Credit Funds: Evolving Hybrid and Other Structures

Insights from SRZ's leading investment management practice

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Stephanie Breslow's practice spans liquid fund strategies (including hedge) and private equity, and often strategies at the intersection of both: credit, litigation finance, activism and blockchain assets, where hybrid skills and knowledge – as well as multiple other expert practices within the firm – come into play. Breslow is a Schulte Roth & Zabel partner who serves as co-head of the Investment Management Group and as a member of the firm's Executive Committee.

Credit funds have become "the new banks" since the 2008 crisis, as traditional banks lent less and a non-bank lending industry flourished. Strategies range from mezzanine credit funds with lower risk and return targets, to loan origination funds and distressed debt funds that get involved in non-performing loans, and entities going through or exiting insolvency or bankruptcy processes. Specialty credit funds can focus on areas such as litigation finance or life settlements, which are also known as viatical settlements. CLOs (collateralised loan obligations) packaging corporate loans are hot again, and in fact anything with a recurring cash flow, such as student loans, credit card loans, auto loans, aircraft leases, film or music rights, can be securitised.

Though a diversity of credit strategies has proliferated, it has been challenging for some funds to raise assets as yield compression reduces their returns while strong equity markets also make for tough comparisons. A dislocation in markets could increase the opportunity set for some credit strategies, by allowing them to earn higher interest rates and increasing the supply of distressed opportunities.

The question is how investment vehicles should be structured to capitalise on these opportunities while aligning interests between managers and investors and mitigating conflicts of interest. Managers need to choose a law firm that understands credit and is familiar with the unique features and differences that apply to closed-end private equity, evergreen liquid funds, and hybrid structures.

Structuring choices

Breslow, who has featured in *The Hedge Fund Journal*'s '50 Leading Women in Hedge Funds' report in association with EY, recalls how, "starting before the crisis, some credit fund managers offered credit-focused investment strategies in different vehicles to cater for investment preferences. A hedge fund style, evergreen open-ended structure with periodic liquidity was offered to some investors while others opted for a private equity style closed end fund. Side pockets were used to hold less-liquid credit instruments within the evergreen structure, creating flexibility."

"Over time, credit fund structures have increasingly adopted a hybrid approach whereby a single credit fund vehicle may now contain elements of both hedge fund and private equity structures. This is logical because credit funds that do not invest in freely tradeable credit instruments are a halfway house between private equity and hedge funds. They do not have classic private equity holding periods of five to ten years with no market price, and nor do they own assets that can be sold in a matter of weeks. They may instead own level three assets, valued by marking to model, which can typically be liquidated in two or three years."

"Preferences vary between managers and strategies, but on balance, credit hedge funds that do not invert in freely tradeable instruments have drifted towards private equity and/or spillover co-investment style structures. They may, for example, choose a closed-end hybrid structure that has a fixed investment term, draws down capital, and charges performance fees above a hurdle rate, but that also contains aspects of hedge fund models, such as fee calculations based on net asset value rather than cost, and 'soft locks' allowing intermittent opportunities for redemptions, possibly at a discount."

Co-investments and side pockets

After the financial crisis, investors in open-end funds grew less accepting of side pockets. As a result, fund sponsors who previously ran credit strategies using open-ended funds with a side pocket allocation had to think of other ways to handle their less liquid investments. This has caused some managers to create sidecar vehicles with private equity structures, or one-off co-investment vehicles, to hold concentrated or otherwise illiquid positions.

Separating less liquid investments into their own vehicle can offer more scaleability than funds can achieve with side pockets alone. "Caps on the size of side pockets at the fund level were often filled up and could easily be hit if redemptions reduced the denominator, since there was no redeeming from the side pocket. This deprives new investors of the opportunity to invest in less liquid opportunities," explains Breslow. Another reason is that, "investors would rather wait on the sidelines until attractive opportunities are found, without paying fees on dry powder. A classic hedge fund structure may not be ideal for such opportunistic vehicles, since it would charge fees on the idle cash, whereas a private equity style or co-investment vehicle would rarely charge on committed capital."

Distressed credit strategies thrive during market dislocations, but can experience return challenges and a lack of attractive investment opportunities during periods of market stability. To attract investors to these strategies in good times, "some funds have set up opportunistic drawdown structures that can spring into life as and when broad based, or idiosyncratic, investments are identified".

Breslow notes, "private equity or co-investment style vehicles will tend to have a hurdle rate trigger for performance fees, typically around 8% with catch up, whereas hedge fund strategies often only have a high-water mark. But this varies by strategy, and a lower octane mezzanine debt fund would be unlikely to charge performance fees higher than 15%." Beyond this, "Larger funds may also have lower management fees. Discounts can be offered for one or more of: early bird founders' classes, larger investments or longer lockups. Non-fee expenses have not changed much, though care should be taken to determine whether line items are appropriately charged as fund or management company expenses."

Conflicts of interest

Indeed, fees are one possible flashpoint for conflicts of interest, which can also arise where managers have different products or strategies that may be investing in different parts of the capital structure, such as a more senior or less senior paper. Sometimes this is intentional because one fund has a higher or different risk mandate. Sometimes this can even be an accidental function of cash flow timing issues which force a fund to buy a particular issue simply because it cannot source the same paper as a sibling fund. Unlike public equity, which generally only has one or two share classes, corporate bond markets can offer hundreds of issues and ISIN codes from the same issuer. Sometimes one fund could own equity and another credit. Ownership of the fulcrum security, which holds the key to control rights in distressed situations (and which can also change over time) is another contentious issue.

"There is no perfect solution to managing and mitigating these potential and actual conflicts of interest, but transparent disclosure is the absolute minimum regulators and investors expect from managers. Regulators may also look favourably upon investor/LP approvals being sought in these situations, but regulators do not in fact provide the most prescriptive advice. Other options include setting out policies on which types of paper are bought by different funds, or on how to prioritise between funds; one possible, if imperfect, criterion for doing so is to favour the largest position. Policies can also be devised on voting where one fund has a position on a creditor committee."

"Some funds make use of an advisory board, or other independent party hired to act as a referee, and others will seek legal advice. A general rule is the 'arm's-length' approach: general partners should act for each fund as they would if the counterparty were a third party rather than another fund run by the same general partner." **THFJ**

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