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Alternative Private Equity Fund Structures

Leveraging Emerging Alternatives to Traditional Private Equity Investment Vehicles

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Today's faculty features:

Alex Gelinas, Partner, **Sadis & Goldberg**, New York

Steven Huttler, Partner, **Sadis & Goldberg**, New York

Michael H. Lewis, Jr., Director, Business Development, **SS&C GlobeOp, Alternative Assets**, New York

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Alternative Private Equity Fund Structures

Leveraging Emerging Alternatives to Traditional Private Equity Investment Vehicles

March 27, 2014

Steven Huttler, Partner
Sadis & Goldberg LLP

Steven Huttler is a partner in the firm's Financial Services and Corporate Groups. Mr. Huttler has extensive experience in corporate, finance, investment fund and securities matters, including the representation of U.S. and foreign investment funds, underwriters, and private clients in various registered public and private offerings of debt and equity securities totaling in excess of $10 billion.

As part of his investment fund practice, Mr. Huttler has served as corporate counsel to many private investment funds and partnerships based in or domiciled in the United States and in international and offshore jurisdictions such as the Cayman Islands, Bermuda, the British Virgin Islands, Ireland, Luxembourg, Isle of Man, Jersey, Guernsey, Cyprus, Mauritius, United Kingdom, Austria, Russia, India and Gibraltar. Mr. Huttler's legal practice has exposed him to diverse fund clients with an exceptionally wide range of investment programs and structures, including large mutual funds and hedge fund complexes, private equity firms, real estate partnerships and funds, venture capital funds and funds focused on specialty finance assets. He has also counseled small start-up hedge funds and financial industry entrepreneurs. His practice has included structuring and establishing start-up funds and managed accounts, and structuring investment funds to benefit from U.S. double taxation treaties. He has advised management companies and fund managers on compensation structures, restructured and reorganized funds, structured, negotiated and documented fund trades, negotiated seed, joint venture and start up agreements, and advised on a range of sophisticated transactions. He has also represented financial services providers, such as brokerage firms (including proprietary trading broker-dealers), fund administration firms and third party marketing firms in structuring their operations, reorganizations to achieve tax benefits, advising on disputes with clients, and in the development of forms for their pension, investment, trading, administration and other services to investment funds, equity, debt and option traders and other clients.

SadisGoldberg LLP

Alex Gelinas, Partner
Sadis & Goldberg LLP

Alex Gelinas is a partner in the firm's Tax Group. Mr. Gelinas focuses his practice on providing tax advice to investment managers of hedge funds, private equity funds and other investment funds on all aspects of their businesses, including management entity and fund formation, partnership taxation issues, compensation arrangements and ongoing investment activities and transactions. Mr. Gelinas also provides tax advice to U.S. pension funds, sovereign wealth funds and other U.S. and foreign institutional investors in connection with their investments in private equity funds, hedge funds and U.S. joint ventures. He also has extensive experience in providing tax planning advice to high-net-worth individuals and families.

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Michael H. Lewis, Jr.
Director, SS&C GlobeOp

Michael Lewis Is a Director of Business Development for SS&C's Alternative Investment division providing software and administrative solutions to Private Equity, Venture Capital, Fund-of-Funds and Hedge Fund managers. Michael has more than 13 years of experience in financial Services. Prior to joining SS&C Michael worked with Citigroup Global Transaction Services and DTE Energy in the treasury department. Michael obtained a Bachelors of Business Administration from the University of Michigan- Dearborn with a Masters of Business Administration from the University of Michigan. Michael is also a field artillery veteran of the United States Army.

Overview of Presentation

- **The Challenge**
- **Emerging Developments**
- **Examples**
- **Cost Benefit Analysis**
- **SPV's**
- **Pledge Funds**
- **Alternative Model: Deal Aggregator**
- **Special Regulatory Issues: ERISA and Tax**
- **Administrative Issues**

The Challenge

- **Raising capital of any kind for new managers is exceptionally hard in current environment.**

- **For managers with Private Equity (PE) expertise, this issues is escalated because PE funds traditionally had long terms (e.g., 7 to 10 years) to allow time for investments to mature and for the manager to introduce sufficient diversification to make PE portfolios profitable.**

- **<u>Irony</u>: there is a lot of institutional and HNW investment money available; but "chicken-and-egg" problem. Institutional money insists on investment minimums of $20 - $50 million but investments must not exceed > 10% - 20% of total AUM in fund.**

- **How does a knowledgeable manager raise money in this environment?**

Emerging Developments as Responses to these Conditions: General

- **Managers seeking capital for PE transactions are "getting deals done" through alternative structures and under alternative arrangements.**

- **Goal is generally but not always to build track record without tremendous burden of raising traditional PE funds.**

- **These structures and arrangements tend to have one or more of the following characteristics:**
  - **Less discretion for manager, more discretion for investors**
  - **Time periods dealing with managers are entrusted with capital are reduced (sometimes radically)**

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Emerging Developments as Responses to these Conditions: Specific Examples

- **Traditional PE Funds with much shorter terms**
  - Instead of 7 – 10 years, half that much
- **Deal-by-deal structures and relationships**
  - "Different "flavors"
  - SPV's for specific transactions
  - This is a variation on an old theme "club deals"
  - "Pledge Funds" - standard PE documents but crucial feature is ability to opt in/out of deal
- **Origination Relationships**
  - PE manager "underwrites" deal but doesn't fully manage it

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Emerging Developments as Responses to these Conditions: Specific Examples - Cost-Benefit Analysis

- **Advantage:**

  It is not hard to see why PE managers would prefer some of these structures and arrangements to sitting on the sidelines, doing nothing, awaiting capital for traditional PE fund which might never materialize.

- **Cost:**

  Each of these alternative structures and arrangements mentioned above come along with extra difficulties on top of the many that already accompany managing traditional PE funds.

Emerging Developments as Responses to these Conditions: SPVs

- **Advantage:**
  Easier to raise capital for very attractive deal than for "unknown, blind" pool.

- **Historical Antecedent:**
  "Club deals" which were used by large PE funds for a very different purpose: these large fund families with great infrastructure shared deals. Here a manager with minimal or perhaps non-existent infrastructure uses in effect the "club deal" structure in another context.

- **Challenges: Liquidity**
  - How with money raised and in what format?
  - Tendency is to use this for NHW not institutions (who have limitations disclosed earlier).
  - Can you trust capital commitments from HNWs?
  - If not, you must overfund at the beginning, for contemplated fees and expenses, which dramatically drags down returns.

Emerging Developments as Responses to these Conditions: SPVs (cont.)

- **Challenge: Track-record "Albatross"**

  Under relevant SEC law your returns are required to be reported precisely in relevant contexts – no "cherry picking".

- **So while you are trying to build track record, the SPV structure drags down the very return numbers in the track record – which is supposed to help you raise more capital.**

- **Further: what if you don't estimate fees & expenses correctly?**

- **Alternative: try to rely on capital commitments.**
  - **What if investors don't honor their capital commitments?**
  - **Deals collapse (initially or subsequently) for lack of funds because of party which doesn't honor capital commitments.**

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Emerging Developments as Responses to these Conditions: SPVs (cont.)

- **Regulatory/disclosure: non-intuitive result – more disclosure required – must give detailed disclosures about target.**

- **Concentration Risk: if one deal goes bust, your whole track record is marred – risk much greater than for a blind pool.**

Pledge Funds

- **Explanation: Typical PE fund, typical documentation and economic terms, except major distinction: right to opt in or opt out of investment.**

- **Scenarios: Sometimes <u>substitutes</u> for regular PE funds, sometimes as an <u>adjunct</u> for PE fund family.**

- **For purposes of our discussion, which is about alternatives, we will focus on Pledge Funds as <u>alternatives</u> to regular PE funds (rather than an adjunct).**

Pledge Funds (cont.)

- **Advantages: Seems obvious. Entire PE structure and economic terms and documentation is in place**
  - In theory just a few investors will opt out, and investments should be able to go ahead.

- **Challenges**
  - Deal Flow/Reputational Risk
    - What if investors repeatedly turn down deals?
    - Not enough to do most deals or a lot of deals?
    - Reputation suffers with deal sources
    - Track record is blurry and perhaps compromised
      - Each investor will have a different track record/returns – constrains whole raison d’etre of developing good track record.
      - Diversification will be severely compromised

Alternative Model
"Deal Aggregator" Rather than Manager

- **Advantages:**
  - Many PE managers double as participants in a particular sector (e.g., entertainment, energy, VC, etc.)
  - Leverage industry connections, without tremendous burden of raising capital for blind pool

- **Challenges:**
  - Regulatory: Broker-dealer registration
  - Regulatory: No track record based on your management, may not bring your closer to goal of eventual PE fund
  - Branding/reputational
  - Loss of control of how deal really is managed: business opportunities can be mismanaged by those without appropriate expertise

Special Regulatory Issues: ERISA and Tax

- **Misleading "Lure/excitement" of institutional money**
- **Even if deal or even fund is 100% funded by institutional following, there could be unmanageable difficulties**
- **Plan assets**
- **QPAM**

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