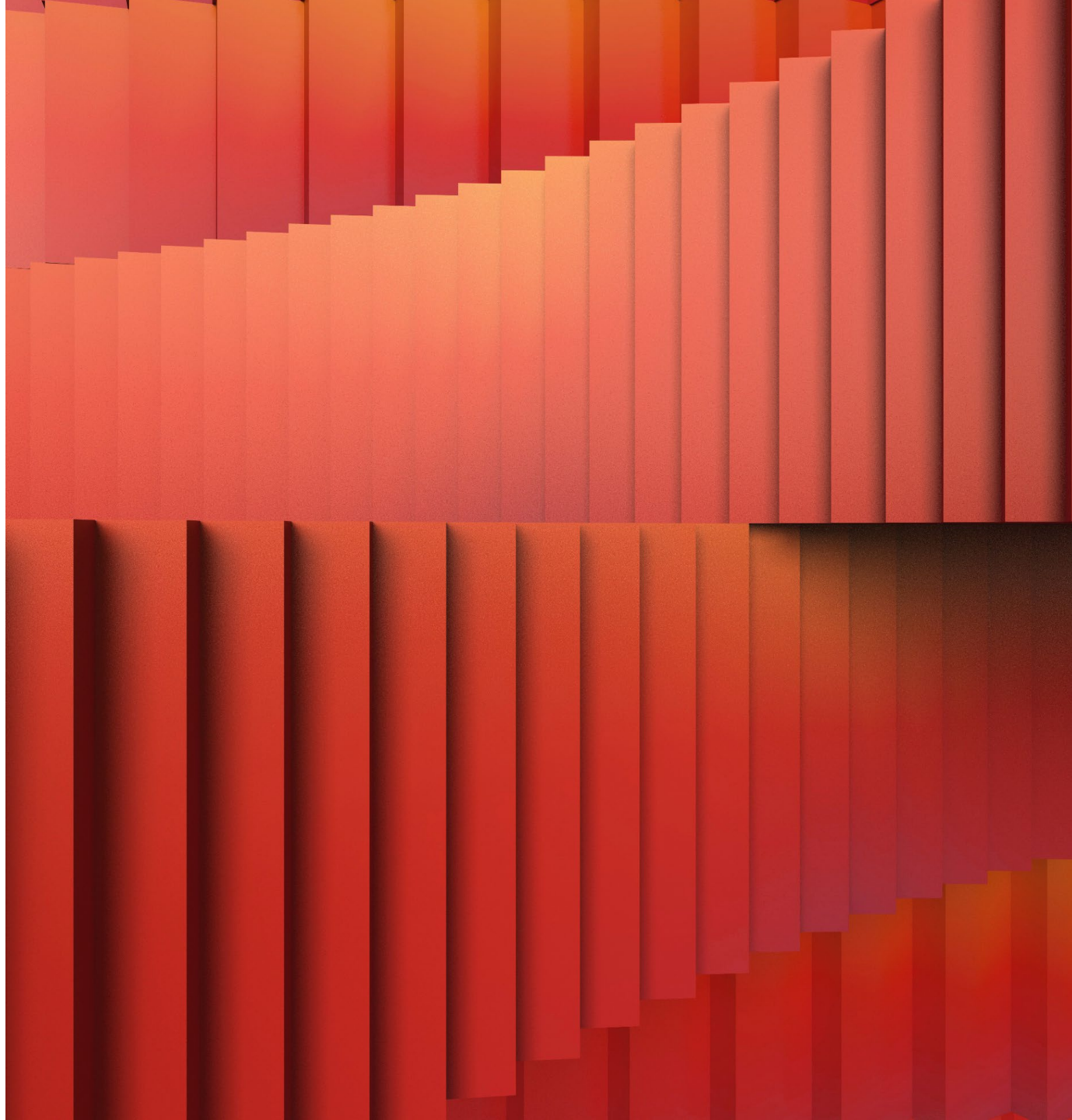


# How We Rate Alternative Investment Funds

Sept. 23, 2024

(Editor's note: This article is an update to the version published on Feb. 23, 2024.)

*This report does not constitute a rating action.*



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- Over the past 18 months, we have seen a growing number of alternative investment funds (AIFs) tapping the debt markets with bonds, private loans, net asset value (NAV) facilities, and capital call facilities, also known as subscription lines. This private market activity reflects a slowdown in traditional fundraising and weaker deal activity, among other dynamics.
- In this primer, we explain how we apply our AIF methodology to various fund structures—notably private equity, public equity, venture capital, and private debt funds— alongside hedge funds and some investment companies that share key characteristics of AIFs.
- Our analysis reflects a fund's ability to repay its recourse liabilities on time in a theoretical liquidation scenario following a 'BBB' or moderate stress. We detail how we calculate stressed leverage for different types of funds, how we capture the risks relating to the funding and liquidity of different fund structures, and how we rate instruments issued by AIFs.
- Some examples reflect public ratings, and some are hypothetical examples that draw on private or confidential ratings.

(Editor's note: This article is an update to the version published on Feb. 23, 2024.)

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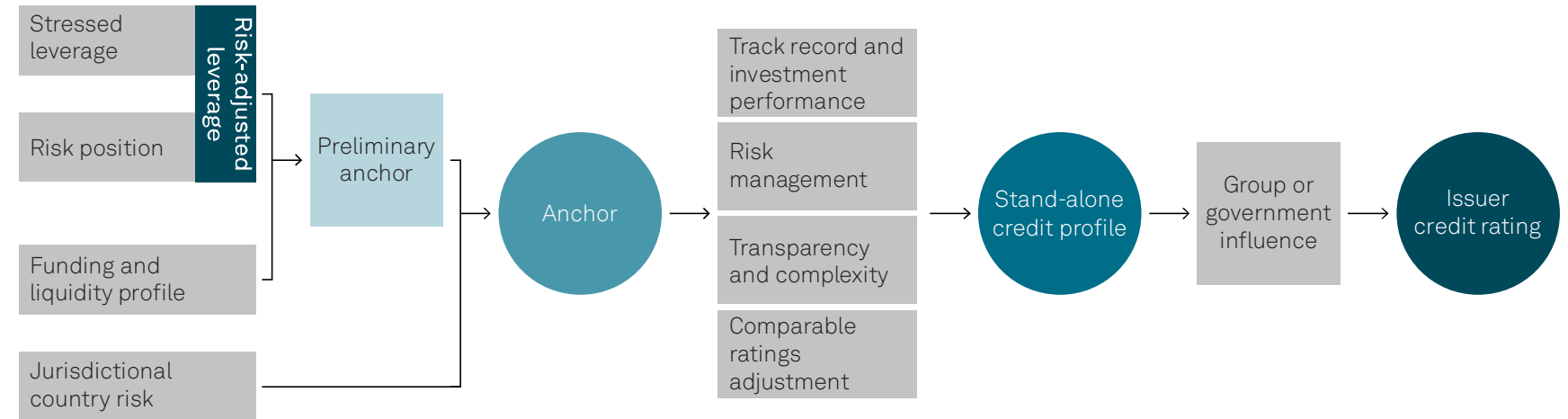
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Our analysis reflects a fund's ability to repay its recourse liabilities on time in a theoretical liquidation scenario following a 'BBB' or moderate stress.



### Underlying sources of data that we use to determine ratings in the AIF space:

- Historical S&P Global Ratings default rates and historical peak-to-trough drawdowns for credit funds.
- Historical drawdowns in prices for equity/private equity and real estate funds.

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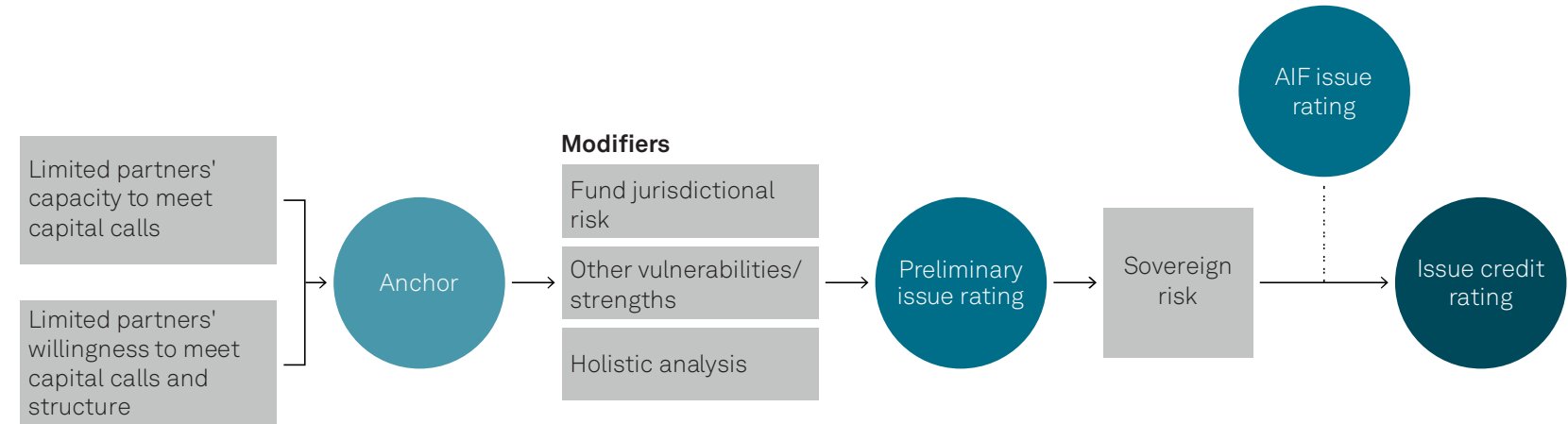
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The criteria primarily address the likelihood that committed limited partners (LPs) provide called capital when requested to allow for repayment of a subscription line on time and in full.



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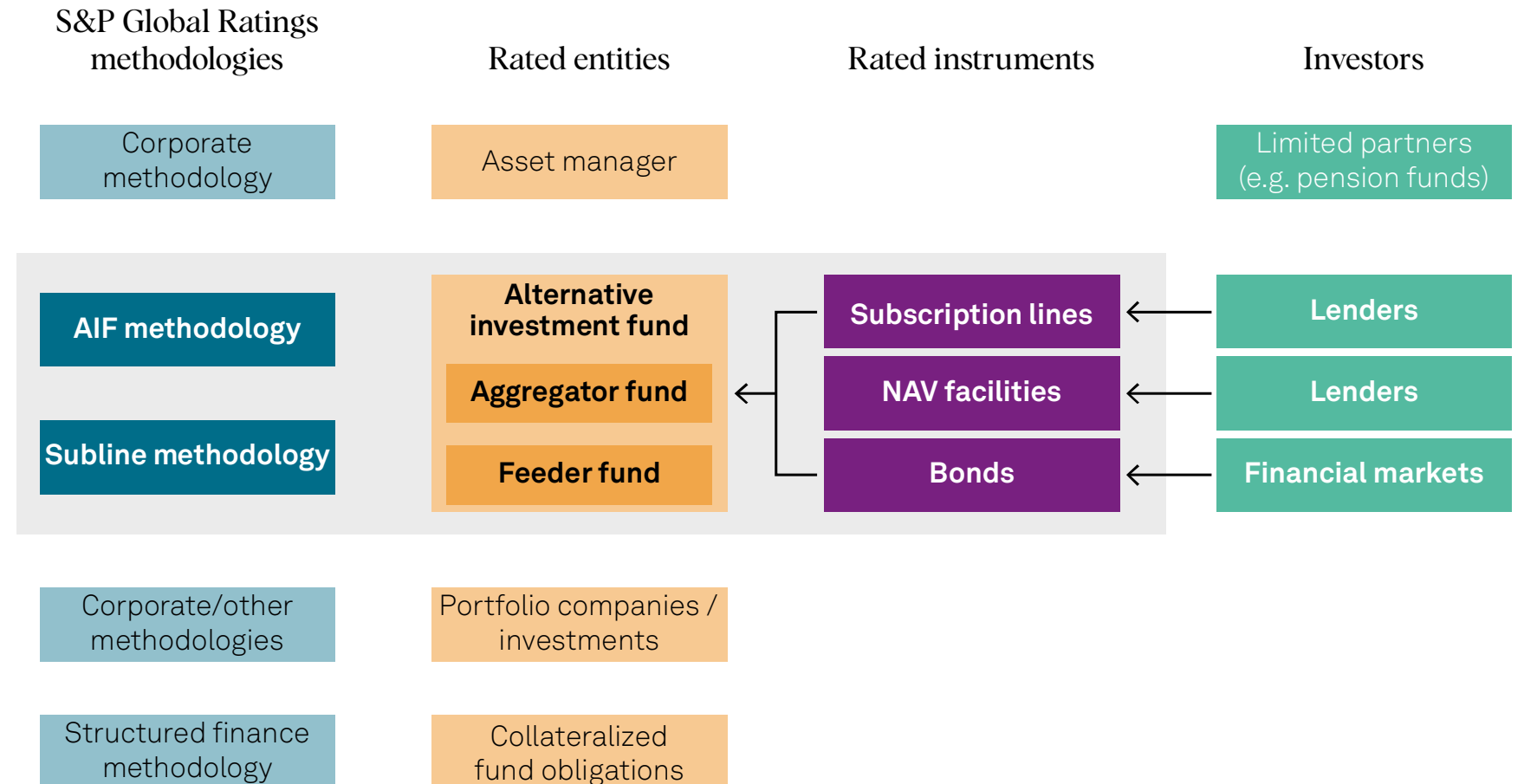
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S&P Global Ratings has provided transparency on AIFs and this expanding market since 2006—and our coverage and criteria have evolved. We apply our global framework for rating AIFs (updated most recently in 2024) to various funds and other investment companies that share key characteristics of AIFs:

Private equity fund

Venture capital fund

Investment company

Listed equity fund

Private debt fund

Real estate debt fund

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# Private Equity Fund

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## Fund X

### A private equity fund with a NAV facility

#### Investment focus

- Fund X is a private equity fund investing in companies in the technology, health care, and business services industries in the U.S. and Europe.

#### Vintage

- The fund is the sixth vintage of the private equity strategy of a leading U.S. asset manager.

#### Status

- Fund X is a closed-ended fund with a remaining life of five years (extendable by an additional two years) and is fully invested.

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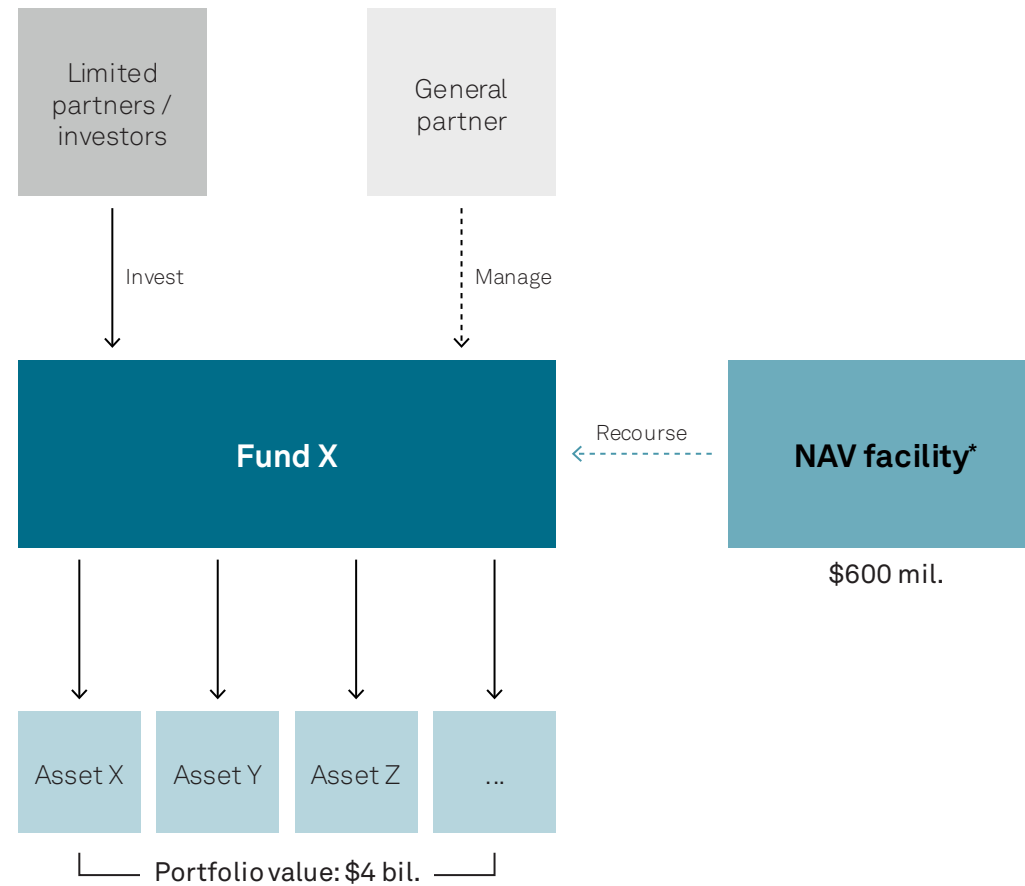
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\*Recourse over the assets of Fund X (the fund's only debt instrument). Source: S&P Global Ratings.

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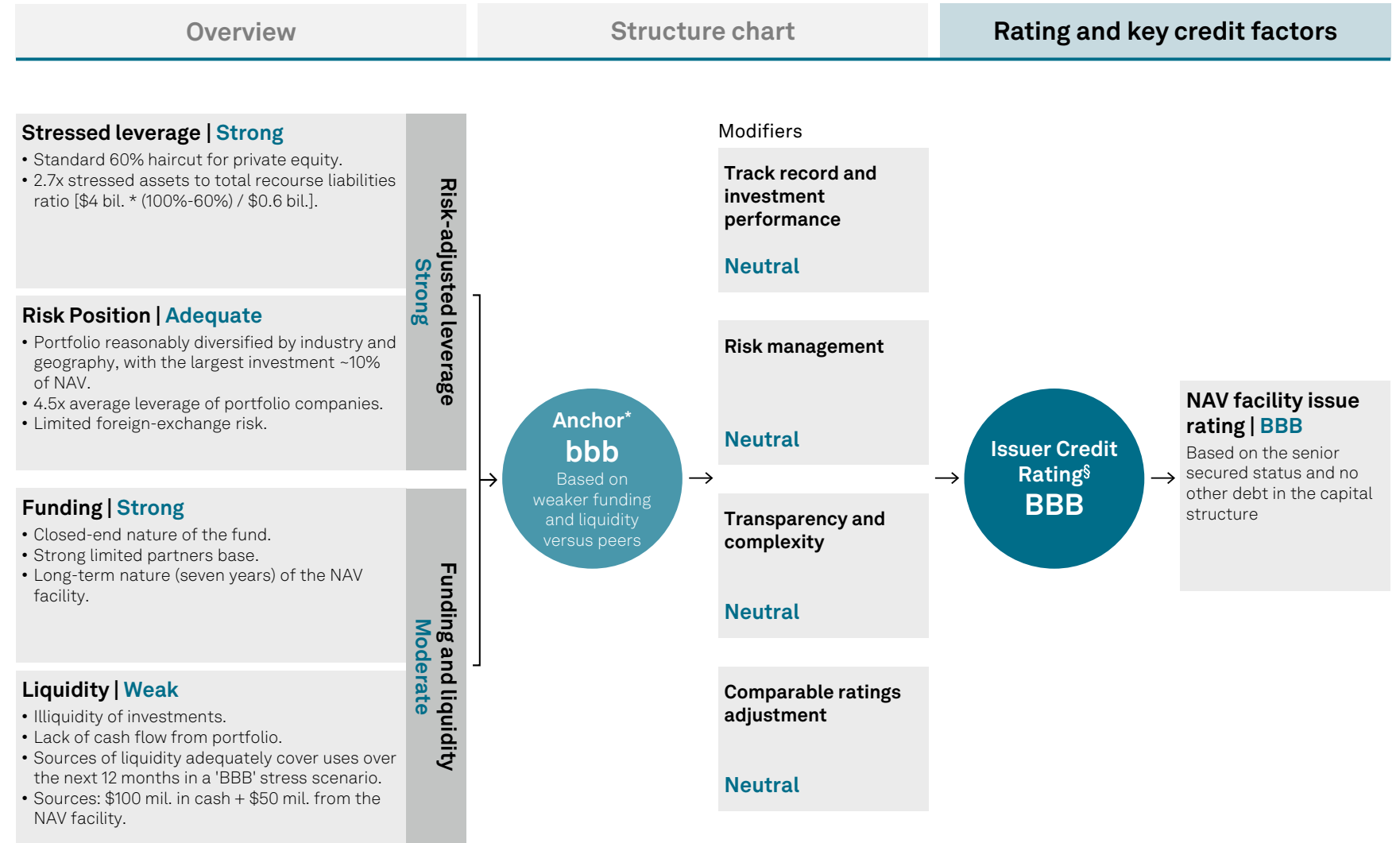
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\*Jurisdictional risk is neutral and therefore the preliminary anchor equals the final anchor. §The fund doesn't have government or government-related entity support.

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## Fund Z

### A closed-end direct lending feeder fund with a subline facility

#### Investment focus

- Fund Z is a feeder fund investing entirely into the master fund. The feeder fund is structured as a mix of 70% debt and 30% equity. The master fund into which the feeder flows provides credit to middle market companies in the U.S.

#### Vintage

- The master fund is the third vintage of the fund's platform of a leading U.S. asset manager.

#### Status

- The master fund is a closed-ended fund with a life of 10 years and a five-year investment period. This fund has the possibility of a one-year extension. The maturity of the feeder fund debt matches the maturity of the master fund.
- There is a subscription line of credit and some limited repo debt at the master fund level.
- The coupon on the feeder fund debt is deferrable.

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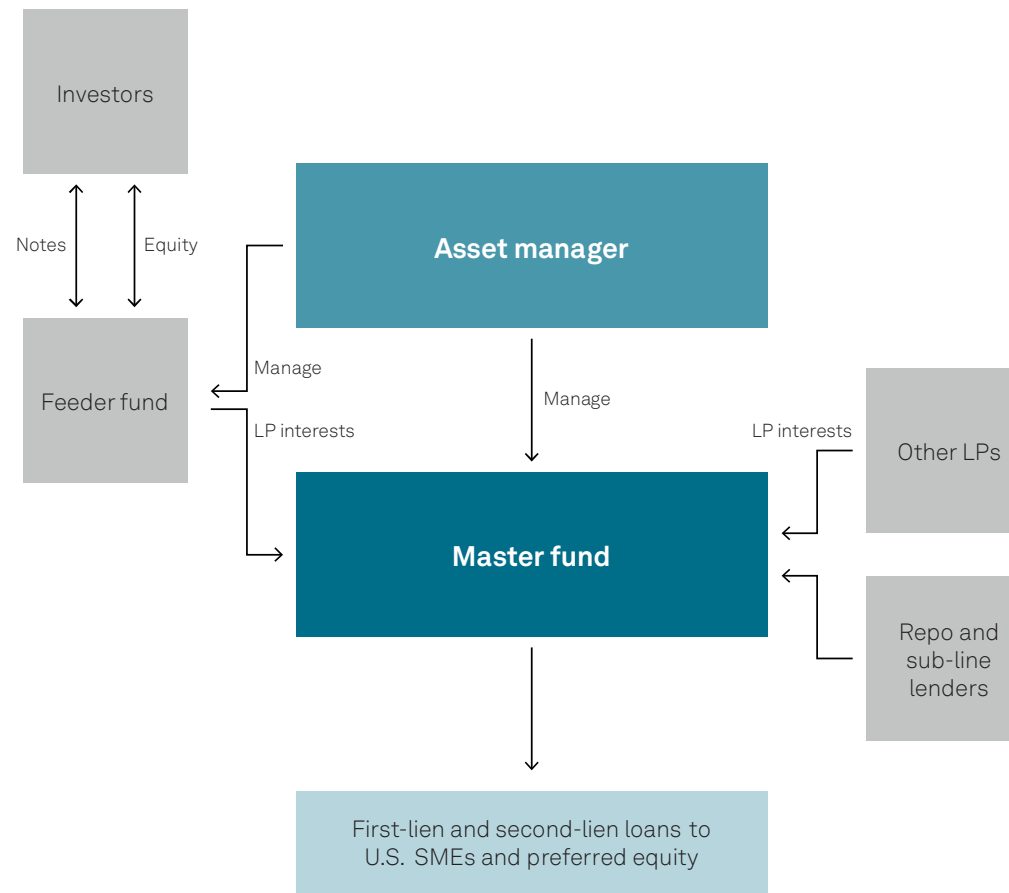
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LPs--Limited partners. Source: S&P Global Ratings.

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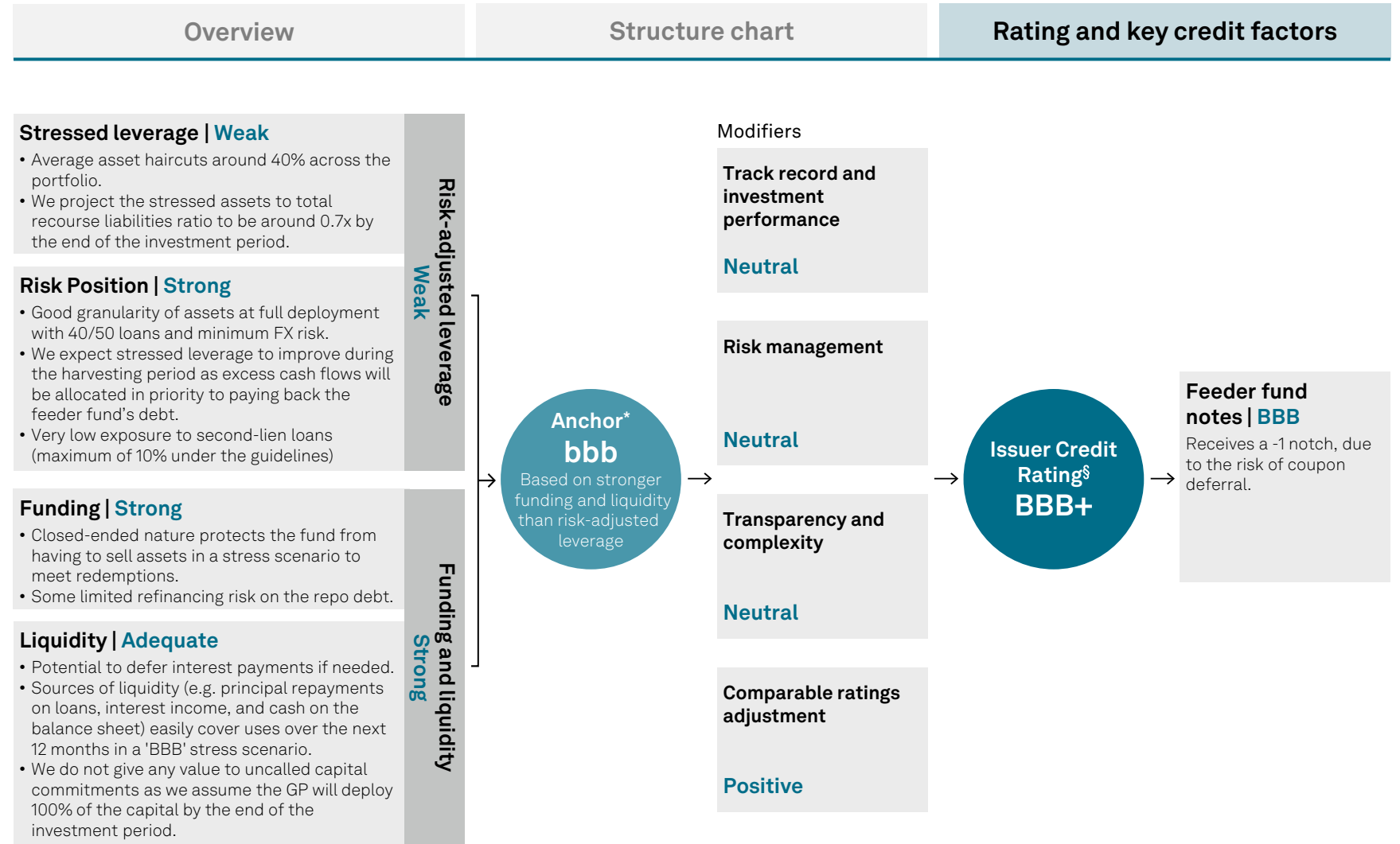
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\*Jurisdictional risk is neutral and therefore the preliminary anchor equals the final anchor. §The fund doesn't have government or government-related entity support.

# Fund Of Funds

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# Fund Of Funds With A NAV-Based Revolving Facility

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## Fund XX

### A fund of funds with a NAV-based revolving facility

#### Investment focus

- Fund XX invests primarily in private equity funds managed by third party general partners and to a lesser extent in other strategies such as venture capital, infrastructure, and private debt. Around 10% of NAV are direct co-investments and around 5% are primary investments in private equity deals. The rest of the allocation is to secondaries funds.

#### Status

- Fund XX is a U.S.-based fund of funds registered under the 1940 Investment Company Act. The revolving credit facility is intended to be used for liquidity management purposes exclusively. The fund offers quarterly liquidity to LPs (with a maximum of 5% of NAV a quarter and a minimum of 3% a quarter) but can gate redemptions if needed.

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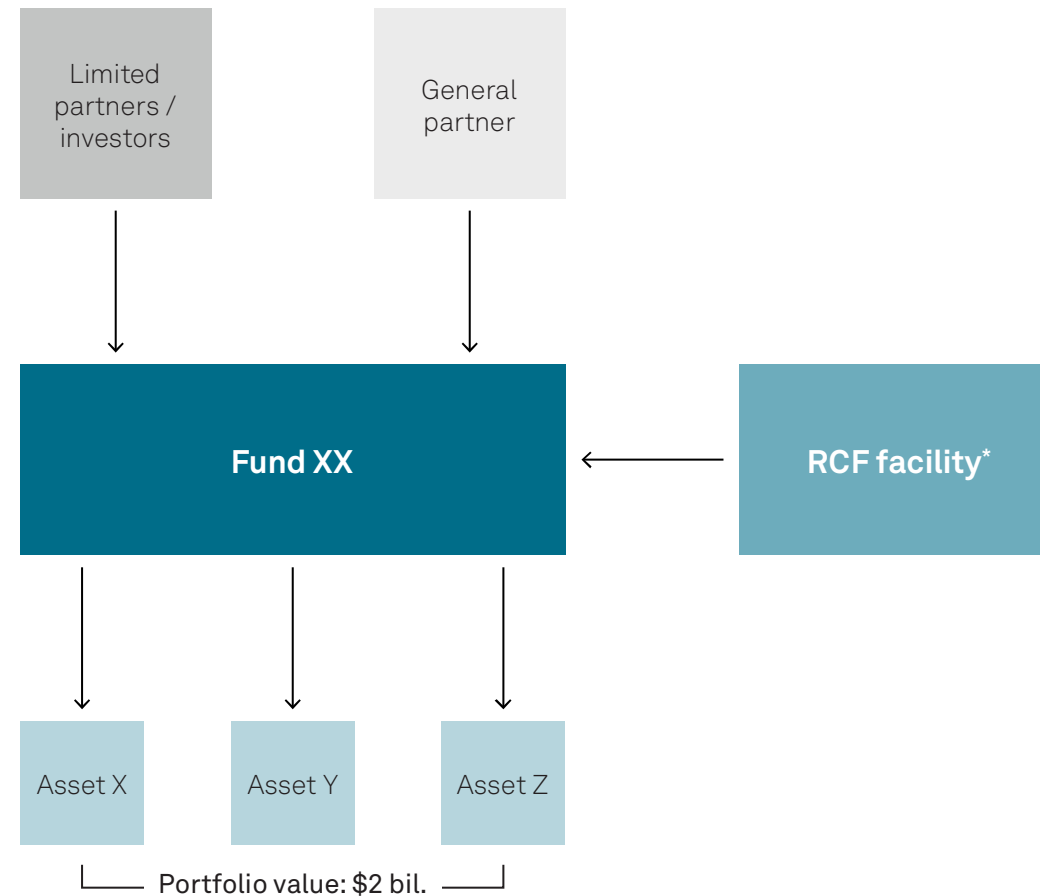
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\*Recourse over the assets of Fund XX (the fund's only debt instrument). Source: S&P Global Ratings.

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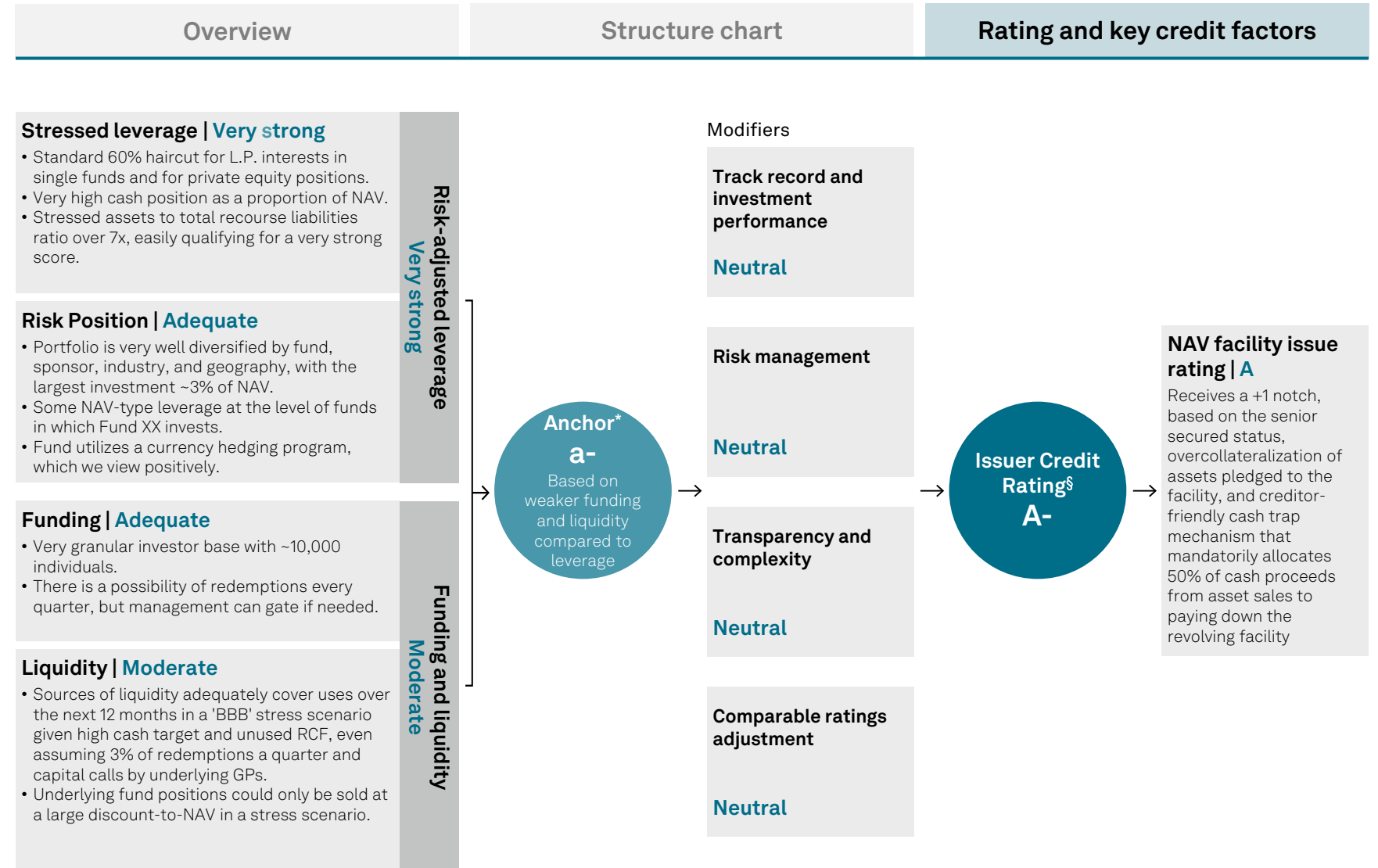
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\*Jurisdictional risk is neutral and therefore the preliminary anchor equals the final anchor. §The fund doesn't have government or government-related entity support.

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## Fund Y

### A venture capital fund with a NAV facility

#### Investment focus

- Fund Y is a venture capital fund investing in companies in the technology, health care, and business services industries in the U.S., Europe, and Asia-Pacific.

#### Vintage

- The fund is the 11th vintage of the private equity strategy of a leading U.S. asset manager.

#### Status

- Fund Y is a closed-ended fund with a remaining life of five years (extendable by an additional two years) and is fully invested.

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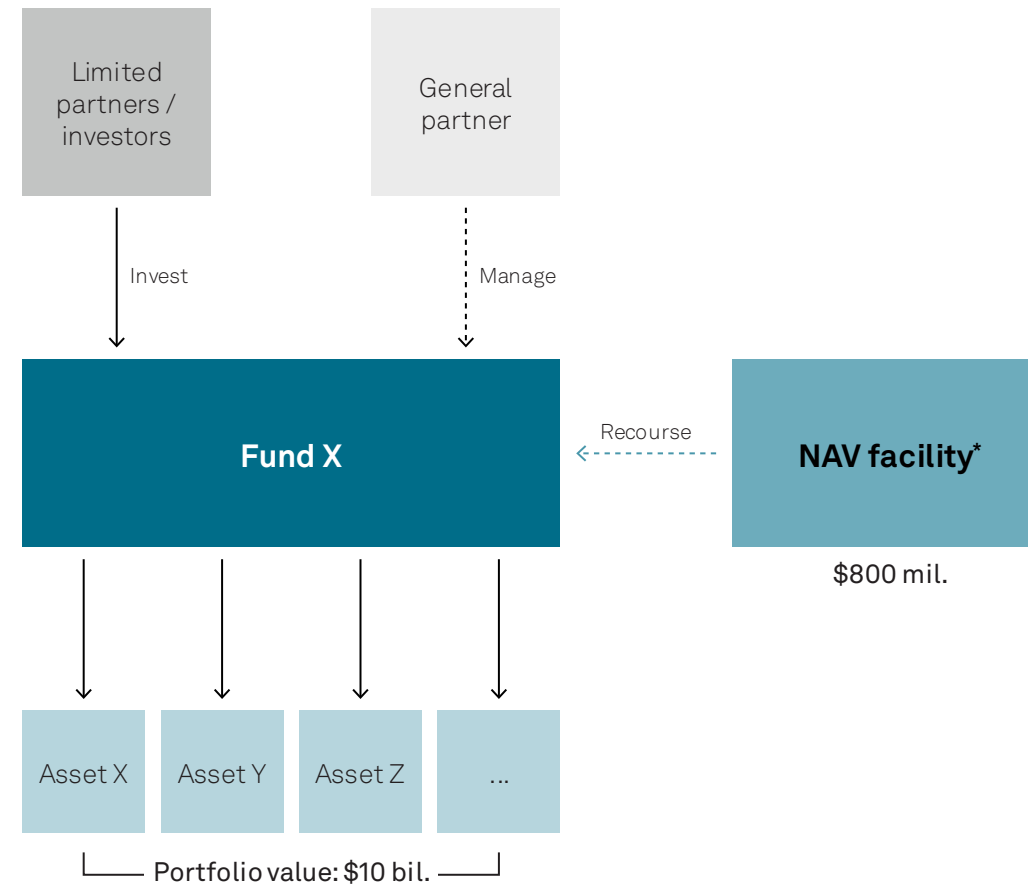
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\*Recourse over the assets of Fund X (the fund's only debt instrument). Source: S&P Global Ratings.

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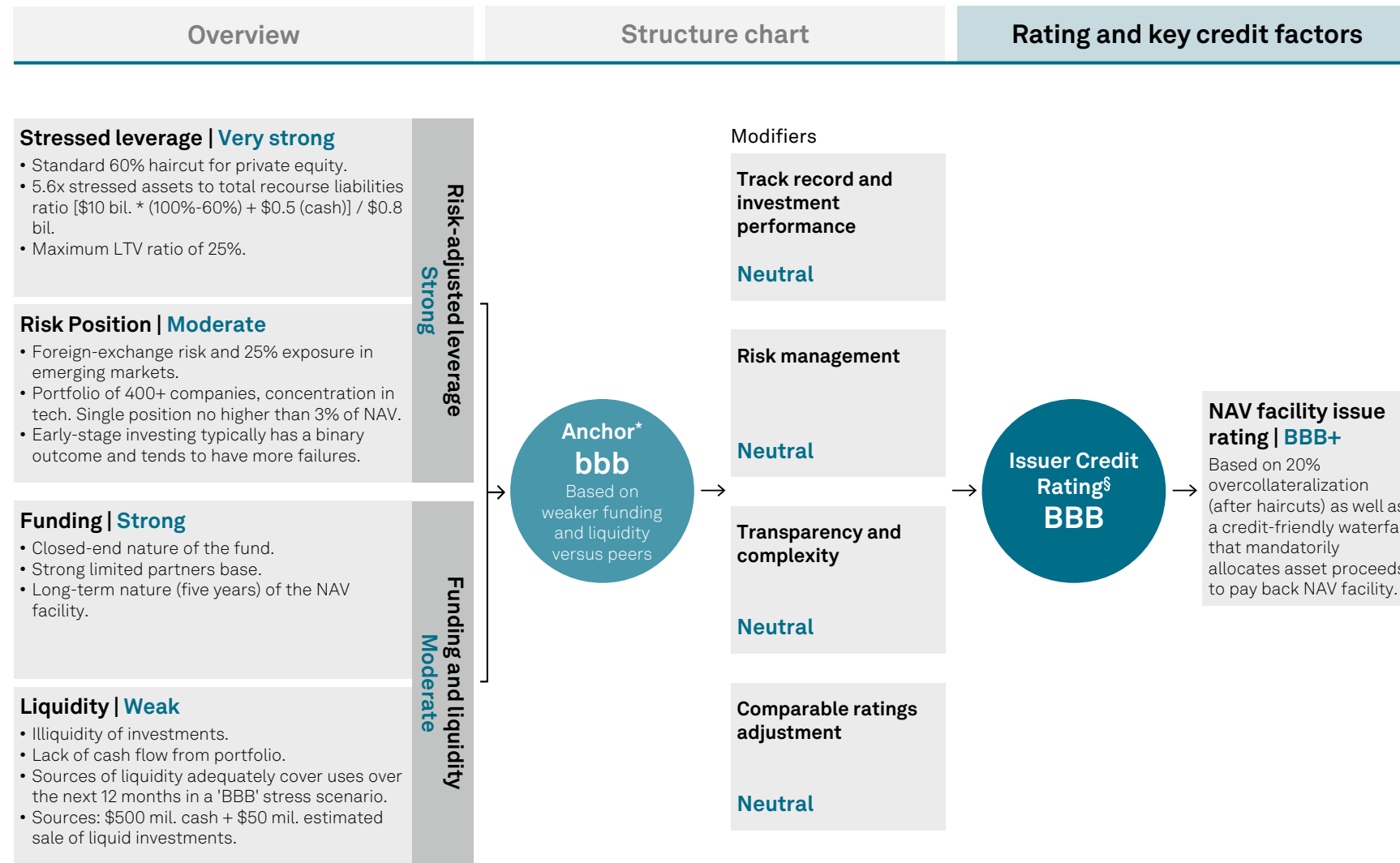
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## 3i Group PLC

### An Investment Company Rated Under Our AIF Criteria

#### Investment strategy

- 3i Group is a FTSE100-listed investment company specializing in private equity and infrastructure and investing in mid-market companies in Europe and North America.
- It realizes assets through business cycles and does not rely on fee income or EBITDA generation to repay its debt obligations (therefore it is closer to a buy-and-hold fund).
- It is also an investment manager of several infrastructure funds, many of which it holds a stake in (for example, 3i Infrastructure or 3iN).

#### Funding policy

- A mixture of shareholder funds and borrowings from banks and capital markets. Limited structural gearing.

# 3i Group PLC

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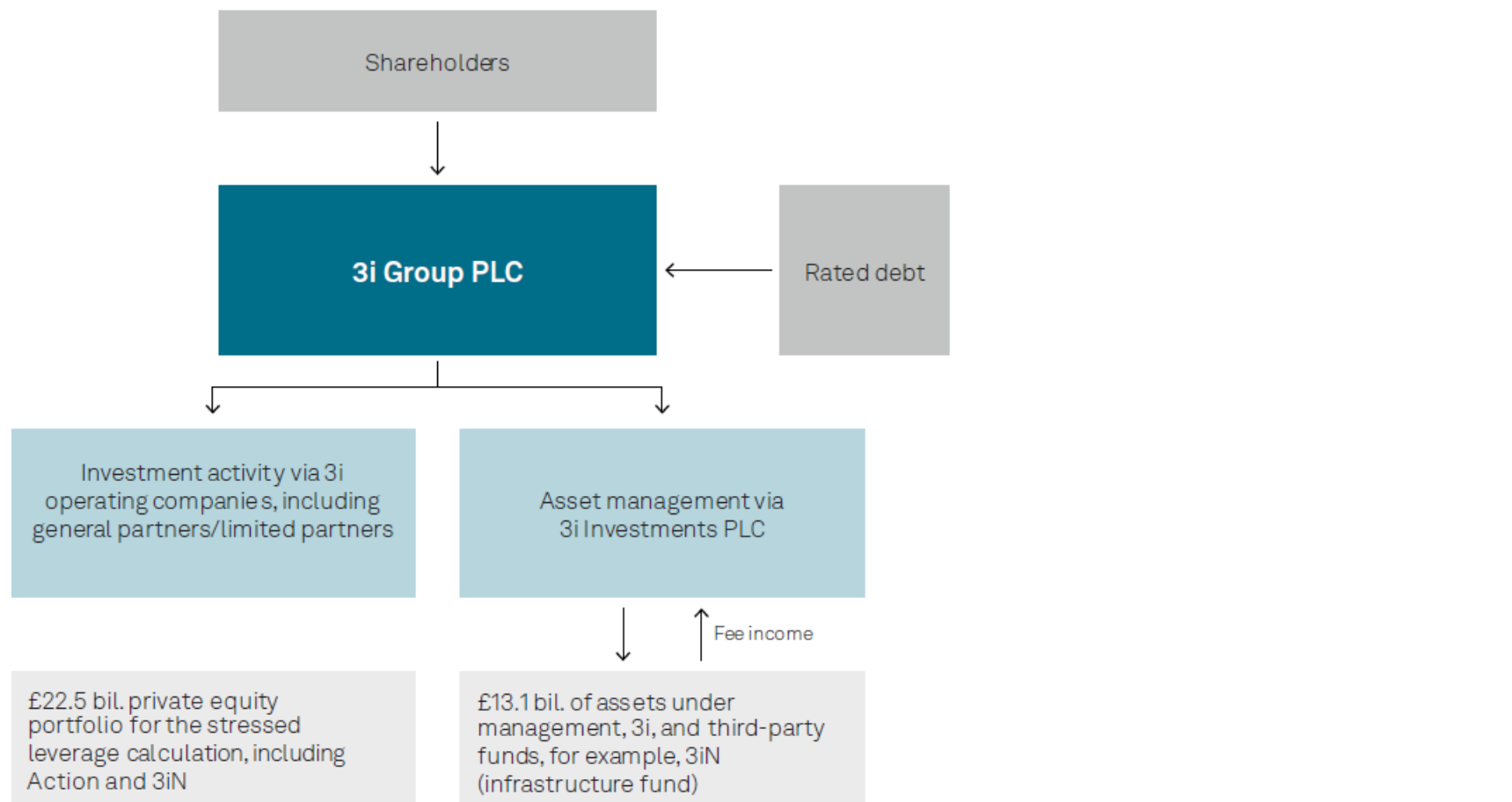
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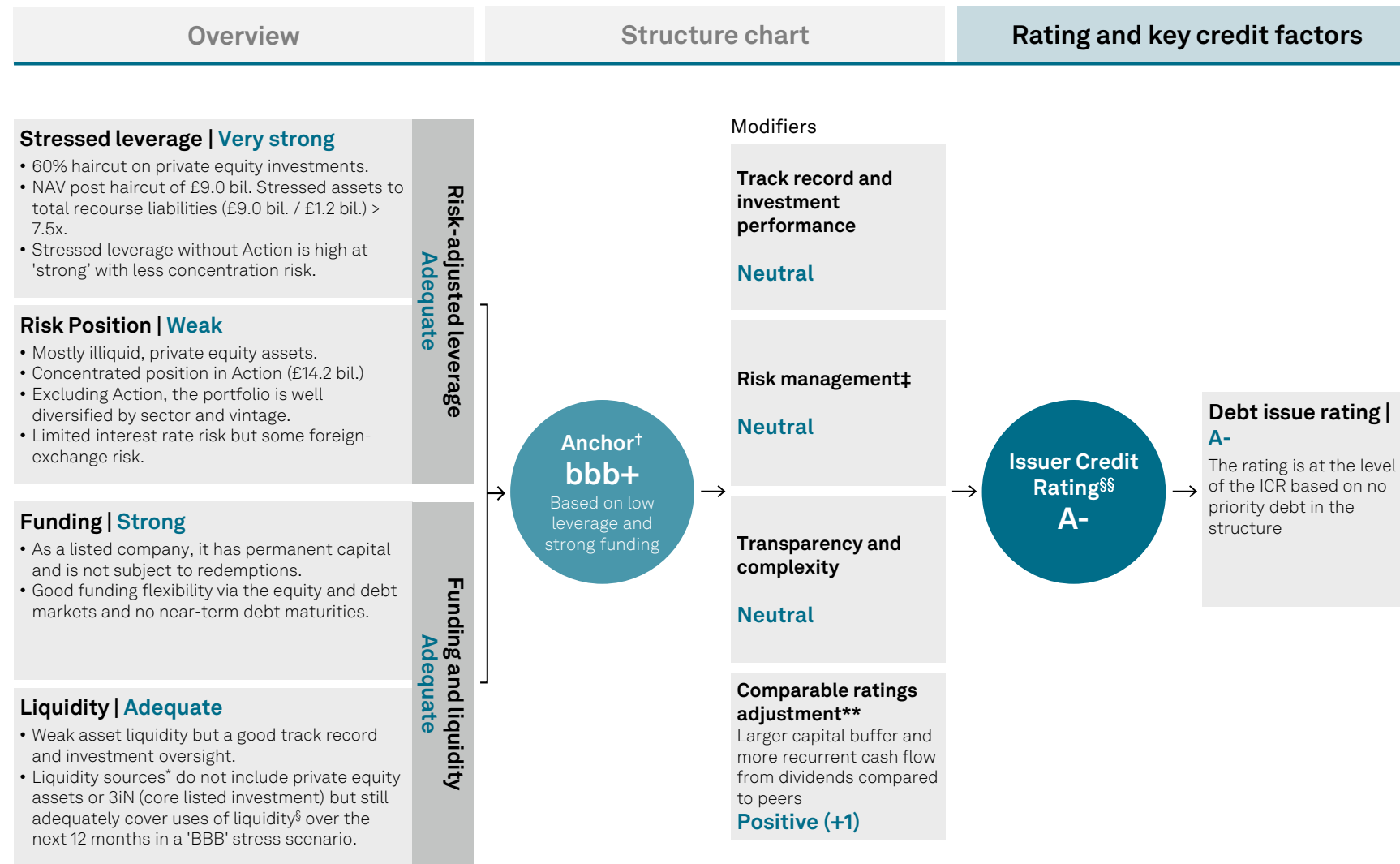
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\*Cash and interest, dividends, and fee income after haircuts. §Interest, fees, and other expenses, distributions, carried interest payable, and acquisitions. †Jurisdictional risk is neutral and therefore the preliminary anchor equals the final anchor. ‡Board oversight, comprehensive investment procedures, and conservative capital management.

\*\*Compares better to peers given robust cash generation and growth of Action and rest of portfolio. §§The fund doesn't have government or government-related entity support.

# Listed Equity Fund

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# Mercantile Investment Trust PLC

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## Mercantile Investment Trust PLC (Mercantile) A Fund Investing In Listed Equity

### Investment focus

- Mercantile is a U.K.-listed investment trust investing mainly in U.K.-listed, public, midsize companies, but also in small and large companies in all sectors in the U.S. and Europe.
- J.P. Morgan Funds Ltd manages the £2.2 billion portfolio.
- Net asset valuation is subject to market volatility.

### Status

- Mercantile is a buy-and-hold closed-ended fund with a 150-year track record.
- The trust benefits from permanent capital and no redemption risk.

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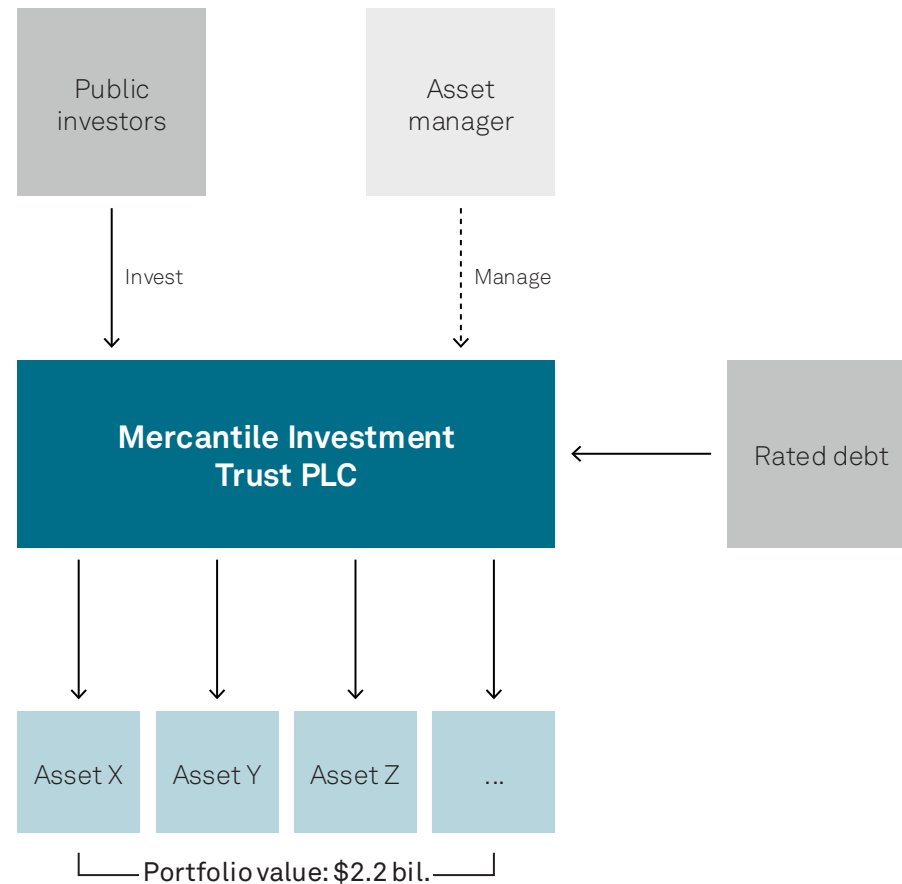
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Source: S&P Global Ratings.

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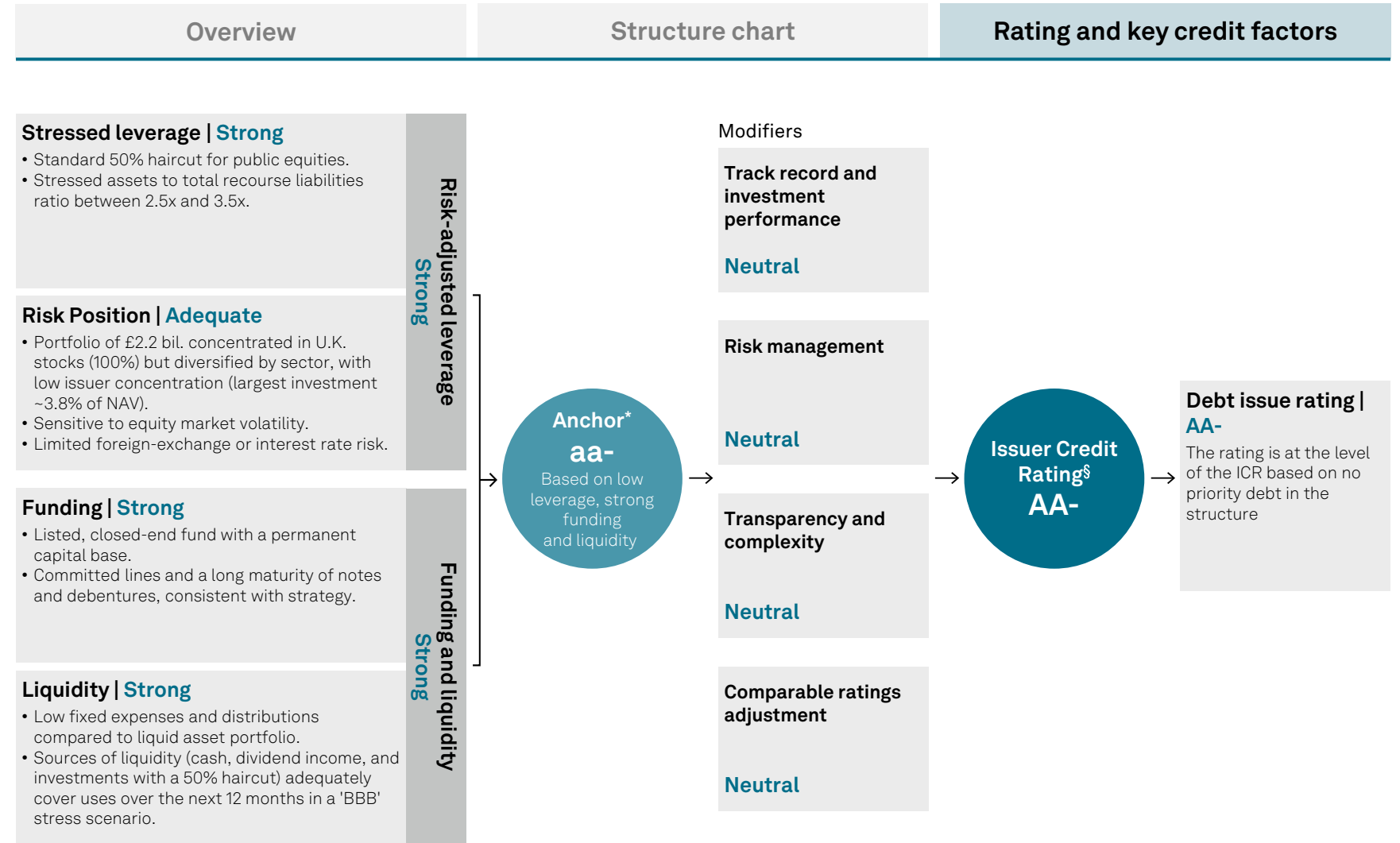
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# Private Debt Fund

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## MCP DASLF

### A private debt fund

#### Investment strategy

- The fund is an open-ended unit trust domiciled in Australia.
- The fund invests in a diversified portfolio of corporate loans, including syndicated loans to public and private companies (45% relates to real estate).
- The fund follows a "buy and hold" philosophy, keeping its loan assets to maturity in nearly all instances.

#### Funding policy

- Permanent capital was about 23% as of Dec. 31, 2022, and comes from listed retail-based Metrics Master Income Trust (the permanent capital provider).
- Other sources of capital are retail investors, overseas feeder funds, and direct wholesale investors (unit holders).
- As of March 31, 2023, the fund had access to a A\$1.25 billion syndicated revolving credit facility and a A\$300 million term loan facility.

# Metrics Credit Partners Diversified Australian Senior Loan Fund

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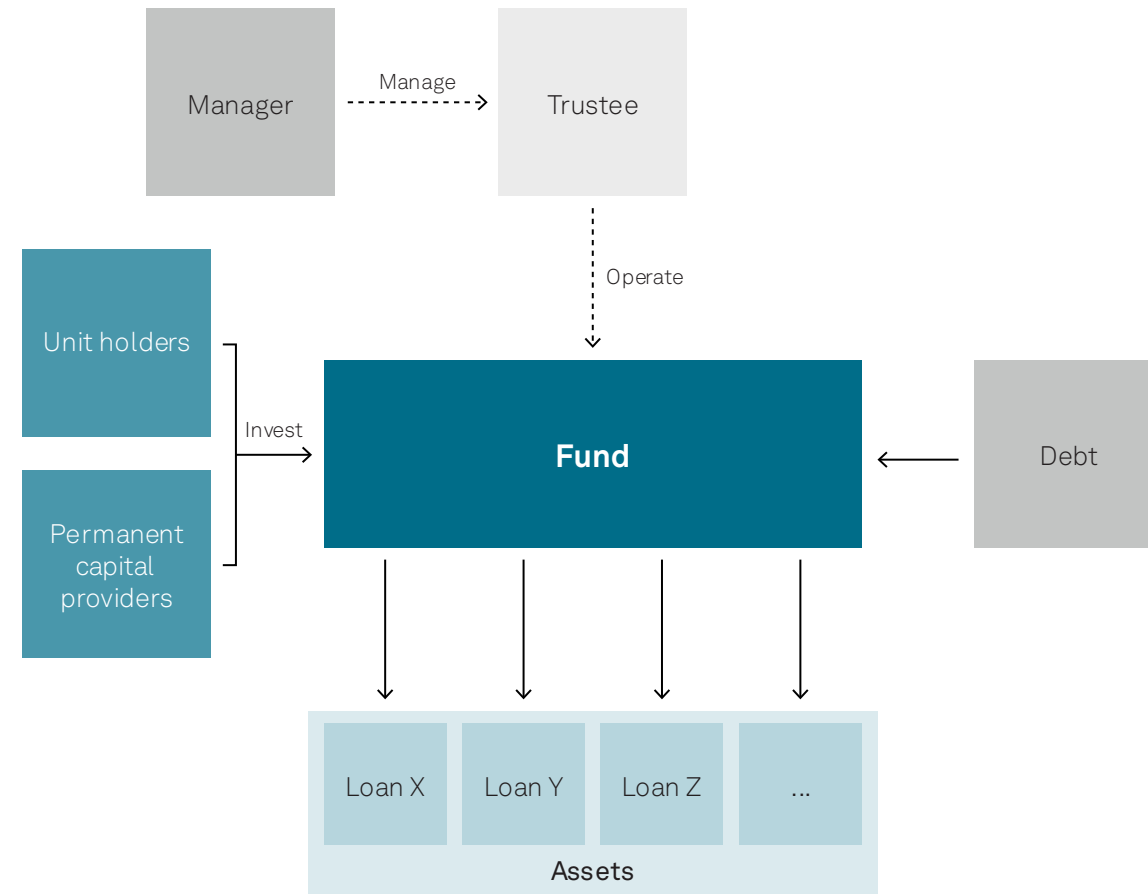
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Source: S&P Global Ratings.

# Metrics Credit Partners Diversified Australian Senior Loan Fund

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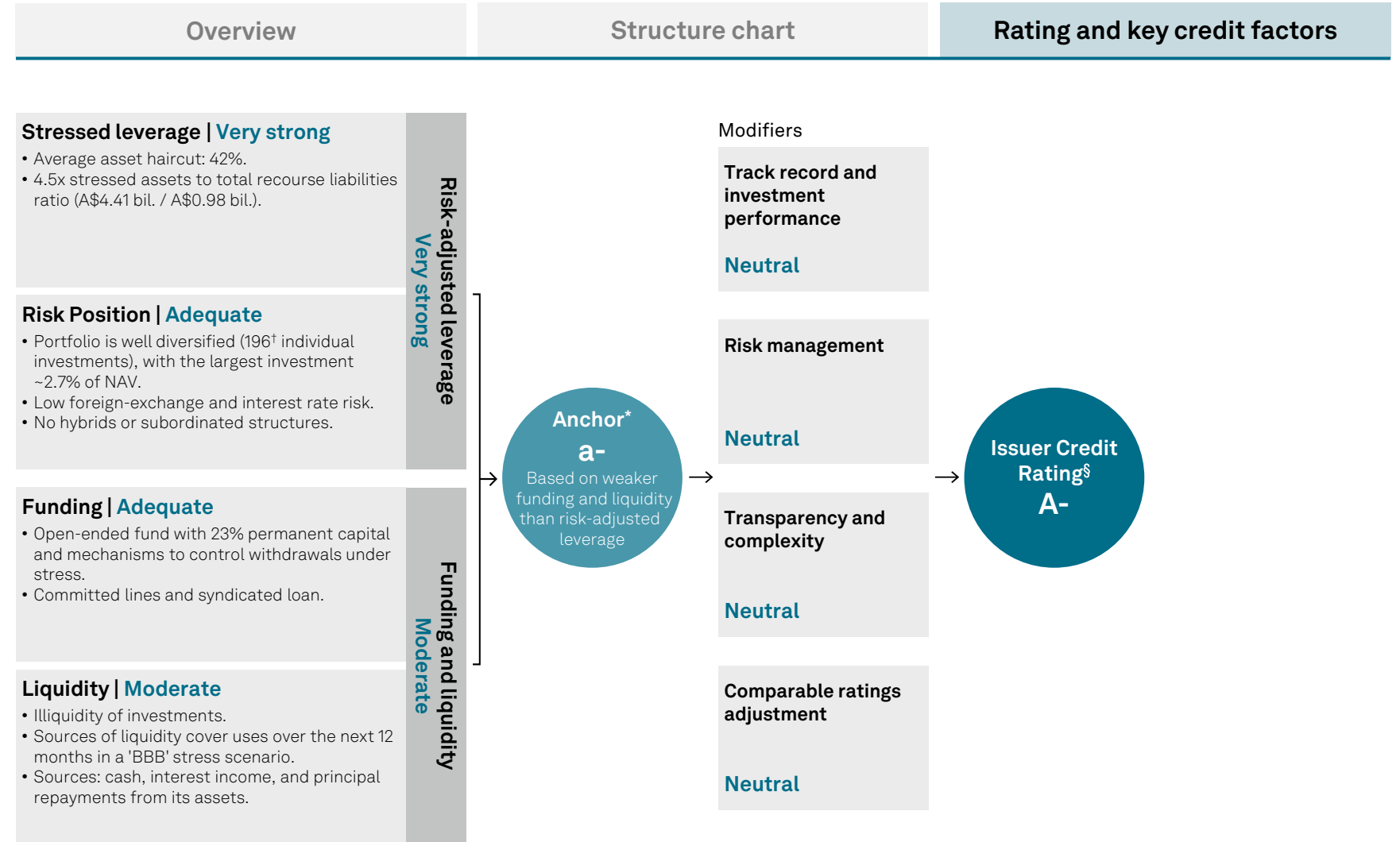
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\*Jurisdictional risk is neutral and therefore the preliminary anchor equals the final anchor. §The fund doesn't have government or government-related entity support.

†As of Dec. 31, 2022.

# Real Estate Debt Fund

Read on ↓

# MCP Real Estate Debt Fund

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## MCP Real Estate Debt Fund

### Investment strategy

- The fund is an open-ended unit trust domiciled in Australia.
- The fund provides debt financing to the Australian real estate sector through a mix of direct and indirect lending.
- The fund follows a "buy and hold" philosophy, keeping its loan assets to maturity in nearly all instances.

### Funding policy

- Permanent capital represented about 30% of total equity funding as of Dec. 31, 2022. The fund receives permanent capital from the group's two Australian Securities Exchange-listed vehicles: Metrics Master Income Trust and Metrics Income Opportunities Trust (the permanent capital providers).
- Other sources of capital are retail investors, overseas feeder funds, and direct wholesale investors (the unit holders).
- The fund has access to an A\$300 million syndicated bank debt facility.

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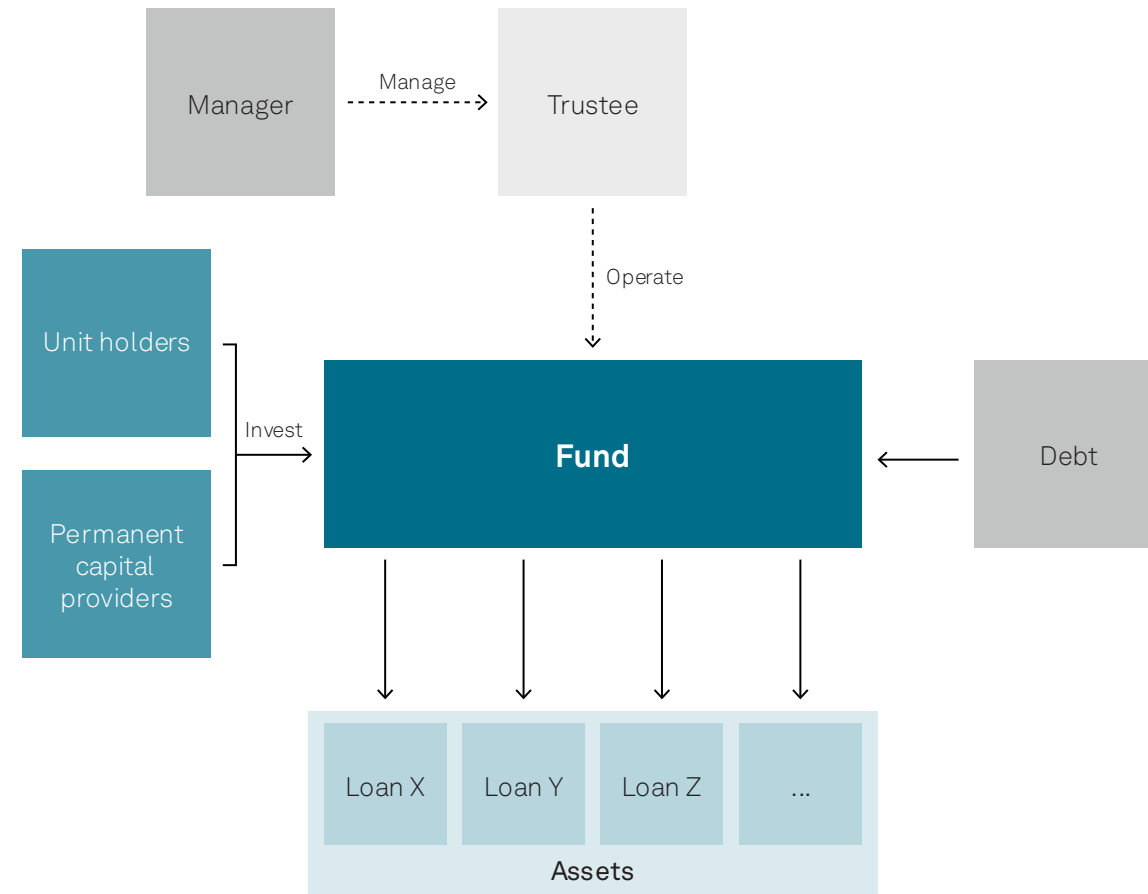
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Source: S&P Global Ratings.

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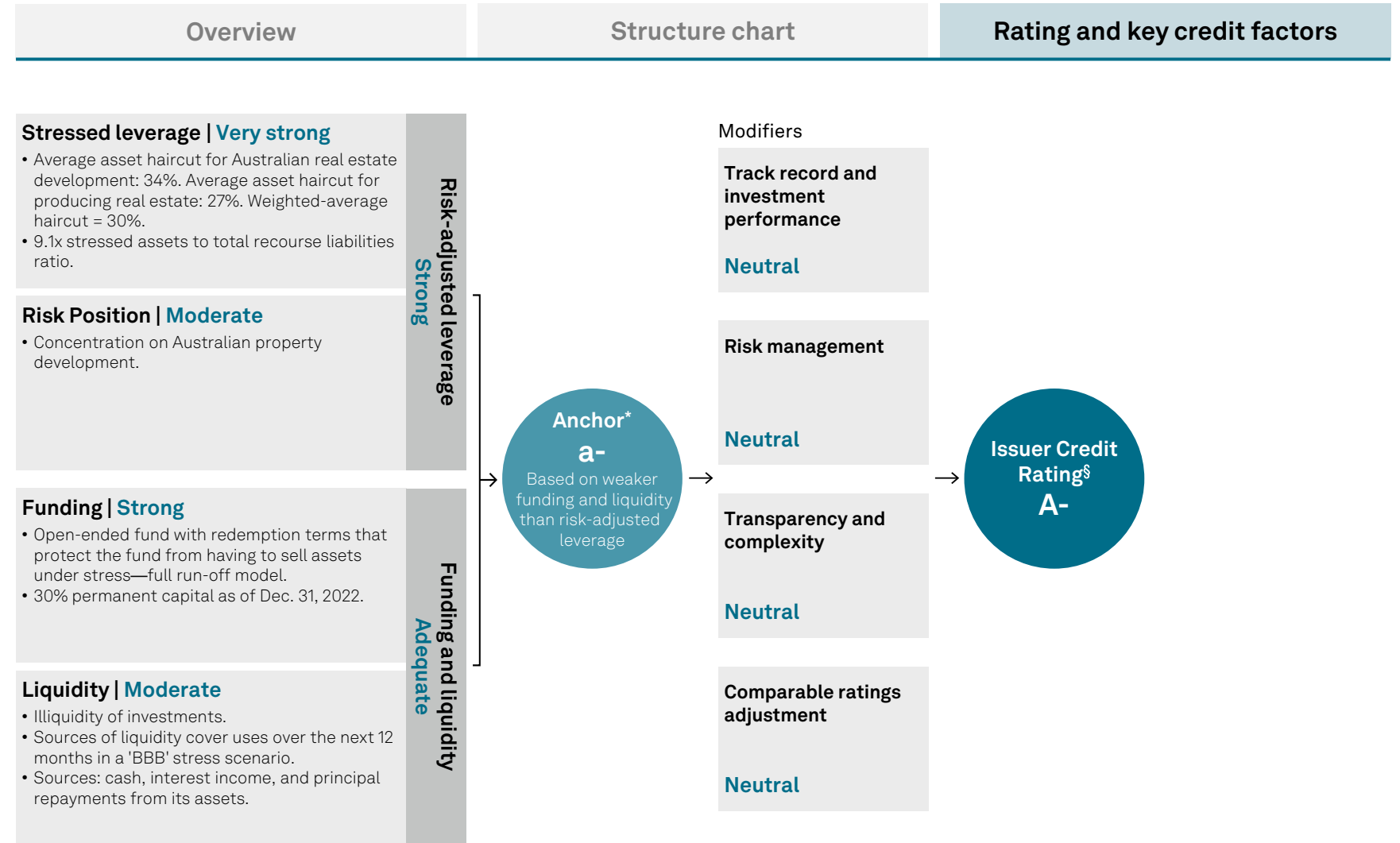
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# Hedge Fund

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## Citadel K/KII/W

### An open-ended hedge fund

#### Investment focus

- The three funds actively trade equities, fixed income and macro credit (including convertibles), commodities, and quantitative strategies. The allocation of capital to the various asset classes and strategies varies depending on trading opportunities.

#### Limited partners' commitments

- The funds are open-ended, with the potential for the general partners to limit or halt redemptions. About 70% of the capital base is redeemable quarterly over 16 quarters (one-sixteenth every quarter). The remaining 30% of the capital is subject to a rolling two-year committed lock without penalty.

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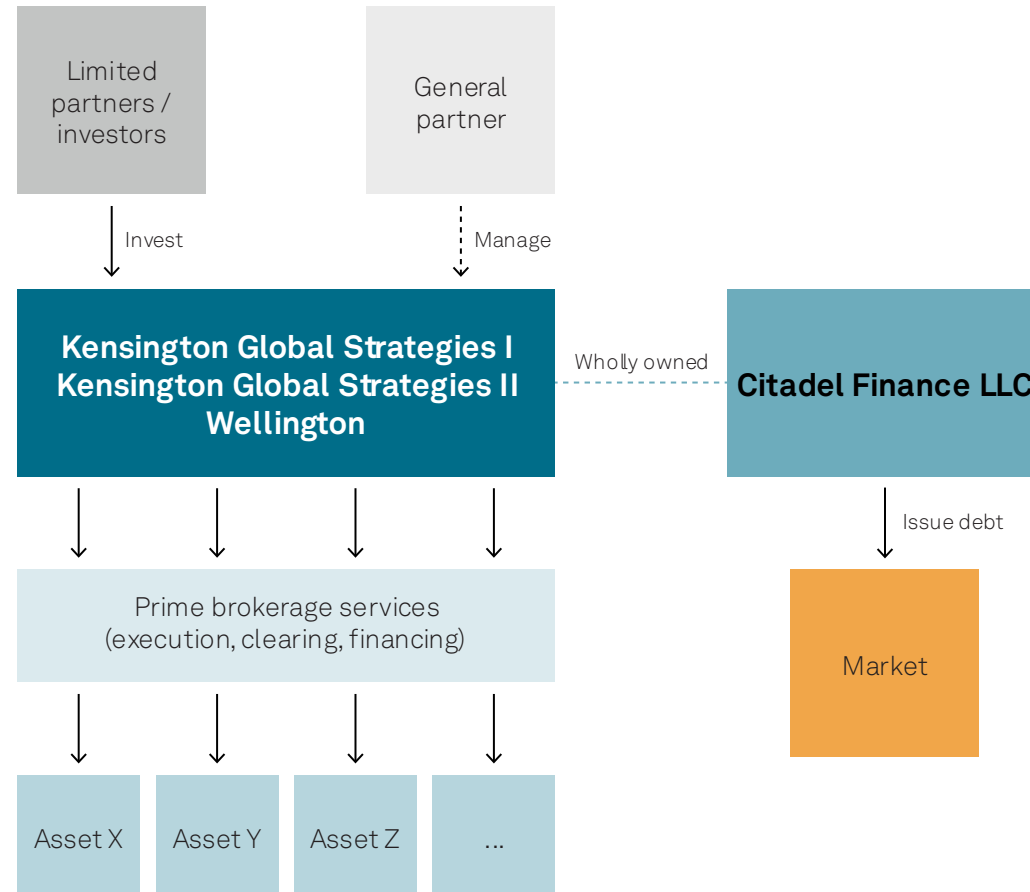
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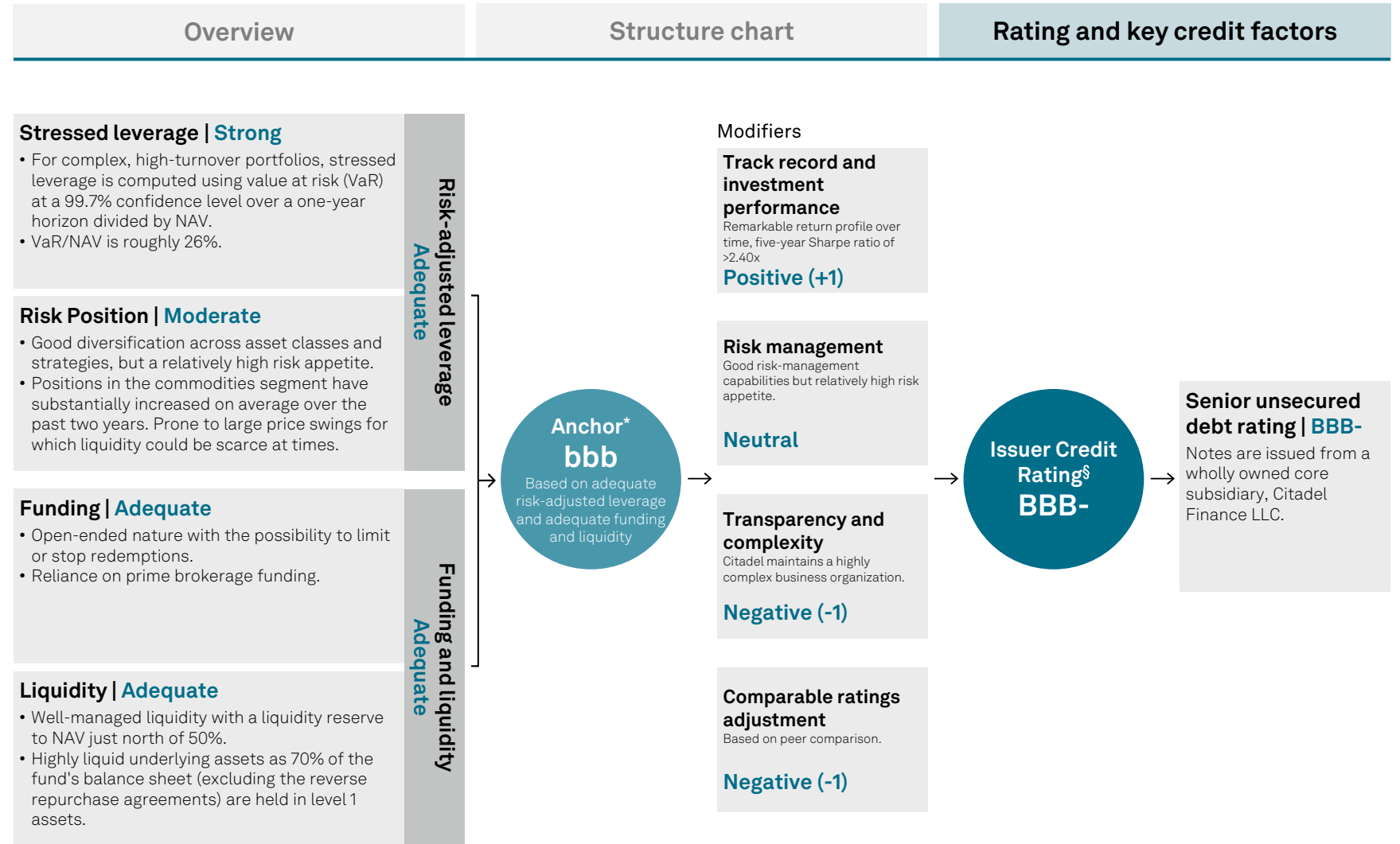
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# Subline facility

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## Subline Facility For Fund X -- A Private Equity Fund

### Investment focus

- Fund X is a private equity fund investing in companies in diverse industries in the U.S. and Europe. The fund targets 15 to 20 investments in next five years.
- The fund is the ninth vintage of the private equity strategy of a leading alternative asset manager; previous vintages performance were top quartile.

### Status

- Fund X is a closed-ended fund with a remaining life of nine years (extendable by an additional two years) and has made a single investment.
- Fundraising closed at \$4 billion. The fund has 120 investors, of which a majority are investment-grade professional investors.

### Facility

- The subline bridges new investments and add-ons before the manager calls the limited partners on their commitments.
- The facility has a three-year maturity, with yearly cash sweep, and a \$2.6 billion maximum drawdown (or 65% advance rate).

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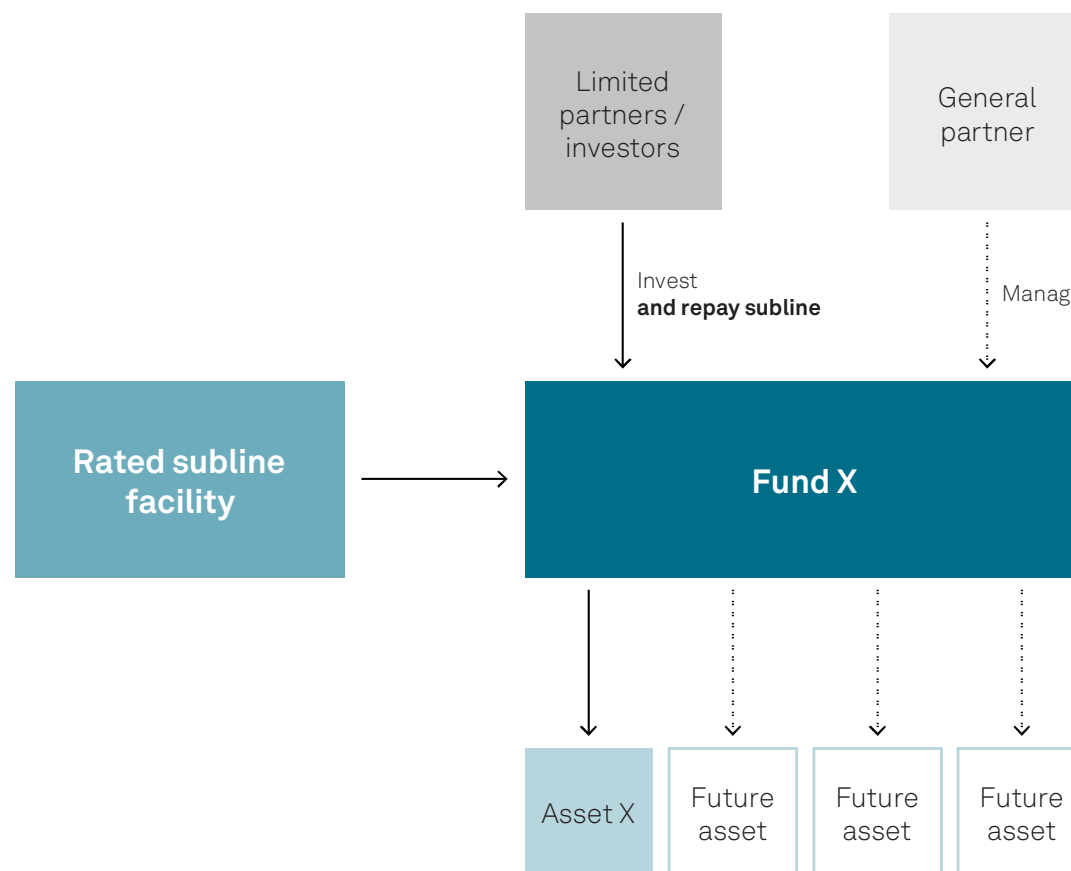
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Source: S&P Global Ratings.

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## Capacity | aa

- Well-diversified investor base, with mostly investment-grade LPs.
- No large concentration in sectoral credit estimates leading to model output uncertainty.
- Limited top investors concentration, not capping the capacity output.
- CDO evaluator model output of aa, with no further adjustment.

## Willingness and Structure | Adequate

- The fund is only starting investing, thus only limited portion of total capital commitment already drawn.
- 50% penalty percentage on NAV share upon not meeting capital calls.
- GP with a good track record in previous vintages, excellent reputation.
- 7% stake in the fund held by the GP and its affiliates, helping align interests with the LPs'.
- Notice period and time for overcalls to be effectuated in the industry norms.

## Modifiers

**Fund jurisdictional risk**

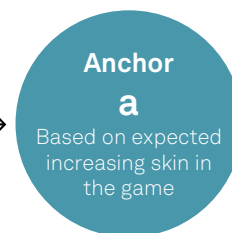
Neutral

**Other vulnerabilities or strengths**

Neutral

**Holistic analysis**

Neutral



\*No sovereign risk identified. AIF issue rating does not apply because it's below the subline issue rating.

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## Related Criteria

- [Alternative Investment Funds Methodology](#), Aug. 30, 2024
- [Methodology For Rating Subscription Lines Secured By Capital Commitments](#), Aug. 30, 2024

## Related Research

- [Bottleneck In Exits Will Increase Some Alternative Investment Funds' Leverage](#), Sept. 3, 2024
- [Rising Global Defaults Will Test Private Credit Funds In 2024](#), May 1, 2024
- [ABS Frontiers: The Blurring Of Private Credit Funds And CLOs](#), Jan. 30, 2024
- [Difficult Markets Will Test Europe's Rated Alternative Investment Funds](#), Dec. 5, 2023
- [Credit FAQ: Defining And Rating An Alternative Investment Fund](#), March 31, 2023



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# Stressed Leverage—Buy And Hold Funds

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**Stressed leverage measures a fund's ability to cover outstanding financial obligations in adverse economic conditions or changing circumstances.**

- **For funds that use more transparent, traditional strategies** and have asset profiles that do not change significantly over a short time horizon, we typically apply a **haircut to the assets** to reflect typical market movements in a 'BBB', or moderate, stress scenario and compare the ability of the stressed assets to cover total recourse liabilities (stressed assets to total recourse liabilities).
- **We devised a set of haircuts for the most common asset classes. For example:**
  - 36% for U.S. 'BB' coupon-bearing corporate bonds with a residual maturity of five-to-seven years;
  - 85% for 'AAA' rated commercial mortgage-backed securities;
  - 50% for listed stocks;
  - 60% for private equity; and
  - 0% for cash and cash equivalents.

**Stressed assets to total recourse liabilities**

Assessment	Range
Very strong	>3.5x
Strong	2.5x-3.5x
Adequate	1.75x-2.5x
Moderate	1.0x-1.75x
Weak	0.5x-1.0x
Very weak	<0.5x

- For asset classes for which we do not already have a haircut, we typically take one of two approaches:
  - We find the closest asset class that we have a stated haircut for and adjust using the risk position; or
  - We apply a haircut to the asset of 25%, 50%, 75%, or 100%, based on our view of the asset as low risk, medium risk, high risk, or very high risk.
- **Total recourse liabilities include all debt obligations issued by a fund, repurchase agreements, and prime brokerage financing.** They exclude nonrecourse liabilities (such as collateralized loan obligation debt) and the portion of hybrids to which we assign equity content.

# Stressed Leverage For Funds With More Complex Strategies

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**Stressed leverage measures a fund's ability to cover outstanding financial obligations in adverse economic conditions or changing circumstances.**

- **For funds that use more complex strategies or have a large turnover position**, we typically consider portfolio-based risk measures to assess the sufficiency of a fund's equity under stress (**VaR/NAV**).
- We typically assess stressed leverage based on a measure of VaR using a one-year horizon and a 99.7% confidence level. We typically adjust with an additional stress to compensate for the fact that regulators typically do not validate VaR calculations for AIFs.
- We typically compute a one-year VaR at a 99.7% confidence level by scaling up (or down) the risk metrics a fund reports. Importantly, the starting point of our analysis is a risk metric that a fund uses in daily risk management and that is regularly back tested. Weak back-testing results result in a higher multiplier.

## Portfolio-based risk measures

Assessment	VaR/NAV range (%)
Very strong	<20
Strong	20-40
Adequate	40-55
Moderate	55-75
Weak	75-100
Very weak	>100

VaR--Value at risk. NAV--Net asset value.

# Risk-Adjusted Leverage

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## Adjustment for risk position

We refine our view of leverage and asset risk beyond the standard assumptions by looking at six factors:

- Risks not captured in stressed leverage (for example, interest-rate risk, spread risk, or currency risk);
- Concentration (for example, single-name, geographical, or sector concentration);
- Risk of the strategy;
- Volatility of past investment returns;
- Appropriateness of stresses (that is, the risks captured in stressed leverage, but for which the haircut might not be totally appropriate given the specific nature of the risks); and
- Quality of capital.

## Determining the risk-adjusted leverage

Stressed leverage assessment	
Very strong to very weak	
Risk position assessment	
Strong	+1 category
Adequate	Neutral
Moderate	-1 category
Weak	-2 categories

# Funding And Liquidity

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## Funding

We consider the **relative stability of an AIF's sources of funding** and the extent to which stable funding is important given the investment strategy:

- Stability and diversity of the investor capital base;
- Stability and diversity of the funding sources (nonequity funding);
- Prime brokerage relationships; and
- Funding flexibility.

## Liquidity

### The quantitative test

- For funds that use a more transparent, traditional strategy—we assess **sources divided by uses under a stress scenario** over a one-year horizon. We typically apply a haircut to assets to reflect their potential loss in liquidation value in a 'BBB' stress scenario.
- For funds that use more complex strategies or have a large turnover position, we typically evaluate liquidity through the key quantitative indicator of **liquidity reserves to trading capital**.

### Qualitative factors

- **Asset liquidity:** Level I assets are a positive. Level III assets are a negative.
- **Cash flow from the portfolio:** Predictable cash flow coming from the portfolio is a positive. No recurring cash flow from the portfolio is a negative.
- **Covenant analysis:** No covenants affecting liquidity (debt, derivative, or performance covenants) is a positive. If there are covenants, the assessment is more negative as the covenants are more likely to be breached, triggering liquidity outflows that the quantitative liquidity test does not already reflect.

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		Funding and liquidity					
		Very strong	Strong	Adequate	Moderate	Weak	Very weak
Risk-adjusted leverage	Very strong	aaa	aa+/aa	aa-/a+	a/a-	bbb+/bbb	bbb-/bb+
	Strong	aa	aa-/a+	a/a-	bbb+/bbb	bbb-/bb+	bb/bb-
	Adequate	a	a/a-	bbb+/bbb	bbb-/bb+	Bb	bb-
	Moderate	bbb+	bbb+/bbb	bbb/bbb-	bb+/bb	bb/bb-	b+/b
	Weak	bbb-	bb+/bb	bb/bb-	bb-/b+	b+/b	b
	Very weak	bb	bb-	bb-/b+	b+	b	b-

We combine the risk-adjusted leverage and funding and liquidity assessments to derive the preliminary anchor.

# Other Modifiers

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## Track record and investment performance

Addresses potential investment return volatility and profitability (both absolute and relative).

## Risk management

Addresses certain risks that are not otherwise captured. These relate to a fund's trading and credit risk management, operational risk management, and management and governance risk.

We may consider risk management practices to be a substantial risk to a fund. Examples include but are not limited to:

- When formal systems to encourage the representation of creditor rights are insufficient;
- When the fund is unable to generate periodic risk reports consistent with past behavior; and
- When we believe that substantial operational deficiencies exist, given the complexities of the investment profile.

## Transparency and complexity

Addresses risks relating to a fund's complexity or the transparency of its disclosures.

## Comparable ratings adjustment

We may apply an adjustment based on our comparable ratings analysis to capture a more holistic view of creditworthiness. This allows for the consideration of additional credit factors that the criteria do not identify separately, as well as existing credit factors that are not fully captured, but that may be informed by our peer analysis.

## Determining the SACP

<b>Anchor</b>	'aaa' to 'b-'
---------------	---------------

## Track record and investment performance

Positive	+1 notch
----------	----------

Neutral	0 notches
---------	-----------

Negative	-1 notch
----------	----------

## Risk management

Neutral	0 notches
---------	-----------

Moderately negative	-1 notch
---------------------	----------

Negative	-2 notch
----------	----------

Substantial risk to the fund	> -2 notches
------------------------------	--------------

## Transparency and complexity

Neutral	0 notches
---------	-----------

Negative	-1 notch
----------	----------

Comparable ratings analysis	+1, 0, -1 notch
-----------------------------	-----------------

\*The modifiers do not cumulatively lower the SACP below 'b-'



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## Senior secured

- We often rate all secured debt and senior unsecured debt at the same level as the ICR.
- However, we may rate first-lien senior secured debt higher than the ICR by one notch if we believe that the collateral backing the debt is sufficient to repay secured creditors after applying our stressed leverage haircuts with 20% over-collateralization.

## Junior secured and senior unsecured debt

- Often at the same level as the ICR.
- One notch below the ICR when either of the following conditions apply:
  - Priority debt is greater than 15% of adjusted assets, and we expect unencumbered assets to be less than the rated unsecured or junior secured debt; or
  - Priority debt is greater than 30% of adjusted assets, and we expect unencumbered assets to be greater than the rated unsecured or junior secured debt.
- Two notches below the ICR when both of the following conditions apply:
  - Priority debt is greater than 30% of adjusted assets; and
  - We expect unencumbered assets to be less than the rated unsecured or junior secured debt.

When considering the conditions above, we deduct nonrecourse secured debt from priority debt, and we deduct the assets pledged to that debt from adjusted assets.

## Dual-pledge subscription facilities

- Dual-pledge subscription facilities secured by both a senior pledge of the assets of a fund and its LP capital commitments could be rated up to two notches higher when we expect UCC to represent a substantial portion of the borrowing base when the facility matures and asset collateral backing the debt and UCC provide a sufficient level of over-collateralization.

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