EMPEA Legal & Regulatory Bulletin

— SPECIAL FEATURE: ALTERNATIVE FUND STRUCTURES —

Evergreen Alternatives to the 2/20 Term-Limited Fund

By Mara Topping, White & Case LLP

As private equity becomes a more significant source of financing in emerging capital markets, particularly in sectors with long-term return horizons such as infrastructure, health, finance and education, private equity sponsors are increasingly seeking evergreen investment alternatives to the term-limited closed-end private equity fund. These evergreen alternatives typically take one of two forms: (i) an investment holding company or (ii) a subsequent subscription tranche combined with a re-opening of a second investment period and long-term extension of a fund entity.

The Investment Holding Company Model

The establishment of an investment holding company with unlimited life enables private equity sponsors to raise capital absent (i) time constraints on fundraising and (ii) artificial limits on portfolio company development and the harvesting of value. Funds can be raised at any time during the life of the investment holding company via the full range of corporate capital increase mechanisms. This means that there is no rush to fundraise during a restricted period of time expiring on a final closing date. As such, the time and effort of the investment advisor team can be spent on what many such investment professionals prefer doing and do best – deal-making, the true value-add of the private equity model. In the investment holding company model, fund-raising need not be an exhaustive, concentrated push and further, there is no requirement to repeat such intensive fund-raising cycles every few years as is the hallmark of the typical private equity fund.

When held by an evergreen investment holding company, portfolio companies can be exited as and when portfolio investments are ripe. This is a sharp contrast to the private equity investment fund with its time-limited exit period. Even where closed-end fund terms are especially long, as in e.g. infrastructure funds which may extend as long as fifteen years, a term limitation nonetheless can force early exits and quasi-fire-sales.

The key to making the investment holding company model work is building in sufficient liquidity for investors. Whereas investors in private equity funds may rely on a time-limited exit period and even fund liquidation to force final pay-outs, investors in an investment company must rely on a flow of dividends or redemptions over the indefinite investment holding company term. However, where portfolio investments are in sectors with underlying value derived predominantly from current income such as infrastructure, finance, healthcare and education or even, in some circumstances, real estate, there is a natural back-to-back liquidity that conveniently accommodates the liquidity requirements of an investment holding company.

The typical closed-end private equity fund provides investors with a built-in exit upon fund liquidation. In contrast, investment holding companies must seek permanent exit opportunities for their investors by other means. Investment holding companies such as Brait have successfully achieved liquidity for investors through listings on the South African stock exchange, for example. Other investment holding companies identify liquidity options for investors via privately negotiated secondaries transactions—facilitated by the recent rapid growth in scale and sophistication of secondary markets.

Depending on how structured, the investment holding company model also offers potential alternatives to investment advisor regulatory status. This is because in contrast to the typical private equity closed-end fund with a manager providing investment advice regarding the purchase and sale of securities to a third party fund entity for compensation, if structured as a joint-venture with true management-sharing, the investment holding company may not be captured by

“The key to making the investment holding company model work is building in sufficient liquidity for investors. Whereas investors in private equity funds may rely on a time-limited exit period and even fund liquidation to force final pay-outs, investors in an investment company must rely on a flow of dividends or redemptions over the indefinite investment holding company term.

regulations such as the U.S. Investment Advisers Act or the European Alternative Investment Fund Managers Directive (AIFMD) regime. Such regulatory issues must be considered carefully on a case-by-case basis, however, and weighed against the loss of limited liability that acceptance of a management role implies. The investment holding company model permits the flexibility to balance such regulatory and limited liability concerns to suit the facts, circumstances and risk profiles of the sponsors and investors involved.

The Subsequent Subscription Tranche and Re-Opened Investment Period Model (the "SST Model")

The SST Model involves the re-opening and reiteration of the customary private equity fund structure to achieve a longer-term, and even, if re-opened for multiple tranches, an evergreen time horizon. The SST Model typically takes one of two sub-forms: (i) a second subscription tranche at the end of the original term of a fund pursuant to which subsequent investors take a portion of any existing fund investments and initial investors remain in the re-opened and reiterated fund, or (ii) a second subscription tranche at the end of the original term of a fund pursuant to which subsequent investors subscribe to the re-opened fund with the option only of investing in new portfolio investments combined with an offer to original investors to withdraw or re-commit.

SST Models, generally, require unanimous consent of existing investors to open up a second subscription tranche at the end of the term of the original fund. Further, if second tranche investors are offered a portion of existing fund investments then original investors must get comfortable with complicated true-up calculations required to allocate to subsequent investors their proportionate share of existing investments. Such true-up calculations must take into account, among other things, the time-value of money as well as the benefit of hindsight and lack of blind pool risk accorded subsequent investors. Second tranche investors must weigh the benefit of knowing the value of existing investments (if allocated to them) and the significant reduction in closing costs associated with the SST Models against the liabilities and risks of subscribing to a vehicle that is neither new nor unencumbered.

"...if second tranche investors are offered a portion of existing fund investments then original investors must get comfortable with complicated true-up calculations required to allocate to subsequent investors their proportionate share of existing investments.

Conclusion

The term limited closed-end private equity fund, with its built in exit mechanisms and limited investor liability, will deservedly continue as a fixture of emerging capital markets. However, without underestimating the challenges of identifying sufficient liquidity and the assumption of managerial liability characteristic of the investment holding company model or the complexities and trade-offs of true-up calculations and the encumbrance taint of the SST model, such new models and their calculated challenges can and increasingly are being embraced by investors as practical and cost-effective evergreen alternatives to move private equity investment in emerging markets forward.

About the Author

Mara Topping is a Partner in the Washington, D.C. office of White & Case LLP.

