

PRIVATE EQUITY manager

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The beginning of a beautiful friendship?

Considerations and deal terms for private equity fund managers negotiating seed investments or joint ventures. By Blayne Grady counsel for Akin Gump Strauss Hauer & Feld

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In the current difficult fundraising environment, a first-time private equity fund manager can give itself a significant jump-start either by bringing in a seed investor who makes a sizeable commitment to the fund and takes a stake in the fund manager or by finding an existing fund platform with which to partner. The key considerations for a fund manager in negotiating with a seed investor or joint venture partner include transaction structure, economic terms, governance and divorce/separation.

Before entering into discussions with a prospective third-party partner, the manager should carefully consider how it would like the relationship to be structured. Is the preferable approach to have the seed investor take a minority stake in a free-standing management company? Or does it make more sense to enter into a joint venture with an established fund management platform to start a new product line? Will the manager, instead, "spin-in" to become a part of an existing fund management platform? Numerous issues can arise when selecting the preferred approach, including decision-making authority, co-branding considerations and subadvisory roles, all of which need careful upfront strategic planning.

Carried Interest Split

The carried interest derived from funds sponsored by the new management company can be divided in many different ways, depending on factors such as the existing reputation of the principals and any track record they might have from previous endeavors. Additionally, new fund managers should consider whether to lock in the carried interest split percentage for future fund vintages at a time when its bargaining leverage is relatively weak. For successful fund managers, carried interest splits for successor funds move in favor of the manager. Also, many new fund managers will target seed investors who not only invest their own capital into the funds, but who can also leverage their existing fundraising network to raise capital from third-party investors. In those circumstances, seed investors or joint venture partners often demand higher carried interest splits for their efforts. However, successor funds of a well-performing predecessor can usually rely on investor overlap from the predecessor fund, and fund managers often find fundraising easier for successor funds.

Management Fee Split

The management fee split percentage can be different from the carry split percentage, as it is often viewed by the parties as more reflective of day-to-day management responsibilities – which are normally handled primarily by the fund manager rather than a seed investor. Alternatively, management fee split percentages can track the relative overhead and back-office expenses of the parties involved, which could lead to a greater percentage split for the seed investor or joint venture partner to the extent the back-office functions are primarily provided by such seed investor or joint venture partner. Fund managers should also carefully consider the impact of "other fee income" in negotiating the fee splits.

Team Member Compensation

Seed investors or joint venture partners will often want some measure of control over the compensation of the management team, which can sometimes take the form of caps on individual compensation or requirements that any additional issuance of a share of the carried interest not have a dilutive effect on the seed investor's or joint venture partner's portion of the carry. Fund managers will need to consider the impact of these restrictions on the expected economic outcome of the relationship and the fund manager's ability to attract and retain top investment management talent.

Expenses

Often due to a lack of existing cash flow from management fees, new fund managers will usually look to negotiate for start-up expenses to be borne – or, at the very least, advanced – by the seed investor or joint venture partner. To the extent the funding of start-up expenses is advanced, attention must be paid to the timing of repayment of such advances in the terms of the documents governing the relationship between the parties.

Governance Terms

The management team will usually be responsible for the day-to-day fund management, as well as most deal sourcing, acquisition, monitoring and disposition decisions. The role that a seed investor or joint venture partner plays will depend on the capabilities of that investor or partner and the needs of the fund manager. Some fund managers will seek out seed investors or joint venture partners who have a broad investor network from which the manager can raise capital. Back-office functions are also often allocated based on capabilities of the parties.

Depending on the size of the seed investment and other relevant circumstances, decisions regarding the investments to be made by the fund vehicles will often be made by a committee comprising investment professionals from the management team and one or more committee members appointed by the seed investor or joint venture partner. A seed investor or joint venture partner will also often request approval rights for certain major decisions, including significant investments, compensation of top management team members, the annual budget or additional fund product lines. Careful consideration must be given by a new fund manager to the scope of these decisions in order to avoid ceding too much control of the manager's operations.

Divorce/Separation

The parties to a new fund manager platform or joint venture almost certainly have expectations that the relationship will be both successful and long-lasting, but fund managers need to pay careful attention to the terms and conditions governing separation or other termination of the relationship. Divorce provisions should clearly specify circumstances under which a party can be removed from, or redeemed out of, the relationship, as well as the expected duration of the relationship (i.e., one fund or all future funds as well). Fund managers also need to give thought to if or how they might want to separate from the relationship with the joint venture partner or buy out the seed investor if the fund manager becomes large enough and successful enough to operate on its own, as well as to going-public considerations. There are numerous options for payouts upon divorce or platform separation to consider, some of which may be more applicable to certain situations than others.

Other Considerations

There are a handful of other considerations that a new fund manager will want to take into account when forging a relationship with a seed investor or joint venture partner, including exclusivity and allocation of investment opportunities (especially when the seed investor or joint venture partner is active in a similar investment space). Also, there are a variety of significant tax issues that should be addressed in connection with such a new relationship, such as jurisdiction of the new fund manager and permanent establishment issues if the fund manager is operating in non-U.S. jurisdictions. Further attention should be paid to appropriate separation of the carried interest and management fee streams – although this may be slightly less crucial for U.S.-based managers, depending on the outcome of legislation currently pending in the United States – and location of the seed investor's interest in the fund manager.

While an investment by a seed investor or the establishment of a relationship with a joint venture partner can be of significant benefit to a first-time fund manager, navigating the economics, governance and other key terms of that relationship can often spell the difference between a potentially painful mistake and the beginning of a beautiful friendship.

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