Together in Harmony: The Potential Benefits of Combining Vintage and Evergreen Structures in Private Debt

AUTHORS

Lloyd Han
Senior Vice President
Quantitative Research Analyst

Marc-Antoine Loo
Quantitative Research Analyst

KEY TAKEAWAYS:

- As private debt continues to expand within institutional portfolios, combining both evergreen and vintage structures has become a crucial strategy for investors seeking to enhance portfolio efficiency and investment outcomes.
- Evergreen funds, which typically call capital more quickly than vintage funds, can help investors maintain a stable allocation to private debt, reducing the risk a portfolio is significantly overweight or underweight illiquid assets.
- In contrast, vintage funds may offer greater flexibility to capitalize on market opportunities and tend to target internal rates of return (IRR) higher than those of evergreen funds.

Private debt has emerged as a strategic component of institutional portfolios, underscoring its growing importance in the investment landscape. The asset class, which includes loans and credit investments that are not issued or traded on public markets, offers potential for diversification, enhanced returns, and reliable income streams, but this may come at the cost of lower liquidity and higher risk. As investors broaden their exposure to private debt, it has become essential to understand the nuances of how evergreen and vintage fund structures differ and to recognize how combining them has the potential to improve portfolio efficiency.

Each structure presents unique advantages and challenges. Vintage funds may offer potential for higher returns through tactical investments, but pose challenges related to timing and reinvestment and are generally less liquid. In contrast, evergreen funds may be more liquid and have more consistent income than vintage funds, but may entail more valuation complexities.

Overview of fund structures in private debt

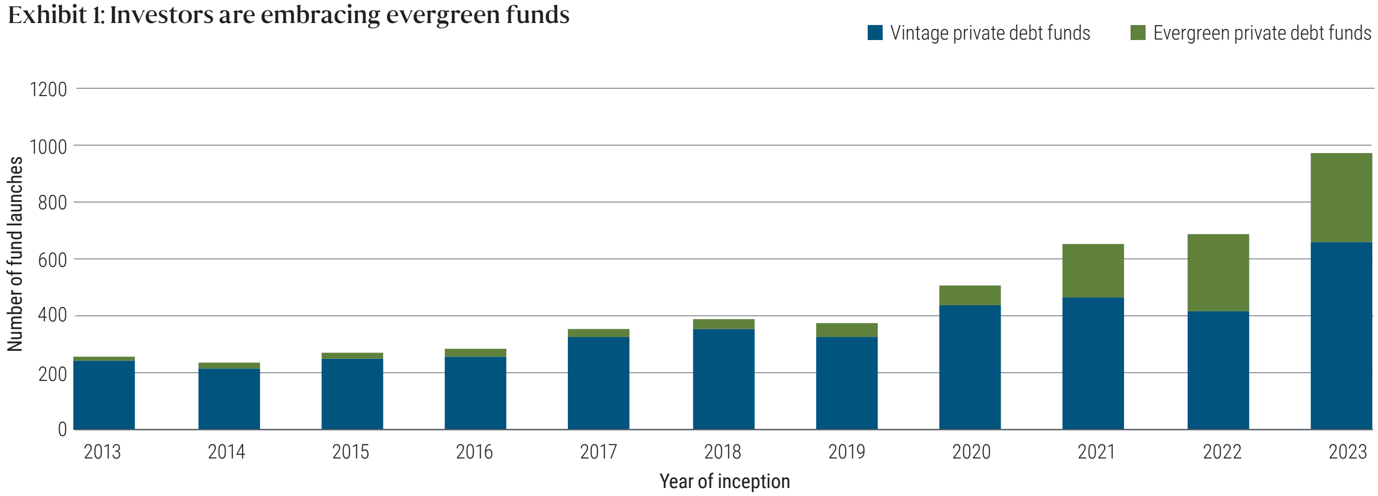
Vintage funds: Also known as drawdown funds, vintage funds are a traditional structure in private debt investing. In this model, investors commit a specified amount of capital that the fund manager calls over several years. The capital is deployed into various investments, and as the assets mature over a number of years, the manager seeks to return the capital to investors, ultimately leading to the fund's termination.

Starting with a blank canvas and enjoying freedom to invest in less liquid securities, vintage funds are conducive to opportunistic strategies and have potential for higher returns. However, predicting the timing of capital calls and distributions for vintage funds can be difficult, complicating investors' management of commitments and target allocations.

Evergreen funds: Also known as perpetual funds, evergreen funds have been steadily gaining popularity over the past six years (see Exhibit 1).[1] These vehicles lack a specified end date and accept investor subscriptions periodically. Evergreen funds generally call capital more quickly than vintage funds, but keep capital invested. This approach aims to provide investors steady exposure to private debt and more consistent distributions and cash flows – without the need for additional contributions.

However, investors receive a share of existing assets based on the most recent appraisal value. Because these values are less certain than those of assets marked-to-market in public exchanges, private net asset values (NAV) may not reflect their true value; investors may pay a premium.

Exhibit 1: Investors are embracing evergreen funds



Source: Preqin as of July 2024. Data represents the global universe of private debt funds, as reported in Preqin.

To facilitate redemptions, evergreen funds typically employ one of two common approaches.

LIQUIDITY MATCHING

The fund's liquidity matches that of its assets. When investors wish to cash out, the fund transfers a slice of the assets into a separate vehicle. This new portfolio returns capital to investors as the investments mature.[2]

LIQUID ASSET RESERVE

Funds allocate a portion of capital to liquid assets that can be sold to meet redemptions.

Exhibit 2 shows the main structural differences between vintage and evergreen private debt funds.

Exhibit 2: How vintage and evergreen fund structures differ

VINTAGE	EVERGREEN
• **Generally higher** return potential • **Clean slate** portfolio • **Greater variation** in capital calls and distributions • May be well-suited to **opportunistic and tactical** strategies	• **Faster** deployment of capital • Immediate access to a **diversified portfolio** • **Seeks higher and more consistent** distribution yields • Reinvestment of capital for **sustained exposure**

Quantifying differences between vintage and evergreen structures

TARGET RETURNS

Data show that managers of vintage private debt funds target IRRs that average 1.3 percentage points higher than those of evergreen private debt funds (see Exhibit 3):

Exhibit 3: Average fund target IRRs for vintage and evergreen private debt

Category	Vintage funds	Evergreen funds
Number of funds	638	69
Average target IRR	11.11%	9.86%

Source: Preqin as of July 2024. Data represent the net IRR for the global universe of private debt funds, as reported in Preqin, for which IRR information is available.

However, this data may obscure significant differences in risk and structure. For example, vintage structures can pursue opportunistic investments and target low- to mid-teen IRRs. In contrast, evergreen structures often invest in performing senior private loans and tend to target low-single-digit to low-teen IRRs. Data limitations prevent us from distinguishing these two effects; however, we find target returns to be a useful benchmark for evaluating the potential benefits while assessing the risk/return trade-off between vintage and evergreen fund structures.

INVESTING AND CAPITAL DEPLOYMENT

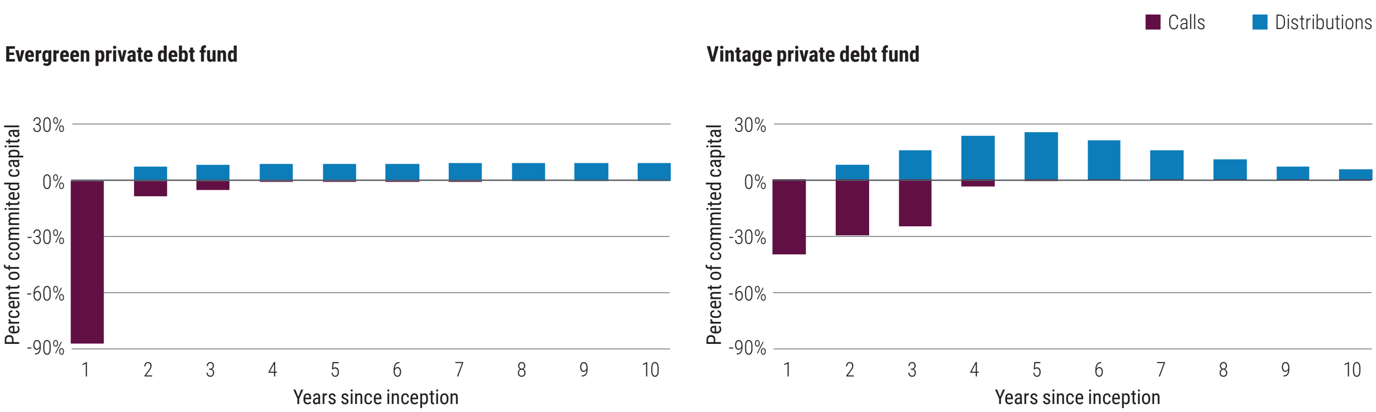
Vintage structures are designed to offer investors access to attractive opportunities as they arise. They call capital more slowly but typically start distributing larger amounts after several years. Investors who come in during later closes receive a proportionate share of existing assets based on the capital that has already been called.

Evergreen funds continuously reinvest capital, which may limit their ability to time investments when new opportunities are most attractive. Thus, allocators may favor evergreen structures during benign credit conditions and vintage structures during credit market dislocations – which occur when asset prices diverge significantly from their intrinsic values, often due to economic disruptions or abrupt shifts in supply and demand.

In addition, investors in evergreen funds buy into an existing portfolio based on appraised values, which may not always be accurate. To evaluate potential mispricing, we analyzed data on secondaries – sales of existing positions in a private fund to third parties – which have historically traded at a 10%–20% discount from NAV.[3] This discount likely represents the limit of what investors would pay, a reflection of the principal-agent problem (where general partners (GPs), the agents, may be inclined to sell underperforming deals to investors, or limited partners (LPs), the principals). Nonetheless, secondaries can provide insight into the uncertainties in valuations investors face when acquiring existing positions.

Evergreen funds also typically have larger initial capital calls. It is not uncommon that 90% of committed capital is called in the first year. Distributions are made gradually over many years, giving investors consistent exposure to private debt (see Exhibit 4).

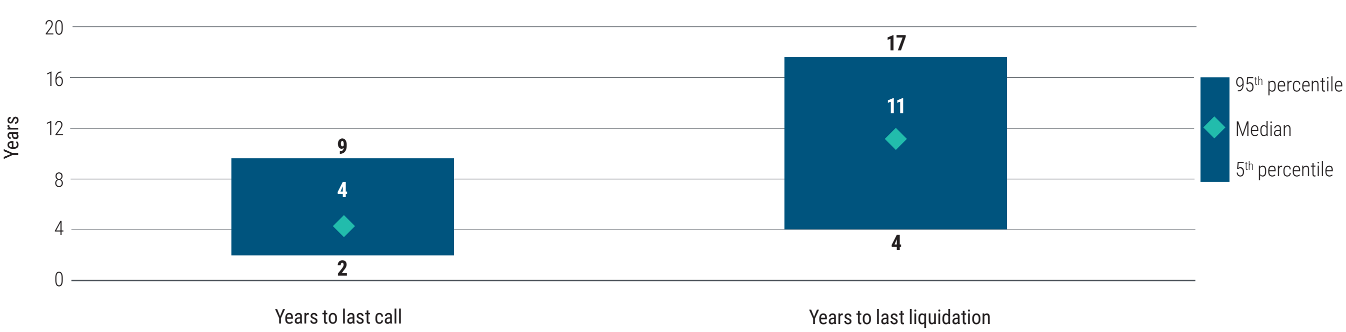
Exhibit 4: Sample cash flows of an evergreen and a vintage private debt fund



Source: PIMCO as of July 2024. **Example for illustrative purposes only.**

Exhibit 5 shows an illustrative cash flow experience, though the timing of capital calls and terminations may vary widely for vintage funds. Calls can take from two to nine years, while capital distributions can range from four to 17 years. The large variation presents a challenge for allocators who need to assess and size commitments to new vintages to maintain a steady allocation to private debt. One solution is to tactically increase or decrease commitments to new vintages depending on market conditions, which can reduce variation in cash flows at the portfolio level. However, liquidity management and commitment pacing may remain challenging.

Exhibit 5: The timing of capital calls and distributions varies widely for vintage

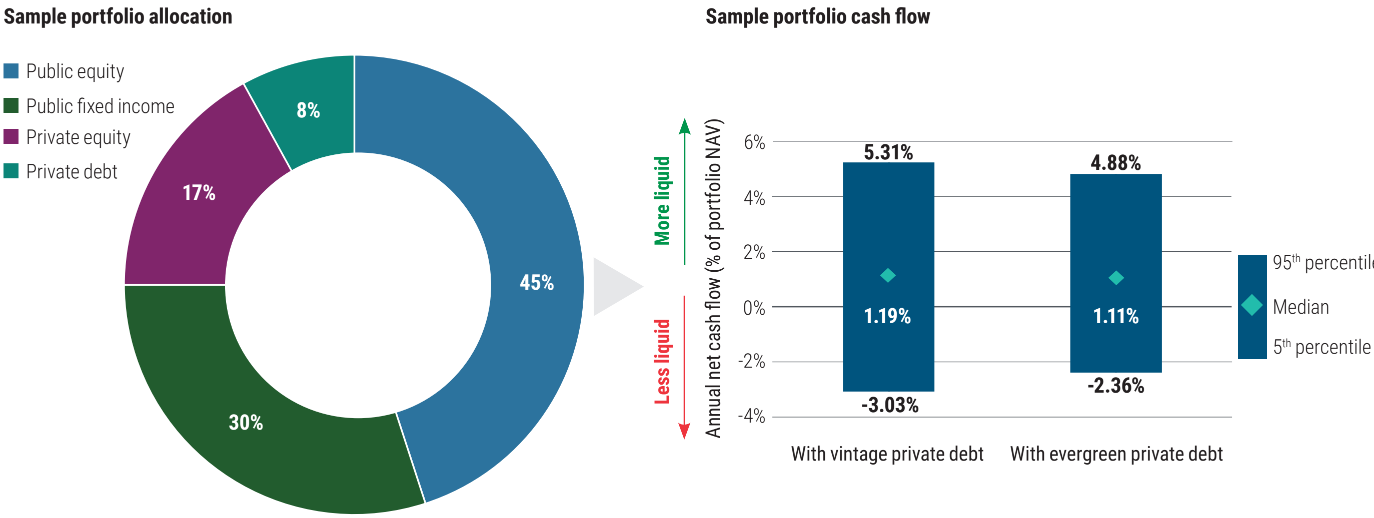


Source: Preqin as of July 2024. Data includes all North American private debt funds with historical cash flow data in the Preqin database.

In contrast, evergreen funds are much simpler. Investors can set an allocation and gain constant exposure to private debt without worrying about future commitments. They also are designed to provide more stable distributions.

Exhibit 6 compares the range of net cash flows (capital distributions minus capital calls) for a sample portfolio with a mature private debt program that uses evergreen funds versus a portfolio that uses vintage funds.[4,5] To isolate the effect of fund structure, we assume both structures carry the same level of risk. In addition, we assume evergreen private debt funds yield returns 1.3 percentage points lower than those of vintage funds, consistent with our findings on target returns. In the first scenario, we assume that the private debt allocation is fully invested in vintage funds. In the second scenario, we assume that the entire private debt allocation is invested in evergreen funds.

Exhibit 6: Evergreen structures may improve cash flow stability[6]



Source: PIMCO and Preqin as of July 2024. **For illustrative purposes only**. The Exhibit shows a sample portfolio's asset allocation and potential cash flows if the private debt allocation is allocated 100% to vintage private debt or 100% to evergreen private debt, based on a Monte Carlo simulation, as outlined in Han and Ramirez (2024). The simulation generates potential paths for asset returns and cashflows. Percentiles are computed across the simulated paths. There is no guarantee that 1) the investment strategies discussed here will work under all market conditions, 2) that the market trends discussed will continue, or 3) that the investment opportunities discussed here will materialize or produce any level of returns.

Unlocking synergy by combining evergreen and vintage structures

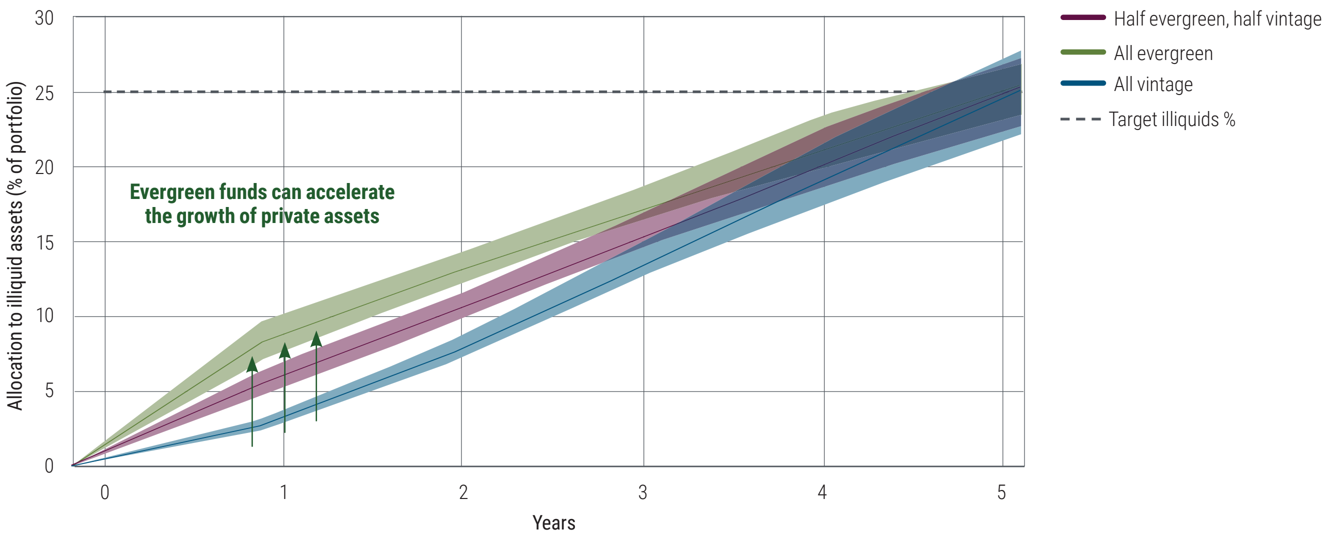
Similar to diversifying a portfolio by allocating to various assets, combining evergreen and vintage fund structures may improve portfolio efficiency for investors. Investors building a private debt program can invest in both fund structures, with evergreen funds constituting the ramp-up phase until vintage funds start calling capital.

Exhibit 7 simulates the portfolio of an investor building a private assets investment program using the sample portfolio in Exhibit 6. Because evergreen funds typically call capital almost immediately, the investor can build a private debt allocation much faster. Around year four, vintage funds in the sample portfolio have called most of the committed capital, enabling the investor to achieve their target allocation of private debt.

Importantly, we find the faster ramp-up of private assets in evergreen funds compensates for the category's lower return assumptions. We estimate the return drag from the slower pacing of calls in vintage versus evergreen structures to be around 1.7 percentage points per year. This may be an underestimate, as we assume investors keep uncalled capital within their liquid allocation. If investors reserve uncalled capital in cash, we estimate a return drag closer to 2.9 percentage points per year for vintage structures compared with evergreen structures.[7]

Exhibit 7: Evergreen fund structures may accelerate a portfolio's private debt allocation[8]

Allocation to private assets



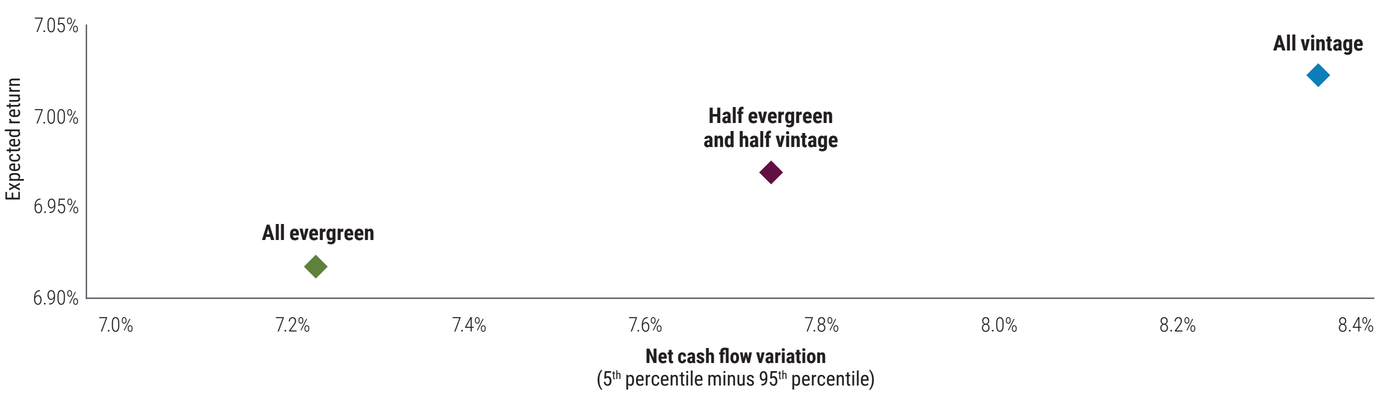
Source: PIMCO and Preqin as of July 2024. **For illustrative purposes only**. We assume the target allocation is the sample portfolio in Exhibit 6, and the investor holds uncalled capital in liquid assets. As before, we assume that vintage and evergreen private debt funds have identical risk profiles, with evergreen funds generating returns that are 1.3 percentage points lower than those of vintage funds. The Exhibit is based on a Monte Carlo simulation, as outlined in Han and Ramirez (2024). The simulation generates potential paths for asset returns and cashflows. Shaded bands represent the 5th and 95th percentile values across the simulated paths.

Exhibit 8 compares the risk, return, and liquidity profiles of a private debt program that incorporates both evergreen and vintage funds. In a mature private debt program, evergreen funds may provide additional liquidity, while vintage funds may help to capture attractive new market opportunities.

Although evergreen funds may deliver lower returns, they may help reduce cash flow variability in the portfolio. The improved cash flow stability reduces the risk of the total portfolio overshooting its target allocation to illiquid assets.

For a portfolio with only evergreen funds, the probability of exceeding the target by more than five percentage points over a five-year period is 13.5%, compared with 18.4% for a portfolio with only vintage funds – a 4.9 percentage point reduction. In addition, according to Baz et al. (2024),[9] using cost-put options to hedge against excessive illiquidity may enhance returns by 88 basis points per year. Furthermore, in a market-shock scenario, the portfolio with only evergreen funds might reach 29% illiquid assets by the end of a five-year period, while the portfolio with only vintage funds may reach 31% illiquid assets.[10]

Exhibit 8: Balancing return and cash flow variability in a sample portfolio with evergreen and vintage private debt[11]



Source: PIMCO and Preqin as of July 2024. **For illustrative purposes only**. This exhibit uses the sample portfolio allocation from Exhibit 6 and projects expected (gross) returns based on a Monte Carlo simulation, as outlined in Han and Ramirez (2024), assuming that the private debt allocation is invested in 100% evergreen debt funds, 50% in evergreen debt funds and 50% in vintage debt funds, and 100% in vintage debt funds. We simulate potential paths for asset returns and cash flows, and estimate liquidity and the cost of liquidity risk, based on the simulated paths. The simulation does not take into account fees and expenses, which will reduce returns. There is no guarantee that 1) the investment strategies discussed here will work under all market conditions, 2) that the market trends discussed will continue, or 3) that the investment opportunities discussed here will materialize or produce any level of returns.

Conclusion

Private debt is emerging as a key component of institutional portfolios. While substantial thought goes into choosing the right strategies within private debt, it is also critical to consider how combining vintage and evergreen fund structures can enhance portfolio efficiency.[12]

KEY CONSIDERATIONS FOR EVERGREEN AND VINTAGE FUND ALLOCATIONS:

- Predictability of deployment and return of capital
- Steady exposure and reinvestment of capital
- Potential for investment income
- Market conditions
- Uninvested capital

1 Evergreen funds are increasingly gaining popularity in other private asset classes as well. Growing interest in secondaries and the perpetual fund structure has led to a surge in the launch of evergreen funds in private equity and venture capital.

2 This approach is known as a slow pay / fast pay system. While slow pay / fast pay may reduce the need for a liquidity sleeve in the fund, it also heightens uncertainty regarding when investors can get capital back.

3 "H1 2024 Global Secondary Market Review." Jefferies Private Capital Advisory. July 2024. https://www.jefferies.com/wp-content/uploads/sites/4/2024/07/Jefferies-Global-Secondary-Market-Review-July-2024.pdf.

4 The computation of capital calls and distributions is based on the methodology detailed in Han and Ramirez (2024). Han, Lloyd S. and Ramirez, German. "A Practitioner's Guide to Managing a Privates Program." SSRN Working Paper, January 2024. https://papers.ssrn.com/abstract=4685467.

5 A mature private program is defined as a portfolio that has been consistently committing to and investing in private assets for a minimum of five years.

6 The sample portfolio is constructed with a strategic allocation of 45% in public equities, 30% in public fixed income securities, and 25% in private investments. Within the private allocation, one-third is invested in private debt, and two-thirds in private equity. This portfolio is designed to illustrate typical institutional investor holdings, balancing growth potential with risk management through a mix of public and private assets. However, this is only an illustration and is not intended to be a recommendation of any asset allocation.

7 The expected return on cash is assumed to be 3.51%, based on PIMCO's capital market assumptions as of 30 June 2024.

8 The sample investor is assumed to begin with a traditional 60/40 portfolio while building a private investment program, aiming to transition to a sample portfolio that allocates 25% to private investments – one-third targeted to private debt and two-thirds to private equity. We examine the case where the private debt allocation consists of all vintage structures, all evergreen structures, and half vintage and half evergreen structures.

9 Baz, Jamil, Han, Lloyd S., and Loo, Marc-Antoine. "Three Models of the Liquidity Premium." SSRN Working Paper, April 2024. https://ssrn.com/abstract=4790409.

10 The estimate of liquidity and the cost of liquidity risk use the sample portfolio allocation from Exhibit 6 and projects expected (gross) returns based on a Monte Carlo simulation, as outlined in Han and Ramirez (2024), assuming that the private debt allocation is invested 100% in evergreen debt funds and 100% in vintage debt funds. We simulate potential paths for asset returns and cashflows, and estimate liquidity and the cost of liquidity risk, based on the simulated paths. The simulation does not take into account fees and expenses, which would reduce returns. There is no guarantee that 1) the investment strategies discussed here will work under all market conditions, 2) that the market trends discussed will continue, or 3) that the investment opportunities discussed here will materialize or produce any level of returns.

11 Exhibit 8 illustrates expected portfolio-level return and the net cash flow variation of the sample portfolio detailed in Exhibit 6.

12 A similar case can be made for evergreen real estate funds, as the underlying assets are also designed to provide steady income. However, evergreen private equity structures typically generate little to no cash flows until the assets are sold. In future work, we will explore the structure of these vehicles across other private asset classes.

PIMCO

CMR2025-0717-4661169

PC626_5973434