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Interested in evergreen funds? Consider this

It won't be easy structuring carry in a permanent capital private equity fund, but LPs may like the prospect of a more predictable, long-term income stream, writes Latham & Watkins attorney Nick Benson.

Evergreen funds – in which realized investment returns are recycled back into a fund rather than distributed to LPs – are not a new phenomenon. Recently such structures have attracted renewed interest from managers and investors, for whom the classic 10 year life closed-end private fund model may not always be optimal.

When might evergreen structures be appropriate?

Investment strategies focused on longer-term hold periods, often with a greater emphasis on yield generation, are the key drivers for evergreen funds. The experience of the past decade has illustrated this well. Some funds, raised in the early 00's on the traditional private equity model made any number of perfectly good investments for which satisfactory exit transactions did not arise. With the onset of their term expiration, these funds have simply run out of time. The result is either liquidation or restructuring of portfolios that ideally would have been held for longer in order to fully realize their value. Put simply, the lifespan of some assets is simply too long to fit into the traditional fund model. Investments that potentially fall into this category include secondary infrastructure assets, core real estate assets, and any other asset class with a significant income component, longer-term hold and lower risk profile than private equity or opportunistic strategies.

Why not just increase the term length of funds that follow these strategies?

Simply increasing the term length may be a superficially attractive solution, but the reality is more complex. Investors are generally reluctant to lock their capital up for even longer periods with no certainty of exit other than reliance on the secondaries market, which may look very different several years later. Managers would likely have to negotiate a lower fee rate to reflect the longer lock-up and typically lower risk assets that would be in play – negating the positive effect of the longer management term. Even worse, the point at which carry becomes payable on a pure cashflow basis becomes ever more distant, raising real issues for the individual management team around team retention and motivation.

Issues to consider

Various permutations of evergreen fund have been well covered in prior editions of pfm. However, a number of potential pitfalls and other issues should be borne in mind when structuring or investing in an evergreen fund.

First and foremost, the product must make sense from a commercial perspective. Following another fund's template will not work if the underlying investment drivers are materially different. Investors such as pension funds and insurers may like the prospect of a more predictable, long-term income stream but will still need adequate protections in the form of suspension, termination and exit rights. The risk of dilution on subsequent capital raisings must also be addressed in a way that balances the interests of both existing and new investors.

As a market reality, periodic redemption rights is often a pre-requisite to raising an evergreen fund, unless the fund is listed or there is a more liquid market for interests than is offered by the private secondaries sector. If portfolio income yields are predictable then the fund may well be able to offer redemption rights. Such rights are typically subject to gating provisions (such as timing or volume limits) designed to manage redemption volumes in order to avoid the need for either credit facilities that drag returns or a "fire sale" of portfolio assets. Redemptions can also be funded by new subscriptions. At the time an evergreen fund is launched, it is difficult to predict in advance whether any of these means of financing redemptions will be a viable option when actual redemptions are made.

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It may therefore be counter-productive to market an evergreen fund as offering materially greater liquidity than a closed-ended private equity fund – redemptions should be viewed as a last resort rather than providing an open door for investors to exit at the time of their choosing.

Investors may also be provided with liquidity in the form of a right to liquidate the evergreen fund, for example if a specified return benchmark is not reached by a reference date, or by specified vote of the investors. However triggered, a forced liquidation raises the prospect of a "fire sale" of fund assets.

Finally, perhaps the most challenging issue for managers and investors alike is how to structure the carried interest or performance fee component of an evergreen fund. If carried interest realization is to be deferred indefinitely, the manager will find it very difficult to attract and retain a high calibre management team. Accordingly, there generally needs to be a mechanism to pay carry on an interim basis, such as a combined cashflow/portfolio NAV test or yield-based hurdle. Although such arrangements create challenges around potential conflicts of interest, these can be overcome, for example by linking the NAV test to the price at which contemporaneous follow-on fundraisings from third party investors (either at fund or portfolio level) have been achieved.

Nick Benson is a London-based funds partner with Latham & Watkins, the US law firm.

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