Walkers

Fundamentals

Trust in Challenging Times

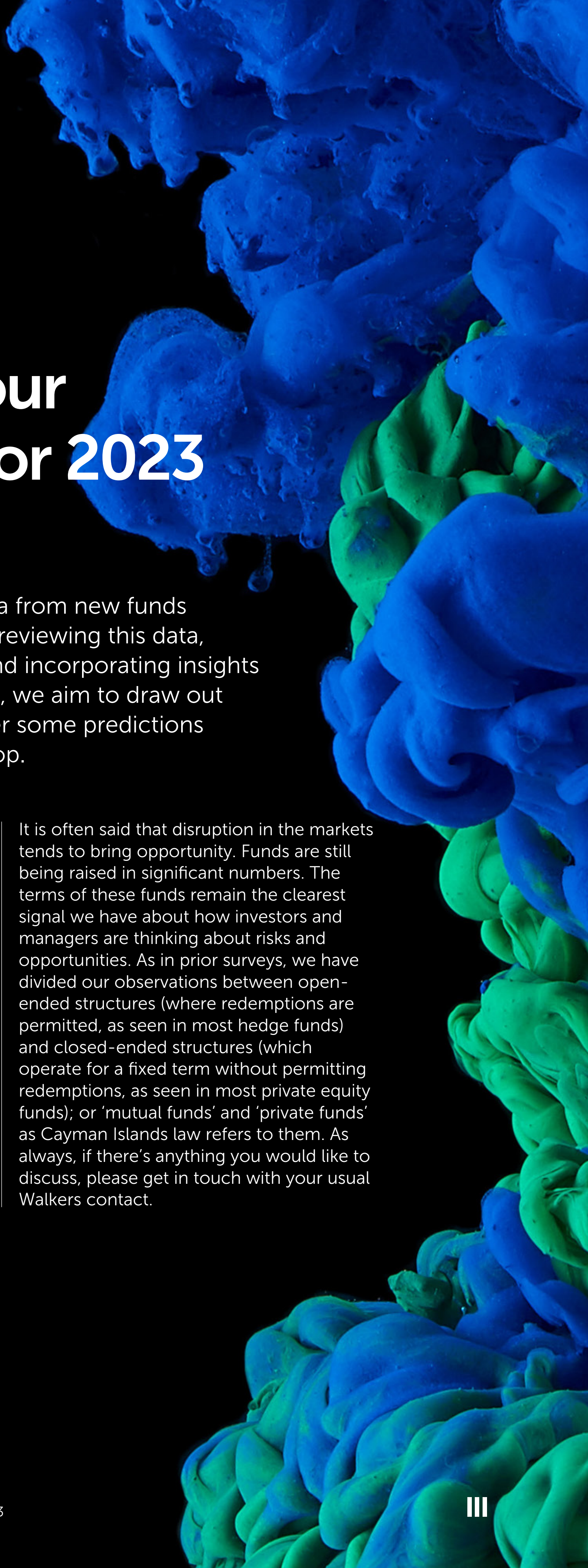
White Paper | 2023

Welcome to our White Paper for 2023

Every year, we track certain key data from new funds that we help our clients launch. By reviewing this data, comparing it with similar surveys and incorporating insights from our conversations with clients, we aim to draw out the key themes of the year and offer some predictions about how these trends may develop.

After several years of dislocations, this year has been no exception. Supply chain issues gave way to inflation not seen since the 1980s, and the response by central banks and governments around the world has been swift. Sadly, the year has been beset by geopolitical tension, conflicts and wars, the like of which we have not seen in years. With election years ahead in the United States, Russia, India, the European Parliament and the UK, politics is likely to lead much of the news in the coming months, and the complex interaction between these macro factors and the markets is likely to continue to be an area of focus for the investment funds industry.

It is often said that disruption in the markets tends to bring opportunity. Funds are still being raised in significant numbers. The terms of these funds remain the clearest signal we have about how investors and managers are thinking about risks and opportunities. As in prior surveys, we have divided our observations between open-ended structures (where redemptions are permitted, as seen in most hedge funds) and closed-ended structures (which operate for a fixed term without permitting redemptions, as seen in most private equity funds); or 'mutual funds' and 'private funds' as Cayman Islands law refers to them. As always, if there's anything you would like to discuss, please get in touch with your usual Walkers contact.



Strategies: debt for equity swap?

According to data from Preqin, equity strategies suffered the most significant losses in 2022, and experienced some of the largest outflows of investor capital across the industry[1]. The challenges facing equity funds in 2022 have been well documented.

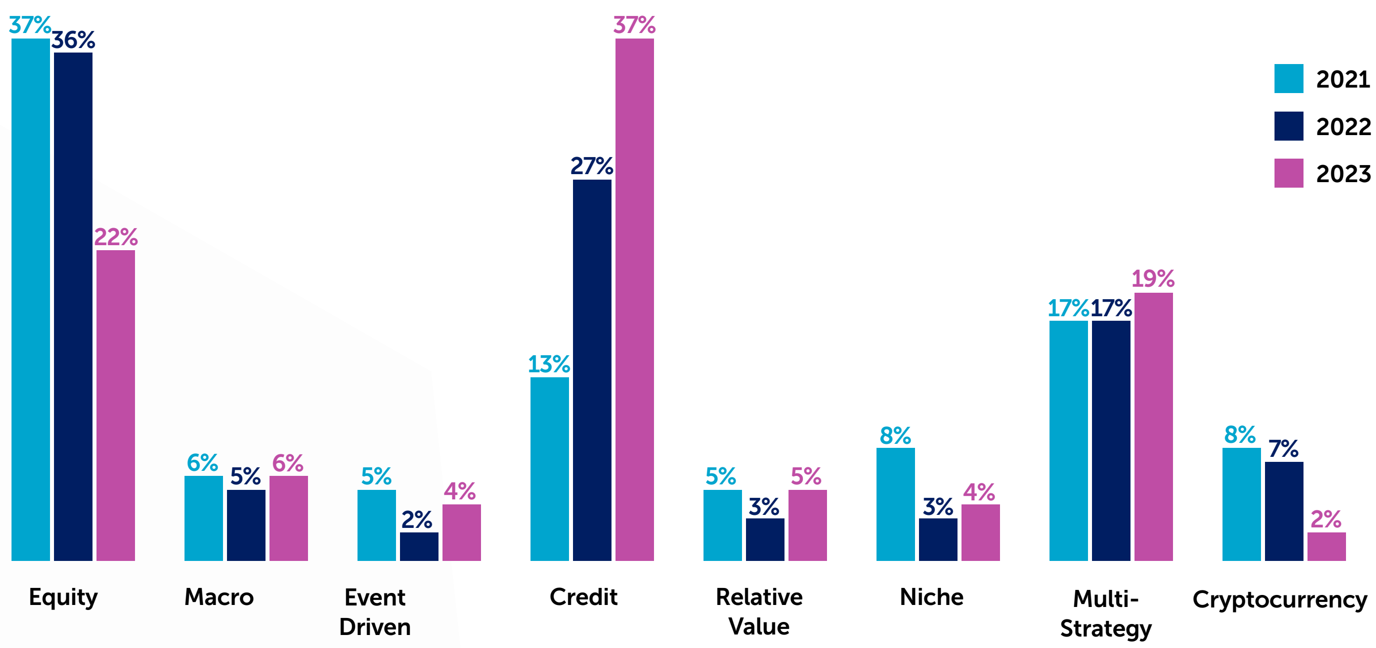
Global inflation, and central banks' efforts to control it by raising interest rates, has impacted all sectors, and particularly those companies that have relied on lower interest rates. The continued geopolitical tensions and disruptions have also posed a significant challenge. As our data represents funds launched in the last twelve months, these pressures saw slightly fewer equity-focussed funds launch this year relative to other strategies.

Will this continue? Inflation data (especially in the US), together with signals from the Federal Reserve that rates could remain higher for longer with some rate cuts by mid-2024, may offer hope of a revival in equity fund launches in the year to come.

Higher interest rates have put pressure on all borrowers, but this has been felt especially keenly by borrowers regarded as higher risk. Credit funds, especially those focussed on distressed debt, have therefore seen a number of opportunities to structure solutions for these borrowers, while also enjoying increased returns from the higher yields such deals typically offer. This too is reflected in our launch data: credit funds represent the largest increase in fund launches this year, and we expect while rates remain high (relative to the last decade or so, at least) they will continue to form a significant portion of our instructions.

[1]Preqin Global Report 2023: Hedge Funds

Hedge Fund Strategies



Fund liquidity depends on the details

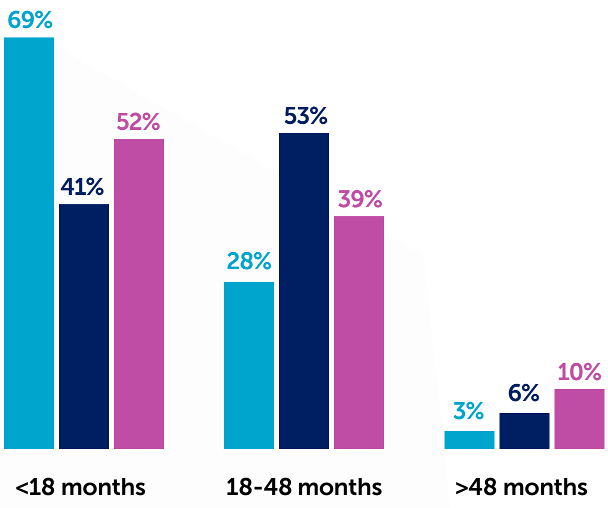
In previous White Papers we have observed the careful management of liquidity profiles among our funds, with increasing use of lock-ups, gates and other mechanisms to ensure a fund's liquidity follows the liquidity profile of its underlying assets.

When asset prices become more volatile, as in recent years, it should follow that this balancing act becomes more important and more difficult. It is in neither investors' nor managers' interest to expose funds to the risk of having to make significant portfolio sales at a time where markets are volatile.

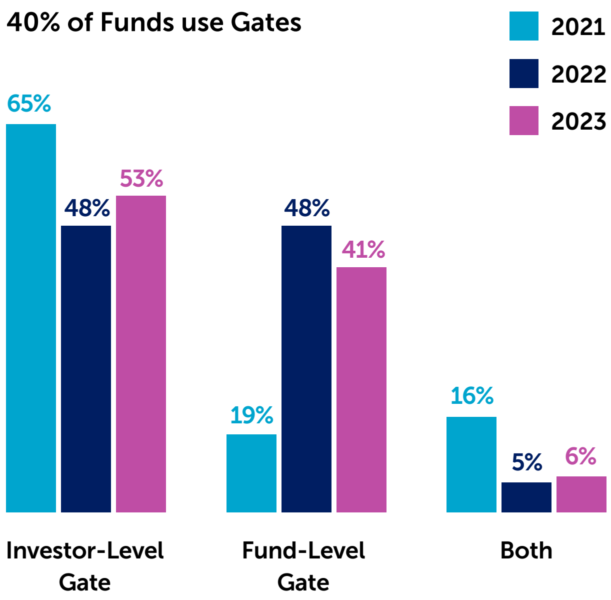
The traditional tools to mitigate these risks are lock-ups – where investors may not redeem their interests until they have held them for a designated period (or may do so subject to a deduction from their redemption proceeds) – and gates, which serve to limit the amount of redemptions a fund will process on a given redemption date, either on a fund-wide or per-investor basis. Among our surveyed funds this year, about 40% of funds used lock-ups of some form, and about 40% used gates. For funds that hold assets that might conceivably become illiquid, 'side-pocketing' and other liquidity management tools that allow the fund to separate problem assets from the broader portfolio in a manner that is fair to all investors and safeguards the fund's continued operations, are also important.

The stability of these figures over time makes it tempting to draw the conclusion that the industry has landed upon an 'agreed position' in relation to these matters. However, as any start-up manager will readily confirm, these matters often do not feel agreed in early-stage discussions with investors. The details matter: the anticipated portfolio, the breadth of the investment discretion, the nature of the investor base, and – ultimately – what the investors and the manager agree.

40% of Funds use Lock-ups



40% of Funds use Gates



Governance: regulatory reflection of best practice

This year, CIMA issued new rules and guidance about how they expected regulated entities to be governed. As a result, we have spent time with our clients helping them evaluate their governance arrangements to ensure they remain compliant with the rules and aware of industry best practice.

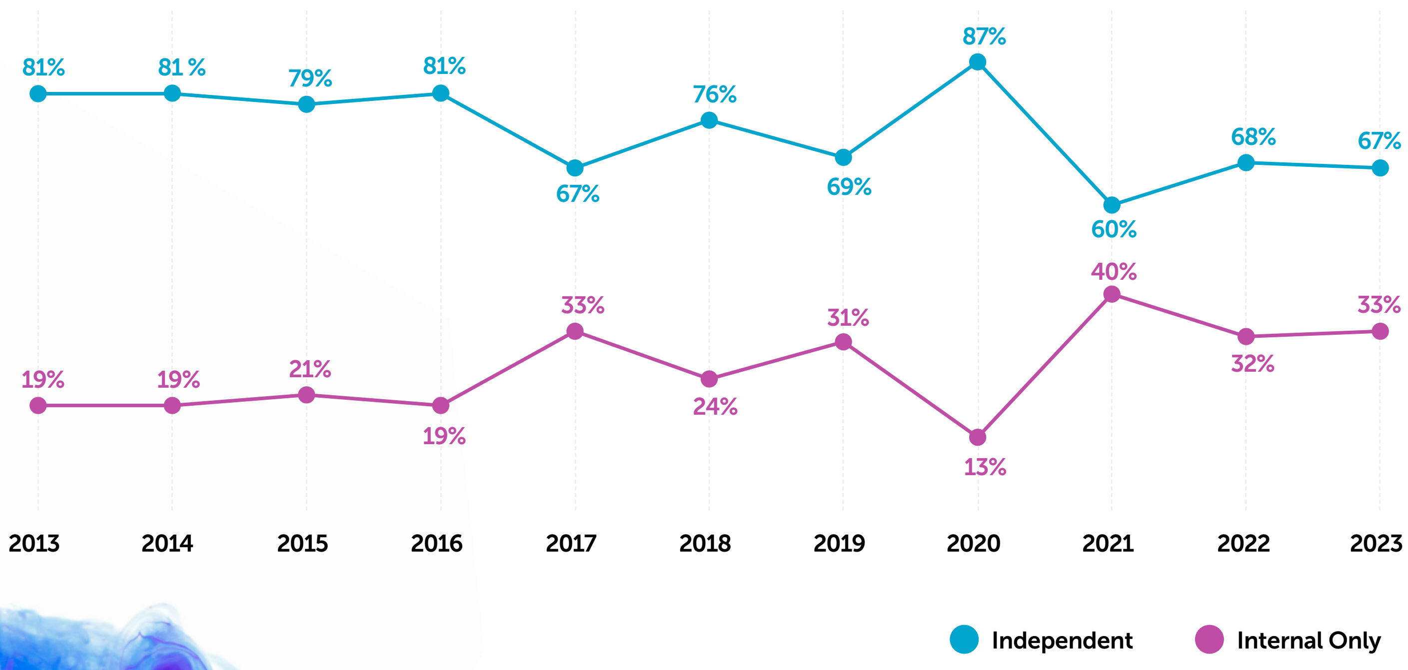
For the vast majority of our hedge fund clients, the rules represent a codification of where the industry has been operating for many years, and a helpful validation from CIMA (who consulted extensively with industry on the rules) of what they already do.

While Cayman Islands funds are not required to appoint directors that are independent of the investment manager – a position wholly unchanged by CIMA's new rules – many mutual funds choose to do so. We have tracked this data for over ten years, and for most of those years, around 75% of hedge funds on average have included one or more independent directors on their board. In more recent years, we saw a mild decline in the number of funds appointing independent directors – the average over the last three years is closer to 65%, and this year's figure (68%) continues this trend.

What could explain this decline? One possibility is the emergence of novel strategies and asset classes, such as crypto / digital assets funds, where governance has traditionally been handled internally.

Today, this explanation is less convincing, because the Cayman Islands now have a number of independent directors and other specialist service providers serving this sector. Possibly as the median hedge fund manager has become more institutional in scale, supported by a robust regulatory framework, investors have been more comfortable relying on internal governance. Three years of data is perhaps not yet enough to call a 'new normal', so we will continue to watch these statistics with interest.

Board Composition

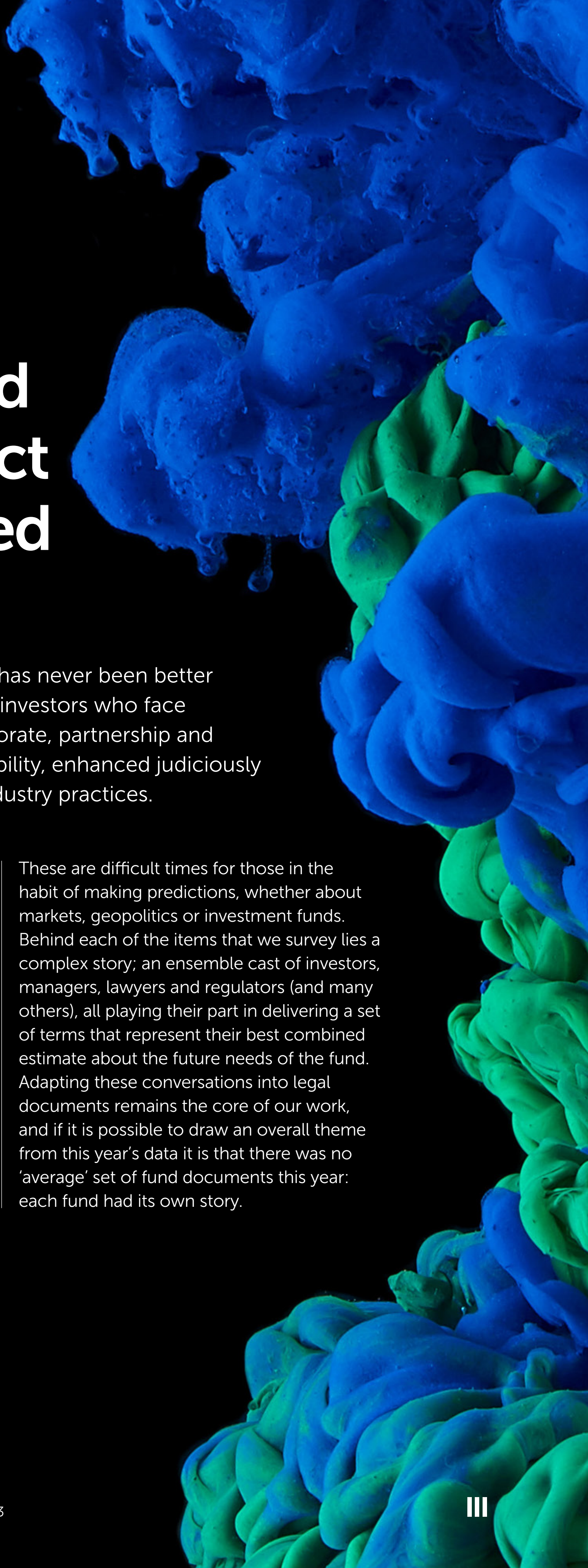


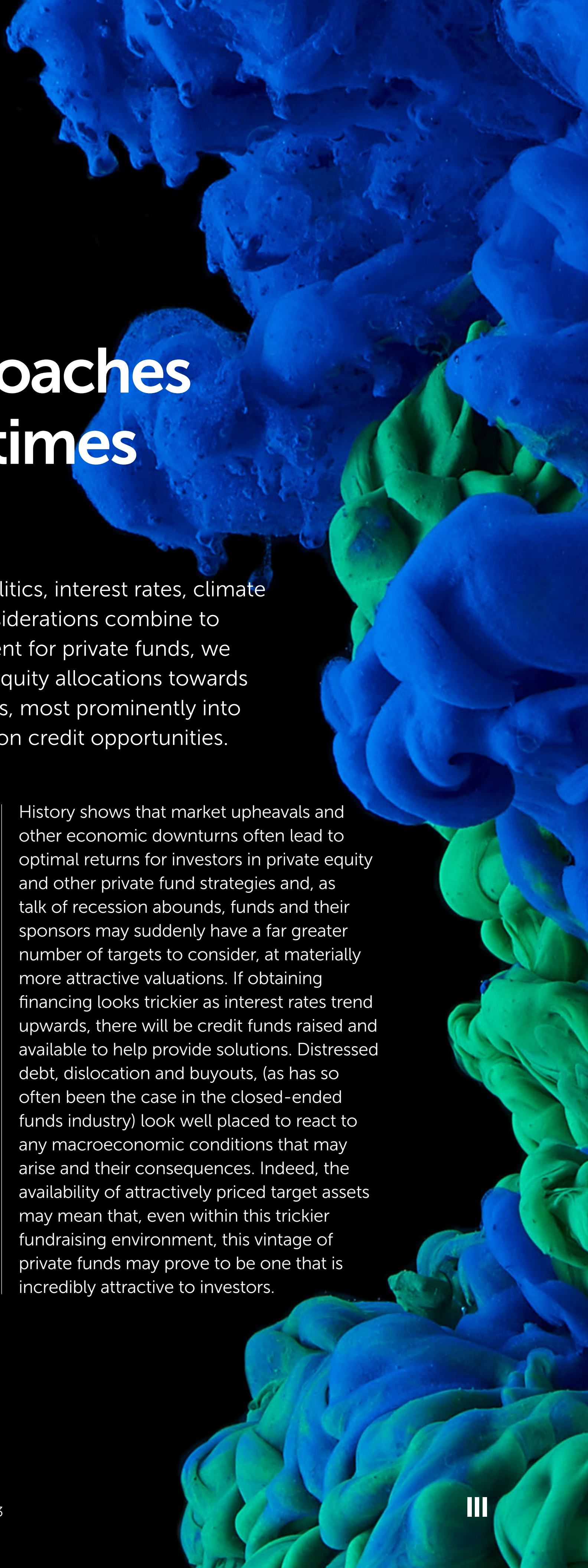
Looking ahead to 2024: expect the unexpected

In many respects, the Cayman Islands has never been better positioned to welcome managers and investors who face operating in turbulent times. Our corporate, partnership and trust vehicles retain their inherent flexibility, enhanced judiciously over the years to support emerging industry practices.

Our regulatory framework remains robust and recognised as such by international organisations, while offering a predictable and commercial environment for funds and their operators. Overall, the Cayman Islands maintain their longstanding approach of offering world-class service providers for clients, while not imposing any particular operating model on managers. The Islands' determination to retain its leading position among international financial centres is one theme we are confident will remain the case in 2024 and beyond.

These are difficult times for those in the habit of making predictions, whether about markets, geopolitics or investment funds. Behind each of the items that we survey lies a complex story; an ensemble cast of investors, managers, lawyers and regulators (and many others), all playing their part in delivering a set of terms that represent their best combined estimate about the future needs of the fund. Adapting these conversations into legal documents remains the core of our work, and if it is possible to draw an overall theme from this year's data it is that there was no 'average' set of fund documents this year: each fund had its own story.





Private funds: evolving approaches for turbulent times

As macro conditions shaped by geopolitics, interest rates, climate change, demographics and other considerations combine to weigh on the capital raising environment for private funds, we have seen investors shift their private equity allocations towards strategies offering more reliable returns, most prominently into private funds with strategies focussed on credit opportunities.

There has in addition been a consistent increase in activity on individualised arrangements such as funds-of-one and co-investment funds. This may have an impact on broader private fund terms and conditions going forward as investors bring their expectations from such arrangements to more widely offered fund vehicles, both by way of side letter but also in the relevant constitutional documents themselves. Equally, as some institutional investors and other traditional sources of capital readjust or meet their private equity allocations managers are seeking to tap new investor pools, both geographically and by establishing access funds and other structures targeted at private wealth and even, in certain circumstances, considering more retail focussed products. Secondaries have also seen increased attention as the market responds to shifting allocations.

History shows that market upheavals and other economic downturns often lead to optimal returns for investors in private equity and other private fund strategies and, as talk of recession abounds, funds and their sponsors may suddenly have a far greater number of targets to consider, at materially more attractive valuations. If obtaining financing looks trickier as interest rates trend upwards, there will be credit funds raised and available to help provide solutions. Distressed debt, dislocation and buyouts, (as has so often been the case in the closed-ended funds industry) look well placed to react to any macroeconomic conditions that may arise and their consequences. Indeed, the availability of attractively priced target assets may mean that, even within this trickier fundraising environment, this vintage of private funds may prove to be one that is incredibly attractive to investors.

Market familiar structures offer some stability

The Cayman Islands Private Funds Act (the "PFA") is now firmly embedded into the Cayman fundraising process. The user-friendly registration process and pragmatic disclosure and ongoing obligations have allowed private fund registration numbers to remain positive, further consolidating Cayman's position at the top of the offshore funds market.

Private Funds

The PFA regime has continued to mature, with the new rules and guidance issued by CIMA and mentioned above now also applying to the ongoing operation and governance of private funds.

The new regulatory measures were finalised in consultation with industry and typically look to codify and fine tune what is existing best practice in the market, thereby providing additional clarity and cogency in respect of minimum corporate governance expectations.

Cayman Islands exempted limited partnerships ("ELPs") remain the vehicle of choice for Cayman Islands closed-ended funds. Cayman Islands exempted companies were again the most common general partner vehicle, followed by Delaware limited liability companies or other foreign companies. The continued stability of this data can be seen as indicative of both the continued success of ELPs in the market and their efficacy as private fund vehicles, as well as a reflection of the prevalence of successor funds which mirror the structures of their predecessors.

ELPs continue to insist on significant sponsor commitment, either on a percentage or absolute number basis, or a hybrid model where the higher of either condition is required to be committed.

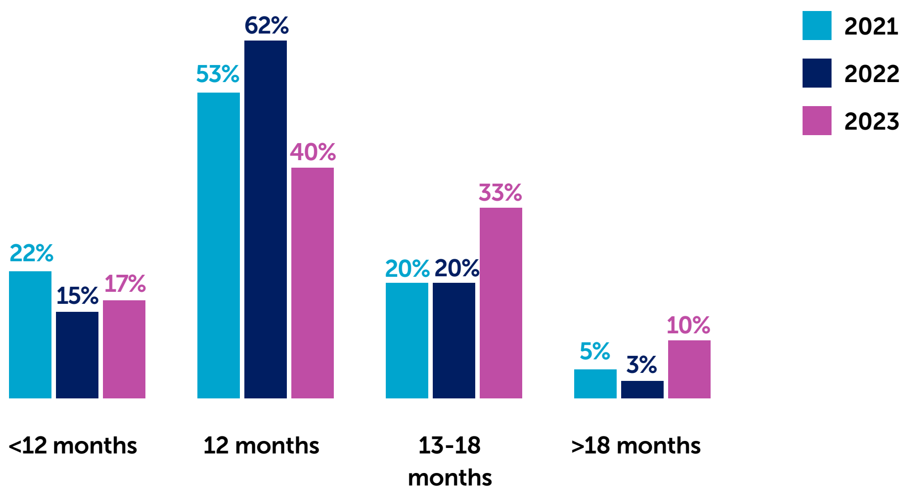
The criteria and underlying numbers vary widely, with percentage-based or hybrid requirements being marginally more popular, reflecting an appreciation that the size of the GP commitment should reflect the size of the fund. Regardless of the specific terms of the required commitment, the overarching theme remains the importance of managers and sponsors having significant "skin in the game" to further align their interests with those of their investors in a tangible, and visible manner.

A challenging capital raising environment

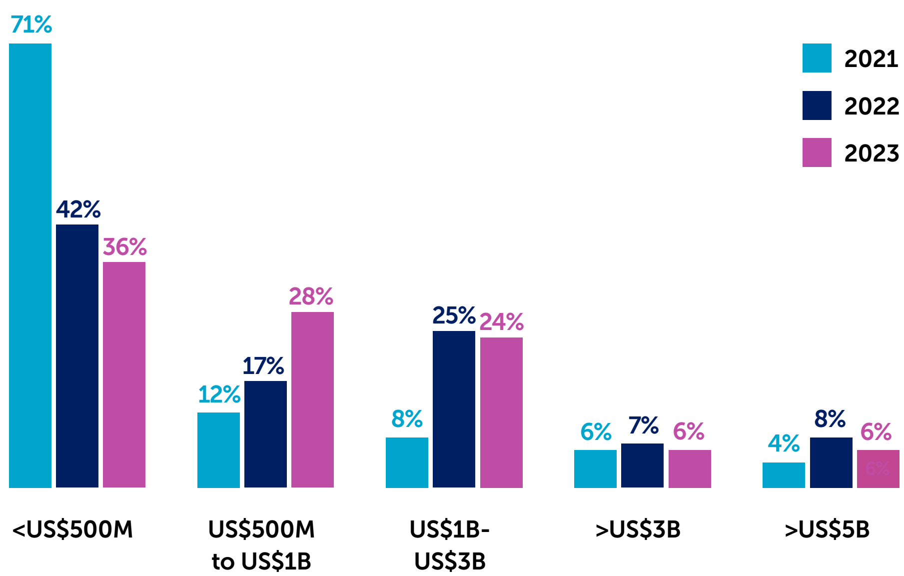
While twelve months remains the most common fundraising period, a considerable swing towards fundraising periods up to and beyond 18 months demonstrates expectations of a difficult capital raising environment.

That being said, as we have seen above registration numbers under the PFA indicate that private fund formation activity in the Cayman Islands has remained strong. We have seen some sponsors raising their first ever Cayman funds, although in the current environment new entrants are slightly less common than in previous years. The more challenging fundraising landscape is further illustrated by data in respect of fund target size, where a fall in sub $500m funds reinforces the thesis that new market entrants are finding it difficult to attract capital. The mid-market up to $1bn has fared better as managers who raised smaller funds in busier times have successfully raised successor funds, often targeting larger aggregate commitment amounts. Multi-billion dollar funds with established managers continue to attract investors and raise capital.

Fundraising Period



Fund Target Size



Private credit to the rescue

In a continuation of 2022 trends, funds operating investment strategies focused on debt and private credit have gone from strength to strength as market conditions draw ever greater numbers of investors to the sector.

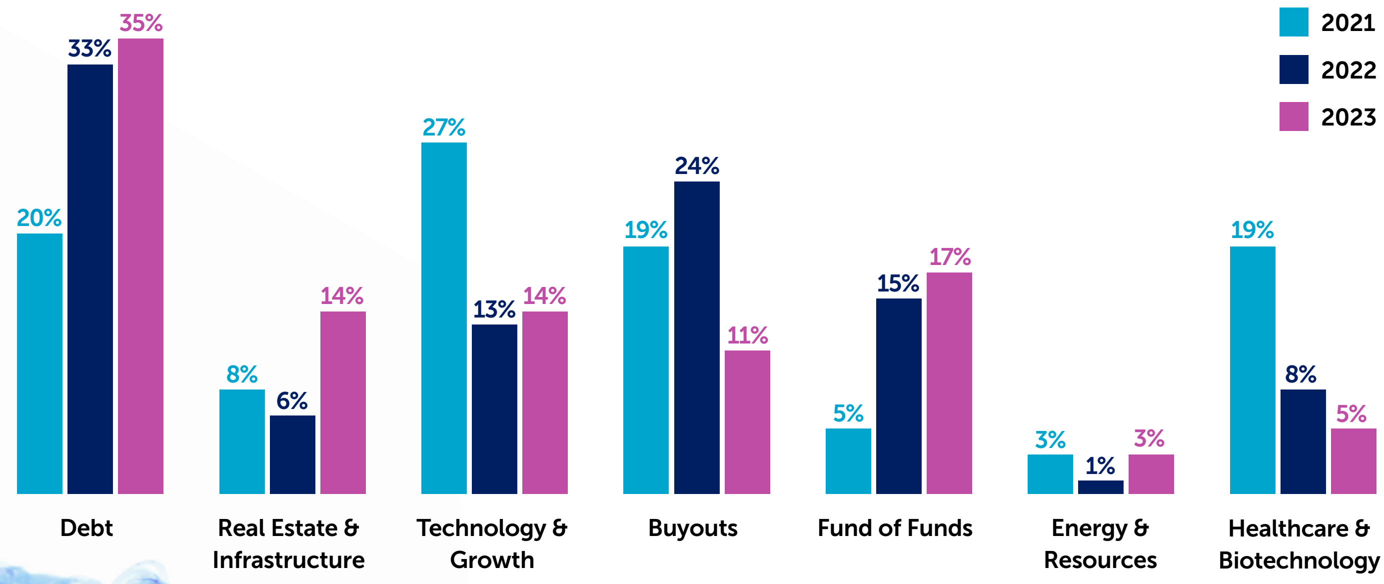
Buyout funds by contrast have been slightly less prevalent, both in absolute and relative terms, from the highs of 2021 and 2022, reflecting macro conditions and higher interest rates. It is possible however that we may see a revival in certain sectors if and when the IPO market threatens to heat up again, particularly with the financing options made available by private credit funds potentially assisting their buyout peers in structuring and executing deals.

Funds focussed on technology and growth or healthcare and biotechnology have become a lesser feature of the fundraising landscape in the wake of 2021 successes, their popularity fading in parallel with the particular market conditions generated by the pandemic. Conversely, the stable, often government backed, returns offered by infrastructure funds have supported a rise in successful launches focussed on that asset class, a trend we would expect to continue as credit funds become attracted to opportunities in this sector.

A number of managers have come to market with funds focussing on GP stakes, as asset managers themselves look to generate liquidity for their principals and founders. The year has also seen smaller funds with more esoteric strategies such as litigation funding and even fine art manage to raise capital.

While funds with an Asian or globally focussed investment strategy have remained popular, the stability and depth of the North American market remains ever attractive to investors, with slight shifts away from most other geographic regions. Of particular note was another slight uplift in the proportion of funds focussed on the European market, while the data suggest Asian investment strategies remain popular, albeit slightly less so than in recent years.

Investment Industry Sector



A long time's a good time

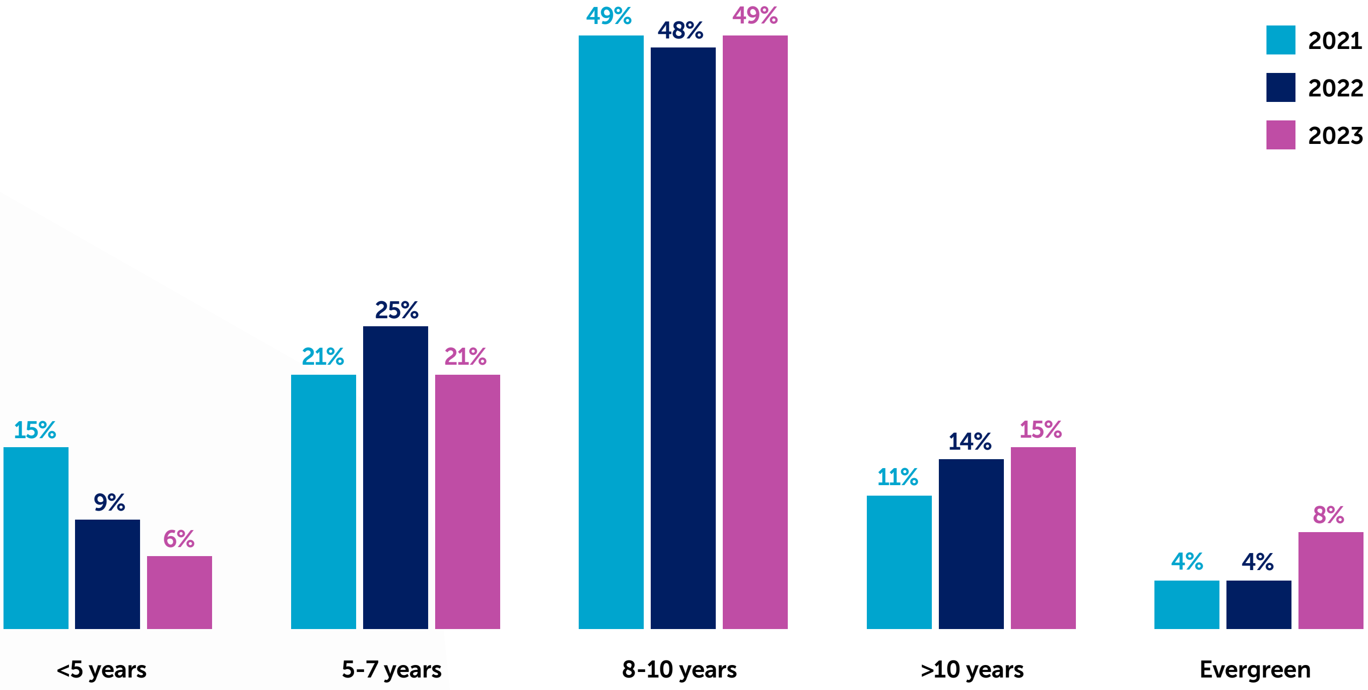
8-10 year terms retain their position as the most common term for private funds generally.

Longer term and evergreen funds are increasingly popular with certain managers and investors. In general, the relative lack of movement in the fund term statistics may reflect the number of successor funds launched this year and an unwillingness to deviate too materially from the key provisions of predecessor funds, as well as a more difficult environment for new market entrants. Continuation funds have also provided an additional tool in the arsenal for GPs looking to maximize exit potential when approaching term ends.

Similarly, the statistics around the ability to extend fund terms remain broadly unmoved, with two consecutive one-year extensions remaining the most popular option alongside various other multi-year extension formulations with differing consent requirements. This, alongside increased incidence of fund terms over ten years and evergreen funds, is suggestive of managers anticipating a weaker exit environment as a projection of current macro dynamics.

Whether through general partner-led secondaries, continuation funds or by enshrining longer extension options in the fund documents, we expect managers will continue seeking to maximise potential exit strategies in uncertain market conditions.

Fund Duration

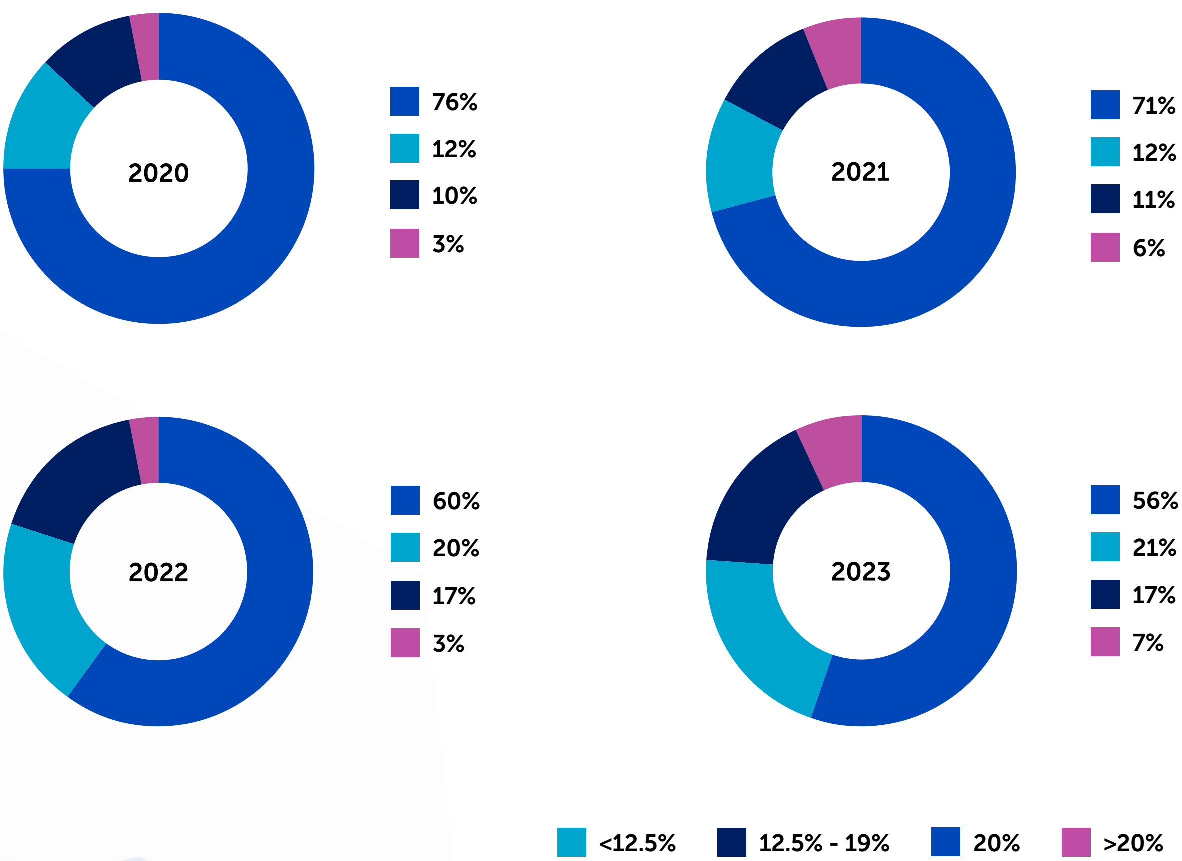


Twenty is plenty

The most frequently reported carried interest rate continues to be 20%, albeit with a distinct increase in the number of managers accepting carry rates under 20%, sometimes matched by lower hurdle rates or tailored carry arrangements reflecting particular investment strategies.

Similarly, staggered rates dependent on factors such as size or timing of commitment remain present in the market, particularly for first-time managers who are most likely to have to drop below 20% in the current fundraising environment.

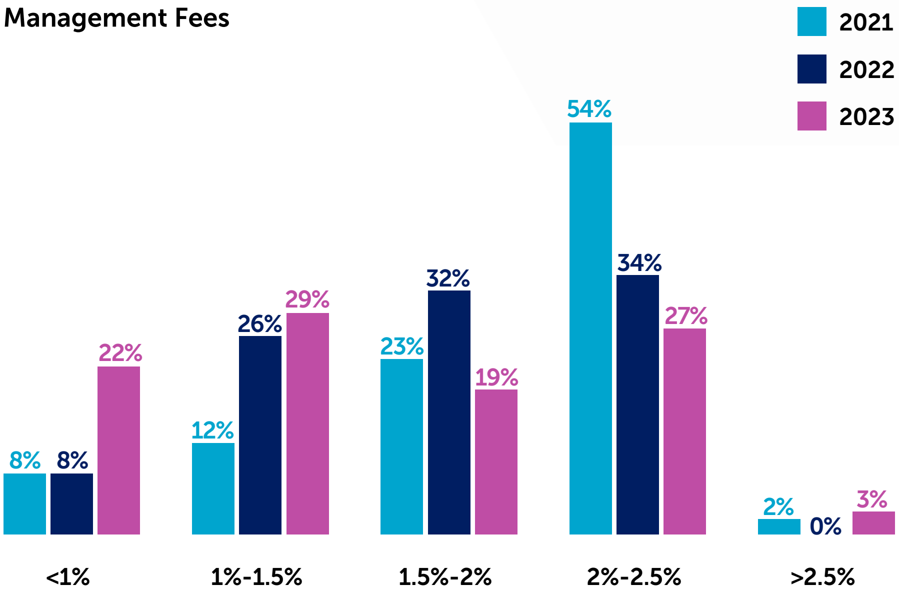
% Carry Entitlement



Twenty is plenty (cont.)

Management fees have also continued their downward trend as investors continue to push for lower costs and value for money in their private fund investments, with fee rates now frequently lower than the traditional 2% rate of earlier years, as fee reductions migrate from individual side letter arrangements to the main fund documents.

Management Fees



Over half of the funds surveyed now feature a management fee below 1.5%, a clear reversal of 2021 and 2022 data. To some extent this may reflect market rotation to debt and private credit funds with different fee dynamics given differing return expectations but, in general, it is hard to escape the conclusion that this fee pressure will remain a presence over the next few years at a minimum.

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