment management industry. For more market insights on current and emerging trends in the private funds industry, read SRZ's Private Funds Market Trends Report for June 2021.

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