

BENEFITS OF EVERGREEN FUNDS IN THE PRIVATE MARKETS INVESTING MODEL

The private markets asset classes (private equity, infrastructure, credit, etc.) have historically been reserved for large institutional investors and closed-ended fund structures were designed to meet the demands of these investors. In recent years the asset class has received increased attention from non-institutional investors who do not have comparable scale, lifespan, and resources as institutional investors. In this paper, we argue that open-ended / evergreen fund structures offer strong benefits for non-institutional investors and even to some institutional investors that will also benefit from having some level of allocation to evergreen structures.

Background

Closed-ended fund structures

The typical framework for investing in private markets is essentially based on illiquid closed-ended structures: most private equity funds feature a 10-year term (but typically last significantly longer, often 15 years or more, after various fund extensions) during which investors are locked in the fund. In such structures, the closed-ended fund manager raises capital from investors and pools their commitments into a fund, this fundraising period typically does not last more than 18 months, after which additional investors cannot be admitted into the closed-ended fund. The fund will use its committed capital to acquire private assets and hold them for a number of years.

Closed-ended funds are cash-in/cash-out structures in which each investor commits to invest a maximum amount of capital into the fund. This capital is called from each investor by the closed-ended fund manager when the fund is making investments (most of the capital being called in the first four to five years of the fund's term) and capital is returned ('distributed') to investors when investments are realized.

Evergreen fund structures

Evergreen fund structures have also been around for a long time and are now becoming more common in private markets. Open-ended funds do not have a termination date (hence the equivalent name "evergreen") and can accept new investors at any point in time (usually monthly). Capital is invested in such funds based on a subscription (i.e. the investor invests the full amount at the time of subscription) and investors can redeem their investments in the fund on an ongoing basis. In such structures, investors typically enter and exit the fund at the net asset value prevailing at the time of subscription /redemption and the evergreen fund manager handles the liquidity and re-investment rate of the fund.

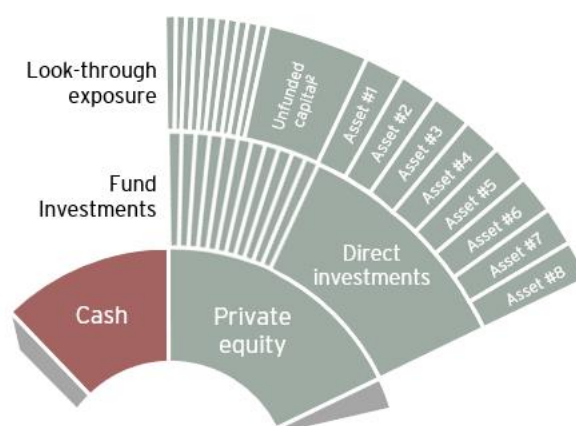
Investing in private markets

Closed-ended fund structures

The capital deployment pattern of closed-ended funds requires the investor to hold sufficient cash or equivalent liquidity reserves to meet the unfunded part of the commitment. Large investors with diversified private markets portfolios typically run statistical models to predict how much capital will be called in a given timeframe. This allows them to optimize the amount of liquidity they will need at any point to meet upcoming capital calls. However, the uncertainty with respect to future capital calls and the conservative nature of institutional investors will often lead investors to hold significantly more cash than the models suggest, thereby diluting the investor's investment returns.

Running a large private markets portfolio with closed-ended funds means continuously making commitments to new funds to mitigate the erosion of older funds. By doing so, the investor will continuously replenish the amount of its unfunded commitments. As a result, unfunded capital can represent a significant portion of the total net asset value of an investor's private markets portfolio, and unfunded capital levels of around 40% of the value of a total private market's portfolio are not unusual.

Also, the continuous commitments to new funds required to maintain the program will over time lead to larger fund portfolios - increasing the complexity for the investor in terms of both monitoring as well as administration (cash flows, reporting, etc.).



Example of typical portfolio allocation for small investor¹

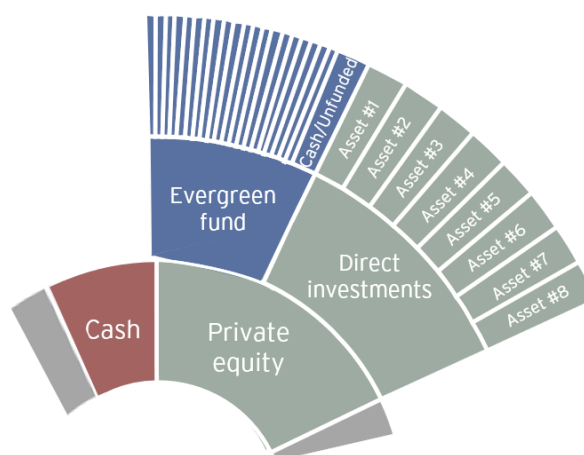
Evergreen fund structures

In evergreen structures, cash management is handled within the fund so the evergreen fund manager will typically need to retain some level of cash to manage the cash-flows of the underlying investments. The cash balance of the evergreen fund will somewhat dilute returns but will often be limited given the managers ability to control capital deployment (e.g. through secondaries or direct investments).

¹ Source: Strategic asset allocation of European family office, UBS Global Family Office Report 2021, Jera Capital

By committing to an evergreen structure, the investor instantly gains access to a diversified exposure to private markets and such exposure comes without unfunded liabilities, thanks to evergreen funds' subscription mechanism.

Finally, given that evergreen fund managers re-allocate distributions received by the open-ended fund, an investor can maintain its exposure to private markets through a single subscription to an evergreen fund, which dramatically simplifies the administration and portfolio management burden on such investor, compared to managing and expanding a large portfolio of commitments to closed-ended funds.



Example of portfolio allocation for small investor using evergreen structure²

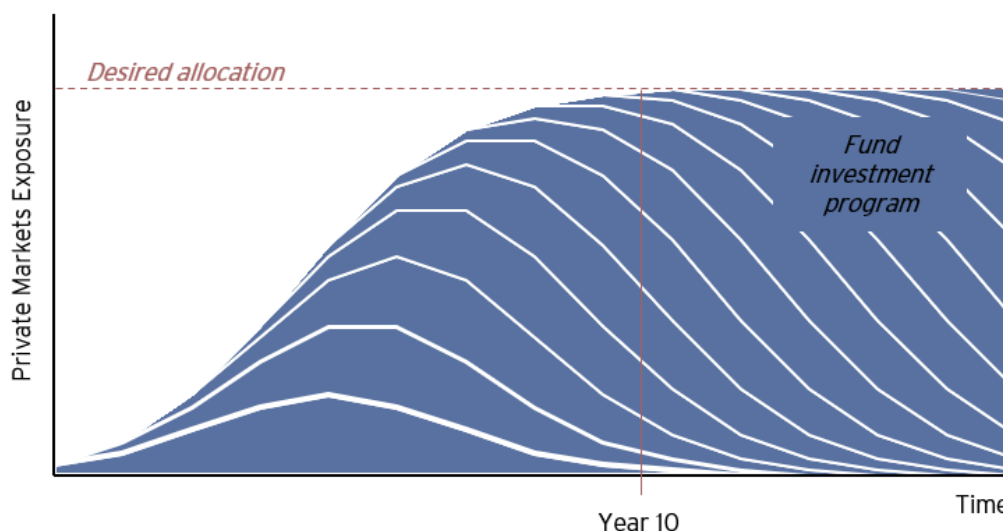
Building exposure to private markets

Closed-ended fund structures

While the closed-ended fund structure makes for an optimal use of capital by the manager (e.g. capital is only deployed for the duration of an investment), in practice it means that the deployment and return of capital are fully under the control of the fund manager. As a result, investors in the fund cannot know in advance the specific deployment of capital for a given fund. This means that the task of building a specific private markets exposure with a diversified portfolio of funds is very difficult and will often take many years.

Additionally, given that some assets are sold early in the life of a fund, and often even before the full commitment has been drawn, investors will usually never have their capital fully deployed at any point in the fund's life. In fact, in many cases only two thirds of a limited partner's total commitment end up actually being invested over the life of the fund. To reach a desired level of exposure, an investor therefore need to undertake an overcommitment strategy (e.g. committing in excess of the desired exposure), which comes with obvious risks for such investor.

² Source: Strategic asset allocation of European family office, UBS Global Family Office Report 2021, Jera Capital

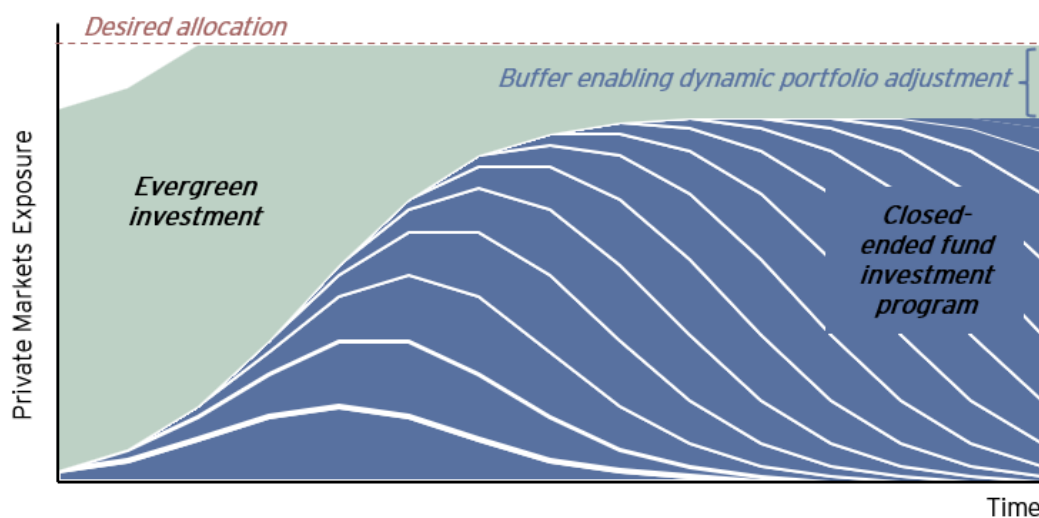


Example of private equity program using exclusively closed-ended funds

Evergreen fund structures

Investors with no prior exposure to private markets can almost instantly achieve their desired allocation to the asset class by subscribing their desired allocation to an evergreen fund and letting the evergreen fund manager manage their investment. In a similar fashion, investors who are below their target exposure can also achieve their desired allocation by investing the shortfall amount to their desired allocation into an evergreen fund.

Investors in evergreen funds which are over-allocated can utilize the redemption feature to decrease their allocation and bring their exposure back in compliance with their guidelines. It is to be noted that redemptions in evergreen fund structures are subject to limitations (typically, a maximum percentage of total NAV can be redeemed each quarter) and that the evergreen fund manager can impose gates on its investors in times of market turbulences to ensure an orderly redemption process and avoid remaining investors to be negatively impacted by the redeeming ones. However, in times of market turbulences lasting over-commitments to the asset class are unlikely because private market assets need to be marked-to-market by their manager.



Example of private equity program using combination of closed-ended and evergreen funds

Institutional investors have a very strong focus on designing asset allocation policies and setting up target exposures per asset class in order to maximize the benefits to their end recipients and avoid the potentially dramatic consequences that may arise from unbalanced exposures. Given the importance of these guidelines, we believe that institutional investors should allocate a potentially significant minority of their private markets' exposure to evergreen fund structures, as it would allow them to achieve their allocation targets and dynamically adjust their portfolios in fluctuating market conditions.

Investor liquidity

Closed-ended fund structures

Given the illiquid nature of the investments and the fact that investors are locked into closed-ended funds for their term, achieving early liquidity is typically a challenge for investors in the asset class. Secondary markets are offering such an opportunity to investors and these markets have developed significantly in recent years. However, selling in the secondary market involves transaction risk, price uncertainty (assets may be sold at discounts to their current net asset value) and a significant delay in achieving liquidity as secondary transactions can take six to nine months from beginning to closing. As such, accessing the private markets through closed-ended structures requires to have the ability to remain invested for the very long term or the ability and patience to undertake sales in the secondary market.

Evergreen fund structures

As noted previously, evergreen fund structures provide investors the ability to redeem their holding in the evergreen, in part or in full, at the reported net asset value of the fund holdings. This feature allows investors to achieve liquidity with a known process and within a reasonable timeframe, which is a valuable option for many investors. However, as mentioned previously, investors should bear in mind that the liquidity option for evergreen structures is an "option" that will only be available under "normal" market conditions. In "draw down" situations, the liquidity held in the evergreen may not be sufficient to meet all redemption requests and the evergreen fund manager may need to postpone redemptions - making the fund an illiquid investment until normal market conditions return. Overall, evergreen fund structures offer significantly better liquidity terms than closed-ended funds and, based on that factor, represent a more suitable investment opportunity for non-institutional investors than closed-ended funds.

Cost, reporting and tax considerations

Closed-ended fund structures

Closed-ended fund managers typically charge management fees to their investors based on the commitment of such investor for the first five years of a fund and usually switch to the cost of the remaining assets in the fund for the subsequent years. Such a fee structure typically results in management fees being paid by investors who have very little to no capital invested in the fund and lead to the infamous J-curve of private markets, where the performance of private markets investments can reach extremely negative levels in the early years of the investment before climbing back up into positive territory. In recent years, closed-ended fund managers have sought to resolve the J-curve by sometimes using credit lines that enable them not to call capital from investors to pay

the first years of management fees but the issue remains that investors pay the highest level of management fee when a fraction of their capital is deployed.

Closed-ended funds are typically established as tax transparent structures, which are well-suited for institutional investors who need to be able to perform a “look-through” all the way to the underlying assets, and report on asset level. However, for non-institutional investors, tax transparency generally creates complexity and additional costs, in particular due to the need to involve tax advisors, accountants, etc.

Evergreen fund structures

Evergreen funds charge managed fees based on the net asset value of the fund, which ensures investors no J-curve because most their capital is at work from the investment date and fees are charged on this productive capital, although it should be mentioned that investor generally pay fees on the cash balance of the evergreen fund.

Evergreen fund structures are typically tax-opaque entities and therefore their investors’ tax reporting is significantly more straightforward than in closed-ended funds. While such structures are simpler for tax-paying investors, it is less so for tax-exempt investors, who would suffer an additional tax burden with limited to no possibility of recouping the tax paid by the evergreen fund.

Conclusion

In conclusion, we believe that the features of the evergreen fund structure offer a much more attractive package for non-institutional investors than closed-ended structure, in particular due to a significantly shorter phase to build exposure and path liquidity, easier administration and a more aligned cost structure.

Additionally, we believe that most institutional investors would benefit from adding some level of evergreen funds exposure to their private markets portfolios, to enable them to reach and maintain desired allocation levels, as well as relieving them of some of the liquidity they hold and, finally, to benefit from a cost structure more aligned with the capital at work. However, we expect that the optimal exposure to evergreen structures will vary widely depending on the investor, as some institutions have a preference for capital call/distributions structures and/or have a high requirement for tax transparency, which partly offset the benefits of evergreen vehicles for such investors.

It is to be noted however that it is critical for investors to select an evergreen fund manager that can control the deployment of capital in a timely and profitable manner to avoid cash dilution or the addition of assets that do not create value for the investors. For our part, we have taken the view that acquiring private markets assets in the secondary market allows to achieve such controlled deployment of capital in assets with strong value creation potential and the added benefit of providing control over the portfolio construction.

Taking the above into consideration, we expect evergreen fund structures to increase in popularity in the coming years and that this part of private markets will grow in conjunction with the increasing appetite of non-institutional investors for private markets in recent years.

About Jera Capital

Jera Capital is an independent private markets asset manager that offers flexible investment private market solutions to a wide group of investors (both institutional and non-institutionals). The Jera Capital team has over 45 years of combined experience in private markets and its members have been active in the secondary market since 2006 and have managed evergreen fund structures since 2008.

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