The Rise of Hybrid Funds

August 11, 2022

The lines between closed-end and open-end private investment fund investment structures have blurred in recent years, as managers structure funds to hold illiquid assets in open-end funds and liquid assets in closed-end funds. Commonly called "hybrid funds" or "crossover funds" (herein referred to as "hybrid funds"), these funds possess one or more elements of an open-end fund structure, such as hedge funds, with one or more elements of a closed-end fund structure, such as private equity, private credit and venture capital funds. Investment managers are developing hybrid funds that offer investors the benefit of access to less liquid, but possibly more lucrative, investments, while retaining acceptable levels of investor liquidity. The term hybrid fund can also encompass an investment strategy that pursues both liquid and illiquid securities in a unified portfolio.

Open-end and Closed-end Fund Characteristics

Open-end funds are structured to accept capital and invest that capital for an indefinite term, and investors contribute and withdraw capital at specific, periodic times. The investment manager will typically receive an incentive allocation based on realized and unrealized gains and losses at an annual or other interval. By contrast, closed-end funds are structured to accept and invest capital for a set term, and investors make capital commitments that are drawn down as needed to fund investments. In closed-end funds, there is a set term, investors have no withdrawal rights during the life of the fund, and the investment manager (or its affiliate) receives their incentive allocation or carried interest through a distribution waterfall only on realized proceeds.

Why the Tremendous Interest in Hybrid Funds?

Hybrid funds have become increasingly popular because they (i) provide maximum flexibility for tailoring a product tied to specific investment goals and time horizons, (ii) allow for a structure that is smoother and more efficient with respect to capital inflows and outflows, (iii) overcome the aversion of many investors to side pocket structures, (iv) give the manager access to a broader investor base, and (v) allow the manager tremendous latitude to best invest across the investment cycle and thus diversify returns in an optimal manner.

Strategies that lend themselves to a hybrid fund structure include but are not limited to:

- Activist and opportunistic investments;
- Public equity strategies in sectors where there are compelling private opportunities (e.g., healthcare);
- Credit strategies where assets can be valued but the investments lack liquidity;
- Catalyst-driven strategies;
- Real estate;
- Infrastructure;
- CLOs;
- Investment strategies with long-term investment theses, such as "best idea" and "top-up" funds; and
- Small cap or structured credit strategies involving thinly-traded securities.

Disadvantages of Hybrid Funds

While hybrid funds have many appealing qualities, there are various disadvantages that they present such as: (i) the accounting, operational and valuation requirements of hybrid funds are quite complex, (ii) the unique aspects of hybrid funds raise numerous regulatory and compliance issues for firm management, including with respect to investment allocations and conflicts of interest, (iii) they are highly bespoke structures that appeal to some but not all investors, (iv) the costs associated with establishing and running these funds may be significantly higher than some more "plain vanilla" structures, (v) investors accustomed to traditional hedge or private equity funds may be uncertain as to which of their allocation buckets these funds fit into, (vi) putting together a compelling track record, especially for a first time hybrid fund launch, creates compliance and other challenges, and (vi) the manner in which managers are paid by hybrid funds may complicate how those managers then pay their own personnel.

Hybrid Fund Structuring Trends

While there is no single model for a hybrid fund and they are often somewhat customized, the primary combination of structuring challenges that will need to be considered include (i) valuation, (ii) liquidity terms, (iii) GP compensation arrangements, and (iv) LP onboarding.

I. Valuation

When a fund holds illiquid and hard-to-value assets, addressing on what basis new investors will participate in existing investments when they invest in the fund is a key challenge that hybrid fund managers need to address. The typical hedge fund model provides that new investors participate in investments in the portfolio at current net asset value given the typically liquid and easy-to-value nature of the assets. On the other hand, given the illiquid nature of typical private equity assets, investors in private equity funds that invest at a subsequent closing effectively "buy-in" to an existing portfolio at-cost and pay an "interest charge" to earlier investors to compensate them for financing the existing investments. For hybrid funds that hold illiquid assets, there are generally two broad approaches taken for accepting capital depending on the fund's particular set of circumstances:

- The "evergreen" private equity model which allows new investors to enter the fund periodically, typically by the fund accepting investments in tranches. Rather than buying into existing investments at net asset value or cost plus an interest charge, investors' investments are grouped, or "tranched" with investors who invest as of the same date. Investors investing in the same tranche participate in future investments on a pro rata basis and are not granted exposure to earlier investments. This approach mitigates valuation issues related to admitting new investors. However, depending on the form of the vehicle, having separate traches of assets in the same vehicle raises cross-tranche liability risks.

- Using a hedge fund-like buying mechanism in a private equity style fund. These types of funds have typical private equity structures, but instead of subsequent investors investing at cost and paying an interest charge to the earlier investors as described above, investors enter the fund based on current net asset value (NAV). However, this approach is contingent on the manager being able to value the assets accurately on an ongoing basis and can be administratively burdensome.

II. Liquidity Terms

In terms of the liquidity of hybrid fund structures, the terms are highly bespoke and negotiated. However, generally, managers should seek to align lock-up periods with the anticipated liquidity profile of the fund's assets. It is important to note that a manager should disclose in the fund's offering documents that the liquidity terms are premised on various assumptions and therefore cannot guarantee liquidity in the event of a downturn. There are multiple approaches that exist with regard to liquidity terms:

- Liquidity on a rolling basis. For example, investor A and investor B enter the fund in the same tranche that invests in assets that have a 3-5 year term. Investor A and investor B are provided the option to provide 90 days – 120 days' notice to not roll into or "recycle" their capital into future tranches. Investor A decides to not recycle its capital (will not invest in future tranches) and therefore, investor A receives liquidity as the fund receives liquidity with respect to the original asset investment. This helps the manager to reinvest capital without raising new capital assuming that Investor B is willing to remain invested.

- "Auction"-like mechanism that seeks to find investors that are willing to buy the existing asset in question held by an existing investor in the structure. Existing investors must wait to redeem/withdraw their capital until new investors enter the fund. This approach could, however, create conflicts of interest for the investment manager.

- An investor or fund level gate. Hybrid funds frequently combine a long initial lock-up that is tied to the anticipated life of the investments with a relatively long redemption window where the redemption is tranched out so that the manager and investor have an agreed-upon payment schedule to the investor.

III. GP Compensation Arrangements

The structure of the GP carry is significantly different between an open-end fund structure and a closed-end fund structure, and these different approaches to valuation and incentive allocations create tax challenges for investment managers with hybrid structures. Specifically, an open-end fund typically marks all of its assets to fair market value each year and makes an annual incentive allocation to its general partner based on that valuation. On the other hand, a closed-end fund typically carries its assets at cost and builds its economics into a distribution waterfall under which the investor regains its investment first, the investor may receive a preferred return, and thereafter the general partner will receive a specified percentage return.

While trying to combine open-end and closed-end fund approaches to allocations can be complicated, various structures are possible, assuming they conform with the critical tax requirement to allocate profits on an annual basis.

IV. LP Onboarding

Institutional limited partners, particularly pension plans, tend to have significant processes around approving an investment in a private fund. Where funds have relatively short terms (e.g., may credit funds), limited partners who invest in successor funds may be required to undergo their fund investment approval processes ever two to three years, potentially straining their resources. To address this issue, increasingly, we have seen limited partners discuss fund structures with managers with longer, or even evergreen, investment periods with significant reinvestment rights, reducing this tension.

S&K Observations

Hybrid structures offer flexibility that can be beneficial to both investors and managers, however, there are challenges associated with these funds of which managers need to be aware.

Seward & Kissel LLP, and our compliance consulting service SKRC (Seward & Kissel Regulatory Compliance), are available to assist advisers with the issues discussed herein.