

Asset Class Introduction: Semi-Liquid Evergreen Private Credit



November 2024

Key Takeaways

- Innovative fund structures in private markets have opened the once closed door to alternatives investing to the intermediary and wealth management channels.
- These structures, known as semi-liquid funds, offer a number of key advantages for wealth investors with features designed to meet their unique liquidity, risk and performance needs.
- In our view, private credit is an asset class that exhibits essential liquidity, diversification and valuation features that are well suited to a semi-liquid fund structure.

Democratizing access to alternatives

A recent report projects that alternatives AUM will rise to \$29.2 trillion by 2029, up 74% from 2016.¹ As alternative asset investing continues to see robust growth, the investor base is inevitably broadening out as fund providers innovate to meet a more diversified set of investor needs.

In particular, the wealth management segment is fast emerging as a key private markets growth area. McKinsey projects that private markets allocations will comprise 3-5% of U.S. wealth management assets by 2025 from 2% in 2020, a rise of \$500 billion to \$1.3 trillion in assets.² Investor requests for increased liquidity and accessibility has been an increasingly important feature of the alternatives' quiet but steady take-off in the wealth channel.

Asset managers are responding to these needs by developing new fund structures and adjusting strategies to help address their varied requirements. In short, they are "democratizing" access by taking a range of private markets asset classes that have historically been the preserve of institutional investors and making them available to a wider investor audience.

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Please refer to page 4 for "Important information and Disclosure."

¹ Preqin. "Global alternatives markets on course to exceed 30\$tn by 2030." September 18, 2024.

² McKinsey. "US wealth management: A growth agenda for the coming decade." February 16, 2022.

Often called semi-liquid funds, these innovative structures offer several advantages for professional and non-professional investors catered to

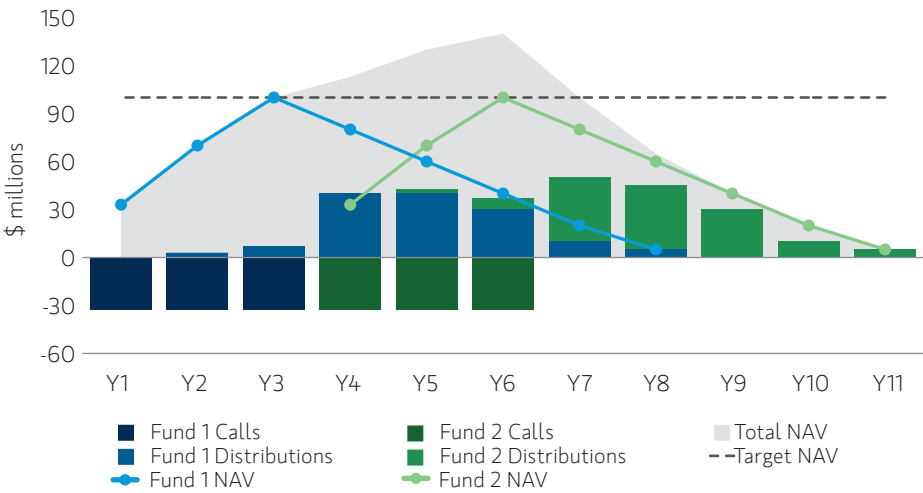
in the wealth management channel. There are also important liquidity and performance considerations to which investors should remain aware. In

this paper, we walk through the main features of semi-liquid funds. We then highlight semi-liquid funds’ suitability for private credit, an increasingly in-demand private markets sector.

DISPLAY 1A
Calls and distributions: Semi-liquid vs. drawdown funds

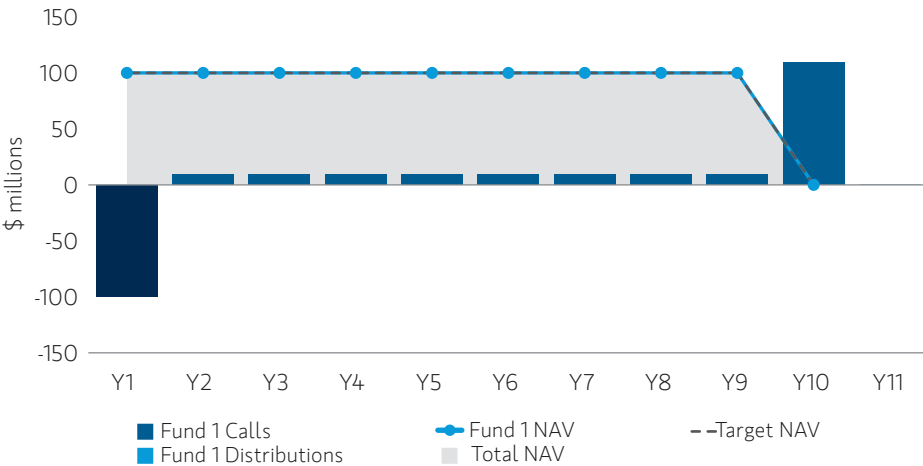
Drawdown fund structures

Investors using traditional drawdown structures must invest in multiple funds to maintain their target exposure to a given asset class over time. Their total exposure will be the combined net asset value (NAV) of these funds, which can fluctuate due to varied timings for capital calls and cash distributions. These factors, crucial in determining a fund’s NAV, often complicate the alignment of actual and targeted exposures. Consequently, investors must take greater care to manage commitment timings, multiple cash flows and consolidated reporting, including for taxes.



DISPLAY 1B
Semi-liquid fund structures

Fully-funded semi-liquid structures allow investors to achieve the desired exposure immediately through a single commitment, while maintaining exposure close to their target allocation. The funds aim to provide a regular cash flow stream. While not guaranteed and subject to caps, semi-liquid funds also aim to provide full liquidity in a single redemption.



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Investing on an ongoing basis

Traditional private market funds, known as drawdown or close ended funds, typically have a pre-defined marketing period after which the investment manager (“General Partner” or “GP”) gradually calls down investor (“Limited Partner” or “LP”) capital subscriptions, typically over four to six years. In contrast, semi-liquid funds are open ended and provide ongoing access, allowing asset owners to remain invested for as long as they choose. From the investor perspective, this is often seen as the democratization of alternatives, placing them closer to traditional investments in how they are transacted. To attract investors into these new structures, investment minimums have also been lowered by some regulators through the introduction of new types of investment vehicles.

Beyond stop/start due diligence

Intermediaries and wealth managers spend a large part of their time performing due diligence on behalf of investors to put products “on platform.” When funds are closed-ended, the process typically requires them to perform due diligence on the fund manager and the strategy. Then, they repeat that process each time the manager comes to market.

For each closed-end fund, the allocator must engage their due diligence team in an episodic fashion and then, upon approval of the due diligence work, promote the offering within a typical short and constrained marketing window. Open-end semi-liquid solutions alleviate stop/start due diligence. Their

IDEA IN BRIEF		
IMPROVED ACCESS: Innovative fund solutions have emerged to streamline allocation and redemption procedures, extending investment access to intermediary and wealth investors within private markets.	DIFFERENCE: Semi-liquid structures have been designed to meet the unique needs of the intermediary and wealth channel, resulting in several differences vis-à-vis traditional closed-end funds that investors should weigh up.	FIT FOR PURPOSE: Certain private markets assets fit more neatly into semi-liquid structures, most notably, private credit—an asset class with consistent payouts, known investment liquidity, established valuation methods and diversification potential.

structure allows the intermediary or allocator to underwrite upfront and then focus on monitoring and ongoing marketing rather than continuously reengaging a new process each time.

“On the shelf” product availability allows investors to gain exposure at the time of their choosing. In a way, the convenience is not unlike allocating to a series of funds over time, but in a much more efficient manner that grants investors greater choice in their given exposure and vintage diversification. Unlike closed-end funds, if conditions change, semi-liquid structures provide investors the flexibility to halt allocations as they see fit.

Operational simplification

From an operational standpoint, avoiding the demands of periodic capital calls appeals to intermediaries and end investors alike. In semi-liquid structures, capital is committed and called just once, after which time investors can opt to make additional subscriptions. For many investors, the ability to make a one-time commitment, as they would in traditional funds, is highly valued. Compare this to a typical private markets closed-end fund: Capital calls and investment occur over several years, obligating the investor to carefully manage capital that has been committed in order to meet future calls.

For intermediaries and wealth managers, semi-liquid funds are less resource intensive. The need for operational teams to monitor and

communicate upcoming capital calls or past calls that an investor may have delayed or missed is far reduced in the semi-liquid format.

Considerations

INVESTMENT RETURN

Traditional closed-end funds are designed for specific investment reasons. For example, by calling capital only when needed, fund managers try to maximize clients’ internal rate of return (IRR) and multiple of invested capital (MOIC) by investing in the best opportunities when they come to market. The arrangement gives investors optionality on their use of that cash in the period when their closed-end fund manager is not calling capital.

The upfront investment for semi-liquid funds may have different return implications. Responsibility for capital deployment passes to the fund manager, who must endeavor to act promptly to avoid “cash drag” on returns, i.e. the lower return of cash sitting in the portfolio diluting the overall return. But by trading off control of cash flow timings, the manager of the semi-liquid fund typically has to maintain a “liquidity sleeve,” consisting of cash and/or public market investments, to hold capital if it cannot immediately be matched with a private investment opportunity.

The untapped capital in the liquidity sleeve may affect the overall return, depending, of course, on how it performs in comparison to the private market targeted. Investors evaluating

semi-liquid funds will have to consider this feature and decide if the illiquidity premium is acceptable and whether having some liquidity is justified.

RISK PROFILE

With upfront capital calls in semi-liquid funds, the investment manager must deploy the capital fully. As mentioned, managers unable to invest quickly into private markets may invest elsewhere, such as mainstream asset classes. Inevitably, such exposure could increase the correlation to traditional markets. Understanding how such exposure affects the risk profile warrants some consideration by investors.

VALUATION

Confidence and accurately calculating valuations for both incoming and exiting investors is paramount in semi-liquid structures. For instance, issues could arise if investors exit at heightened valuations and this occurs at the expense of remaining investors. Likewise, investors coming in at undervalued entry points could disadvantage other fund participants. Valuation issues can, of course, be mitigated through appropriate valuation procedures. Investors should test the procedures through the due diligence process and select only those strategies that display a consistent ability to price investments in a fair manner for all investors.

Like semi-liquid structures, reliable valuation methods for closed-end funds are also key. However, the more synchronous nature of calling and

distributing capital to all fund investors on a simultaneous basis reduces the complexity on pricing that is faced by semi-liquid funds.

REDEMPTION BENEFITS

Investors will always find the ability to make redemptions at their own discretion to be an attractive feature. Semi-liquid structures facilitate choice in redemptions compared to less liquid conventional private market solutions. Specifically, semi-liquid funds feature an option that allows periodic redemptions, typically on a quarterly basis subject to fund level gates (a mechanism in place to restrict redemptions when over a set percentage). The redemption mechanism lets fund managers pay out cash in an orderly fashion, giving investors the option to adjust their exposure over time and to tap liquidity from a hitherto less liquid solution.

Other liquidity provision mechanisms include subscriptions replacing redemptions and, in some cases, credit lines; both, while helpful, should not be fully depended on.

Investors should assess the redemption options to determine what is most appropriate for their needs. They must also consider any potential trade-offs in their sought-after illiquidity premium and whether they believe they will receive a commensurate level of return and risk. Answers will vary for each semi-liquid strategy and individual investor appetite.

OTHER INVESTOR BEHAVIOR

By introducing additional liquidity demands, manager behavior may change and influence the fund’s risk-and-return profile. In a semi-liquid structure, the manager may be under pressure to deploy cash quickly to avoid cash drag and in response lower underwriting standards. They may also need to satisfy redemptions by selling to meet investor orders. In contrast, more traditional structures grant managers the flexibility to deploy and liquidate as they see fit over time.

Consequently, the investment process is not as straightforward for the semi-liquid fund manager. They have to employ a disciplined approach to asset sales in order to avoid becoming a forced

seller. Gating mechanisms, which allow managers to limit redemptions, do help with this. However, they may risk some client dissatisfaction if mishandled. Managers can also mitigate liquidity risks by having a diversified investor base.

Strategy Fit for Semi-liquid Funds

Bearing in mind these considerations, the key question centers on which private markets strategies are best suited to semi-liquid structures. Clearly, the most illiquid investments make little sense, as it would be impossible to realize the investments when needed and suggests a clear asset liability mismatch. In our opinion, strategies that are best suited to this structure should have some of the following characteristics:

- Some form of scheduled consistent pay out over time
- Known liquidity or term of investments
- Contractual end to the investment or an end that is not subject to unknown catalysts

DISPLAY 3
Key differences

SEMI-LIQUID FUNDS	CLOSED-END FUNDS
■ RETURNS: A portion of capital is typically held as cash and/or public investments in a liquidity sleeve, which implies that a slice of fund returns derive from mainstream markets.	■ Fund managers try to maximize clients’ IRR and MOIC by calling capital to invest only when the best opportunities come to market.
■ RISK: Correlations for assets held in the liquidity sleeve may be higher to traditional assets versus the fund’s private market holdings.	■ Public asset holdings are limited compared to semi-liquid vehicles, which should deliver an extra degree of diversification to traditional assets.
■ VALUATION: Clear, reliable valuation procedures are critical for fair treatment on pricing for incoming and outgoing investors.	■ Closed-end funds face less complexity on valuing assets, given the relatively straightforward pattern of a fund’s contribution and distribution schedule.
■ REDEMPTIONS: For investors, redemption mechanisms provide greater flexibility in redeeming capital on a more predictable and regular basis.	■ The frequency of distributions typically depends on when assets held in the fund are realized, which can be difficult for investors to time.
■ INVESTOR BEHAVIOR: Managers must balance the need for liquidity availability with holding less liquid assets in the portfolio, which places added emphasis on discipline in buying and selling.	■ The reduced pressure to maintain liquidity provides managers greater flexibility for choosing when to buy and sell their private market holdings.

- Plentiful availability of investible assets
- Diversification opportunities
- Lower susceptibility to specific vintage risk
- Ability to value assets effectively and consistently using standardized metrics
- Strategies with limited spread in returns between the conventional closed-end structure and the open-ended semi-liquid structure

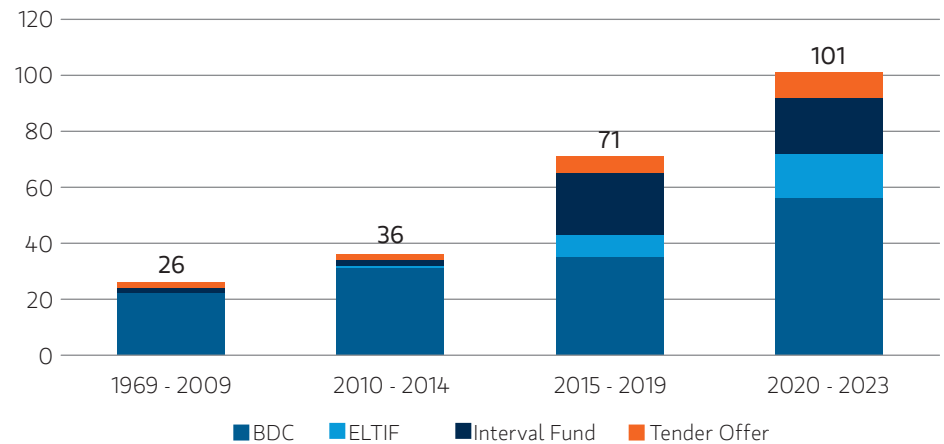
Many of the above criteria match well with the characteristics of private credit. The asset class tends to be contractual in nature, with many of the investments paying regular coupons and self-liquidating when principal is paid back through refinancing or at the end of the loan term, thereby providing liquidity. As such, it is not surprising to see the large growth of semi-liquid solutions focused on the private credit space.

Launches of private credit investment vehicles have grown steadily in recent years, particularly over 2020 to 2023 (*Display 4*). The principal investment structures include BDCs, European Long-Term Investment Funds (ELTIF), interval funds and tender offers. Part II SICAV structures are also becoming recognized and available in Europe and Asia.

DISPLAY 4

Private credit funds proliferate to meet investor demand

Private credit fund launches



Source: Preqin, Morgan Stanley Investment Management. As of December 31, 2023.

Private credit is a growing private markets segment with assets under management and committed dry power valued at roughly \$1.7 trillion in the U.S. alone.³ Private credit is also an area where fund investing tends to be diversified in nature and where it is possible to apply consistent methods for valuation.

Conclusion

The growth of semi-liquid funds is likely to continue and, as highlighted, there are many positives for investors seeking exposure to private markets through these vehicles. Importantly,

there are a number of key differences when compared to traditional closed-end funds that merit investor consideration. Investors should also consider which asset classes are best suited to an open-ended structure and how an allocation could complement their overall investment strategy. In our opinion, private credit is an ideal asset class for semi-liquid vehicles, as it features several of the essential liquidity, diversification and valuation characteristics that grant these structures greater durability without sacrificing the benefits of a private markets exposure.

³ Morgan Stanley. Private Credit Tracker. As of July 29, 2024.

Risk Considerations

Alternative investments are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for long-term investors willing to forego liquidity and put capital at risk for an indefinite period of time. Alternative investments are typically highly illiquid—there is no secondary market for private funds, and there may be restrictions on redemptions or assigning or otherwise transferring investments into private funds. Alternative investment funds often engage in leverage and other speculative practices that may increase volatility and risk of loss. Alternative investments typically have higher fees and expenses than other investment vehicles, and such fees and expenses will lower returns achieved by investors.

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