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FUND INTELLIGENCE

What LPs are looking for after covid: Cash is king

Fund structures, cloud costs and benchmarks up for grabs as private debt managers and investors come to terms

Investors, from endowment funds to sovereign wealth managers to family offices, are looking for greater liquidity as well as more flexibility and negotiating hard on fees when allocating capital to credit funds, according to Daniel Hunter, a partner at **Schulte Roth & Zabel**.

"Cash is king", an age-old saying coined for a global stock market crash occurred last century, appears to once again become the truism for credit-fund allocators.

The confluence of stressed markets, growing concerns about a coronavirus resurgence, and uncertainties brought on by the US presidential election has put liquidity in sharper focus, making the capacity of providing instant liquidity an ever more important feature in credit fund managers' marketing pitch.

The holy grail is to form an evergreen credit fund, which allows investors to hold relatively illiquid assets but still have monthly or quarterly liquidity. Evergreen funds, by and large, are created with long-dated life spans, but they give investors the flexibility to either withdraw investments or renew the structures in a short term. This structure aligns with investors longer-term investment mentality and makes it easier for general partners to source investments.

However, such an investment vehicle is rarely built that can perfectly merge all the best qualities of a hedge fund and a private equity fund, Hunter noted.

One type of structure that has gained some traction recently is co-investment vehicles or overflow funds launched alongside the main fund to serve as a venue for housing less liquid assets. Hedge fund investors typically have periodic redemption rights, so fund managers need more tools to accomplish liquidity management without resorting to preventing redemption altogether. Through this structure, investors can put capital to work when new opportunities arise and get the money back when this window of opportunity disappears.

"There are a lot of conversations still going on about co-investment capacity - allocations to deal flow that sits outside of the mandate, and it appears to be a substantial desire to allocate large amount of capital into opportunities as they arise, " said Stephen Escudier, a partner and co-head of credit opportunities at **Bridgepoint**.

"The challenge for investors is whether to lock up capital to take advantage of actual restructuring opportunities. It depends on the investor's liquidity profile," says Adam Perez, a senior investment director from **Cambridge Associates**. He goes on to say that while some

investors are able to flex that liquidity budget and choose more illiquid opportunities, others are restrained and have to deal with cash crunch."

They are looking into hedge funds or hybrid vehicles, which becomes a nice spot for investors that want to invest in some of the longer-dated restructuring opportunities but can't sit in it for more than three-to-four years." he adds

Flexible benchmark, and lower hurdle rates

Investors are also getting flexible about benchmark and return targets when looking at opportunistic strategies, instead of requesting a hard target managers feel obligated to meet, according to Perez.

While institutional investors have been under pressure to pursue higher returns in a low-yield environment, they maintain a risk-averse attitude in the volatile market.

"Investors don't want managers to chase after investments aiming to hit a hard target, especially with risks they do not feel comfortable with," he said. "They want to allow the widest net to capture opportunities as they arise."

In certain cases, investors even lowered hurdle rates for recently launched credit funds, allowing a 2%-4% drop from an 8% hurdle rate, the preferred return that investors would ask for before the coronavirus pandemic. The trade-off was lower incentives or lower management fees.

"We have seen hurdles come down certainly, and it is a recognition that rates are low or likely be low for a quite long time," Perez noted.

Negotiations around fees and expenses intensifies

Moving data storage to the cloud is also emerging as an unforeseen battleground as fee negotiations heat up.

Hunter points out that management fees in general have become an area of focus for investors these days.

"We have spent a lot of time drafting, negotiating, and renegotiating management fees," he said. "For a credit fund, it can be complex. Whether a fund manager should charge them against the net assets value, committed capital, or invested capital? What rates are they using? And what is the early bird discount?"

"Nowadays, investors also look at your list of permitted expenses and try to put caps on these," Hunter said. "The negotiation could be quite stressful as investors don't want the management fees to get out of hand."

In the old days, the management company would cover the overhead expenses of a fund, including the cost of fund-related hardware and software. With the shift towards remote work and home offices in response to the coronavirus pandemic, firms have scrambled to migrate on-site data storage to the cloud and adopt other cloud computing services. There have been heated arguments among LPs and GPs over who should take care of those cloud-computing services expenses that have incurred as a result of working from home.

"Expenses nowadays are very important to investors, who are not as generous as they were before the pandemic," Hunter said. "There are fewer allocators now than before, but they all have a lot of dry powder. That gives them more power to leverage a better deal."

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