

DECODING PRIVATE MARKETS

**EVERGREEN
FUNDS:** A DEEPER
LOOK INTO THE
REASONING – AND
RISKS – OF USING
LEVERAGE



EVERGREEN FUNDS: A DEEPER LOOK INTO THE REASONING – AND RISKS – OF USING LEVERAGE

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At Pantheon, we don't use NAV-backed leverage in our evergreen strategies, although we do use fund management tools such as liquidity facilities. However, it is increasingly common for other GPs to rely on leverage, and discerning investors need to understand the dynamics involved and their impacts.

“Give me a lever large enough and I can move the world.” While Archimedes may not have specifically been referring to acquisition leverage in his famous quote, he did identify how important leverage can be to direct lending funds, amplifying returns when managed well, but magnifying risks when market dynamics shift.

Acquisition leverage is used by credit funds to amplify their purchasing power. Through leverage, an entity can acquire more loans than its equity base alone would permit. For semi-liquid direct lending funds that invest primarily in senior secured loans or similar credit assets, leverage can help to boost returns but also adds complexity.

The process works as follows:

- The fund raises equity from investors.
- It then borrows capital, often from banks or institutional lenders, using the loan portfolio as collateral.
- This debt is deployed alongside equity to buy loans, increasing total assets under management.

In a semi-liquid direct lending structure, leverage can:

- Enhance yield: leverage can magnify income, since interest earned on loans often exceeds the cost of borrowing.
- Impact duration and liquidity: semi-liquid funds often offer periodic liquidity (quarterly or semi-annual windows), but leverage introduces refinancing and maturity risks.
- Allow for dynamic adjustments: fund managers may adjust leverage ratios in response to market conditions, portfolio performance, or regulatory requirements.
- Be affected by coverage ratios: lenders require certain debt-service coverage ratios to limit risk, which constrains the maximum leverage of a transaction and triggers deleveraging if breached.

Evergreen funds: a deeper look into the reasoning - and risks - of using leverage

A declining rate environment changes the dynamics around an acquisition transaction in subtle, but important, ways:

- Variable rate loan income may decline: most direct lending assets are floating rate and so often tied to benchmarks like LIBOR or SOFR plus a spread. Lower central bank rates typically mean lower coupon income, reducing the yield on the underlying loan portfolio. In turn, a wealth investor in a semi-liquid fund with a target coupon figure in mind may end up disappointed, leading to potentially higher redemption risk.
- Leverage cost dynamics: while the interest expense on floating-rate borrowed capital often adjusts downward with central bank rates, some fund-level debt may have fixed components or floors, limiting cost reduction. This can compress the net interest margin available.
- Refinancing risks and reset terms: if leverage is renewed or rolled over during lower rate periods, funds might be refinanced on less favorable terms if market conditions deteriorate or if lender appetite wanes.
- Potential pressure on coverage ratios: reduced loan income may challenge debt covenants and coverage ratios, potentially forcing early deleveraging or asset sales. This can disrupt portfolio management and returns.

For wealth investors, leverage creates key risks to consider in a shifting rate environment:

Risk	What it means
Income compression	Lower floating rates reduce cash flow, which impacts distributions and reinvestment capacity.
Leverage mismatch	If borrowing costs don't fall as much as loan income, net returns may suffer.
Liquidity risk	If leverage must be reduced quickly due to covenant breaches, funds may have to sell assets at unfavorable prices.
Market volatility	Rate moves can coincide with credit market stress, increasing defaults and impairing loan valuations.
Extension risk	Lower rates may slow borrower prepayments/refinancing, extending loan maturities and duration.

These challenges are not insurmountable though, and fund managers can navigate them in several ways. Active liability management allows them to stagger and diversify their debt maturities and structures to avoid refinancing cliffs, while ensuring that leverage targets are conservative enables them to maintain coverage buffers that can absorb income fluctuations. Managers should ensure that their redemption policies are flexible and allow for liquidity windows that reduce the need for forced sales, while hedging strategies such as interest rate swaps or caps can manage exposure.

And of course it goes without saying that managers should always be focused on investing in the highest-quality assets, prioritizing resilient borrowers that offer strong investor protections via robust covenant packages.

A double-edged sword

While acquisition leverage in a semi-liquid direct lending fund can be a powerful tool to enhance returns, it also adds a layer of complexity and risk, especially in a changing interest rate environment. With central banks on the cusp of moving rates down, the interplay between loan income, borrowing costs, and refinancing dynamics can be central in determining how any semi-liquid credit exposure performs.



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