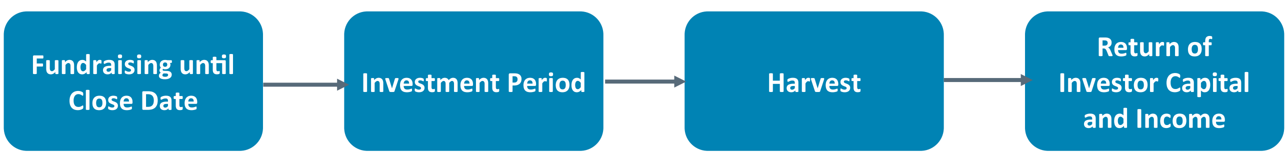
Proper Expectations for Evergreen Private Credit

As institutional private credit portfolios mature and re-up cycles become more commonplace, the asset management community is increasingly offering evergreen vehicle structures to asset owners. The goal of this paper is to highlight the merits and considerations of these vehicles so that allocators can make more informed decisions around the implementation of their private credit program. But first, an overview of the history of evergreen vehicles, their ideal use cases, and the various types of evergreen structures will provide useful context to the overall understanding of this vehicle.

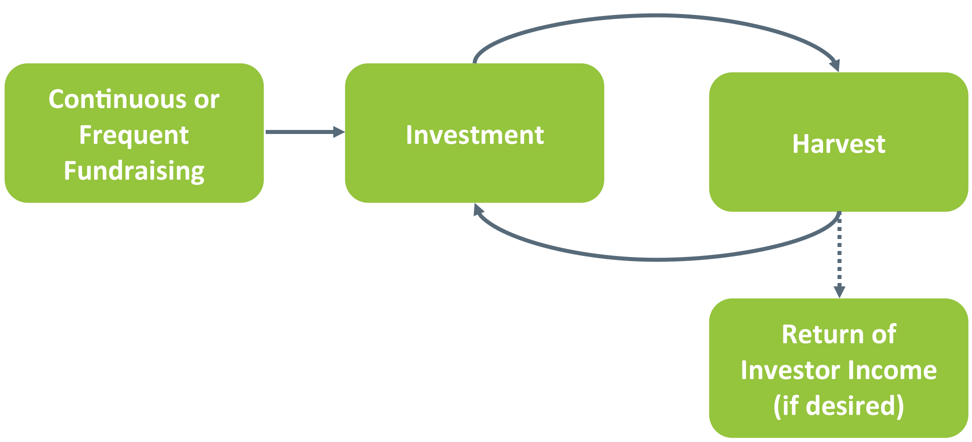
Background

The use of evergreen, or open-end, investment vehicles in private markets asset classes is not new. It has been the vehicle of choice in core real estate and core infrastructure for some time. Compared to closed-end (also known as draw-down) vehicles, which have pre-defined fundraising, investing, harvesting, and capital distribution schedules, evergreen vehicles typically have open-ended fundraising periods and reinvest capital distributions (and sometimes income) back into the fund.

Lifecycle of a Typical Closed-End Private Credit Fund



Lifecycle of a Typical Evergreen Private Credit Fund



This recycling of capital is particularly well suited to asset classes where returns are derived from the income generated by the underlying assets. Conversely, asset classes that derive the bulk of returns from capital appreciation are better suited for closed-end structures. Examples of each are provided below:

Ideal for Evergreen Vehicles:
- Asset-Based Lending
- Direct Lending
- Core Real Estate
- Core Infrastructure

Ideal for Closed-End Vehicles:
- Distressed Debt
- Value-Add/Opportunistic Real Estate or Infrastructure
- Private Equity
- Private Equity Secondaries

Variations of Evergreen Vehicles: Series Funds and Periodically-Liquidating Funds

Although all evergreen vehicles recycle and accept new capital periodically, there are many variations to these structures, each with their own nuances that may or may not be an ideal fit for client portfolios. Broadly, there are two types of institutionally viable evergreen structures: series funds and periodically-liquidating funds.

Series funds resemble closed-end funds at the beginning of the investment period with defined terms of engagement. However, when the fund enters its harvest period and begins distributing capital to shareholders, distributions are rolled into the next vintage in the fund series and invested accordingly, unless directed otherwise. New investments in series funds are only possible during the fundraising window of the next vintage and capital is deployed as new opportunities are identified.

Periodically-liquidating funds perpetually recycle capital and allow investors to elect distributions on a periodic basis, typically quarterly or annually. Shareholders can make new investments on a schedule similar to that of distributions and, in many cases, new capital is immediately invested at the net asset value of the fund, giving new investors immediate exposure to the asset class.

Both structures can offer investors the ability to receive or reinvest income distributions. Reinvesting income distributions can make sense for clients with positive total fund growth rates that want to try to maintain a relatively consistent allocation percentage to a specific manager or asset class. Electing to receive income distributions can provide clients with a small amount of liquidity and can provide control over the growth of the investment. Investors are usually able to change this election annually.

With both structures, investors must elect to take redemptions, which are not immediately available. The specific timing of these elections is spelled out in the limited partnership (LP) agreement. When an investor elects to exit a series fund, they must notify the manager and instead of having distributions rolled into the next vintage of the fund, they will remain in their current vintage, which winds down like a typical closed-end fund. With periodically-liquidating funds, investors that elect to take redemptions have their assets set aside and distributions are made as loans naturally mature. The distribution period for both variations is generally dependent on the underlying loans maturing, which averages around three years, with the bulk of distributions occurring in the latter part of the period.

There are other ways to invest in evergreen structures, such as interval funds and business development companies. However, these structures have a more retail-oriented clientele and typically are not included in institutional private credit portfolios.

Merits of Evergreen Investment Vehicles

There are two main merits to evergreen investment vehicles: reduced administrative burden and consistent market exposure. The legal and back-office burden posed by closed-end funds can be significant hurdles for allocators with limited resources. LP agreements generally need to be reviewed by legal counsel and managing capital calls and distributions can require significant operational support. Evergreen vehicles solve this by requiring a single document review and recycling capital, eliminating the need for ongoing back-office support and allowing investment staff to allocate their time elsewhere. It should be noted that there are situations in which evergreen fund investors are required to approve changes to LP agreements, blunting this administrative advantage.

Recycling capital is a way for investors to maintain consistent asset class exposure. With closed-end vehicles, asset managers harvest investments at the end of the fund’s lifecycle and return that capital to shareholders. That capital needs to be aggregated and then recommitted by the asset owner to the next vintage (if doing a re-up) or a new fund that is in the market at the time. Once the fund closes, it will begin to deploy capital into new investments during the investment period until all capital is called, a process that can take several months to years. During that time, the full commitment is not invested and thus not earning returns for investors. Evergreen vehicles avoid this dilemma by remaining fully invested at all times.

Considerations of Evergreen Investment Vehicles

With those merits come two main considerations that allocators need to weigh before deciding if an evergreen vehicle is right for their program. The first consideration is that “open-end” or “evergreen” does not mean “liquid.” As noted above, requests for redemptions typically take years to complete. There are some structures that allow for the netting of fund inflows and outflows, which could provide increased liquidity during normal market conditions, but these still lack certainty.

The second consideration is enhanced manager monitoring. This is a critical ongoing task, regardless of the investment vehicle utilized by an investor. However, once invested in closed-end funds, there is little one can do if the performance does not meet expectations or if there are changes to a firm that do not trigger a clause in the LP agreement that would allow investors to withdraw capital. This is not the case with evergreen strategies, making it critical for investors to continually monitor these managers and ensure the strategy remains suitable for their program.

Conclusion

Evergreen vehicles can play an important role in institutional private credit portfolios. They can relieve administrative burdens and help maintain consistent asset class exposure. However, there are also some considerations that allocators should keep top of mind when moving forward with an investment in this structure. Above all, it is critical to remember that within private credit, “open-end” does not necessarily mean “liquid.”

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