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Evergreen credit funds
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Introduction

Private credit continues to mature as an asset class. A sign of this increased maturity has been the trend for sponsors to launch evergreen funds as a means of providing investors with an alternative to the traditional closed-ended fund. In the US, for example, the majority of the top 20 private credit sponsors[1] offer a private credit open-ended fund. For European sponsors adoption has been slower (less than half of the top sponsors currently offer evergreen funds), but several are currently exploring their options.

Possible evergreen models range from NAV-based open-ended structures, through hybrid vehicles that combine elements of closed- and open-ended funds, to vintage structures that closely follow closed-ended fund concepts but seek to "roll" investors directly from each vintage to the next without requiring a fresh commitment. All models aim to provide sponsors with greater permanence of capital through which to execute their strategies and reduce re-up decisions for investors while, in exchange, typically offering a degree of liquidity to investors.

We have advised on the structuring and launch of a significant number of evergreen private credit funds in recent years. In this note, we share some of our observations on this developing area of the market.

1 Top 20 private debt managers in US and Europe were analysed. Ranking according to Preqin Ltd based on total funds raised as of March 2024.

Picking the right model

There is no one type of evergreen fund. The right model for a given sponsor will typically be driven by two factors.

The first is to make sure that underlying portfolio liquidity aligns with the liquidity promised to investors.

The second is the sponsor's broader vision of how its evergreen offering fits within its wider fund stable. Considerations under this second heading include, whether the sponsor intends the evergreen fund to target institutional capital or private wealth, be the sponsor's principal private credit offering (or sit adjacent to a more traditional closed-ended flagship fund), and/or pursue a levered strategy (and, if so, how to deliver this within the framework of the incoming AIFMD 2 loan origination fund rules).

Investor preferences will also be crucial. Do investors have sufficient confidence in valuations to support a NAV-based model? Do investors want their cash deployed without delay, or are they happy to invest in a commitment-drawdown model? On the way out, do investors expect a quick cash payout, or is a slow payout mechanism acceptable (and if so, with or without continuing exposure to future investments within the fund's portfolio)?

NAV-based models

Assuming there is confidence in the ability to strike a reliable and robust NAV, a true open-ended fund model (with a NAV-based subscription and redemption mechanism) can work, particularly for sponsors targeting a broad investor base (potentially including private wealth) and for sponsors for whom an evergreen fund is their principal private credit offering.

We typically see European funds of this type structured using a Luxembourg corporate vehicle (such as an SCA) within a RAIF regulatory wrapper. This allows the creation of multiple bankruptcy remote compartments (for instance, to pursue separate levered and unlevered strategies within the same vehicle), with the ability to create separate currency share classes.

Traditional "hedge fund-style" open-ended funds are usually structured with investor subscriptions being paid in full on the subscription date. However, in the private credit space, we sometimes see funds structure subscriptions as contractual commitments (similar to those in closed-ended funds) which are then drawn down into the fund as and when needed. Upon a drawdown, the fund will then issue shares at the prevailing NAV per share. The result is that investors effectively buy into the existing portfolio at NAV, with no need for equalisation. Thought should be given as to whether investor commitments should be "queued" or whether all investors should simply be drawn down pro rata to undrawn commitments (the latter will often be simpler, and avoid potentially lengthy delays in putting later investors' capital to work in the fund).

Notwithstanding that a reliable fund NAV may be calculated, a critical consideration in using an open-ended model is whether, in practice, it will be possible for sufficient cash liquidity to be attained to meet investor redemption requests within the agreed parameters. Sometimes, cash may be available from income generated by loans and debt instruments within the fund's portfolio, or it may be possible to obtain cash through borrowing or by utilising undrawn commitments from new investors. However, there are also a variety of tools available to managers to manage the risk of a liquidity mismatch, and we frequently see funds include safeguards such as redemption gates (often set at a level that matches the anticipated time it would take for the fund's entire portfolio to run off in the ordinary course), lock-in periods and slow payout mechanisms, whereby the manager may elect to switch all or a portion of the requested redemption amount into a liquidating class of shares, which continue to fluctuate in value along with the fund NAV until the manager determines that the fund is in a position to redeem them.

For funds that charge a performance fee, an interesting consideration is whether and how the fee should be charged on the performance of the liquidating shares after the conversion date (given that the starting point will be that the performance fee crystalises on the redemption date). It may be more palatable to investors not to charge a performance fee on shares converted to liquidating shares, and instead include a carried-over high water mark and only charge the performance fee once the liquidating shares are finally redeemed.

Within otherwise NAV-based fund structures, we sometimes see funds structured such that, instead of paying out a NAV-based redemption payment, the fund converts all of the redeeming investor's shares into "run-off" shares. These are similar to the slow payout liquidation shares described above, but the run-off shares have no exposure to new investments made by the fund after the conversion date, with their NAV instead only corresponding to the "vertical slice" of investments attributable to the shares as of the date they were put into run-off. The run-off shares are then redeemed at NAV (in one or several tranches) by the fund at its discretion as and when cash is available. This sort of run-off model may be more suitable for an institutional investor base accustomed to investing in illiquid closed-ended funds and for whom a quick redemption payout is less important than the ability to "switch off" their exposure to new investments once they take the decision to redeem.

Vintage models

For sponsors concerned about reliably striking a NAV, or for sponsors wanting an evergreen structure to sit alongside a closed-ended flagship fund, a vintage model may be preferable to an open-ended fund.

With the vintage model, the fund is set up like a traditional closed-ended fund; however, instead of the fund having a fixed life, it has an indefinite term and comprises a number of different vintages. Each vintage has its own term and its own investment period (and its own waterfall) and, effectively, is treated as a segregated series within the larger fund structure. Typically, an investor's commitment to the first vintage is automatically recycled into succeeding vintages, unless and until the investor elects to terminate the arrangement. If desired, the vintages can be structured to align with the investment periods of the sponsor's closed-ended funds, with each vintage tracking the next "successor" fund.

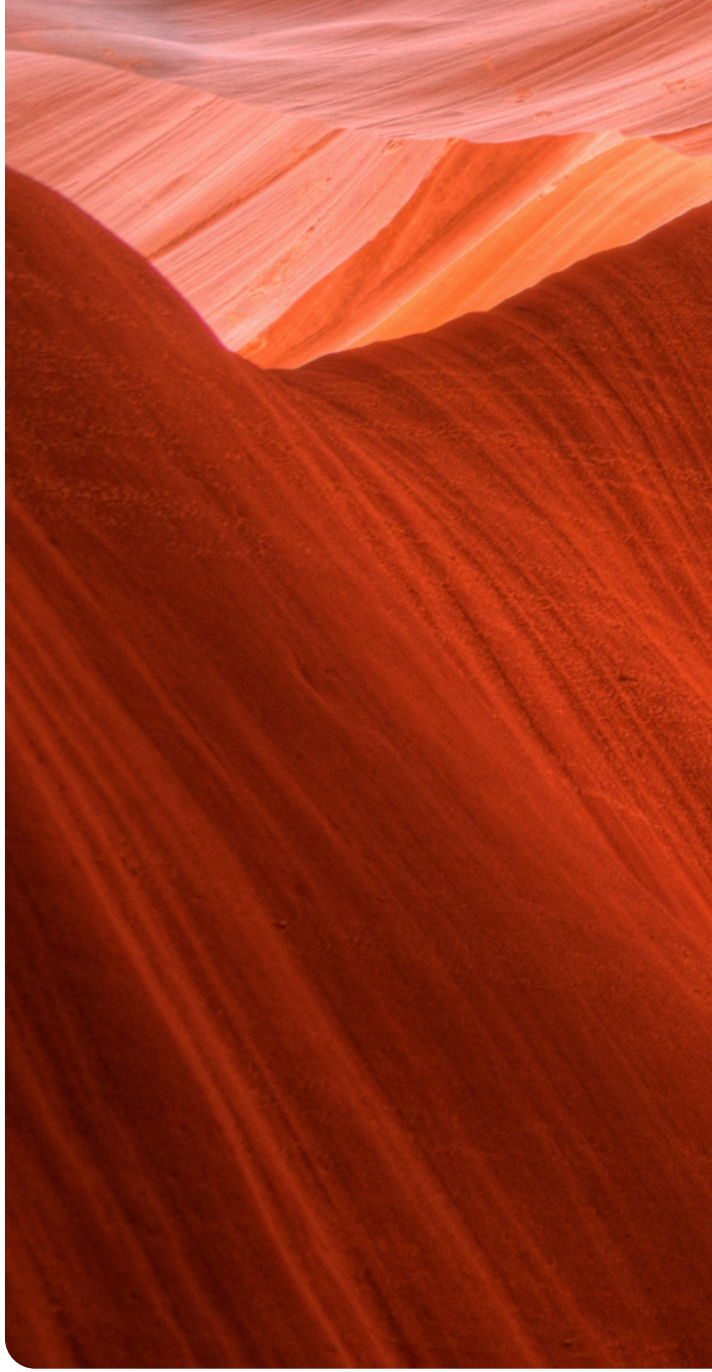
In the European market, we see vintage-style funds structured as Luxembourg special limited partnerships (SCSps); often, again, within a RAIF regulatory wrapper. The RAIF wrapper means the SCSp can create bankruptcy remote sub-funds for each new vintage. If necessary to accommodate the sponsor's strategy, separate sub-funds can be created for levered and unlevered vintages, and to offer different currency sleeves.

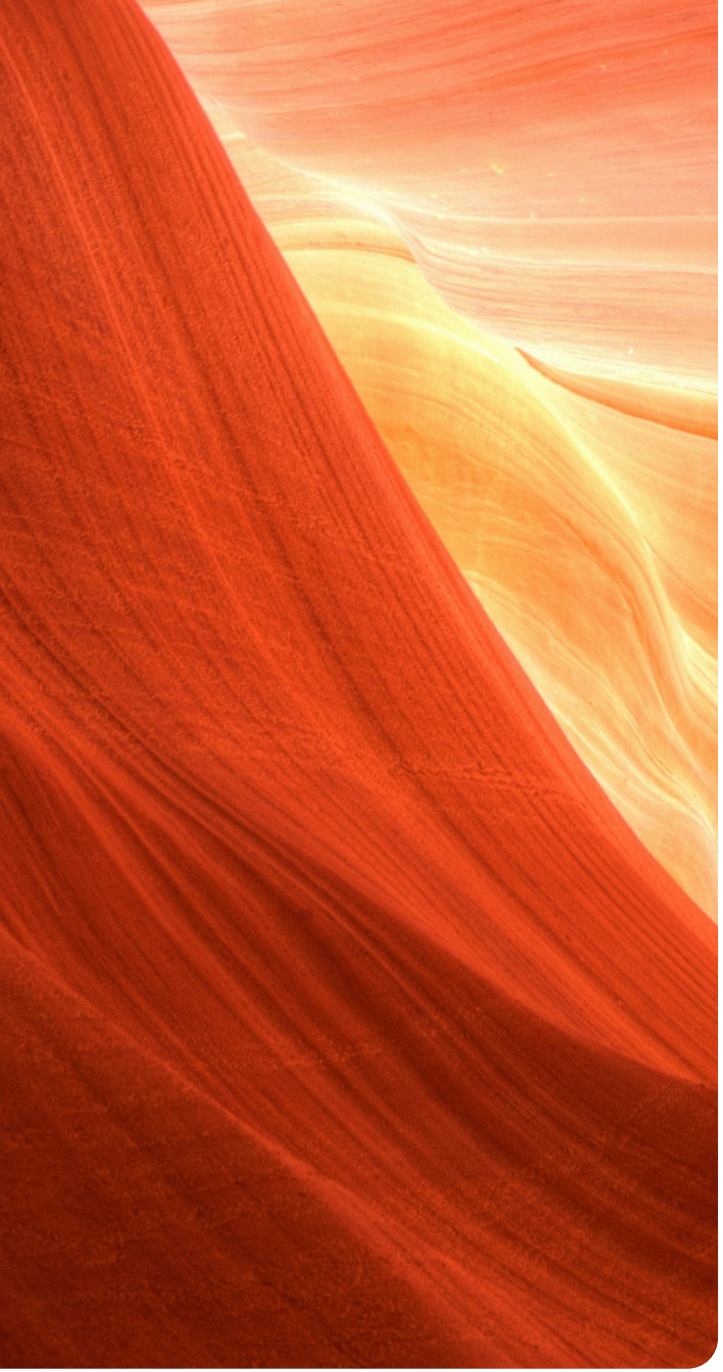
An example of how the vintage model works is as follows. Vintage 1 has, say, a two-year fundraising period, during which subscriptions from new investors can be accepted, and a three-year investment period. New investors will typically be excluded from returns accrued before admission to reduce issues around equalisation. At the end of the Vintage 1 investment period, the fundraising period and investment period for Vintage 2 open. The undrawn commitments of Vintage 1 investors automatically roll into Vintage 2, plus any investment proceeds from Vintage 1 (perhaps excluding income). Fresh capital can also be raised into Vintage 2, by existing investors making additional commitments and/or by new investors committing capital.

One of the issues this raises relates to the deployment of capital in Vintage 2: the undrawn commitment of (and thus capital available for deployment from) a Vintage 1 rolling investor is likely to be proportionately much smaller than the undrawn commitment of a new Vintage 2 investor, and will increase over time as Vintage 1 proceeds are received and recycled into Vintage 2. Sponsors therefore need to think about the most appropriate drawdown and equalisation mechanisms and/or consider how best to manage the rate of deployment for Vintage 2 in light of available undrawn commitments.

For sponsors to whom the vintage model appeals, but who also want to offer investors additional flexibility, we have seen vintage models that include a "run-off" element. In other words, investors have the right, at certain points during the investment period of each vintage, to "switch off" their participation in future investments and put their interest into run-off. This is an additional right, over and above the right to decline to roll into future vintages.

Incorporating a run-off element such as this will have an impact for lenders under a subscription line facility, given that undrawn commitments can effectively be removed from the borrowing base during the course of the investment period.





Leverage

Evergreen funds are frequently used for levered strategies. Leverage can be used to enhance returns and increase available capital for deployment but also, for NAV-based structures, as a liquidity tool to assist with redemptions. Whatever the purpose for which leverage is employed, the implications of using leverage might significantly impact the chosen model and so merit careful consideration.

Cost is one of the more important factors from the perspective of marketing and investor relations. In particular, the higher cost of leverage facilities (in both margin and fees) compared to subscription facilities requires a manager to demonstrate to investors that it has used that leverage in as efficient a manner as possible. That means being able to use the leverage as early as possible in a fund's life and to keep the facility as well utilised as possible. In order to do so, a fund will need a portfolio of assets that is "ramped" (i.e. of sufficient scale) at the early stages of the fund's life. In addition, there will need to be sufficient origination to keep the facility ramped during its life.

For a vintage model, the short(er) investment period places even more importance on having a sufficiently ramped portfolio as early as possible (e.g. by seeding a vintage with assets from a manager's other funds and managed accounts). The shorter period in which to use the leverage can also make the costs appear disproportionate to its utility. In this context, managers are giving increasing thought to the use of umbrella facilities (both subscription lines and less well tested umbrella leverage facilities). Umbrella facilities would allow a manager to utilise the same agreement across multiple vintages but each with a separate (and segregated) facility. Costs would therefore be shared across those vintages.

A more fundamental question than cost with a vintage structure is cross-collateralisation. On the basis that each vintage needs to be standalone, the ramp issue will arise with each vintage. One possible mitigant to this is using a subscription line to bridge to a usable leverage facility later in the vintage (as is often the case for closed-ended funds). It may be possible to have a single sub-line for the platform across multiple vintages (or indeed an umbrella subline facility (as above)) given it is secured on investor commitments and not underlying assets although consideration will need to be given to the exposure of investors across vintages.

It is also important to think about the compatibility of vintage models and the creation of separate run-off portfolios with the requirements of a leverage provider. With a run-off model, it will be highly complex to segregate liability for run-off investors and so they will likely have to accept exposure to the leverage across the portfolio (even though no longer exposed to new investment risk).

AIFMD 2 loan origination fund rules

AIFMD 2 is expected to come into force in the coming months and to apply from 2026. One of the new rules it will introduce is to set a leverage limit of 175% for open-ended loan originating funds (and a limit of 300% for closed-ended loan originating funds). Sponsors with existing levered evergreen funds, or about to launch new levered evergreen funds, are analysing their structures to determine whether this limit will apply to them.

One of the threshold questions is whether an evergreen fund that uses a run-off model to pay out redemption proceeds qualifies as open-ended. If carefully structured, it should be possible for an evergreen fund to avoid being classified as open-ended, thus benefiting from the 300% leverage limit.

Alternatively, if the fund is classified as open-ended, it may be possible to characterise enough of the fund's investment portfolio (below 50% of NAV) as not comprising originated loans at all (which would mean falling outside the loan originating fund definition altogether). In some cases, this will require a careful analysis of how the loans in a fund's portfolio are originated and the extent to which the sponsor is involved in structuring the loans' terms – this analysis can be particularly nuanced where a sponsor frequently participates in club loans, for instance.

Concluding thoughts

There is no one-size-fits-all when it comes to evergreen private credit structures. Sponsors have considerable flexibility to design structures tailored to their needs and those of their investors. Investors for their part are often open to considering innovative structures that provide access to the asset class while also delivering more liquidity than a traditional closed-ended fund. There can be technical and practical challenges in designing an appropriate structure, but with careful thought these can be identified and navigated.

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See page 7 for examples of some large institutional investors allocating capital to evergreen private credit funds.

Examples of institutional investors allocating to evergreen funds

Investor	Country	AUM (bn)	Comments
Arizona State Retirement System	US	$51.5	The investor commits to private credit almost exclusively through evergreen funds-of-one. One of their reasons for doing so is the ability to scale commitments easily. ASRS has typically fostered long-term partnerships with a small number of managers.
Compenswiss	Switzerland	$42.6	Currently building its private debt programme looking to achieve a 3% allocation. To build its allocation the investor will use a combination of both closed-ended funds and evergreen funds.
National Employment Savings Trust (Nest)	UK	£45.7	The investor has been an early adopter of evergreen structures for private credit although typically through funds-of-one covering infrastructure debt, real estate debt and corporate loans either independently or multi-asset. This is driven by the ability to scale commitments quickly, given Nest's own growth trajectory, and the ability to rebalance.
New Mexico PERA	US	$16.3	In consultation with Aksia, as of October 2023, the investor was targeting "four evergreen open-end private credit commitments of up to $200m each that will recycle principal and pay out quarterly income".
Chicago Teachers' Pension Fund	US	$11.2	The investor announced in September 2023 that it would begin investing in private credit (initial target of 3%) and was advised by its investment consultant, Callan, to start the programme by investing in core evergreen strategies in the initial three years to build to the target allocation. To help diversify and complement the core portfolio, opportunistic and niche draw-down structures (closed-ended) will also be included.
City of Austin Employees Retirement System	US	$3	Currently building their new private markets portfolio with a small investment team of four people. The investor will be focusing solely on evergreen products. In an interview with Top100funds, the CIO mentioned the key reasons for opting for evergreen were the ability to do more detailed due diligence than on blind pool drawdown funds and the ability to get into the market quicker (given they are a new investor in this segment) and "buy some time to identify the resources needed".

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