ALTERNATIVE CREDIT COUNCIL

IN PARTNERSHIP: TRENDS IN PRIVATE CREDIT FUND STRUCTURING

AIMA

ALTERNATIVE CREDIT COUNCIL

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FOREWORD

The Alternative Credit Council and Dechert LLP are pleased to share the findings of our research, which explores current fund structuring and product design trends in private credit.

The ability to tailor finance solutions to meet the needs of borrowers is a key attraction of private credit. Our research finds that many private credit fund managers are also providing a higher level of customisation to their investors. This paper highlights the key areas where this customisation is influencing product design and the drivers behind why investors are seeking more specialised ways to access private credit strategies.

The rapid growth of the private credit sector over the past decade means that investors and asset managers have become more sophisticated and experienced, both in their approach to the asset class and its role within their portfolios. They are now exploring structures that provide ongoing exposure to private credit strategies and enhance the returns that they are able to achieve on their capital.

Our findings highlight how risk management and alignment of the structure with the investment strategy remain critical to how investors and private credit managers structure their investments. While efficiencies are important, the alignment of the investment structure with the liquidity profile of the underlying assets remains fundamental.

This research also provides insights into the growing interest in raising capital from retail investors and the challenges faced by private credit fund managers when developing products that can raise and deploy this capital at scale.

Policymakers and industry are collaborating to address these issues through reforms such as the UK Long-Term Asset Fund and European Long-Term Investment Fund and, over time, these vehicles could see a similar level of growth to US Business Development Companies.

While the development of private credit as an asset class was built on institutional capital invested through traditional commingled closed-ended structures, we anticipate that a growing amount of capital will be invested both through alternative structures and from retail clients. Our paper describes the key questions considered by managers and investors when establishing alternative structures and explores the implications of these for the future of the asset class.

We would like to place on record our thanks to the firms and individuals who supported this research and contributed their time and expertise. We hope that investors, private credit managers and policymakers will find our data and insights useful when assessing the structures used to deploy capital and manage risk within the private credit sector.

Jiří Król
Global Head of the Alternative Credit Council

EXECUTIVE SUMMARY

Investors increasingly seeking customised investment structures

80% of respondents manage capital through a mixture of commingled funds and other vehicles. While the majority of capital allocated to private credit strategies continues to be invested via commingled structures, 95% of respondents stated that they offer managed account structures for single investors. Half of firms offering managed accounts did so at levels greater than $100m with the remainder able to offer them at lower allocations. 69% of respondents expect demand for co-investment to increase. While maintaining such structures entails greater costs for private credit managers, our research indicates that there is growing demand from investors for tailored investment structures and private credit managers see being able to meet this demand as strategically important.

Liquidity supporting permanent capital allocations

Investor demand for permanent capital allocations to private credit strategies is being met by fund structures which offer partial liquidity. Such funds are often described as evergreen or hybrid vehicles which combine elements of open and closed-ended fund structures. 51% of respondents offer their investors some form of right to redemption and 48% stated that they expect investor demand for liquidity to increase in 2023. Evergreen or hybrid structures are attractive to investors as they support efficient capital raising and deployment, while also providing investors with more control over their capital allocations to private credit strategies. Investors and their private credit managers employ a range of liquidity risk management tools to align the liquidity profile of the fund with any right of redemption.

Borrowing plays a modest but important role

Investors increasingly recognise how well-structured borrowing arrangements are an important driver of returns. 66% of respondents use leverage within their investment strategy and there are a range of approaches to how leverage is employed across the sector. 41% include levered and unlevered sleeves within their private credit funds. Where leverage is employed, private credit managers offer investors flexibility and multiple points within the investment structure to accommodate their preferences and enhance their returns on capital.

A growing role for retail capital

41% of respondents currently have retail clients and 66% stated that they will or are considering raising capital from retail clients for upcoming fund offerings. Amongst those targeting retail capital for future fund raises, the majority will focus on high-net-worth individuals and semi-professional retail investors. Private credit managers seeking to raise retail capital at scale still face important operational challenges relating to marketing and distribution, but new vehicles such as the European Long-Term Investment Fund and UK Long Term Asset Fund are expected to boost retail participation in Europe.

Familiarity matters when it comes to fund formation

Luxembourg and the Cayman Islands are the most popular fund domiciles for private credit fund managers amongst respondents with 59% stating that they have a fund based in these jurisdictions. The US, Ireland and UK were the next most popular fund domiciles amongst respondents. Our research highlighted how investor preferences on domicile are driven by a combination of factors including familiarity, marketing restrictions, tax neutrality and regulatory certainty. Interest and demand for US investment opportunities continues to grow among non-US investors, with multiple approaches being used to facilitate their investment into the US market.

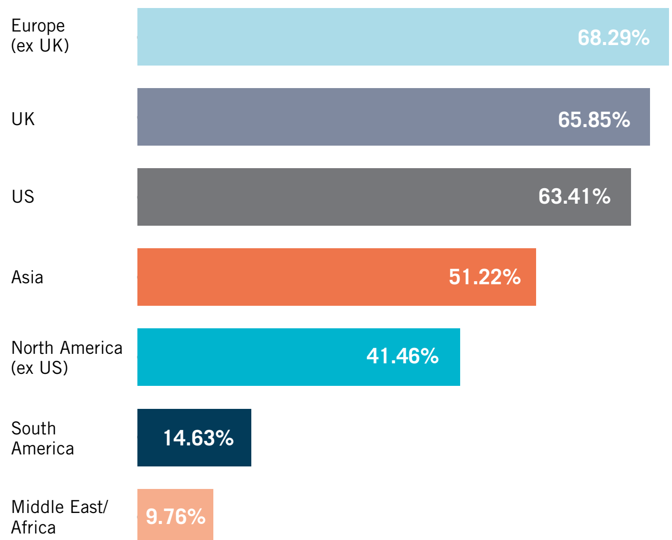
RESEARCH METHODOLOGY

This research paper is based on data from several sources. The Alternative Credit Council (ACC) and Dechert conducted a survey which received responses from 40 private credit managers.

Respondents collectively manage an estimated $800bn in private credit investments and invest across a broad cross-section of jurisdictions.

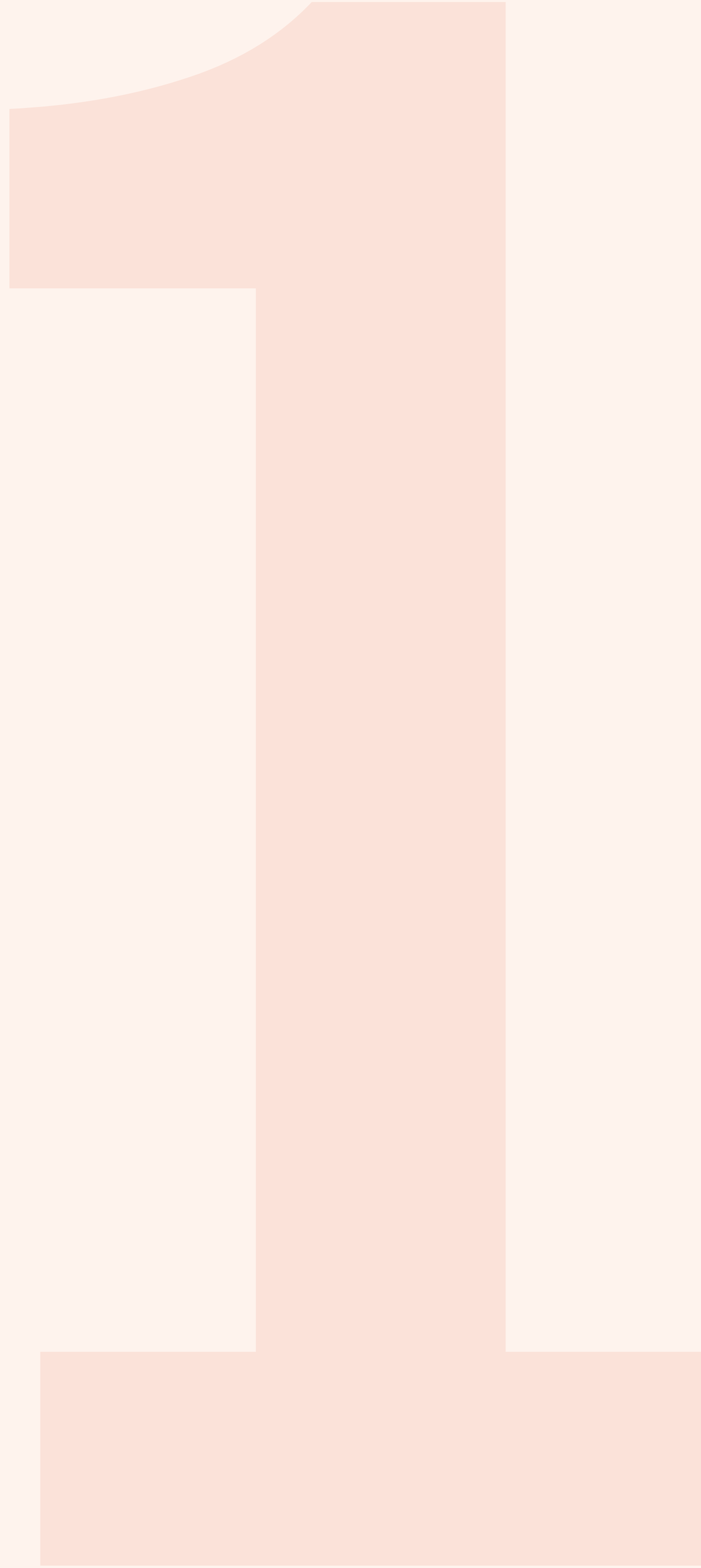
The survey data was then explored by the ACC and Dechert in a series of one-on-one interviews.

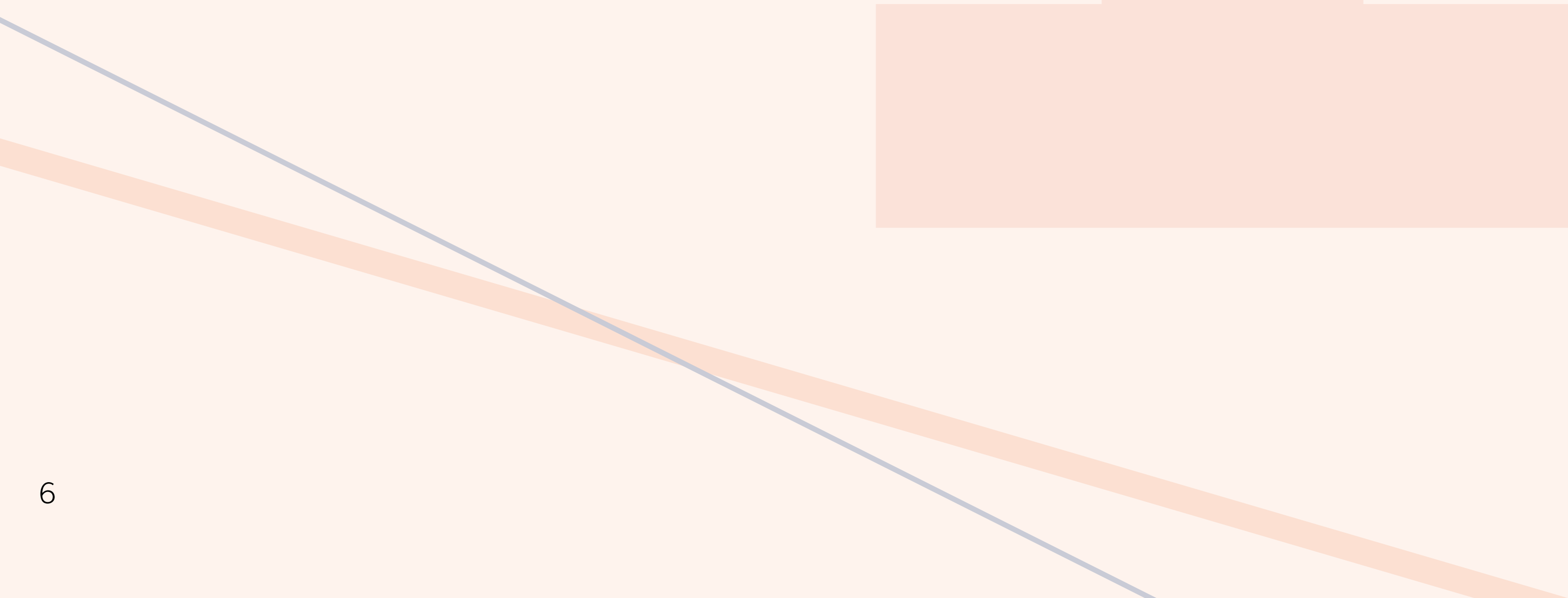
Figure 1
In which markets do you currently invest?
(Select all that apply)



"Fund structuring starts with two things: really thinking about the nature of the assets that are going to go into the fund, and whether they are liquid or illiquid. The next step is thinking about who our target market is going to be in terms of investors."

Peter Clark
General Counsel & CCO, Leadenhall Capital Partners





CHAPTER 1
PRODUCT DESIGN

Summary of key findings

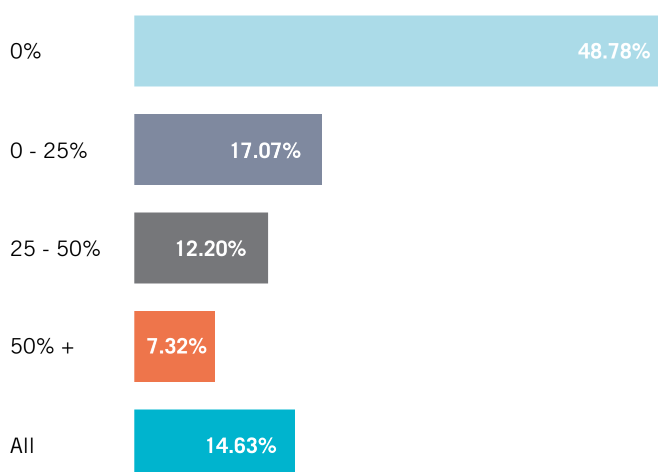
- Traditional commingled closed-ended structures are still attractive to institutional investors, but managers increasingly offer a wider range of structures and customise ways for investors to access their private credit investment strategy. This is consistent with increasing demand for tailored structures amongst investors across the wider alternatives sector.
- Managers are increasingly exploring using evergreen or hybrid structures to invest in private credit strategies. While there is no single form of evergreen or hybrid structure, they typically combine elements of open and closed-ended fund structures.
- Investors increasingly recognise how well-structured borrowing arrangements are an important driver of returns. Managers follow a mix of approaches to leverage across the industry and offer investors multiple points of access within the investment structure to accommodate their preferences on where leverage can be used to support and enhance the investment strategy.

Liquidity considerations and the rise of evergreen

Liquidity is one area of product design where practices are evolving, with a notable proportion of private credit fund managers and their investors seeking greater liquidity in their fund structures.

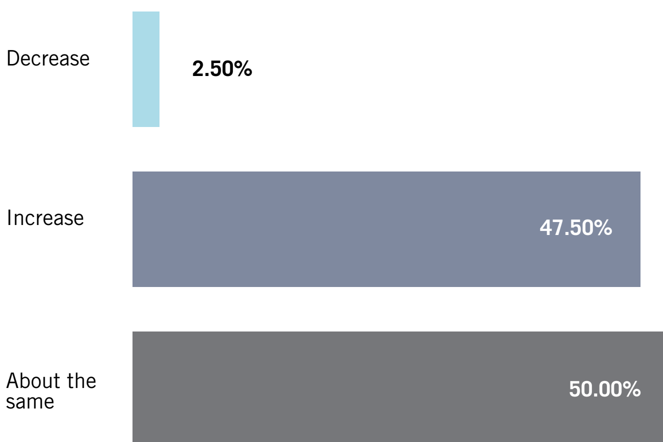
During the initial growth phase of the private credit asset class, the approach of managers and investors towards product design was often influenced more by their experiences with private equity than with liquid credit or other alternative investment strategies. This meant that the starting point for many private credit structures was typically closed-ended commingled funds with little or no liquidity available. These structures are still used for many private credit strategies, with our data showing that the majority of capital allocated to private credit is still invested through these structures (see Figure 2).

Figure 2
What proportion of your private credit funds provide some type of liquidity to investors by allowing a right to redemption?



While such structures remain attractive for many investors, our research also highlights how investors can now access private credit assets through a wider range of structures. Figure 2 shows that 51% of respondents have at least one fund in their range that offers some form of liquidity via redemption terms. Furthermore, 48% of respondents stated that they expect demand for liquidity to increase (see Figure 3). This chapter explores the drivers behind these trends and how private credit fund managers are accommodating demand amongst institutional investors for more flexible and customised structures. The trends driving change for products designed for retail investors will be considered in the next chapter.

Figure 3
Do you expect net investor demand for liquidity in your private credit funds will increase or decrease in 2023?



Private credit fund managers using open-ended funds employ multiple liquidity risk management tools to align the fund structure with the liquidity profile of the assets and the needs of their investors. As shown in Figure 5, there are multiple tools available to investors and means by which they can be adjusted (e.g., length of notice period or size of a gate) to align with the investment strategy.

Another concept arising during our research was that of evergreen funds. The term evergreen fund is somewhat subjective, as there is no precise or commonly accepted definition. In simple terms, evergreen funds seek to behave like open-ended vehicles with respect to subscriptions (e.g., in allowing new subscriptions over the life of the fund) and like closed-ended vehicles when it comes to redemptions (e.g., in returning value based on actual proceeds rather than a book valuation). As such, the liquidity associated with these vehicles is generally more limited in nature than the ability to redeem capital on demand (as per a classic open-ended structure). This is an important distinction given that the design of such structures often needs to reconcile potential mismatches between the less liquid profile of the assets and the liquidity profile of the investment fund.

When thinking about liquidity for their private credit funds, interviewees for this research emphasised several points. The first was that the typical dichotomy between open-ended and closed-ended funds when it comes to characterising liquidity (see Figure 4) was unhelpful when considering private credit fund structures. Most described their approach as a hybrid, whereby liquidity is provided but on limited terms that are established at the outset of the fund and work in a predetermined fashion consistent with the liquidity of the underlying portfolio.

> **"Some funds have all the fundraising and the timing determined by GPs, but LPs are increasingly saying that they would like to have more influence in the process, highlighting that they have more money to spend today and do not want to wait for the GPs' fundraising schedule. The concept of open-ended funds is increasingly a requirement in order to have that vintage diversification in a way that is convenient for the investor instead of the GP."**
>
> Nicole Downer
> Managing Partner, MV Credit

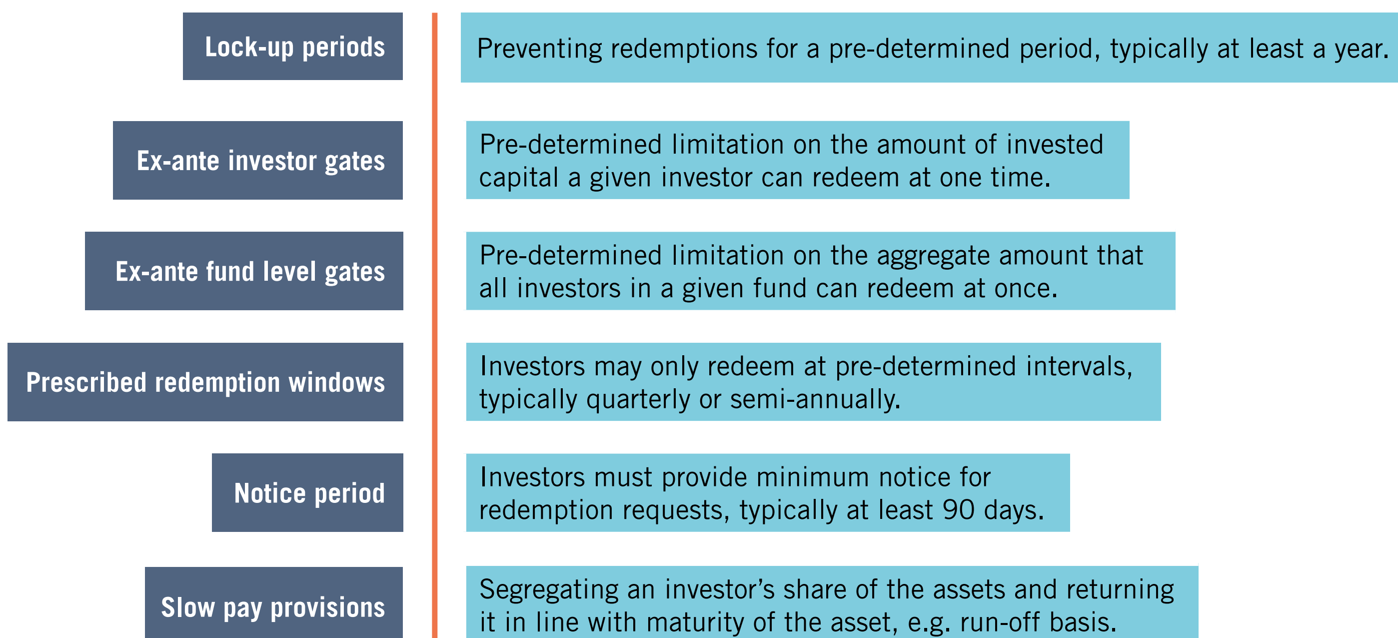
Figure 4
What is an open-ended fund?

An open-ended fund repurchases or redeems its shares or units, at the request of an investor, prior to the commencement of its liquidation. It does so at a prevailing NAV per share/unit, on a specified frequency and notice terms. Typically, the fund is continuously offered and new investors can also join (or existing investors can upsize their investment) on each dealing day.

This contrasts with a closed-ended fund which does not offer redemption or repurchase on specified terms.

With a closed-ended fund, the investor typically remains invested for the duration of the fund (a finite term specified at the outset); any early exit would be dependent on a secondary market transaction. The fund is also raised over a limited period of time and once raised, no new investors can join and existing investors cannot upsize. As no redemptions are permitted prior to liquidation, the fund's NAV is for reporting purposes only with investor returns driven solely by actual investment proceeds, not their carrying valuation.

Figure 5
Typical liquidity risk management tools employed in open-ended or hybrid funds



> **"Our clients are demanding innovative liquidity solutions, which has resulted in the development of new hybrid products."**
>
> Nada Aswad
> Sales Product Management – Global Private Markets, Man Group

Our research suggests that demand for hybrid or evergreen structures is coming from both investors and asset managers. For investors, these structures can provide important efficiencies that improve their returns. For example, by permitting investors to remain fully and continuously exposed to the strategy over a longer period, as the allocation does not need to be ramped down and re-invested.

Evergreen funds also give an investor flexibility to manage their capital allocation to a particular strategy more efficiently. The ability to invest in newer funds or vintages is partially limited by their existing capital commitments, and evergreen funds help address this by giving investors more opportunities to manage their allocation up or down towards a particular manager or strategy. There are also ancillary operational efficiencies, for example, from leveraging their existing due diligence or reducing the need to (re)negotiate terms when increasing their commitment when compared to allocating to a new fund or manager. This gives investors more flexibility to construct and manage their portfolios and supports their ability to capitalise on opportunities and adapt to changing economic circumstances more effectively.

> **"Open-ended funds are both about providing a sense of control as well as liquidity. When moving into retail and high-net-worth, there is a greater expectation for liquidity. With an open-ended fund, you can keep investing until I tell you to stop, which then avoids the inefficiency of going back to committees every time there's a new fund."**
>
> Nicole Downer
> Managing Partner, MV Credit

Whether investment efficiencies were the only drivers of demand for liquidity was also a point of discussion amongst interviewees. Some identified recent market pressures, either tied to specific events or more general market conditions, as driving demand for liquidity amongst certain types of investors. Another trend highlighted was the impact of some investors being more selective in terms of the number of managers they allocate capital to. Being able to offer structures with more than one liquidity profile was seen as one way to remain attractive to such investors. A final consideration driving this growth from an investor perspective is firms seeking to accommodate the needs of different investor types, such as defined contribution pension schemes and retail investors.

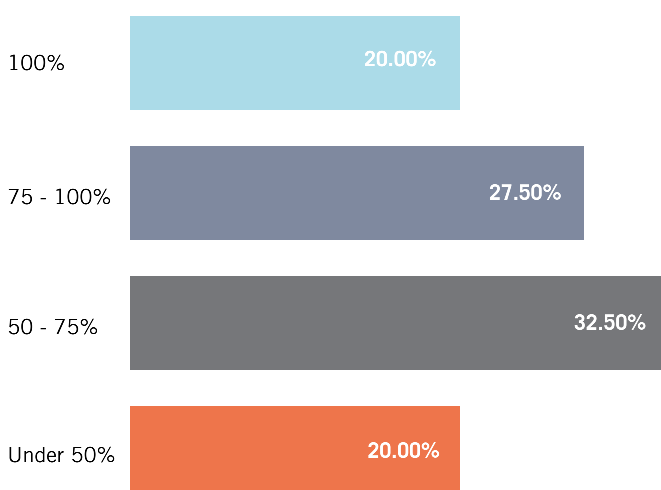
For asset managers, well-designed evergreen structures help strengthen their relationships with investors and provide them with a more permanent and renewable source of capital to pursue their investment strategies. Capital raising for new funds requires significant resources and investment from all parts of the business. In the simplest terms, raising and managing a single fund is more efficient than raising and managing multiple funds or vintages, however alike these may be. This creates a strong incentive for asset managers to develop such structures in partnership with their investors and is one important factor in the development of evergreen or hybrid funds.

Despite the advantages offered by evergreen structures, many interviewees emphasised that closed-ended structures still work very well and any liquidity and flexibility that can be offered remains limited by the liquidity profile and ease of exit from the underlying asset. For some investors, the benefits of evergreen structures are not seen to sufficiently compensate for the greater complexity involved in investing through such funds. Investor familiarity with closed-ended structures was also cited as an important factor when raising capital for private credit strategies. When considering this point, some interviewees also sounded a note of caution regarding instances where accommodating demand for liquidity might require some deviation from the core investment strategy, which could impact the intended returns.

Customising access to private credit assets

Our research indicates that managers are increasingly offering investors customised ways to access their investment strategy. While the majority of capital allocated to private credit investment strategies remains within commingled structures, 80% of respondents stated that they are managing capital through a mixture of commingled funds and other vehicles (see Figure 6).

Figure 6
What proportion of your private credit assets are managed within a commingled funds (as opposed to an SMA or fund of one structure)?



"We have a lot of entry points, and we'll customise bespoke arrangements to deal with investor preferences which cover tax structuring, levered vs unlevered, currency, AIFMD and regulatory to name a few."
Matthew Jill
Partner and General Counsel, Private Funds & Secondaries, Ares

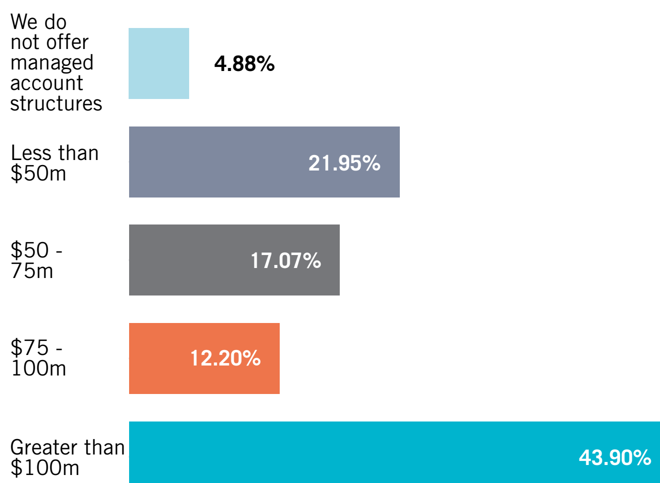
Demand from investors for tailored structures is increasingly common across the alternatives sector. For private credit, our data highlights some key areas where this trend is being expressed. As shown in Figure 7, respondents to our survey indicate that SMAs are available at a range of allocation levels. The 44% of respondents who stated that they are only able to offer managed account structures for $100m+ allocations conform to the commonly held view that such structures are only available for investors willing to invest larger amounts. At the same time, the 51% of respondents who offer managed account structures for single investors at levels below $100m indicates that there is a high degree of willingness to consider such structures at lower allocations.

"Flexibility is everything for us, which obviously adds complexity, but we have designed internal systems to deal with that."
Nathan Brown
Chief Operating Officer, Arcmont Asset Management

Even though there are a few things that can be done to offer a bit more liquidity, the asset class is still intrinsically illiquid and you cannot put a square peg in a round hole.”

Nathan Brown
Chief Operating Officer,
Arcmont Asset Management

Figure 7
At what level are you able to offer managed account structures for single investors?



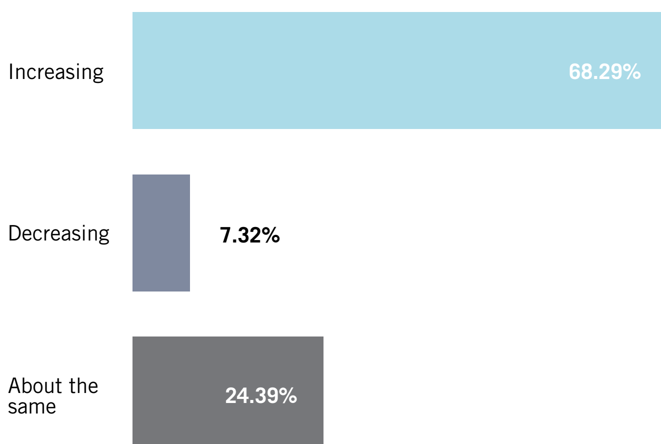
While only a small proportion of respondents stated they do not offer managed account structures, increased costs and operational complexities were cited as a significant factor by both managers and investors when considering a managed account structure. For investors, such structures need to offer ‘value for money’ relative to commingled structures. It was also noted that managed account structures offered at lower allocations were unlikely to have the same level of customisation as those offered at higher allocations. When asked about considerations other than size of allocation, interviewees highlighted the way in which these structures could support the development of a long-term partnership with key investors. These opportunities were seen by managers as important when balancing the increased cost of maintaining these structures.

Our research also indicates that demand for co-investment opportunities is expected to increase, with 68% of respondents stating they agree with this sentiment (see Figure 8). It is likely that similar factors to those driving the demand for managed account structures are driving this expectation, with the additional attraction to investors being the potential for preferential terms.

Investors’ increasing sophistication and appetite for customisation has led to a proliferation of vehicle ‘entry points’ for our offerings. Beyond Luxembourg main funds – which used to be the primary entry point for most – we’ve seen a rise in requests for bespoke vehicles, whether they be ESG-focused, capital-efficient, currency-hedged or other.”

Nicole Adrien
Chief Product Officer and Global Head of Client Relations, Oaktree Capital Management

Figure 8
Do you see demand for co-invests and direct investment in private credit assets increasing or decreasing?



When discussing these findings with private credit managers, there was a consensus that investors in the asset class were now more experienced and willing to consider co-investment.

While investor appetite to increase their exposure to specified deals or markets through co-investment is growing, our research indicates that there are different approaches being followed in the market. For some investors, the origination, underwriting and management of the underlying investment remain fully with the manager, with investors setting the criteria for investments where they would consider co-investment. Where these criteria are met, investors typically retain the final say on whether to take up the opportunity, requiring some review and assessment from them, likely involving further dialogue with the manager. For others, co-investment may involve taking on some or all of the functions typically carried out by the manager (e.g. underwriting). Practices under this approach were described as both strategy and investor dependent, meaning there is little consistency across the market.

> **The market seems to self-select – if you are small you tend to follow the vehicle, if you are big you tend to drive the terms which, in turn, drives the structure.”**
> Samyuktha Rajagopal, General Counsel, Arrow Global Group

Competition amongst private credit fund managers was also identified as another factor acting as an incentive to offer flexibility towards current and potential investors. When discussing specific reporting needs, ESG was commonly cited by investors seeking bespoke arrangements to address regulatory requirements or their own ESG policies. These requirements are expected to increase in scope and complexity over the coming years.

It was also noted that managed accounts in the private credit arena take a number of forms, including funds of either one or relatively few aligned investors who invest alongside a main fund, and platform structures (where the managed account investor has a dedicated ‘sleeve’ or sub-fund on an umbrella platform). Traditional managed account structures, where the investor retains ownership of assets, can be less practical and are, therefore, less common in the private credit space.

> **Sophisticated investors now prefer to retain some control in terms of deployment, rather than committing capital to a traditional commingled structure where full discretion is given to the investment manager.”**
> Nada Aswad, Sales Product Management – Global Private Markets, Man Group

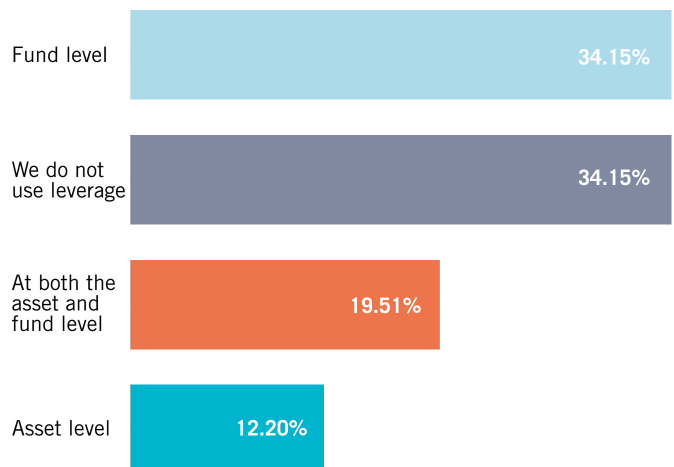
Discussing the implications of this trend with asset managers confirmed that there are trade-offs that need to be considered. While accommodating multiple investor preferences and providing multiple points of access to an investment strategy can help provide an important competitive advantage, the infrastructure needed to support and manage the commensurate increase in complexity inevitably requires more operational support than a single fund. Investment in technology, people and systems can address this issue, provided the additional capital is sufficient to justify it.

> **"Managing a myriad of investor preferences adds complexity, but we try to accommodate them where possible. Our goal is to invest in a manner consistent with our investors' objectives, both in substance and in form."**
>
> Nicole Adrien
> Chief Product Officer and Global Head of Client Relations, Oaktree Capital Management

Leverage

Our research indicates there have been some changes in how private credit funds are structured to meet the needs of their investors in relation to leverage. Our data (see Figure 9) shows that 34% of respondents do not use leverage as part of their investment strategy. 54% and 44% of respondents to previous ACC research in 2018[i] and 2021[ii] respectively stated the same, suggesting that the number of levered funds in the market has been slowly increasing over the past six years. While this research shows that overall levels of borrowing by private credit funds remains modest in relative terms, this trend indicates that investors increasingly have an appetite for leveraged returns in this asset class.

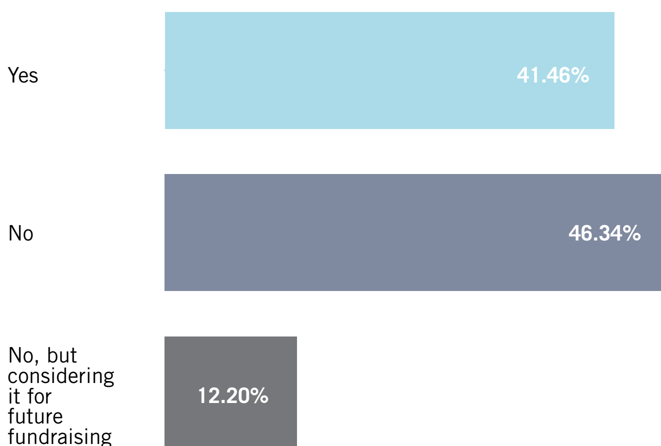
Figure 9
At which structural level do you typically deploy leverage as part your private credit investment strategy?



Our data highlights that there are multiple points within the investment structure where leverage can be used to support the investment strategy and there is a mixture of approaches across the industry. The approach employed in any given scenario is likely to be influenced by a combination of investors' appetite for risk, the nature of the investment strategy, the underlying assets, structuring considerations such as tax and creditor protection, as well as the availability and price of any borrowing required.

Leverage is also another area where the market is seeking to accommodate multiple investor preferences when accessing their strategy. As Figure 10 shows, 41% of respondents include levered and unlevered sleeves in their private credit funds, with another 12% of respondents considering offering such flexibility for future fundraising.

Figure 10
Do you include levered and unlevered sleeves in your private credit funds?



> **"Managers are driving ESG terms; rather than the banks asking for it, and we are asking the banks to incorporate this proactively. For subscription facilities, raising new financing and bank proposals we ensure that ESG is a key criterion."**
> Murtaza Merchant
> Managing Partner, MV Credit

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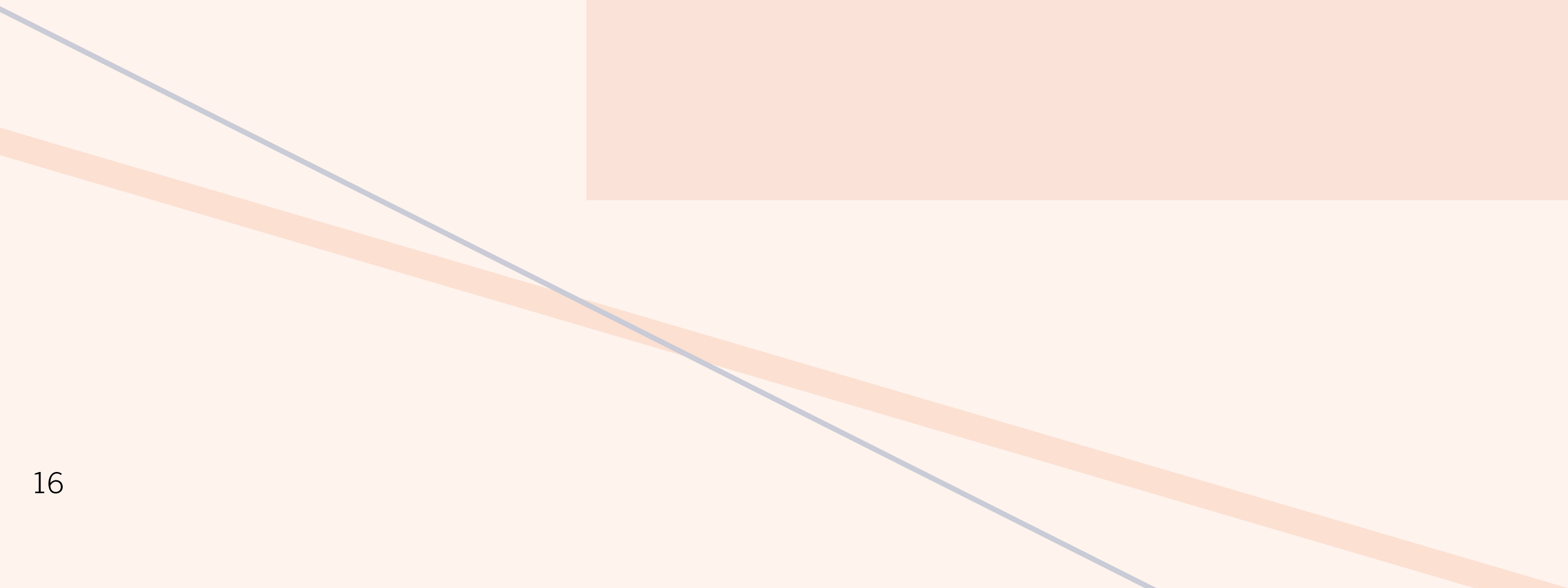


CHAPTER 2
RETAIL CAPITAL

Key takeaways

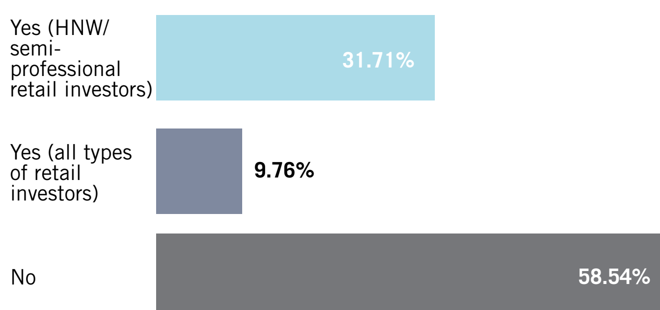
- Managers have a growing interest in raising capital from retail clients in the future but there are significant challenges to raising retail capital at scale.
- New European vehicles such as the European Long-Term Investment Fund (ELTIF) and the UK Long-Term Asset Fund (LTAF) are seeking to replicate the success of US Business Development Companies (BDCs) in helping retail clients participate in the asset class.
- Private banks, wealth management firms and retail fund distributors are key drivers in the retailisation of private credit, which has led to a higher demand for liquidity to meet the preferences of retail investors.
- Education is key, both for retail investors on the nature of the asset class and its risk profile, as well as managers on the operational hurdles and regulatory challenges they will face when seeking wealth management and full retail clients.

The retailisation of private credit, and private assets generally, is one of the most discussed trends among industry analysts. The growth of the sector in recent years has been primarily driven by institutional investors, with the notable exception of US retail clients.

One means of illustrating US retail participation in the asset class is by looking at BDCs. During the past decade, the fair value of BDC portfolios has increased from $82.2bn in 2016 to $278.4bn in March 2023, with the majority of this capital coming from US retail investors. There are no other equivalent vehicles that have been able to raise capital at a similar scale, and marketing by private credit fund managers globally is largely focused on institutional clients.

The primacy of institutional capital is also reflected in our data (see Figure 11), which shows that nearly 60% of respondents have no retail clients and, of those who do, the majority are either classed as high-net-worth individuals or semi-professional clients.

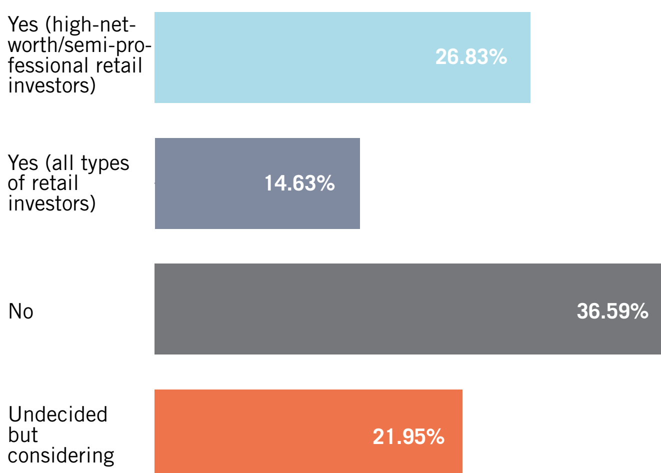
Figure 11
Do you currently have retail clients?



> **"The average US retail investor is much more sophisticated and willing to take on risk than the average European retail investor. Maybe European retail investors are not yet ready to invest in private credit but they will be over time."**
>
> Nathan Brown, Chief Operating Officer, Arcmont Asset Management

When asked about their future intentions, respondents to our survey indicated that there is a growing appetite to raise capital from retail clients in the future, albeit with some important differences across the market (see Figure 12). 37% of respondents do not expect to do so, 41% do, although mostly from high-net-worth and semi-professional retail investors, and approximately 22% are undecided but considering. Within those planning to expand into retail, we also see different expectations around which type of retail clients would be targeted.

Figure 12
Do you intend to raise capital from retail clients in upcoming fund offerings?



> **"The only way in which retail capital can be reached at scale in Europe is through the ELTIF, and the hope is that ELTIF 2.0 will change things drastically as the expected explosion of ELTIFs will make access to retail much easier. So far it has been hard to put ELTIF funds on platforms to reach the scale that you want with smaller tickets. In Europe, ELTIF is the ticket, but we need the operational side to catch up for it to really take off."**
> Jane Griffin
> Head of Product Strategy, PICTET Alternative Advisors

> **"For this asset class specifically, from a tax perspective you need a friendly Withholding Tax regime and that's the key point."**
> Murtaza Merchant
> Managing Partner, MV Credit

Private credit fund managers interviewed for this research noted that, for a sector with an institutional client base, it was a more natural development to target the private wealth sector (i.e. high-net-worth and semi-professional investors) than the mass affluent or consumer component of the retail capital base. Such clients are likely to be easier to accommodate within existing structures, marketing and distribution networks.

The emergence of new products such as the ELTIF and LTAF in the EU and UK respectively are seen as helping to catalyse this trend. These funds have many similarities to BDCs, and it is hoped that they can replicate the success of the US BDC market in providing retail clients with an appropriate vehicle to participate in the asset class.

However, interviewees noted that a lot of work is needed to support the development of a retail client base and an ecosystem that can serve it. The platforms and service providers needed for ELTIFs and LTAFs to operate at scale have not yet caught up with the demand from private credit managers to build a retail client base. Examples cited included automated subscription processes and reporting systems tailored to illiquid assets, as well as more developed marketing and distribution channels. While there was interest and investment in addressing such challenges, bottlenecks are expected to emerge with demand for such services likely to initially outweigh supply. While the approach of regulators in developing new structures to increase retail investment in private credit or other illiquid assets is welcomed, the approach towards the supervision of such funds is untested.

A recurring theme across our interviews when discussing retail clients was education. Supporting the ability of retail clients to understand the return profile of private credit assets was seen as paramount to creating a sustainable retail client base outside the US. Using liquidity as an example, our previous chapter demonstrated the growing demand for liquidity in private credit. Important constituencies driving that

demand are private banks, wealth management firms and retail fund distributors who would like to offer their clients products that more closely resemble the liquidity offered to traditional retail funds.

Interviewees added that, in general, some form of liquidity is a requirement for retail investors even if in practice such rights are rarely exercised. Balancing this demand or expectation of liquidity with the constraints of some investment strategies, and communicating this effectively to retail clients, continues to be a challenge.

Another area where education was described as necessary relates to the risk profile of private credit strategies and the costs incurred by retail clients when investing. The growth of private credit means there are multiple strategies within this broad label that each have a different risk profile, even before one considers the relative seniority of the investment, use of leverage, exposure to particular industries, sectors or geographies etc. Outside of the US, the risk appetite of retail investors remains relatively uncertain for asset managers looking to develop new products.

Any discussion relating to retail clients will inevitably need to consider the costs incurred by retail clients when investing. Fees are a key driver of competition in the retail market and, all other things being equal, private credit investment strategies are typically more costly to run than traditional fixed income strategies. For example, originating a private loan will require greater investment by the asset manager in deal sourcing capacity, credit underwriting, due diligence, investment monitoring and reporting compared to purchasing a publicly traded corporate bond on a regulated market.

In addition to costs, the design of the ELTIF and LTAF also introduces constraints on the investment managers (e.g., with respect to borrowing or the portfolio composition) that may lower the returns managers are able to achieve on capital via these structures.

"Accessing wealth management and retail clients is a natural evolution. Once you excel in the institutional space, you then move to the wealth management space and then into the full retail space."

General Counsel at fund of funds manager

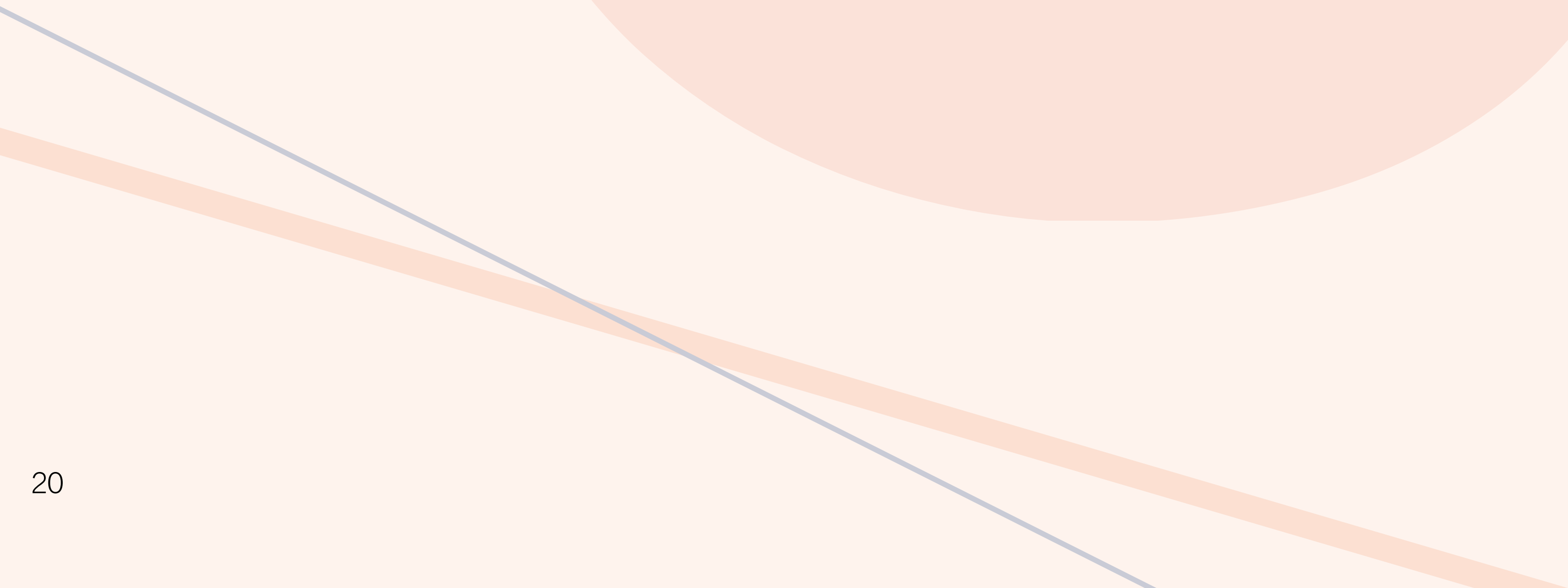
"Historically, retail investors provide very sticky capital, but semi-liquidity is still a requirement for those investors even if they are not going to make full use of it. So, curiously, you are offering semi-liquidity to European retail investors to attract permanent capital."

Nathan Brown
Chief Operating Officer,
Arcmont Asset Management

Managers interested in the retail space will also need to address operational hurdles, as the marketing and investment structures they currently employ may not necessarily be able to accommodate a large inflow of "retail capital. Interviewees highlighted that scale is a central consideration, particularly with respect to investor reporting and product distribution. This last point is particularly acute when considering a broad approach towards raising capital from retail clients and potentially dealing with hundreds or thousands of investors. These issues can be avoided or ameliorated using intermediaries such as private banks, wealth managers and technology platforms, but firms following this approach will still be required to implement due diligence and ongoing oversight mechanism to manage counterparty, legal and brand risk.

The full retailisation of the market, which interviewees considered a real trend, would also challenge how the use of subscription facilities would work with large numbers of retail investors. Interviewees were sceptical about the compatibility of the commitment model with large-scale retail investment. With large numbers of retail investors, managing a capital call process may be inefficient when compared to alternatives such as a paid-in approach or setting up a separate feeder with a paid-in structure for retail investors. Interviewees also highlighted that some investment platforms are not yet able to deal with non-daily dealing funds like ELTIF and LTAF.

The key outcome of these conversations is that the wealth management and retail market entails a different type of complexity in terms of operations and regulation than the institutional market. Managers who succeed in overcoming these challenges when raising retail capital will enjoy a considerable first-mover advantage in markets outside of the US.



CHAPTER 3
FUND FORMATION

Key findings

- Amongst respondents, Luxembourg and the Cayman Islands are key fund domiciles for private credit fund managers. As Figure 13 shows, more than half of respondents have funds based in those jurisdictions with the US, Ireland and UK also identified as key markets.
- The Luxembourg Reserved Alternative Investment Fund (RAIF) is the preferred vehicle to invest in EU-based private credit assets.
- Treaty access and sponsor ability to demonstrate substance can be a consideration when deciding domicile, with familiarity and regulatory certainty highlighted as other key factors.
- Interest and demand for US investment opportunities continues to grow among non-US investors, with multiple approaches being used to facilitate their investment into the US.

Fund domicile

Our research suggests that there are relatively few jurisdictions involved in a typical credit fund structure (see Figure 14). When this finding was discussed, it was noted that while there may only be one or a small number of jurisdictions where the fund is concerned, the number may be higher when accounting for feeder vehicles, special purpose vehicles or asset holding companies which may also be part of the investment structure.

"The difficulty of exploring new jurisdictions for fund structures is that many don't travel well with investors. You would need to be certain that you could attract sufficient AUM to justify it."

Peter Clark
General Counsel & CCO,
Leadenhall Capital Partners

Figure 13
In which of the following jurisdictions are your private credit funds domiciled? (Select all that apply)

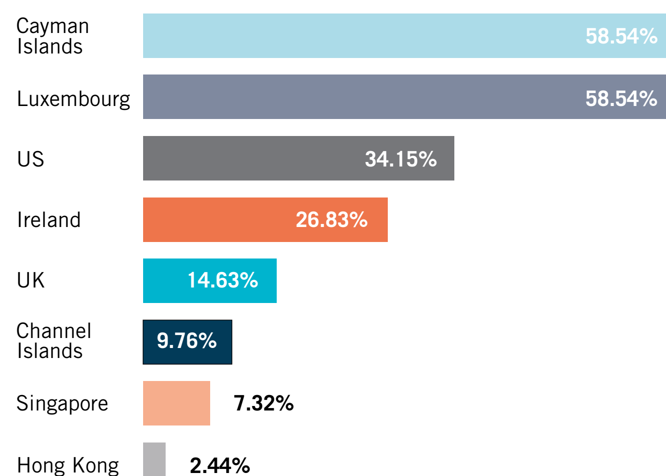
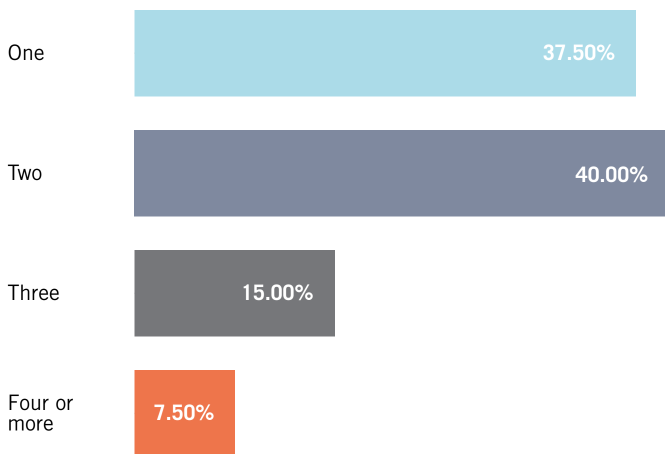


Figure 14
How many jurisdictions are involved in a typical private credit fund structure?

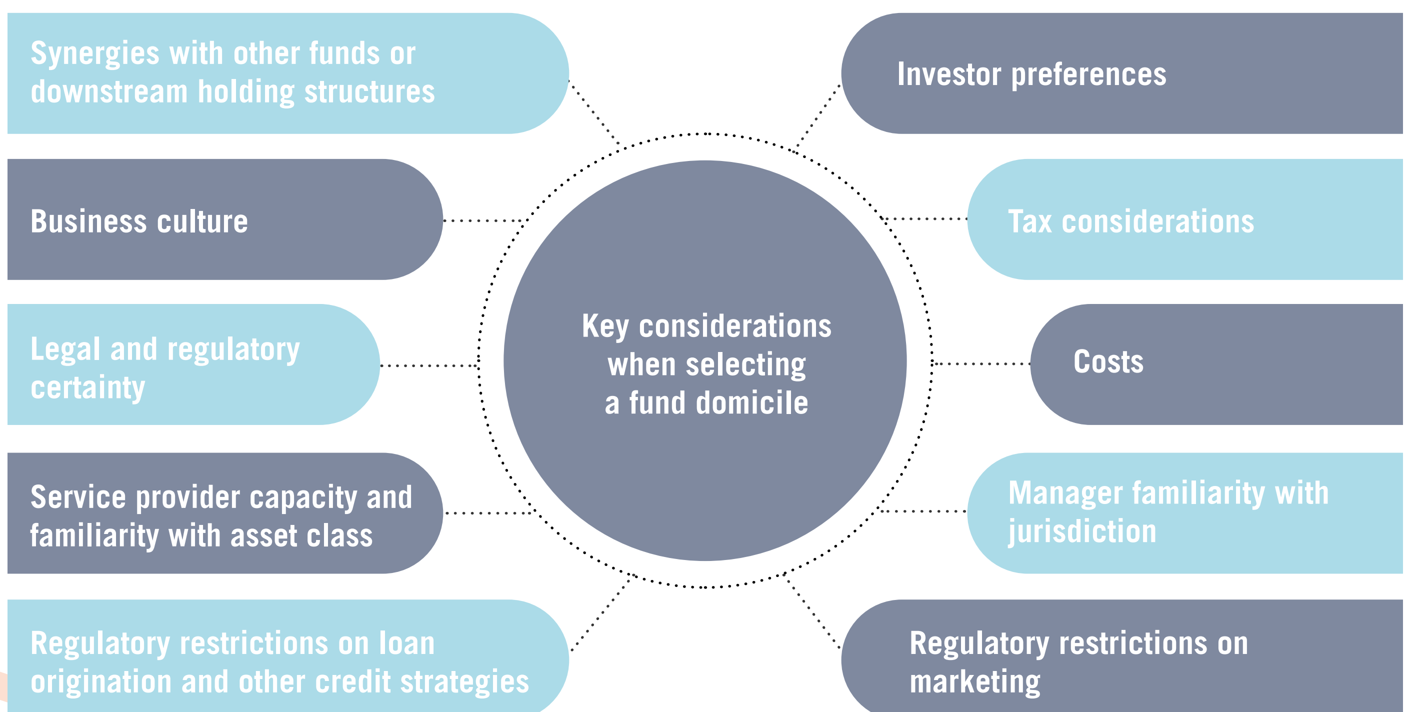


When discussing fund domicile, our interviews indicated that this is driven by a range of factors. Figure 15 illustrates the typical drivers on any given fund. While not all these factors would have equal weighting in the decision making process, the need to balance multiple considerations remains vital.

Some markets have been able to create a reputation for particular strategies. For example, Luxembourg is the traditional domicile for loan origination, while Ireland is the hub for aviation finance. The global popularity of the Cayman Islands for funds investing in all types of assets means most investors are familiar with it.

> **"A lot of structural decisions are driven by tax considerations and tax planning. For various investors, I think that's the primary consideration when we look at fund domicile when structuring a product."**
> Matthew Jill
> Partner and General Counsel, Private Funds & Secondaries, Ares

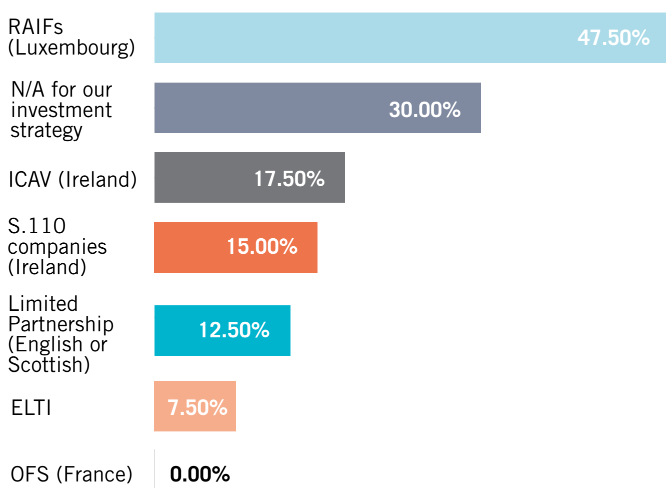
Figure 15
Key considerations when selecting a fund domicile.



Our research also explored how private credit funds are approaching their investments in EU-based private credit assets. As shown in Figure 16, the largest single cohort of survey respondents (48%) reported using the Luxembourg Reserved Alternative Investment Fund (RAIF) as their vehicle to invest in EU-based private credit assets. Other popular vehicles include the Irish Collective Asset-management Vehicle (ICAV), a UK Limited Partnership or Irish S.110 companies. It is hoped that the small number of respondents (8%) using the ELTIF to invest in EU-based private credit assets will increase in coming years, once the reforms to the ELTIF Regulation finalised earlier this year take effect.

As noted above, our research indicates that investor preferences are often the main driver of any decision on fund domicile. These conversations also indicated that when it comes to a choice between Luxembourg or Ireland, there is often little difference for asset owners who are familiar with both. This means that, for investors in EU-based private credit assets and their asset managers, other factors such as familiarity, costs and service provider capacity can be more relevant. This is likely to become an increasing driver of competition for funds investing in EU-based private credit assets when determining where to domicile.

Figure 16
What fund structures do you use to invest in EU-based private credit assets? (Select all that apply)



> **Investor preferences are often accommodated via parallel funds or separate accounts that invest alongside or separately from our main funds.”**
>
> Nicole Adrien
> Chief Product Officer and Global Head of Client Relations, Oaktree Capital Management

> **When navigating fund domiciles, service provider availability has been a relevant but secondary consideration for our clients. In our experience, the primary deciding factors for clients have been tax structuring and regulatory marketing or distribution requirements. Familiarity may also come into play. For smaller organisations with less in-house capacity, service provider availability perhaps becomes a more material factor.”**
>
> Sonia Mohindra
> Managing Director, Head of Global Product Management, Man Group

Interviewees also highlighted several challenges they were facing in some jurisdictions.

For example, while a broad range of providers are available to support the operation of the fund, there may be challenges finding firms or individuals with the necessary understanding of private credit assets. One specific issue identified was the high turnover of staff at service provider firms, which complicates the relationship between the manager and its service providers and can even cause a disruption to business.

By contrast, service providers who made the necessary investments to meet this demand, for example in training and retaining staff, were valued. Firms also highlighted that the size and scale of many firms in the private credit market meant that there were growing incentives to develop in-house or proprietary systems to service the needs of the business rather than using third party providers.

"There is no one-stop shop for service providers. The firms that have private markets expertise are limited when you want to launch a private market funds with certain features such as semi-liquid/evergreen or paid in share classes."

Jane Griffin
Head of Product Strategy,
PICTET Alternative Advisors

"You want service providers that not only have a good reputation, but have specific knowledge of the particular asset classes that you're putting in your funds. Working with a service provider that isn't familiar with the asset class, particularly when it comes to things like private credit, can definitely increase the risk of operational errors or other mismatches."

Peter Clark
General Counsel & CCO,
Leadenhall Capital Partners

"When we were setting up, we chose Luxembourg as it is well recognised, established and was a preferred jurisdiction for some of the key investors that we were hoping to target at the time of fundraising."

Samyuktha Rajagopal
General Counsel,
Arrow Global Group

The interplay between domicile and ECI

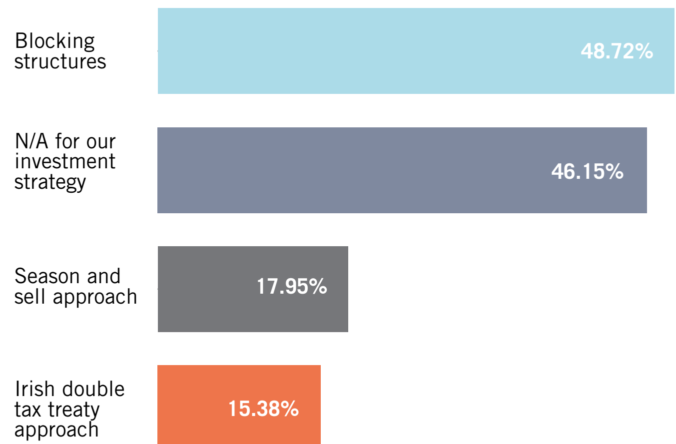
The position of the US as the key global private credit market means that interest and demand for US investment opportunities continues to grow among non-US investors. Our research also considered how private credit fund managers are structuring funds with US originated loans to mitigate the exposure of non-US investors to Effectively Connected Income (ECI). Figure 17 explains why this is an important consideration for private credit fund managers.

Figure 17
Why does ECI matter?

A non-US resident person carrying on a trade or business in the US is generally subject to US tax filing and payment obligations on income that is effectively connected to such US trade or business (or ECI). There are safe harbours for trading in stocks, securities or commodities, but the US tax authorities view loan origination as generally outside of the scope of such harbours. In the absence of the safe harbour, credit funds adopt various approaches to address ECI issues.

In this regard, our research indicates that there are multiple ways to invest in a manner that addresses ECI related concerns. Nearly 50% of respondents stated that they use corporate blockers (see Figure 18) with 18% and 15% respectively stating they use either a season and sell approach or rely on the US-Ireland Double Tax Treaty. Interviewees indicated that while the use of blockers was relatively commonplace, there was great variation in the industry over how such structures were set up in practice. While some differences were deemed to be expected (for example, due to the investor base or nature of the investment strategy), such variation also entails additional costs or inefficiencies. With demand amongst non-US investors for US private credit assets expected to remain strong, greater certainty and consistency of structures to support this investment were identified as something that would help greater volumes of non-US capital to invest in US assets.

Figure 18
What structures do you use to ensure compliance with the Effectively Connected Income rule when investing in the US? (where appropriate, select all that apply)



Endnotes

[i] See https://acc.aima.org/research/fte-2018.html
[ii] See https://acc.aima.org/research/financing-the-economy-2021.html
[iii] See http://cdn.hl.com/pdf/2023/direct-lending-update-summer-2023.pdf

ABOUT

ACC

The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents 250 members that manage over US$800bn of private credit assets.

The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business.

The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US$2.5 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage US$800 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

Dechert

Dechert is a global law firm that advises asset managers, financial institutions and corporations on issues critical to managing their business and their capital – from high-stakes litigation to complex transactions and regulatory matters, answer questions that seem unsolvable, develop deal structures that are new to the market and protect clients' rights in extreme situations. Dechert's team of 1,000+ lawyers across 21 offices globally focuses on the financial services, private equity, private credit, real estate, life sciences and technology sectors.

The global private credit team creates value on hundreds of private credit transactions each year across the full spectrum of strategies and the capital stack. With more than 75% of *Private Debt Investor*'s top 100 private credit firms as clients, Dechert provides exceptional market insight and innovative structuring to support clients' business objectives. They are one of the only firms offering strong financing capabilities alongside market-leading fund formation, regulatory, M&A and tax expertise across the U.S., Europe, Middle East and Asia.

Dechert engages with key industry stakeholders across jurisdictions, to navigate regulatory challenges and shape the industry's future, providing clients with early insights into how the market is developing and the opportunity to gain a competitive advantage.
dechert.com/privatecredit

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