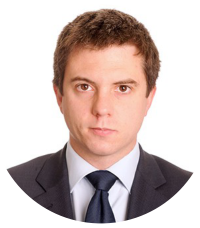
MEETING IN THE MIDDLE: CONVERGENCE OF HEDGE AND PE



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Historically, hedge funds and private equity funds occupied two distinct realms within the alternative investment funds industry; hedge funds typically being structured as open-ended funds pursuing generally liquid and public investment strategies, and private equity funds typically being structured as closed-ended funds pursuing generally illiquid and private investment opportunities.

A 'convergence' of the two structures accelerated following the 2008 financial crisis as managers moved into less liquid credit strategies. Traditional hedge fund managers have been increasingly pursuing longer-term, more concentrated and less liquid investment strategies as part of, or as a supplement to, their primary strategies.

Conversely, traditional closed-ended private equity and private credit managers have been increasingly seeking to access a new source of capital and investor base through the offering of more liquid and shorter-term private strategies through open-ended vehicles. This article sets out the approaches taken to fund and product structuring in this hybrid space to meet the needs of the investment strategies and opportunities described above.

Types of Hybrid Fund Structures

There are generally two types of 'hybrid funds'; closed-ended, or 'private equity lite' hybrid funds, and open-ended, or 'evergreen' hybrid funds.

Closed-ended or 'private equity lite' hybrid funds

A typical closed-ended fund would require investors to commit their capital for a minimum period of time, usually at least three to five years, and often up to ten years.

There are pre-agreed dates on which the fund will stop making new investments (i.e., the end of the 'Investment Period') and be wound up (i.e., the end of the 'Term'). A closed-ended hybrid fund typically has a much shorter Investment Period and Term than a more traditional closed-ended fund and will typically have fewer closings (i.e., typically no more than one or two).

The manager receives a carried interest only upon the disposal of the fund's investments, but in many cases only after all the fund's capital has been returned (i.e., at the end of the Term).

Where a fund is approaching the end of its Term and has yet to dispose of certain investments, the manager may have the right to extend the Term (in order to sell the assets at a more favourable price) and thereby restrict distributions to investors.

As investors have no redemption rights during the fund's Term, managers have certainty over their available investment period. Accordingly, in the private equity space, these structures may be suitable for managers seeking to 'house' a small number of investments and/or investors. They may also be appropriate for certain private credit strategies, for example, a direct lending strategy making a small number of short-term loans.

Open-ended or 'evergreen' hybrid funds

In an 'evergreen' hybrid fund, the liquidity terms utilized are often similar in their impact to the 'private equity lite' hybrid fund (e.g., investors will have no redemption rights for a fixed term - their investment will be 'locked-up'). However, there are key distinguishing factors:

• Structure of the manager's compensation. An evergreen fund offers more immediate financial rewards than a 'private equity lite' hybrid fund due to the different compensation structures. Evergreen funds typically provide for annual performance based compensation on realised and unrealised gains, as opposed to a carried interest upon the disposal of the investments and return of the fund's capital. There is generally no clawback of the performance fee in the event of subsequent losses.

• Ability to continuously market the fund and receive further capital. Evergreen funds are open-ended and therefore managers can continuously market the fund and raise capital at any time. In light of the less liquid nature of the strategy being pursued, a manager might utilize a draw-down and commitment structure, thereby allowing the manager a reasonable period of time to source and allocate capital to investment opportunities without diluting investment returns.

Key Characteristics of an Open-Ended Hybrid Fund

As it is difficult to define a 'hybrid fund' due to the variation of terms across asset classes, it is more practicable to identify and discuss common terms and mechanisms that are found in a fund structure which, when combined, create a 'hybrid fund'.

Funds pursuing longer-term and less liquid strategies, or housing less liquid assets within the fund's portfolio, need to incorporate mechanisms to ensure that the liquidity of the fund matches, as closely as possible, the liquidity of the underlying assets within the fund's portfolio. We deal with some of the key mechanisms used below.

Lock-up periods

Hybrid funds will typically have lock-up periods which provide some certainty as to the capital available to invest. Lock-up periods can be structured as 'hard' locks or 'soft' locks, the latter allowing investors to redeem or withdraw their investment subject to a redemption or withdrawal charge. Soft-locks are more commonly used as a mechanism to help ensure longevity of capital (regardless of the investment strategy), whereas hard-locks are often utilized as a mechanism to help align investors' investment term to the liquidity applicable to the underlying strategy of the fund.

An increasingly common feature of hybrid funds is the inclusion of rolling lock-ups, whereby if investors do not redeem/withdraw at the end of a lock-up period, they are automatically rolled into a new lock-up period. The length of the lock-up period may depend on the liquidity of the underlying strategy, and different classes might be set up with different fee arrangements (whereby the longer the rolling lock-up period, the higher the fee discount).

Gates

A gate limits redemptions from the fund by reference to the net asset value of the fund (a 'fund level gate') or the net asset value of an investor's investment in the fund (an 'investor level gate').

A typical gate would prevent investors from redeeming more than 25% of the fund's net asset value on any dealing day. The investor level gate works in the same way by reference to the investor's investment in the fund.

The purpose of a gate is to avoid situations where the fund is forced to sell a significant proportion of its assets at an undervalue to the detriment of the investors as a whole.

It also seeks to avoid concentration issues, whereby the non-redeeming investors are left with the fund's less liquid assets (where the more liquid investments are realised to meet the redemption requests of the redeeming investors). Investor level gates might also be used as a way to align investors' investment behaviour with the long-term nature of the investment strategy (even for more liquid strategies).

Fund level gates may be perceived negatively by some investors and can have unintended consequences in times of financial turmoil. In the financial crisis in 2008, fund level gates were blamed for encouraging investors to submit standing redemption requests, even where they did not want to redeem from the fund (so as to avoid being the last investors left holding the fund's least liquid assets). As a result, investor level gates are often favoured, given that they focus an investor's behaviour on its own investment/redemption intentions and not on those of other investors.

The fund documentation should state whether deferred redemptions are treated pro-rata to new redemption requests or in priority to new redemption requests. Treating redemption requests in priority to new investment requests may also encourage a run on the fund.

Side pockets

Hybrid funds may use side pockets to separate a fund's illiquid assets from its more liquid investments (either in respect of a specific investment opportunity or problematic assets). Once designated and placed into a side pocket, the relevant asset is accounted for separately from the assets in the fund's main portfolio. The investors remain invested in the side pocket until the asset is realised (even if those investors redeem from the main fund). Fees would typically be applied to the side pocketed assets separately to the main portfolio.

The use of side pockets to deal with problematic assets has often been viewed negatively by investors due to the potential for misuse. Managers have in the past been accused of overvaluing side pocketed assets, leading to higher fees from investors and the hiding of unrecognised losses. Some managers have also been accused of using side pockets to prevent new investors from participating in a particular investment opportunity (thus avoiding investment returns from certain assets being diluted).

Investors may be more comfortable with the use of side pockets in funds where they are used for the purpose of actively pursuing specific and less liquid investment opportunities (often referred to as 'special situation investments'). These investments are often limited to a specified percentage of the fund's net asset value. Investors generally seek clarification as to the maximum length of time the 'special situation investment' will be imposed.

Frequency of redemptions/ withdrawals

Open-ended hybrid funds usually offer monthly or quarterly liquidity. To stereotype, US investors tend to be more comfortable with less liquidity compared to European investors, many of whom are used to the minimum twice-monthly liquidity (often daily or weekly) offered by UCITS.

Managers pursuing less liquid strategies would need to consider whether monthly liquidity is appropriate taking into account other liquidity management tools, including redemption notice periods, lock-ups, gates etc. A quarterly (or even semi-annual) redemption/ withdrawal dealing day might be more appropriate.

Redemption/withdrawal notice period (e.g., 30, 60, 90, 120 days)

The notice period for redemptions/withdrawals should be guided by the time it would take the fund to realise investments (both liquid and illiquid) to meet the redemption/ withdrawal request (in a way which does not require such investments to be sold at an undervalue to the detriment of the fund and its investors).

Liquidating SPVs and in specie redemptions/withdrawals

In the event of redemptions, hybrid funds often provide for investors to receive assets in specie directly from the fund or, alternatively, to receive interests in a special purpose vehicle ("SPV") used to 'house' an illiquid asset until it is sold. The establishment of an SPV should be carefully considered, in particular to avoid any regulatory and tax issues.

The SPV will ordinarily be established in the same jurisdiction as the fund to avoid double taxation. The SPV should also be structured to avoid unworkable investor consent rights over the operation of the SPV.

Co-Investments and One-Off Investment Opportunities

Managers pursuing a range of alternative strategies have also increasingly turned to co-investment and/or single-investment structures to take advantage of single name (or similar) investment opportunities which are not suitable for a manager's existing investment products, whether due to the type or liquidity profile of the relevant asset(s), or due to capacity or concentration limits imposed on existing investment products.

This may be particularly relevant to special situation and distressed investment opportunities. Where such investment opportunities arise, a manager would need to determine whether such investment is also appropriate for its existing fund(s).

If so, the manager would need to determine how to allocate the relevant opportunity between the existing fund(s) and the co-investment vehicle and on what terms (including as to size of investment and timing of entry and exit).

The manager should consider its trade allocation and conflicts of interest policies to ensure that all investment vehicles are treated fairly and equitably with respect to such investment.

The manager will also need to determine whether the opportunity to participate in an investment outside of the existing fund(s) will be offered to all current investors (often a key side letter point). Depending on the types of investors that are participating, an appropriate structure for the co-investment vehicle will then need to be created.

Co-investment arrangements are often structured on a one-off basis through standalone SPVs or partnership structures (which is common in the private equity space).

Alternatively, managers could establish an umbrella structure, allowing for multiple investments to be pursued on a periodic basis. An umbrella structure typically offers a cost and time efficient route to market for managers pursuing investment opportunities on a relatively regular basis.

This has been particularly common in the credit space as managers have sought to take advantage of special situations or distressed opportunities arising.