Aksia

Perverse Incentives

INTRODUCTION:

One reason the private markets industry has generally performed so well for decades is that much of a manager's remuneration tends to be aligned with investor returns. This alignment is accomplished via "incentive fees," whereby the manager of a fund receives a portion of the positive return of the fund. If the investor earns strong returns (typically needing to be above a hurdle rate[1]), then the manager receives a portion of those returns. However, if the fund has negative returns or returns below the hurdle rate, then the manager does not receive any incentive fees whatsoever.

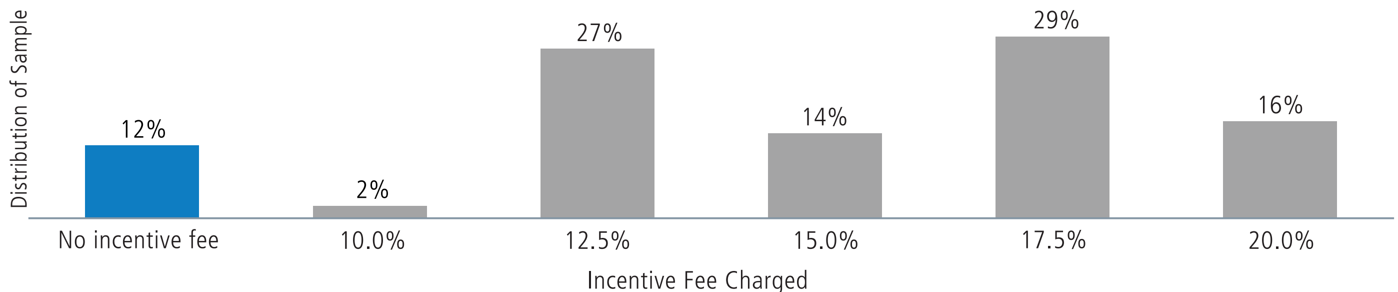
REGISTERED PRIVATE CREDIT FUNDS:

In this paper, we examine how the concept of an incentive fee is used in today's registered private credit funds industry. How common are incentive fees in registered private credit funds?

The data below represents all registered private credit funds with over $1 billion in net asset value as of 6/30/24 (51 funds). Collectively, this sample includes over $191 billion in NAV, representing over 80% of the total market.

As you can see below, 88% of these registered private credit funds charge an incentive fee, which ranges anywhere from 10% to 20%, and averages in at 15.8%.

Level of Income-Based Incentive



Source: SEC Edgar Database

Where things get interesting is looking at how these incentive fees are structured. Of the funds that charge an incentive fee, 80% of them do not "net" interest income versus capital gains/losses.

Terms of Income-based Incentive Fees

Source: SEC Edgar Database

[1] Hurdle Rate: The minimum return that a fund must achieve for investors before the manager can share in the profits

WHAT IS NETTING?

Netting (with respect to incentive fees) is typically the norm in private markets and refers to the gains and losses from all of a fund's investments being netted together into one fund-level gain (or loss) which is then used to calculate the manager's incentive fees. Netting aligns an investor's outcome with that of the manager.

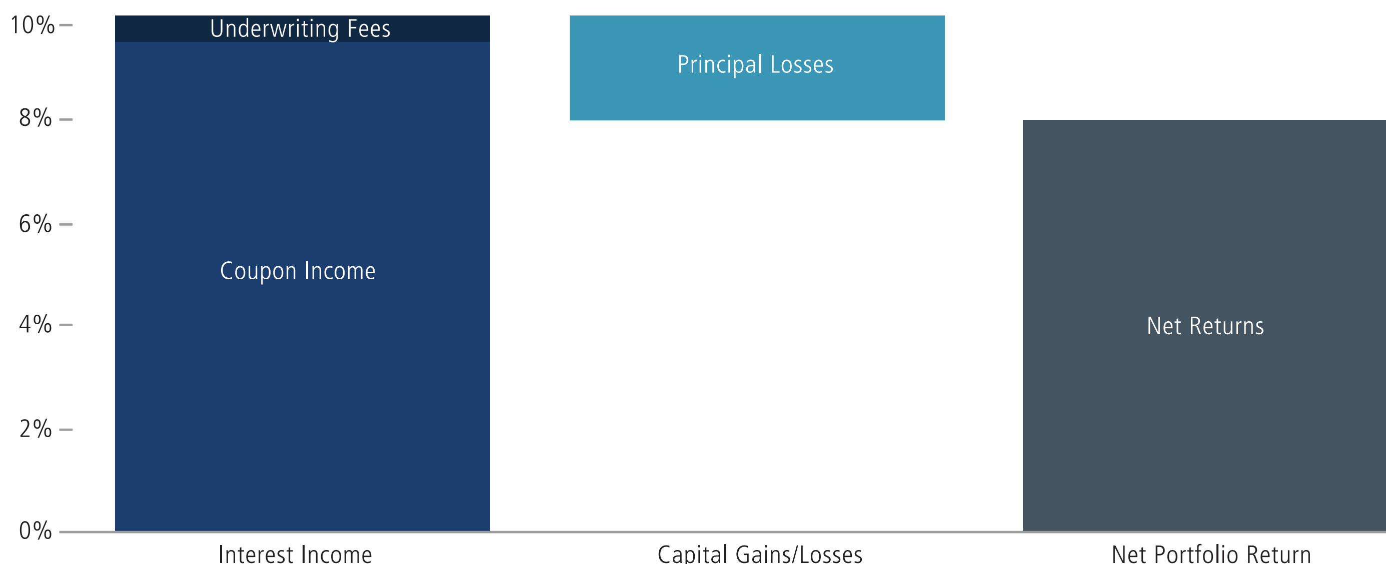
Non-netting incentive fees creep up differently in private equity versus private credit funds.

In private equity funds (not today's topic), non-netting is typically done by having incentive fees charged on individual investments as opposed to on the "net" returns of all investments. This results in investors incurring incentive fees on the portfolio's "winners" regardless of how much the portfolio's "losers" lose.

In credit funds (today's topic), incentive fee non-netting is typically done by separating the two components of returns: [interest income] is separated from [capital gains (or losses)]. Below is a simplified illustration:

Interest income is what compensates a lender for the risk of not being repaid. Registered private credit funds use the term "net interest income" to define the combination of coupon income paid, coupon income accrued, and any origination fees earned when a loan is made. Defined in this way, net interest income can only be positive.

Illustrative Example of a Credit Portfolio's Returns



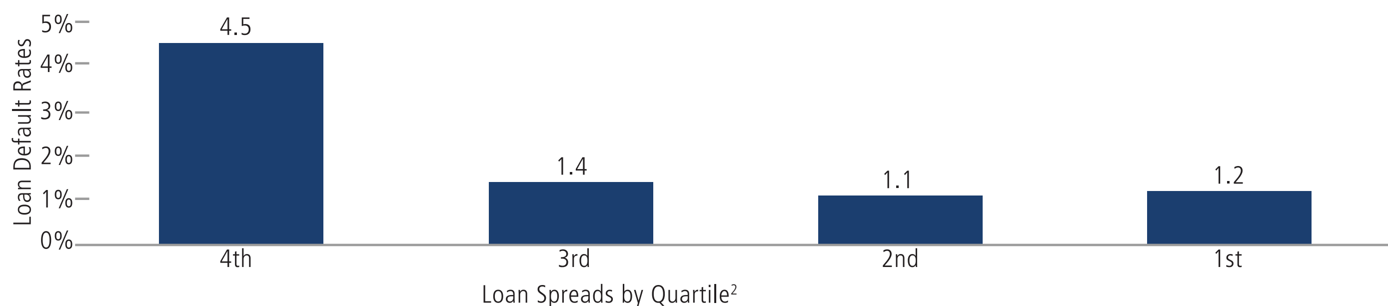
Capital gains (or losses) are where the risk of borrower defaults shows up. If a borrower does not repay a loan, that is a capital loss. Typically, there is some recovery value on loans, which can be high depending on the underlying collateral value and seniority – but any recovery less than 100% creates a capital loss.

Anyway…it is the netting (or combination) of these two components, interest income and capital gains (or losses), that determine a portfolio's overall net return. To pay incentive fees on interest income without netting capital losses is simply not fair.

So why is this piece titled "Perverse Incentives"? It's because non-netted incentive fees can also create perverse incentives. If incentive fees are not netted, managers could try to earn higher incentive fees by making riskier loans, because those risky loans come with higher coupons that create higher net interest income. Managers could also be incentivized to make Payment-in-Kind loans ("PIK"). PIK loans are loans that do not pay cash coupons but instead accrue interest for payment at a future date (interest on interest). PIK loans tend to be associated with financially weaker borrowers and tend to have coupon rates much higher than non-PIK loans. Because the fine print for net interest income includes accrued but unpaid interest, PIK loans would be expected to result in even higher incentive fees.

The chart below compares the spread levels of private credit loans to their eventual default rate. Not surprisingly, higher coupon loans tend to be associated with higher eventual default rates.

Payment Default Rates[1]



[1]Source: Aksia as of 12/31/2023. Sample includes over 10,000 private credit loans.

[2]4th quartile includes loans with the highest spreads (top 25% of sample) at new issue. 1st quartile includes loans with the lowest spreads (bottom 25%) at new issue.

WHAT ABOUT FUNDS WITH NETTED INCENTIVE FEES?

To better align incentive fees with investor returns, some funds with incentive fees (18% of the sample) do have interest income versus capital gains (losses) netting mechanisms. These netting mechanisms do help, but they are different from the "whole fund waterfall" netting of traditional private markets and can set a high bar for incentive fees from net interest income to actually be reduced by capital losses and markdowns. The two common netting mechanisms used in registered private credit funds are:

- Total return incentive fee caps – which reduce the performance fee on Net Interest Income by the amount of net capital losses (realized and unrealized) that have occurred over a (typically) 3-year time period.

- Look-back provisions - require that a fund's overall return exceed a hurdle rate across a (typically 3-year) rolling period in order for any incentive fees to be paid.

Both of the above netting approaches certainly do help, but they each have drawbacks because the calculation is based on a cumulative three-year income figure, which sets a high bar before an incentive fee in interest income is not paid.

CONCLUSION

Many of today's registered private credit funds have non-netted incentive fees. Non-netted incentive fees mean that a fund will pay incentive fees on interest income even if the fund has incurred losses from defaults or markdowns. This creates a misalignment of economic outcomes between fund investors and fund managers. What is worse, non-netted incentive fees could incentivize managers to make riskier loans, or make PIK loans, both of which create higher net interest income. And, do not be shy about looking under the hood. Some private credit funds have substantial holdings in other private credit funds, making it important to understand the extent to which those underlying funds have non-netted incentive fees or not.

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