GUEST COMMENTARY

FUND STRUCTURES

A pledge of allegiance

With some LPs hesitant to give GPs carte-blanche with their money, the popularity of the pledge fund has resurged. Fadi Samman *of law firm Akin Gump highlights some issues to keep in mind when negotiating the terms and conditions for such a vehicle*

Is the private equity and real estate fund raising market poised for a "back to the future" moment? With an increasingly difficult fundraising environment for fund managers, the market has seen a resurgence of interest in an old concept: the so-called "pledge fund."

Most notably, Brookfield Asset Management recently raised a $4 billion real estate investment consortium in late 2009 to take advantage of distressed real estate opportunities. Pledge funds are usually structured as limited partnerships and in many respects look and feel like a traditional private equity fund. However, in contrast with the traditional "committed" or "blind pool" model where an investor makes a firm commitment and has no investment discretion, a pledge fund is a non-committed fund where investors make a soft commitment and retain a degree of investment discretion, deciding whether to invest on a deal-by-deal basis. This flexibility makes pledge funds potentially attractive for fund sponsors who encounter difficulty raising a committed vehicle in the current environment, but would prefer to avoid the approach of "fund-less" sponsors who raise capital on a pure deal-by-deal basis.

The terms for a pledge fund can vary greatly from fund to fund, as they tend to be highly negotiated based on the sponsor's investment goals and needs of the investor base. In evaluating and structuring a pledge fund, sponsors will want to bear in mind several key considerations, including the management fee and carried interest terms, and the investment and due diligence process.

Samman: poor structures = missed opportunities

MANAGEMENT FEES

In order to properly motivate the sponsor to actively source transactions and ensure that investors are serious about participating in the programme and making investments, a pledge fund sponsor and its potential investors will need to agree on an appropriate fee structure. Given the nature of the soft commitment and ability to participate in deals on a selective basis, investors typically seek to allocate as much of the upfront costs and broken deal cost risk to the fund sponsor as possible by requesting a management fee payable only on invested capital. Sponsors on the other hand will typically seek some level of fee on the pledge commitment in order to fund up-front deal sourcing and fund administration expenses. In an effort to bridge this gap, fund sponsors should consider a variety of approaches that combine both a fee based on a percentage of each investor's "pledge amount," often at a significantly lower percentage than a committed fund, with an additional fee on invested capital. Alternative approaches could also include a fixed monthly or quarterly "membership fee" which is then offset against the fee on invested capital or some form of expense reimbursement mechanism with budgets and negotiated caps.

Carried interest

In a pledge fund, distributions typically follow the traditional private equity model: distributions are made upon the disposition of an investment (or as proceeds are otherwise generated), and the manager earns a carried interest once capital has been returned and a preferred return hurdle achieved. However, the key issue for pledge funds is the degree to which investment performance is aggregated across all of the fund's investments. Sponsors will typically advocate that each deal should stand on its own with no aggregation based on the theory that investors had the discretion whether or not to participate. On the contrary, investors will typically seek aggregation, with the carried interest determined on a fund-wide basis and a clawback of any excess carried interest paid. A common potential compromise is to provide investors with a degree of aggregation based on the level of actual participation in transactions, effectively rewarding those investors who participate in more deals.

STRUCTURING THE INVESTMENT PROCESS

The investment process needs to be carefully structured to match the nature of the investment opportunities, the sponsor's transaction process and the investors' approval process. The process needs to ensure that investors receive sufficient information and have an appropriate amount of time to underwrite and make an investment decision while at the same time allowing the fund to bid and compete effectively for transactions. Too short a period and the sponsor may find that investors cannot sufficiently evaluate and approve a deal; too much time and other bidders with readily available capital will have an advantage. Also, in the event a particular investment is under-funded due to a lack of investor participation, the sponsor will want to ensure it has enough time and flexibility to go back to participating investors to take up the unallocated amount or pursue third party co-investors. A poorly structured process will ultimately lead to missed opportunities, a frustrated sponsor and disappointed investors.

"Pledge funds are ultimately highly customised and highly negotiated structures"

DUE DILIGENCE AND DISCLOSURE

Unlike a committed fund, in a pledge fund investors are, to varying degrees, active participants in the due diligence process. In connection with a prospective investment, each investor will typically receive a package containing the necessary diligence to decide whether to invest. The scope and timing of diligence can vary and depends primarily on the amount of review the investors want to undertake and the amount of diligence the sponsor is willing to provide. Some investors will want the ability to do direct diligence on the target company. Sponsors should carefully evaluate the level of diligence to be provided and should bear in mind their fiduciary duties and obligations under applicable securities laws in preparing investor disclosure materials since, in essence, each investment constitutes a separate investment decision. Finally, due to the extent and potentially sensitive nature of the diligence materials, the investors may be asked to agree to confidentiality obligations directly with the target companies as well as non-compete obligations preventing them from investing in the company in question while the fund pursues the investment. Both of these measures may be necessary in order to preserve the investment opportunity for the fund.

HYBRID STRUCTURES

Pledge funds are ultimately highly customised and highly negotiated structures. Their terms are dependent on and directly influenced by the nature of the sponsor's target investment opportunities, the relationship and level of comfort between the sponsor and the investors and each individual investor's needs in terms of underwriting and approving an investment. A variety of hybrid approaches have been developed that combine both committed and pledge fund features. For example, funds have been structured that combine both firm and soft commitments, giving the sponsor a committed pool of capital as well as a pre-identified and presumably willing source of additional capital for larger transactions. Other funds have been structured whereby the investment decision is made based on an investor vote (majority or other percentage) as opposed to an investor-by-investor basis, making it easier for the sponsor to pursue and consummate transactions. Also, as discussed previously in greater detail, the management fee and carried interest can be structured in ways that combine committed fund and pledge fund concepts.

The degree to which pledge funds will become a viable alternative to the traditional fund model in light of the fragile fund raising market remains to be seen. However, for first-time fund sponsors and other managers having difficulty raising capital, the pledge fund, when properly designed, can provide a degree of investment discretion that is more attractive to investors, while simultaneously providing the sponsor with a more structured reliable source of capital than pure deal-by-deal fundraising. ■