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Seeding

A New Role for Seed Investors: Enhancing Evergreen Fund Liquidity Via a Committed Equity Backstop Facility

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Evergreen funds have rightly been heralded as a key solution to balance the benefits of exposure to illiquid asset classes while attempting to meet investors' liquidity preferences. However, that balance becomes precarious during periods of net redemptions (*i.e.*, when new redemptions are greater than new subscriptions), which can frustrate the practical liquidity that evergreen vehicles offer by forcing redeeming investors into liquidating accounts.

A solution to that problem may exist in creating a structure that incentivizes traditional seed investors or other strategic capital with a long-term mandate to backstop net redemptions via a committed equity backstop facility. That approach may offer substantial benefits to both strategic investors willing to assume that role and to fund investors for whom liquidity may otherwise be illusory, as well as to GPs of evergreen funds by improving their fundraising opportunities and overall fund stability.

This article describes how a committed equity backstop facility would practically work by leveraging traditional seeding arrangements; some of the economic benefits, additional protections and bolstered rights that could inure to strategic investors; advantages that GPs and fund investors could reap; its potential impact on fundraising; and how it compares to other forms of liquidity solutions.

See "Trends and Key Drivers in PE and Private Credit Seeding Transactions" (Jul. 11, 2024); and "The New Trend in PE Fund Seed Investments, Unique Deal Features and Several Options for Seed Sources" (Mar. 17, 2020).

Overview

Background

As background, one of the key benefits that seed investments provide hedge funds and other open-end products is a critical mass of locked-up capital that ensures the stability of a fund portfolio even if there are net redemptions – much like the "ballast" mass at the bottom of a ship that ensures the

ship will remain righted in a stormy sea. For example, an investor that wishes to make a $10-million investment in an open-end fund may be more confident they will be able to actually redeem their investment if there is already $100 million of locked-up capital in the fund, as their $10-million investment would only represent ~9 percent of the fund's overall assets such that a relatively small portion of the portfolio would need to be liquidated to fund the redemption.

The stability offered by seed investments allows investors to feel confident that they are unlikely to be restricted from redeeming their investment (*e.g.*, via suspension) as a result of too large of a percentage of a fund's capital being redeemed in a single redemption cycle, which could otherwise cause a fire sale of the fund's portfolio. As realistic liquidity is a key question during the underwriting process for potential investors in an open-end fund, having a stable capital base – whether through a locked-up seed investment or a critical mass of assets under management – dramatically enhances a fund's ability to successfully attract more capital.

That concern is all the more acute for evergreen funds. With portfolios heavily weighted to illiquid investments, evergreen funds often struggle to make good on their stated liquidity in times of significant redemption pressure. Further, scaling may not itself provide a suitable solution because the portfolio construction of an evergreen fund is likely to continue to emphasize increased exposure to illiquid investments as there are net inflows to the fund. Therefore, even the largest evergreen funds will still have the problem of converting their portfolio investments to cash to fund net redemptions. A solution is therefore needed to help evergreen funds realize their promise as a superior tool to offer fund investors liquid access to otherwise illiquid and less-liquid portfolio investments.

See this three-part series on permanent capital vehicles: "Why Sponsors Look to Unlisted Registered Funds to Achieve 'Functional' Permanence Beyond Typical Private Funds" (Dec. 8, 2020); "Confronting Certain Challenges of Operating Unlisted Registered Funds, and the Appeal of Private BDCs" (Dec. 15, 2020); and "Weighing the Merits of Pursuing Permanence Through Unlisted Closed-End Funds of PE Funds and Interval Funds" (Jan. 12, 2021).

Liquidity Ballast Solution

The proposed liquidity ballast solution involves strategic investments by seeders or similar large institutional investors that are capable of remaining exposed to an evergreen fund's strategy for an indefinite time frame. Those investors would provide a redemption backstop through a committed equity backstop facility, committing to fund new subscriptions to offset any periodic net redemptions. The facility acts as a liquidity ballast, ensuring true liquidity for the fund's investors. When an investor needs to redeem its investment and the available capital from new subscriptions is insufficient to fund that redemption request, the liquidity ballast would provide the additional subscription proceeds needed to enable the redeeming investor to fully cash out.

Critically, the liquidity ballast approach requires regular guidance on the fair value of the fund's portfolio to ensure that all parties are treated fairly. Those valuation marks are already a feature of many evergreen structures, however, and are likely to be even more available – faster, and at cheaper costs – as valuation products become more accessible and artificial intelligence is broadly assimilated into valuation engines.

See "Data Is Changing the Face of Value Generation and Compliance in PE" (Sep. 19, 2024); and "Embracing AI in Private Funds: Emerging AI Technology and Valuable Legal- and Compliance-Related Applications (Part One of Two)" (Nov. 16, 2023).

Benefits for Strategic Investors

Economic

In return for providing a committed equity backstop facility, strategic investors would be expected to negotiate various economic benefits. Similar to the economic benefits that have become standard in fund seeding transactions, those benefits would likely involve revenue sharing or other economic participation in the fund's profits. Additional incentives could include highly reduced fees on funded amounts, and potentially on other investments via a capacity investment or a seed investment in the evergreen fund at launch.

Another significant benefit for the strategic investors could be requiring an economic haircut from investors who are receiving liquidity as a result of the backstop. For example, a redeeming investor could be required to accept a reduced valuation of its redeemed interests (similar to an early redemption fee in a soft lock-up), with the strategic investor receiving the full economic benefit of the position that is redeemed and therefore immediately accreting in proportion to the discount.

Those economic advantages make it highly attractive for a strategic investor with an adequate capital base to serve in the role of a liquidity provider. Not only would providing a committed equity backstop facility foster a symbiotic relationship between the evergreen fund and the strategic investor, but it would also bolster a GP's relationship with any third-party investors benefitting from the facility.

Protections and Rights

To safeguard their interests, strategic investors that provide committed equity backstop facilities would likely require a variety of protections and rights, including:

- facility termination events, similar to early lock-ups and commitment terminations in seed deals;
- consent and informational rights; and
- other protective measures.

Additional terms would prevent the fund manager from exiting the business and jeopardizing any economic participation for the strategic investor, as well as shield the committed equity backstop facility provider from third-party actions.

It is important to note that strategic investors providing facilities would not be expected to simply underwrite other investors' ability to escape from faltering portfolios. Instead, the facilities would be oriented to ensure enhanced liquidity that aligns with the terms outlined in the offering documents,

therefore giving investors who need liquidity – for reasons apart from any underperformance by the fund – an ability to cash out in the ordinary course.

The strategic investor's obligation to act as a net redemption backstop would not be expected to operate in certain defined and negotiated circumstances, particularly when the applicable fund is experiencing secular underperformance and/or portfolio risk. Therefore, strategic investors may request safeguards that limit a facility's funding obligations if the post-redemption portfolio would become more concentrated in illiquid positions than a stated liquid-to-illiquid ratio – *i.e.*, if the fund is using a large amount of its cash or selling liquid investments to minimize the imbalance of new subscriptions and redemptions. Also, the funding obligations may be limited if significant adverse events affect the GP.

On the other hand, because those types of strategic investors would have near-unlimited duration capital, events impacting markets generally – even if severe – may not be a basis to terminate or suspend the liquidity facility. Instead, strategic investors may view those conditions as an excellent opportunity to gain greater exposure to the portfolio at distressed prices. A fund manager would need to provide assurances, however, that the strategic investor would not be expected to "catch a falling knife" by doubling down on investments in a failing portfolio. Further, protections for liquidity providers would likely include the expectation that the valuations used to mark the fund's investments fairly and reasonably represent their true value, mitigating the risk of overpaying at subscription.

For more on funds with similar features, see this three-part series on contingent dislocation funds and market disruptions: "Appeal, Application and Adoption Before Adverse Events" (Mar. 15, 2022); "Unique Mechanisms That Position Them to Pounce" (Mar. 22, 2022); and "Suitable Fund Participants and Potential Downsides to Avoid" (Mar. 29, 2022).

Benefits for GPs and Fund Investors

Incorporating a liquidity ballast into an evergreen offering provides many advantages for both fund investors and GPs.

A committed equity backstop facility not only enhances an evergreen fund's actual liquidity, but it also instills confidence among investors about their ability to redeem investments when needed. By providing practical liquidity, the facility would effectively reduce a significant hurdle to an allocator's decision to invest in the fund. Further, the enhanced liquidity broadens the pool of potential investors by accommodating investors that are traditionally unable to allocate to strategies focused on illiquid or less-liquid assets.

For GPs of evergreen funds, having a committed equity backstop facility in place would likely alleviate the risk of investors feeling pressure to redeem immediately when a potential need for liquidity appears on the horizon. As a result, there would be a reduced likelihood that GPs would face excess redemptions from panicked investors. That factor would also confer a significant advantage in the evergreen fund's fundraising efforts, even for investors that are unlikely to actually need liquidity.

The economic benefits conferred by putting a committed equity backstop facility in place may – in many cases – pay for the costs and inconvenience of putting the facilities in place. For example, if a

strategic investor receives a 20-percent revenue share, and having a liquidity ballast in place results in just a 25-percent increase in the capital raised (and minimal variable cost to manage the incremental dollars), then the strategic investor's economics are paid for by the fees generated on the additional capital, with any further capital being highly accretive.

Also, enhancing liquidity facilitates more frequent carried interest crystallizations or loss carryforward reductions/resets for GPs, as investors will be more likely to take advantage of the offered liquidity. In that situation, when full liquidity is provided, the facility would mitigate risks to the GPs associated with deferring crystallizations until any liquidating accounts are fully resolved.

Finally, a drawback of the traditional evergreen structure is that GPs are never relieved of focusing on fundraising to ensure a substantial syndicate of existing and/or potential investors can step in when other existing investors need liquidity. Adding a liquidity ballast to an evergreen fund meaningfully addresses that problem by allowing the investment team to focus on the growth and success of its portfolio as opposed to spending huge amounts of time fundraising to ensure new subscriptions will exceed any redemption requests.

See "What Does It Take to Get Across the Finish Line in the Current Fundraising Environment?" (Mar. 7, 2024).

Impact on Fundraising and the Fund Structure

A committed equity backstop facility offers a significant fundraising advantage for evergreen funds capable of partnering with strategic investors. Given that liquidity is a value for which investors are willing to pay a premium, putting a facility in place could attract larger and more lucrative allocations that could potentially supercharge a manager's fundraising efforts.

Many large allocators are restricted from creating an investment portfolio with too much exposure to illiquid investments. That is particularly the case for allocators that need to demonstrate to regulators or other oversight bodies that their investment portfolios are aligned with the actuarial solvency they require to be able to pay their expected obligations when due (*e.g.*, insurance companies or pension funds). An evergreen structure with enhanced liquidity could attract significant inflows from those types of investors who wish to increase their exposure to investment funds that have significant investments in illiquid and/or less-liquid assets, but otherwise would be restricted.

It is worth noting that fund managers may not be limited to working with just one large strategic investor when putting a liquidity ballast in place. The structure could also be achieved via a special LP class filled by multiple suitable investors. That approach could also be used for conventional PE, private credit and similar funds that are able to generate periodic fair value marks, which would usher in a change to the overall liquidity profile of the broader category of closed-end funds.

See "Structuring and Finance Considerations of Evergreen Private Credit Funds" (Sep. 5, 2024); and "Challenges of Accessing Insurance Company Investors Via PE CFOs (Part One of Two)" (Aug. 16, 2022).

Comparison With Other Liquidity Measures

Working with strategic investors to put committed equity backstop facilities in place presents a clear advantage over using a debt facility to fund net redemptions, as a GP may not be permitted to incur debt under the fund documents. Further, even if a debt facility were permitted, it would have the undesirable effect of indirectly levering the remaining investors. Alternatively, an evergreen product could employ both debt and equity facilities, with the equity backstop facility acting as a further backstop to a debt facility that would only be accessed to the extent that either the net redemptions would push the debt facility beyond agreed leverage ratios or the debt facility was fully drawn.

Also, committed equity backstop facilities could help fund managers achieve goals similar to those pursued by continuation funds, GP-led transactions and other types of secondary transactions. Typically, at the end of a closed-end fund's term, a manager is forced to scramble to either liquidate its portfolio or find existing investors willing to remain exposed to – or increase their exposure to – the remaining assets in the portfolio, and then find additional capital to replace any durational capital shortfall. Conversely, the committed equity backstop facility approach proactively offers a mechanism to provide investors with the liquidity they will likely need. That offers a more direct and integrated solution that enhances liquidity and stability for the fund and its ordinary investors while also providing attractive benefits for strategic investors.

See "PE Tools in a Slow Economy: Taking Advantage of Leverage and Finding New Capital Sources (Part Two of Two)" (Jun. 29, 2023); and "Emerging Trends in the Evolving Continuation Fund Market" (Jul. 12, 2022).

Conclusion

The concept of a liquidity ballast in the form of a committed equity backstop facility presents a real solution to the liquidity challenges faced by fund managers during net redemptions. By leveraging long-term capital from strategic investors, funds can ensure liquidity, attract larger allocations and foster a more stable investment environment. The economic benefits and protections offered to strategic investors further incentivize their participation, making it a mutually advantageous arrangement. As the private funds landscape evolves, committed equity backstop facilities could help redefine how funds manage liquidity and growth to benefit all stakeholders.

Gerhard Anderson is a partner in the corporate finance group at Seward & Kissel LLP, focusing on investment fund seeding and staking transactions; portfolio investments/acquisitions for private funds; and general mergers and acquisitions. He represents private investment funds; investment management firms; financial institutions; public and private companies; and business owners and managers in connection with a variety of business transactions, financings and general corporate matters.

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