

## **RPM Ep. 52 | Why private debt is well-suited for evergreen fund structures with Fabian Körzendörfer**

**MV:** Hi and welcome to RPM, the StepStone Group podcast that delivers quick takes and sharp insights on the themes and trends shaping private markets. I'm your host, Michael Venne. Today I'm joined by Fabian Koerzendoerfer, a Zurich based partner on our private debt team to discuss what makes private debt particularly well suited to Evergreen Fund structures. Fabian, welcome to RPM.

**FK:** Thank you very much, Michael. Thank you for having me and also thank you for pronouncing my name almost correctly. I'd say even for Germans, it's a tough one.

**MV:** Well, that means a lot. I'm really glad to hear that I did not butcher it. Fabian, before we tuck in today, I was wondering if you could tell us a little bit about your journey. How long have you been at StepStone?

**FK:** I've been with StepStone since 2016 already, and I've always been focusing on private credit. While I'm based in the Zurich office, the StepStone private credit team is a truly global team with offices in the US, UK and in Switzerland as well. And within the investment team, I'm specifically focused on two things, co-investments and secondaries. And then on the other hand side also our private debt Evergreen Funds. Before joining StepStone, I've been working in corporate finance, M&A and effectively have been focused more on the stress and distress side of things.

**MV:** What was it about private debt that drew you to the industry?

**FK:** Right...I've been starting my career in the aftermath of the global financial crisis, back at that time in Europe, but I'm sure also on the other side of the pond, many banks were not performing extremely well. And my first job was looking into these types of banks and making acquisitions in that sector, restructuring those entities and eventually selling them

on to strategic buyers. I always found it fascinating how loans could be structured and the flexibility that they can provide to borrowers, but I also learned a lot during that time, specifically what can go wrong. Private debt as an asset class has been significantly evolving since 2010, so there has been a lot of dynamism in the industry overall, paired with the flexibility that I've been describing and the lessons I've learned. I thought this is the perfect asset class to go after.

**MV:** That's great, and thanks for sharing that about yourself. Now for the main topic, so over the past five years the number of Evergreen Funds or semi liquid funds has exploded. Now they can take a number of forms from BDC to LTIPs. If you're in the eurozone, LTAFs if you're in the UK, to name a few. And while I believe there are some structural differences between each one of these vehicles, generally speaking private debt seems to be well suited to each of them. What is it about private debt?

**FK:** Sure., and I mean, private debt has actually, over the last three years, taken the vast majority in fundraising. So the strongest fundraising out of all the various evergreen asset classes has been within private credit. I think that is driven by a couple of reasons. First of all, this is an investment that maximizes the multiple uncommitted capital. What do I mean with that? Because investors can invest swiftly into the asset class. They get exposure 100% on day one. And because they don't have the opportunity costs that a closed ended fund investment has, they can actually optimize their multiple on their committed capital. We at StepStone we did a bit of an example, I'd call it, where we have been comparing an Evergreen Fund and a closed ended fund over a ten-year lifetime. And we saw that both structures achieved the same multiple on committed capital after ten years. If the Evergreen Fund does a 10% return and the closed ended fund does a 17% IRR. And the main reason for that is the undrawn capital, which we had assumed to be 50% invested into money market funds and 50% into equities. Why is that just an example? This is illustrating the benefit for the multiple on committed capital.

The second thing is Evergreen Fund structures give investors more flexibility. That is on the way in. They can typically subscribe monthly or even daily for some of the fund structures, which is very comfortable for the investors. And they can then also get out of these fund

structures because many of them are offering periodic liquidity. I think the third point is very specific to the private debt asset class, which is an asset class that has significant opportunity costs of not being invested. The gross returns between the various GPs in this asset class is not as big as it is, for example, in private equity or even worse in venture capital. And as a result of that, getting that swift exposure is very important. Another important concept within private credit is diversification. Evergreen Funds offer diversification on day one, which is very helpful. And then lastly, I think that Evergreen Funds are also very suited for this asset class, because private debt is producing contractual cash flows and has very stable valuations, which makes the entire Evergreen Fund concept quite a bit easier.

**MV:** So in addition to the, you know, you touched on some liquidity features, multiple on committed capital. Could you talk to us a little bit about private debt risk profile and how it aligns with evergreen structures?

**FK:** Right. Absolutely. So private debt as an asset class mostly consists of the direct lending asset class. And we think that around 70% of private debt is direct lending. And when we are talking about direct lending, we mean senior secured first lien loans to corporate borrowers, which are mostly based in the US and in Europe. That means because you're firstly senior secured, you're on top of the capital structure. If a default happens in these type of structures, you are the one that gets your money back first. So as a result of that, this asset class historically has shown favorable loss rates. Also, these loans are floating rate in nature, that means that their coupon payments is adjusted with the wider interest rate environment, typically on a quarterly basis. And therefore these type of assets have little duration risk. I think this is particularly important in today's market environment where fluctuations in interest rates have been much more pronounced than in the previous decade. And I think the third thing is, again, the diversification aspect, I've already mentioned that previously, but private credit as an asset class does not have upside potential, and the returns are coming through interest payments. And as a result of that, diversification is a super crucial concept.

If you keep to these concepts that I've been mentioning, we think that private credit as an asset class is offering low volatility and drawdowns and therefore is a very interesting addition to a portfolio.

**MV:** So a lot of what you've touched on right there, you've hit on the risk and return characteristics in a somewhat theoretical sense. But how is this translated to real world performance, specifically private debts performance over the past 20 years during which we've experienced a few different credit cycles.

**FK:** Sure, I like it, Michael. Let's talk numbers, right.

**MV:** That's what we do.

**FK:** Exactly, So, we have done an analysis where we have been comparing equities as represented by the S&P 500. Public debt, that is investment grade leveraged loans and high yield, as well as the direct lending asset class. And we have been doing that since 2005 because we wanted to include the global financial crisis, which was obviously a test for all of these asset classes. And we see that equities did around 11% per year. During that time period. Public debt did between 4 to 7%. Direct lending did 10% over that same time period. So, give or take, direct lending has actually achieved equity like returns, 11 versus 10%. Now that sounds interesting from a return perspective, but how about the risk in the various asset classes? And one of the risk measures that we have been looking into is the volatility. The S&P over that same time period had a 16% volatility, public debt had a volatility of 7 to 11%, and direct lending had a volatility of only 4%. So, significantly lower volatility than some of the other asset classes.

**MV:** That's really interesting. Sorry to jump in here. You know you mentioned at the top that you know diversification is so important to private debt because it doesn't have that. You know, I guess theoretically, it doesn't have that same upside potential as equity. But the historical data shows that, in fact, it has delivered similar returns to equity. How do you square that?

**FK:** That's right, that's right. And I mean obviously to get to these type of returns, you need the diversification as you have just outlined it, right. Why is the asset class not very volatile? I think it goes back to two factors again, right. First of all, being on top of the capital structure is very important. If you think about global financial crisis. Yes, default rates increased massively during that time period. But what you ultimately care about as an investor is losses. And losses is the product of probability of default. Default multiplied by one minus recovery rate. If you are on top of the capital structure, your recovery rate is high and as a result of that, your loss rates are lower. This is very helpful. Changes in interest rate environment had very little impact on the direct lending asset class overall, which is way different for other asset classes. We just need to see what happened in 2022 and 2023, where many of the public debt asset classes suffered significantly from the hike in interest rates.

**MV:** So, I'd like to go back to something you said earlier, about private debts natural liquidity mechanisms. You know, could you help me fill in the gap and explain how things like contractual cash flows are then put in use by Evergreen Fund managers to meet the liquidity and redemption requests. Kind of complete the circle for me.

**FK:** Absolutely. Private credit as an asset class, specifically direct lending again, has a lifetime of around three years. So when you have a diversified portfolio, you actually receive around 30% of your portfolio back each and every year. This has been fairly stable over vintages. There obviously some fluctuations in that regard, but give and take, it's those 30%. I think this is one of the big strong suits of the private credit asset class, because the lifetime of these assets is significantly shorter than in other private market asset classes. And as a result of that, you're actually generating a lot of liquidity on the way. Just to put things into perspective. In most vintages, GP's have much more of a reinvestment risk than they have a liquidity risk, because if you receive 30% of your portfolio back in Evergreen Funds, most GP's offer around 20% per year in terms of liquidity. Your repayments alone are typically sufficient to manage liquidity for these type of funds. That comes from the fact that if you

do a loan, you have a contractual maturity date, and as a result of that, you don't need to sell an asset to generate liquidity.

This is, I think, a very important feature overall. But when I said earlier that private credit is very interesting for Evergreen Funds specifically, I was referring to this, but also other features. Another key important feature is, in my view, valuations. The valuations in private credit are less reliant on macroeconomic factors. And because the asset class is floating rate, also not reliant on the duration risk side of things. Therefore, we have low volatility, which gives investors, I think, much more certainty at which price they buy in and at which price they can get out of these type of funds. Also, I think that the risk of a bank run on a private credit asset class Evergreen Fund, is lower than in other asset class stability. We feel that these two factors are generally a good fact pattern but are not sufficient to manage liquidity appropriately within an Evergreen Fund. We think that an Evergreen Fund should also have what we would call a short-term asset bucket or liquidity bucket. We think that there should be some cash in the fund. We think that you should also invest into warehousing facility bridge loans, which are effectively loans with very short economic lifetime to have an additional buffer for your investors. We know a lot off Evergreen Funds out there that also invests into public debt. We think this is likely not the best liquidity management tool because simply, when do you need the most liquidity? It's going to be in a market downturn. And as a result of that, these type of assets are not very well suited for the asset class. I would add to that a couple of factors which are not long-term liquidity management tools but can certainly be helpful in the short term.

**MV:** Please.

**FK:** The first one is leverage. I mean, on private assets, you can obtain leverage of 2 to 1 fairly easily in this asset class. So banks will be providing two \$2 of debt versus \$1 of equity, which is which is quite a lot. We think that utilizing that leverage is way too much, because you need to keep a cushion for downturns in the market in order. You can always manage your portfolio. But if you manage that portfolio at a conservative level, let's say at 0.5 or 1 to 1 debt to equity, you leave a lot of cushion on the table. And at the same time, you can use that cushion to manage liquidity more efficiently. As I said, not in the long term, but certainly

very helpful in the short term. And we have seen that crisis come, but crisis also go again. Other measures may be secondary opportunities. Secondaries in private credit have become much more active over the last couple of years. And as a result of that, secondaries may be another route out there. We think that in a bad market environment, secondaries are likely less viable because the discounts are going to increase very significantly. But in good market environments, it's an interesting tool to generate liquidity.

To be honest with you, I think secondaries are even more interesting on the asset side, i.e. buying into these type of secondaries, benefiting from discounts, from diversification, from immediate investments. But that wasn't your question.

**MV:** Yeah, I'm going to hold you to that though. We should do an episode on private credit secondaries in the future.

**FK:** Absolutely. I'd love to do that. You will realize that I have not even mentioned subscriptions as a liquidity management tool. Obviously, if you get new money in, you have money to pay it out to investors again. I don't think that this is going to be available in a more significant downturn. And as a result of that, I didn't even note it in our conversation.

**MV:** Liquidity has been such an important topic, whether you're an individual investor or a pension or endowment fund. Although evergreens might have been initially conceived of with the individual investor in mind, I think that increasingly we're seeing a lot more institutions using Evergreen Fund structures. Could you walk our listeners through the ways that different investors, different investor types are using evergreens, maybe some use cases?

**FK:** Absolutely. And I mean, I was, to be honest with you, a bit surprised because, as you said, many of these Evergreen Funds were designed for individual investors. But if I take some of the Evergreen Funds that we manage, we see 80% plus of institutional investors in these type of funds. And I'd say specifically in private credit. Again, the institutions are attracted to these type of structures because they can get this immediate deployment in an asset class that does not generate as much alpha as other private market asset classes. The

opportunity costs are high and being able to invest swiftly. There is a key criteria for them also getting into a portfolio which is already diversified on day one and as a result of that is mitigating downside risk is an interesting value proposition for institutional investors. So we see institutional investors doing an allocation to evergreens for strategic reasons. And in the long term, we also see some institutions that use evergreens in a tactical sense. What do I mean with that? They invest in evergreens, but they also invest in closed ended funds.

Effectively what they are doing, they are putting together portfolio and close lending funds, and a part of their undrawn capital goes into the evergreen und world. So in that sense, they are immediately at their target exposure. They can still benefit from all the advantages of the closed ended fund structures, which we haven't discussed today. But there are obviously significant advantages there as well. And at the same time, they have this liquidity option on the table, which in the end again, maximizes their returns and multiples. On the individual investor side, I think the advantages are fairly clear. For them, it is the immediate investment. It is lower investment amounts. It is simplified access, they don't have to take care of capital calls of very lengthy and difficult subscription documents. And many Evergreen Funds are also offering a very efficient tax reporting. And that simplicity, I think, has enabled and democratized the market quite to a significant degree also for individual investors now.

**MV:** Thanks for that. During our prep call, you mentioned the growing importance of co-investments in this landscape. Most institutions will be familiar with them, but this concept may be less familiar to individual investors. Two-part question, one, what is a co-investment? And two, how do they factor into the discussion on evergreens?

**FK:** Yeah. So as you said, institutional investors, they allocate big to co-investments. They think this is a very attractive tool to implement their portfolios. Unfortunately, individual investors did not really have the chance in the past to get into co-investment deal flows. So first of all, important, as you said, to explain what co-investment even means. Right. And effectively, it's very simple. It's a direct investment into a loan when it comes to private credit, right. Together and alongside a leading GP. So, if we co-invest on the private credit side of things, we underwrite our own loans, we monitor our own loans. We typically become lender of record as well. Which means we have the same risks and rights as every other



lender in the transaction, but we don't source from the market we source through our GP network and therefore invest alongside those leading GP's. Now, what type of advantages does that have? I'd highlight a very evident advantage first, but it's super important when it comes to the net returns for the investors, which is fees. Co-investments are typically much more fee efficient than investments into primary funds. And as a result of that, net returns are getting optimized.

Second is through co-investments. You can diversify your portfolios much more. I mean, the funnel on the co-investment side is, very big. And as a result of that, you can get a lot of diversification in the portfolio. Again, this is important in the private credit asset class because our upside potential is limited, we have to manage the downside risk.

The third factor is selectivity. If you see a lot of deal flow across various market segments, and you can actually be very selective in what you're doing, which is an important feature, when again, managing downside risk.

Four is deployment, I mean, co-investment your source through the entire market. As a result of that, there's more volume available to you. You can invest proceeds significantly more swiftly. And ultimately, it's also a relationship through co-investments. LP's can build deeper relationships with leading GP's. That last aspect, may be less relevant for the individual investor side, but is still a massive incentive for the institutions to invest into this asset class. Therefore, I think that co-investments offer a lot of benefits for investors, and there are some co-investment funds out there that actually bring this these types of features also to the individual investor world.

**MV:** Oh, it's really interesting, thanks for that insight. So, to maybe quickly summarize, you know, we've talked about why private debt has some really interesting return. Liquidity characteristics that gelled nicely with the evergreen model. Before I let you go, what are some of the biggest challenges investors need to think through when contemplating an evergreen allocation?

**FK:** Yeah, there are many Evergreen Funds nowadays out there, specifically in the private credit asset class. So, I think the selection of these funds is super crucial. I'd highlight a couple of things. Look for diversification in this asset class i.e. the funds need to be



diversified. They need to have at least 200 different borrowers in their portfolios in our view. And the largest borrowers should not be more than around one and a half to 2% of the total fund. The second thing that I'd highlight is fees. Fees are always important. Fees can compensate for a lot, specifically in private credit, so look for efficient fees. Third, look for GP's that have really implemented an efficient liquidity management tool. We have talked about liquidity management. As I've mentioned a couple of factors. As I said, look for GPs that have headroom on their leverage, facilities that don't use a lot of public market assets for liquidity management, but instead of that, have a liquidity management bucket in private markets. And I think ultimately also look for a GP with a good and stable track record in this asset class. Which I think varies also here a lot because many of these Evergreen Funds are fairly new. So as a result of that, you need to dig a level deeper and go into the GP's track record as well.

**MV:** Fabian, this has been a fascinating discussion, thank you very much for your time. I hope to be in Zurich this fall, so hopefully we can connect in person then.

**FK:** I'm looking forward to it, thank you very much, Michael, and thanks for giving me the opportunity to be part of the series.

**MV:** Absolutely. We'll have you back again soon.

### *Music*

That does it for this episode of RPM. We've got a lot of great content in our thought leadership library on private debt, evergreens and private debt and evergreens, so be sure to check that out at [StepStoneGroup.com](http://StepStoneGroup.com). As always, please like and follow RPM wherever you like to listen to podcasts. And finally, we're really pleased to announce that this is going to be the first episode of RPM available on our YouTube channel, so be sure to follow us on YouTube as well. Thank you.

