The private fund model... have you considered the alternatives?

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The traditional private equity investment model is the blind pool fund, with investors committing capital to a fund for the manager to invest and divest at its discretion, in line with the fund's investment policy. Typically, once they have committed their capital, investors do not have the ability to review, "opt in", "opt out" or evaluate underlying investments to be made by the fund. On the contrary, investors must fund requests for capital, irrespective of the underlying investments to which they relate.

Whilst this fund model works for many, there are growing numbers of investors in today's fundraising market who are seeking a greater degree of transparency and control over the opportunities they invest in. This greater degree of transparency and control can be achieved through the use of certain non-traditional fund models, including in particular deal-by-deal and pledge funds. So, looking at each in turn...

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DEAL-BY-DEAL

The deal-by-deal approach involves raising capital for a specific investment opportunity as and when it is identified by a manager. The investment is made via a dedicated vehicle formed for the purpose of making that particular investment. Certain investors prefer this model because they can pointedly channel their capital into a vehicle specifically created for the purposes of investing in a pre-identified target, giving them full transparency and the opportunity (albeit often time-constrained!) to "kick the tyres" of the target. Investors in this kind of structure often view themselves as that of an active co-investor rather than a passive fund investor, leading them to seek a range of investor protections and investment-level rights that they would not otherwise require.

PLEDGE FUND

The pledge fund approach involves investors making a soft commitment to fund future investments, prior to these investments having been identified. The difference between this and the traditional model is that when an investment opportunity arises, investors have the right to "opt in" or "opt out" of funding that particular investment (or, as an alternative, the right to invest up to a certain percentage more or less than their pro rata share), rather than having to participate in all investments, as they typically would in a blind pool fund.

...but what are the implications of using these alternative models for the manager?

For managers, particularly first-time or emerging managers, managers seeking to deepen their track record or those looking to build relationships with new investors, the option to utilise these types of alternative models can help greatly. There are, nevertheless, some implications of adopting a deal-by-deal or pledge fund approach that managers should be aware of.

By their nature, both deal-by-deal and pledge funds involve investors taking time to decide whether or not to participate in a specific investment opportunity before the investment actually goes ahead. This can place the manager at a commercial disadvantage (for example, in a competitive and inevitably time-sensitive acquisition process, or where a seller is hesitant to engage with a fund manager who is unable to guarantee or control its funding). Delays in obtaining consent (and money!) from investors can materially disadvantage a manager's ability to make investments.

Another implication for managers is that both deal-by-deal and pledge fund models are likely to involve a greater degree of administrative burden and cost than if all investments were made through a traditional blind pool fund structure.

Specifically in respect of the deal-by-deal model, the manager must, in the first instance, front the costs of identifying, negotiating and investigating investment opportunities prior to prospective investors deciding to invest (unless and until cost-sharing and break fees have been agreed with investors). It is also costly to have to establish and operate a new vehicle each time an investment is made.

In the case of pledge funds, the manager will also need to find a way to track and allocate the payment of costs and expenses between investors fairly, since, due to their opt-out rights, investors will have different levels of investment participation. Similarly, the extent to which the fund's performance can be aggregated across all of its investments needs to be established.

Fees and carried interest

When it comes to management fees, some deal-by-deal funds do not pay a management fee at all, although the manager may charge a one-off transaction fee upon successful completion of the underlying investment. And, of course, if a management fee is charged, it will be on invested rather than committed capital and is therefore likely to be charged over a shorter period of time than management fees in blind pool funds, resulting in a lower aggregate amount. Pledge funds often charge a low management fee on subscribed capital, i.e. "pledged amounts" (whether or not invested) during a pledge fund's investment period and a higher fee (relative to the fee charged on subscribed capital) on invested capital.

In terms of carried interest, sponsors of both deal-by-deal and pledge funds typically receive carried interest on profits. Whilst the carried interest rates for pledge funds tend to be close to carry charged by traditional funds (20%-30% after an 8%-10% hurdle), deal-by-deal funds can be subject to lower carried interest rates. Of course, deal-by-deal managers have a key economic benefit of deal-by-deal carried interest across the investments they manage – carried interest from well-performing investments not being affected by those that underperform.

And the implications for investors?

For investors, there are also a number of important points to consider. In the context of the deal-by-deal approach, investors will need to perform their own diligence on investments prior to deciding whether or not to invest, which can be costly and resource-intensive. With pledge funds, despite being invested through a fund arrangement, investors lose out on having a manager to make all of their investment decisions and instead are themselves responsible, to some degree at least, for carrying out their own analysis and decision-making.

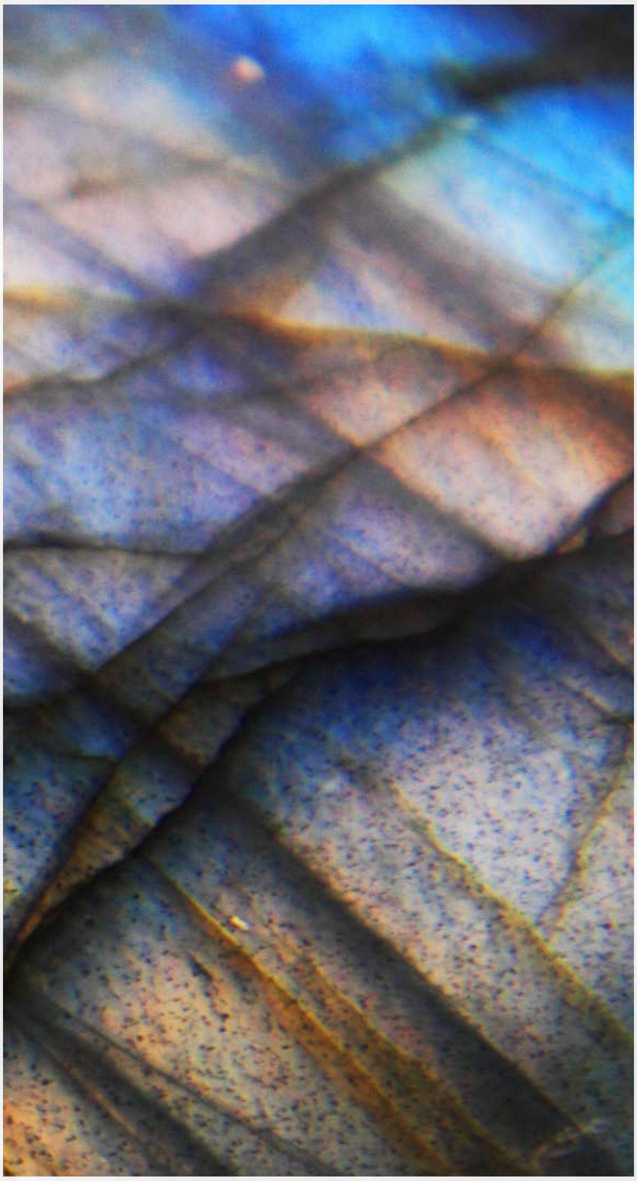
Market trends

There is a less well-defined set of "market standard" terms and approaches for deal-by-deal and pledge funds compared to the traditional private equity fund model. As a consequence, there is scope for a broader variation of economic and governance-related terms and more flexibility as to the terms offered by any one manager. Bespoke provisions are often used by deal-by-deal and pledge fund managers, both addressing some of the implications associated with these alternative models mentioned above and/or reflecting particular features of, for example, the investment strategy, asset class or particular investment opportunity.

While some attention should of course be given to current market trends, when determining the economics and governance of a deal-by-deal or pledge fund, it is also important to consider what is appropriate on a case-by-case basis.

And so...

Against the backdrop of today's market, which sees certain investors seeking transparency and direct involvement in their investment decisions, the models used for pooling capital for private market investing are evolving and the deal-by-deal and pledge approaches undoubtedly offer very useful and flexible options. For the right manager and the right investors, these models really work, so it's certainly worth considering the alternatives.



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