Seeking Simplicity in Private Real Estate and Credit

June 2024

As more individual investors try to figure out how to add alternative investments to their portfolios, fund managers are innovating on simpler fund structures. One of the biggest product trends seen from these managers are evergreen funds. These fund structures are individual investor-friendly in that they typically offer periodic liquidity and are perpetually offered. From a niche product a decade ago, these funds now account for nearly $500 billion in assets and are on their way to becoming an important part of the alternative investment offerings into the wealth management channel.

Historically, alternative investments have been limited to the upper end of the wealth spectrum where only certain investors can commit to traditional, closed-end drawdown funds. Drawdown funds typically have a finite fundraising window, require a minimum commitment amount in the millions of dollars, make capital calls over multiple years, and generally have a fixed term of about a decade. These attributes require tolerance in withstanding the tendencies of a J-curve return and also create logistical hurdles from making sure an investor's timing lines up with the fundraising window to managing cash flows for capital calls over multiple years, not to mention that these traditional GP-LP structures produce a K-1 for tax reporting, which can come months after the mid-April filing deadline.

Evergreen funds solve many of these challenges by offering mutual fund-like features: a continuous capital raising process (no fundraising window), lower minimums, upfront investments (no capital calls), and no defined start or end date. Additionally, they come with streamlined 1099 tax reporting for enhanced ease of use.

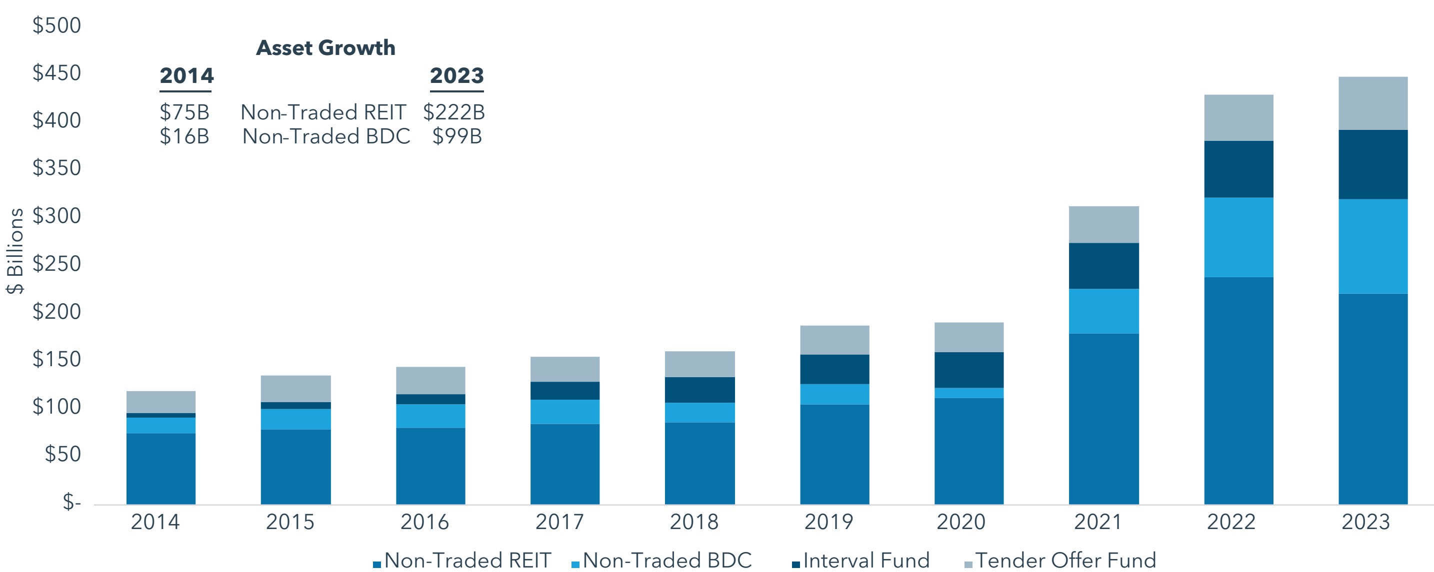
The most commonly used structures for exposure to core/core plus real estate and middle market direct lending private credit are through non-traded real estate investment trusts (REITs) and non-traded business development corporations (BDCs).

INCOME-PRODUCING NON-TRADED REITS AND BDCS

The goal of these funds is straightforward – to provide investors with exposure to income producing private real estate or credit. In fact, both REITs and BDCs are required to distribute 90% of their net income. An added benefit to the income-producing nature of these underlying assets is how they provide added liquidity through redemptions, typically on a quarterly basis. As compared to traditional, closed-end drawdown funds that pursue similar strategies, we've observed that investors in BDCs may only be giving up approximately 1% of net returns in exchange for enhanced flexibility. On the real estate side, even funds

Exhibit 1: The Growth in Non-Traded REITS and BCDs Validates the Product Innovation

Registered fund assets under management by structure



Source: iCapital, SEC filings. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

targeting the upper end of the wealth spectrum for core and core plus strategies utilize an open-ended structure.

Proof of the benefits of these structures is seen in fund flows. Non-traded REITs and BDCs have taken hold in the wealth channel and now account for over $300 billion in assets under management, or roughly 70% of the space. Non-traded BDCs have seen some of the fastest growth, with a five-fold increase since 2019 to $100 billion in assets.

Even with individual investor-friendly attributes, the liquidity of these funds is considered semi-liquid, as it's limited and at the discretion of the manager. Most funds offer quarterly liquidity of up to 5% of net asset value (NAV); if this 5% threshold is exceeded, then investors may be rationed back on a pro rata basis until their request is fulfilled. This is designed to offer investors opportunities to cash out while also protecting other investors in the fund who do not wish to redeem. Said another way, these funds are intended to be longer term investments with a quarterly redemption option that is intended to prevent a "run on the fund."

The ability for these funds to meet redemption requests ultimately will prove their merit — in validating that the products work as designed. Following an up and down 2021 – 2024 period in public market equity and real estate valuations, several non-traded REITs that saw a rush in redemption requests were able to fulfil all requests while others are still working through a backlog. There's always the possibility that a fund can't meet all investor redemption requests, especially when they come in waves. In such cases, these fund structures could face a mismatch in assets and liabilities. But to date, we've observed that a majority of funds are performing as expected.

Continued product innovation with evergreen products is helping investors gain exposure to the private markets in a simpler structure relative to drawdown funds. As time goes on, we may even start to observe certain institutional investors utilizing evergreen funds for parts of their private real estate and credit exposure, which would further validate the evolution and democratization of the market.

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