On core or anchor investors in private equity houses *Cash + Reputational Risk = Everlasting Privileges?*

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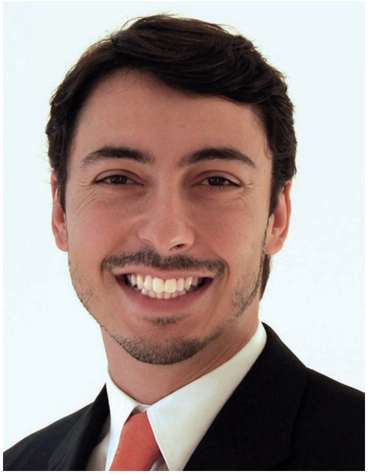
Much disarray in the private equity world had been predicted at the onset of the financial crisis, in the fall of 2008. Private equity houses would crumble, common wisdom went, under the weight of falling asset valuations, vanishing exit avenues and retreating institutional investors.

Not many of those predictions actually became reality. Relatively few name brand houses failed to survive the storm. But a few large private equity groups have undergone restructurings on the back of the struggles of their corporate parents. And many more of the smaller ones have been pushed to enter into combinations in order to acquire a more solid financial footing or stave off anxiety among their investors.

These restructurings and combinations have often entailed the participation of large outside financial investors.

Economic arrangements and governance principles – which are difficult issues for the principals of a management company to tackle at any stage of development – have had to be revised and adapted.

In this commentary, we are going to explore situations involving the participation of financial investors in the capital structure or the strategic positioning of private equity houses, and highlight associated complexities and potential pitfalls.



Dante Leone

ECONOMIC ARRANGEMENTS

Acting as the core

An increasing number of established private equity management companies have been associating themselves with "core" financial investors.

Sometimes, this association originates in connection with the spinout of an established management group from a diversified institution that cannot or will not continue retaining very large principal commitments to private equity.

In this circumstance, the core investor – typically a sizeable financial player – is called upon to perform two key functions: providing current or future funds with a bedrock of commitment, in amounts that go beyond the means of the fund managers, and lending faith to the fledging stand-alone management company.

At other times, the acquisition of a strategic stake by a large permanent capital investor is but the continuation of a trend that had already started during the previous market rally. The trend is that of unleashing the pent-up value of established private equity houses, as an offshoot of the desire of the founders to monetise and or as a way to facilitate generational change. This kind of acquisition is also typically accompanied by large commitments to the managed underlying funds, although the emphasis is less on the support provided to the managers and more on strategic advantages and potential synergies, such as the political coverage created by an investment by a sovereign wealth fund.

"The core investor typically expects good returns on both its investment in the management company and its commitment to the underlying funds"

Regardless of the origin of the relationship, the core investor typically expects good returns on both its investment in the management company and its commitment to the underlying funds.

The appreciation in the value of the investor's stake in the management company is meant to arise from ever-growing assets under management or increasing profits deriving from carried interest originated by successful dispositions. The return on the underlying fund investments, while dependant on the performance of the portfolio companies, is supposed to be enhanced by a discount on charged management fees or carried interest.

Many variations exist of this arrangement. For example, core investors do not always obtain the right to receive a portion of management fees charged to the funds, which are often exclusively intended to fund the operations of the management team.

In addition, when private equity houses manage several generations of funds, at different stages of maturity in their term, the entitlement of new core investors to streams of income may not extend to fully invested funds or other legacy investments and may instead be limited to the most recent fund pools.

All these economic arrangements are much facilitated, in sophisticated private equity structures, by the usual separation of flows of management fees and carried interest, and the further compartmentalisation of the carried interest streams coming from each different fund vehicle.

Anchoring emerging ventures

Philosophically similar to the acquisition of an interest in an established house by a core investor is the situation in which an institutional player acts as an "anchor" investor for a first time fund group.

Occasionally, the institutional player is actively involved in supporting fundraising efforts. But even when it is not so involved, the participation of a respected institution – by lending gravitas to the managers – works as a flywheel for fundraising and in building interest in the new fund group.

In any event, it is extremely important that both parties enter into the combination with a clear idea about what they can bring to the table, lest the failure to deliver on perceived promises should sour their relations in the years to come.

In return for its more-or-less active involvement, the anchor institution receives preferred economic terms (in the form of reduced management fees or carried interest) as well as, in most circumstances, a stake in the management company.

When the institution invests permanent capital, as in the case of a large family office, the association with the new fund group is relatively easy to structure, because there are no potential conflicts of interest internal to the anchor investor.

On the contrary, when the anchor institution does not invest permanent capital but manages variable pools of third-party money – as in the case of a fund of funds – a more carefully balanced act is required. The institution must be fully transparent about the special advantages flowing to it from the anchor relationship, so that they are appropriately perceived as being for the benefit of the investors as opposed to the exclusive profit of the institution.

Branching out and core investors: some call it 'Put up or…'

Giancarlo Capolino Perlingieri

A remarkably complex situation is that which arises when a private equity house that is the recipient of a core or anchor investment determines that it is in its best interest to exploit its brand name and branch out in different investment areas.

In these instances, the question is to what extent the core or anchor investor should share in the value originating from the new venture.

On the one hand, a large part of this value will benefit from the brand name that was developed with the support of the financial investor. On the other hand, a sizeable portion of the profits of any new venture will have to remunerate the work of the operating partners dedicated to its development, and the remaining profits must be substantial enough to elicit interest from the managers of the original management company.

It is a fact that many management teams try and exclude financial investors from new ventures capitalising on the same brand name. This is , understandably, a source of serious tensions.

One possible solution is offering the financial investor the right to participate in any such venture with a new dedicated investment of capital and commitment, based on a new set of terms and conditions. In so doing, the financial investor would again lend its reputation to an entrepreneurial undertaking. Declining the offer – unless justified by another form of involvement or by serious conflicts – would instead signal a negative attitude towards the project, and provide fewer arguments to support the request of an enduring entitlement.

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GOVERNANCE IN A SHARED ENVIRONMENT

In addition to the issue of the economic structuring, strong and clear governance is the other pillar of any successful core or anchor arrangement.

While this applies to any investor-manager relationship, it is particularly true with respect to core relationships.

To begin with, core investors are not typical fund limited partners.

To the contrary, other third-party fund investors would require any commitments by the core investor to be treated as coming from an affiliate of the management company. As such, these commitments – often very large both in absolute terms and as compared to those by any other single investor in the funds – may not allow the core investor to exercise its full voting rights on important matters such as the removal of the manager, the assessment of any conflicts of interests or the waiver of any investment restrictions.

In addition, when core investors are diversified financial players, attention must be paid to preventing conflict of interest provisions applying to affiliates of the management company from extending to other areas of business of the core investors, such as principal trading or corporate finance.

More generally, in order to balance the restrictions imposed on the investor in the underlying funds, it is crucial for a core investor to be able to benefit from certain governance rights at the level of the management company.

While it is unrealistic to think that a core investor could have significant control or veto rights over an established management company, it is not unusual for anchor investors in small boutique fund managers to hold considerable stakes that give them real sway over a number of meaningful business choices, such as the creation of new families of investment funds, the search for new sources of income or the making of significant capital investments.

Likewise, it is quite common for most if not all core investors to have standard tag-along rights in the event of a sale to third parties or a public offering of the management company, as well as to be able to appoint one or more representatives to the board of the management company. Through this mechanism, core investors benefit from a steady flow of information about discussions with potential acquirers and on key management decisions, such as concentrating investments in a particular geographic or business area or entering into strategic alliances with potential sources of deal flow.

It is also usual for core investors to participate in coinvestment programmes that allow preferred direct side-by-side investments in the funds' portfolio companies – along the lines of investment programmes generally reserved for management team members – and to have a right of first refusal over minimal guaranteed allotments with respect to commitments to any future underlying funds.

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Successor funds of successful first-time groups

The participation by core or anchor investors in future generations of funds is a particularly delicate matter. While at the outset an investor-manager association may be equally and mutually beneficial, at some point in the future the balance of benefits is likely to become skewed.

Anchor investors in new fund groups, in particular, are frequently victims of their own success. The managers, now independently well known and strong of the success of their first time fund, may not want their larger successor funds to be as closely associated with the anchor investor. Nor may they wish to continue sharing their rewards with it.

At the same time, the anchor investor may feel that, while it is not in a position to take up the same percentage of overall commitments in larger successor funds as it had committed in the first-time fund, it should be entitled to receive outsized returns in consideration of its original highly risky investment in the new management group.

In these situations, the combination of incentives should be such as to encourage a reasonable resolution of any differences in opinion between the managers and the anchor investor.

Or, put another way, no structure should create an incentive for the managers to force their departure in order to set up their wholly-owned private equity house or for the anchor investor to disparage its former management partners.

In fact, one of the best ways to prevent or reduce these conflicts at the outset is to include a proper mechanism that allows the managers to buy out the anchor investor in the future, for good consideration based on the growth of the management company. A win-win situation, of sorts. ■

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