Term tracking

Alternatives to raising private debt hurdles

Floating hurdle rates, catchups and carried interest tiers

In the first article of this two-part series on private debt hurdle rates, we looked at how the recent rise in interest rates has led some private debt investors to view hurdles as "too achievable" and the arguments that can be made both for and against increasing hurdles.

Not many funds have come back to market since interest rates increased drastically, which makes sampling harder, however, whilst so far only a few fund managers have increased hurdles, several have felt pressure from investors to justify maintaining the same waterfall structure given the current market environment.

One of the key concerns of increasing hurdles is that market conditions may change, and managers may be left with hurdles that are too high. This could lead to a misalignment of GP and LP interests which does not benefit either party - a hurdle that is too high may disincentivise GPs or incentivise them to take on excessive risk. For GPs that do not wish to raise their hurdles, this article will explore options to improve alignment and appease investors who wish to see some change to fund terms.

Floating hurdle rates

Floating hurdle rates are not a common feature of private debt funds. However, in recent months they have been increasingly mentioned by both managers and investors as a potential alternative to address interest rate volatility. Typically, hurdle rates in private debt funds have a fixed percentage (e.g. 5%). Given that most private debt funds lend on a floating rate basis, a floating hurdle rate may be better suited to align the GP incentive with the underlying assets.

A floating hurdle rate varies according to a reference rate[1] guaranteeing that the manager is not being compensated solely due to a market-wide rise in interest rates. Because the objective is to align performance compensation to underlying instruments, the reference rate used for the hurdle should be consistent with the fund's underlying loans and consider the market/geography and the currency most relevant for the fund's strategy. This implies that determining an appropriate reference rate is more challenging for funds with a greater global focus. A margin, also known as spread, would also typically be added to the reference rate. As with fixed hurdles, floating hurdles can be compounded annually in arrears based on the previous year's average reference rate. The challenge however is in determining the margin over the reference rate.

Different approaches for determining the margin

- **Implied historic margin:** considering the period between 2018 and 2022 when UK reference rates were close to 0.6%[2], the margin of a direct lending floating hurdle would have been 4%-4.5% to mirror the fixed hurdle offered at the time. That same margin today would imply a current hurdle in excess of 9%, which for direct lending would be considered excessive.
- **Margin based on underlying loans:** one possible approach is to mimic the underlying terms so that if, on average, a fund expects to lend at reference rate + 5% for example, the hurdle would be set at reference rate + 3%. However, if reference rates return to 0.6%, this hurdle could be considered too low.
- **Adding a floor:** establish a relatively lower margin over the reference rate and add a floor e.g. reference rate (floored at 3%) + 2% margin. In this case, the hurdle rate is floored at 5% and is likely to vary in coming years between 7.5% and 5% based on ING's forecast for UK interest rates.
- **Adding a cap:** caps, also known as ceilings, can in theory also be included. However, it is uncommon for lenders to cap interest payments, instead it is usually up to borrowers to manage this risk[3]. In the context of hurdles, LPs may also not find caps as attractive.

[1] As with underlying debt instruments, potentially relevant reference rates vary by currency and market, and include the following (and rates derived from them): EURIBOR, SOFR and SONIA.

[2] Based on yearly averages for SONIA between 2018 and 2022 for simplicity - please note that SONIA-based loans are likely to use SONIA "compounded in arrears" across the relevant interest period of the loan (usually 1M, 3M or 6M).

[3] It is often up to the borrower to cap its interest rate risk via linked interest rate derivatives.

Hurdle rates, often referred to as preferred returns, set the minimum return required before GPs can start sharing in the profits with LPs. In private debt, these are typically "soft" hurdles meaning that the GP receives carry on the entirety of the profits (if the hurdle is met).

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Benefits and challenges of floating hurdle rates

Benefits	Challenges
They are more intuitive than fixed hurdles as they match the behaviour of the underlying loans.	Linking private debt hurdles to interest rates implies a linear relationship between interest rates and fund performance. However, as mentioned in the previous article of this series, this relationship is not linear. Private debt loans are primarily exposed to credit risk, which is expected to continue to increase in the current environment.
They aim to maintain alignment through different market conditions.	In a high interest rate environment, the floating hurdle will likely only reflect the behaviour of fully performing loans. However, at the fund level, it is expected that during such a period, several portfolio companies will look to amend or restructure their loans and some might experience technical or actual default. Notably, this is not reflected in the floating hurdle.
They can be protective for the GP and for the LP.	Floating hurdles are not market standard. They can create some additional complexity when calculating the preferred return and when calculating equalisation interest for LPs entering the funds at later closes.

In practice, there are few examples of private fund managers using floating hurdle rates. Some examples can be found in business development companies (BDCs). Notably, Barings has had a floating hurdle for one of its BDCs since 2020 and TCW suggested in 2017 (a time when interest rates were rising in the US) that Hercules Capital should also adopt floating hurdles[4]. Still, from publicly available information, private credit BDCs launching in 2023 are still opting for a fixed hurdle.

Barings Capital Investment Corporation

Launch	2020
Strategy	Senior secured private debt
Hurdle	**Floating hurdle:** LIBOR, no spread. Determined quarterly based on the average daily rate for that quarter **Floor/ceiling:** 0% floor, no ceiling

Hercules Capital

Launch	Proposed in 2017 as part of TCW's bid to become Hercules' external asset manager. The proposal was not accepted and Hercules remains with a fixed hurdle
Strategy	Secured debt financing for venture capital-backed and institutional-backed companies in technology-related industries
Hurdle	**Floating hurdle:** LIBOR + 5% **Floor/ceiling:** LIBOR floor of 2% i.e. hurdle rate floor of 7%, no ceiling

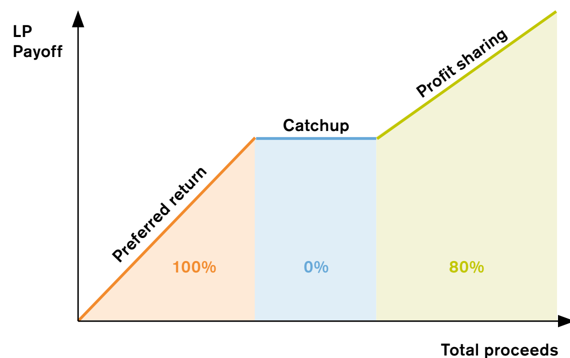
[4] In 2017, TCW submitted a proposal to Hercules' independent board members to become its external investment advisor. This proposal was not accepted.

Catchups

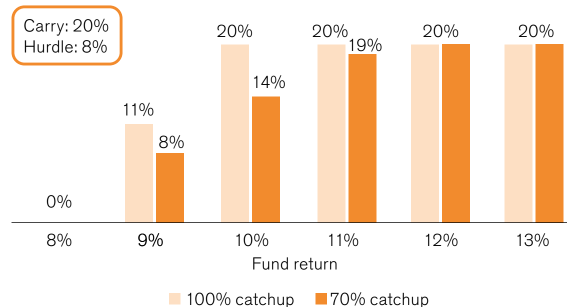
Most hurdle rates in private debt are "soft" meaning that the GP receives carry on the entirety of the profits (if the hurdle is met). This means that, after the LP receives the preferred return there is an imbalance in carry distributions that must be rectified. The catchup period addresses this by awarding the GP a higher percentage of the profits until the profit split determined by the carried interest agreement is reached.

The percentage distributed to the GP during the catchup period can vary. For example, an 80% catchup implies that during this period, 80% of the profits are distributed to the GP and 20% to the LP until the profit split is reached, whereas with a 100% catchup the entirety would go the GP. Historically, the 100% catchup has been seen as the standard term in private debt – this has been the case for over 80% of the direct lending funds we have established in the last five years.

Illustration of LP payoff given a 100% catchup
(after management fee and return of invested capital)



The following graph illustrates the impact of different catchup rates on the manager's carried interest.



With a 70% catchup, the GP only gets to the agreed carry split if the fund returns 11.2% compared to 10% with a 100% catchup. This illustrates how catchups impact GP incentives by requiring a higher effective rate of return to get to full carry. It also illustrates how catchups do not impact profit distributions when the hurdle is comfortably surpassed i.e. the catchup does not correct a large misalignment between the hurdle rate and the target return.

In the following example we use typical direct lending terms, 5% hurdle and 10% carry, to illustrate how a 50% reduction in catchup may be a better tool for alignment than increasing a hurdle by 50 basis points, which, as mentioned in our previous article, is the most common increase we currently see.

Hurdle	Catchup	Percentage return required for full catchup
5%	100%	5.5%
5%	50%	**6.25%**
5.5%	100%	6.11%
5.5%	50%	**6.87%**
6%	100%	6.67%

By lowering the catchup to 50%, rather than increasing the hurdle by 50 basis points, the GP starts participating in the profits earlier, but only reaches the agreed carried percentage later when compared to a higher hurdle where the catchup is kept at 100%.

This can be a helpful tool to align GP and LP interests whilst simultaneously diminishing the risk that if fixed hurdles were increased for current vintages and then interest rates came down, managers could be incentivised to take on excessive risk to get into carry.

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Tiered approach

Currently investors believe there is potential for higher returns in private debt and therefore want higher hurdles to ensure managers are incentivised to make the most of current opportunities. Essentially, investors do not believe private debt managers should receive high levels of carried interest for returns that can be achieved in more liquid markets.

Another way to incentivise managers to achieve higher returns is by using a tiered approach for carried interest - the carried interest percentage increases as the fund hits certain return benchmarks. This approach has typically been seen in private funds with a higher upside potential, such as venture capital, to reward managers for extraordinary returns. They have also been seen in continuation funds more recently. However, it could also be applied to the private debt context to align different levels of return to appropriate reward.

What we see in practice

- We see some increase in managers reducing catchups in order to be perceived as more LP friendly and to help differentiate their funds. However, 50% catchups are still rare.
- Whilst some managers are known to be currently considering a floating hurdle, this is still far from being a common term for private debt funds.
- Tiers are not often seen in private debt funds; these have been so far mostly seen in private equity continuation funds and venture capital.

Key takeaways

- There are some merits to floating hurdle rates, but margins must be defined carefully to account for the fact that, at the fund level, very high interest rates over a defined period do not always translate to very high returns over the life of the fund.
- Lowering catchups does not correct a large misalignment between the hurdle rate and the target return. However, it can be an effective alternative to a small increase in hurdle.
- Although there are alternatives to increasing hurdles, these are still not commonly used. The alternatives to increasing hurdles mentioned in this article are a deviation from the standard private debt terms. As such, they may create friction when marketing to some investors. Several managers see an increment of 50 basis points to the hurdle as a less complex solution.

How we can help

This note was prepared by our private capital advisory team who provide holistic advice on how to shape products, terms, structures and marketing strategies to support fundraising efforts and fund level transactions and deals. Learn more about our expertise. For more information, please contact one of the contacts listed below, or your usual Macfarlanes contact.

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