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Private Equity

# Primer on Deal-by-Deal Funds: Balancing Deal Uncertainty Issues Against Attractive Carried Interest Opportunities (Part Three of Three)

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Uncertain investor funding can make sellers and lenders reluctant to engage with buyers employing a deal-by-deal fund structure, while also exposing sponsors to the risk of absorbing broken deal expenses. On the other hand, the unique treatment of carried interest – by not netting losing investments, in addition to immediately paying it upon selling an investment – presents undeniable upside that may make the risks worth enduring. Weighing these fiscal considerations, among others, against each other is part of the complicated calculus sponsors must perform when deciding whether to adopt the deal-by-deal fund structure. See "Structures and Characteristics of Activist Alternative Investment Funds" (Mar. 12, 2015).

This three-part series aims to provide a holistic consideration of the features of the deal-by-deal structure. This final article analyzes the risks of deal uncertainty; ways sponsors can overcome those risks; and the unique management fee and carried interest treatments that can make the deal-by-deal structure a lucrative option to consider. The first article provided an overview of the deal-by-deal fund vehicle and detailed certain investor sentiments toward it. The second article described some of the challenges of the fundraising process, as well as important structural and mechanical considerations when establishing a deal-by-deal fund. See "Interest in Bespoke Fund Structures Surges As Markets Adjust to New Administration and Regulatory Regime" (Mar. 18, 2018).

## Deal Uncertainty

A hallmark of the deal-by-deal fund model is that sponsors raise funds for each individual acquisition they pursue, rather than only once when establishing a blind-pool fund. This uncertain funding can create discomfort for some counterparties, however, that transact with deal-by-deal funds.

### Counterparty Discomfort

Sellers bear a degree of opportunity cost when they opt to sell to one potential buyer instead of another, so the deal-by-deal approach represents a risk some may not be willing to assume. "If a seller has a competitive auction with several buyers and one is a deal-by-deal fund that needs to

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raise money from investors after committing to the deal," explained Macfarlanes partner Christopher Good, "that fund is undeniably in a weaker position on paper than a buyer with committed capital or a strategic buyer with a balance sheet."

There is a risk that a deal will fall through if an insufficient number of investors choose to invest in the deal after performing their diligence, added Debevoise & Plimpton partner Geoffrey Kittredge. Thus, sellers may be more comfortable avoiding this risk altogether by choosing buyers with secure sources of funding. Exacerbating this risk for sellers is that they may be forced to swallow broken deal expenses, discussed at greater length below, if a deal fails because of timing issues from a lengthy fundraising process or inadequate investor interest.

Lenders may also require investor-level diligence, Good added, to satisfy their own know-your-client (KYC) requirements that are complicated by the deal-by-deal approach. While a blind-pool sponsor can represent to the bank that the fund lacks a single, beneficial owner and that the sponsor has performed its own KYC review of the investors, he continued, banks may not be satisfied with the same approach in deal-by-deal funds. If banks demand to perform their own KYC diligence on the underlying investors, that can add even more time and logistical headaches to an already-complicated acquisition process.

## Broken Deal Expenses

Beyond reputational concerns from a deal falling through because of a lack of investor interest, a deal-by-deal sponsor assumes its own risks from this deal uncertainty. Broken deal expenses – costs incurred by a party before a deal lapses – are borne by investors in a blind-pool private equity structure, but that is not always the case in a deal-by-deal fund model.

Sponsors employing the deal-by-deal approach are more likely to bear the risk of paying broken deal costs because they pay expenses out-of-pocket to get a deal developed to the point where it is compelling as a realistic opportunity to the investor base, noted Debevoise & Plimpton partner John W. Rife, III. "If the deal falls apart before investors are sufficiently interested to enter into a cost-sharing agreement, then 100% of those costs falls on the sponsor," Kittredge added. See "SEC Enforcement Action Involving 'Broken Deal' Expenses Emphasizes the Importance of Proper Allocation and Disclosure" (Jul. 9, 2015).

Addressing this at an earlier stage in the process is not a very viable option either, said James Almond, partner at Duke Street, a well-established deal-by-deal sponsor. "It is difficult to go to investors before you start working and ask them not only to invest, but also to share the abort fees when you are not deep enough in your diligence to know if you even want to pursue the deal," he explained. This issue is exacerbated, added Willkie Farr & Gallagher partner Mark Proctor, by the sophistication of investors, who often delay signing equity commitment letters or limited partnership agreements imposing responsibility for a portion of broken deal expenses on them until they have visibility into whether the deal is moving forward.

Without a signed document providing recourse against investors for broken deal expenses, there are few avenues for deal-by-deal sponsors to offset those expenses. Because sponsors are reluctant to ask prospective investors to cover failed deals, Proctor noted that they often try to manage those expenses through their service providers. "Sponsors will ask their law firms and other vendors to eat a significant portion of the fees, with the understanding that they will have it made up to them when there is additional deal flow in the future," he explained. It is worth noting, however, that there may be regulatory issues with this approach.

For deals far enough along that the sponsor and investors are prepared to sign an agreement addressing broken deal expenses, there is no fixed approach to allocating those costs. "In the

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past we have split the abort fee risk with our co-investors, where we, as the sponsor, have taken 50% of the risk and the investors have taken 50% divided pro rata by their equity interests in that deal," said Duke Street's Almond. "We have also done deals where we bore all of the abort risk as the sponsor. It varies," he added.

Sometimes sponsors agree to assume a sizable share of the broken deal expenses, Good noted, to show their interests are aligned with those of investors.

## Simple Ways to Mitigate Deal Uncertainty

Most deal-by-deal sponsors take practical approaches – even if they are not necessarily easy to implement – to reduce the uncertainty inherent in the fund structure. One method is to attract a single "anchor investor" to back the fund. That anchor investor agrees, formally or informally, to provide a significant percentage of the capital for each deal; therefore, the sponsor only needs to secure small investments from a handful of investors, said Proctor. "Typically, this anchor investor will not delegate decision-making authority to the sponsor. It will still want to look at each deal, but it will have a relationship with the sponsor and will be brought into the process early to ensure there is a good chance it joins each deal," he explained.

Another common approach used by successful deal-by-deal sponsors is to develop relationships with a small group of dedicated, but uncommitted, investors who can act quickly, said Gibson Dunn partner C. William Thomas, Jr. "You need to be able to trust that they will be there when they say they will, and they need to trust you when you come knocking and say it is a good transaction," said Good. These relationships streamline the fundraising process and reduce the uncertainty, he continued, but it still requires significant effort for sponsors to develop this rapport with investors. "It demands a pretty active approach to investor relations –an almost continuous fundraise – to get to know your investors, how their internal processes work, areas where they are looking to invest and the like."

Using either, and sometimes both, of these approaches to successfully close several acquisitions with a deal-by-deal structure can provide reputational benefits to allow sponsors to overcome seller concerns about deal uncertainty, which was the case for Duke Street, Almond said. "Years ago, sellers would ask about our funding and where it was coming from," he explained. "We do not get those questions much anymore after doing so many deals with this approach and delivering each time. It is a bit of a self-fulfilling process – once you have done it for a bit, then you are good for it."

Even with an established deal-by-deal track record, however, Almond noted that some sellers remain sensitive to the issue of deal uncertainty. "Sometimes advisors request a referral or to speak with a company we recently purchased about its experience in terms of funding and process," he explained, "but it is certainly less of an issue for us than for sponsors doing their first acquisition with the deal-by deal approach."

See "Marketing and Reporting Considerations for Emerging Hedge Fund Managers" (Jun. 16, 2016); and "How Can Emerging Managers Raise Institutional Capital While Avoiding Regulatory Pitfalls?" (Aug. 22, 2013).

## Eliminating Uncertainty With a Little Help

One way to eliminate the risk of deal uncertainty is for a deal-by-deal sponsor to avoid fundraising pre-closing altogether. Some sponsors accomplish this by partnering with an established private equity sponsor or other capital source to have it front the purchase price of

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a deal, said Thomas, with it pre-agreed that the deal-by-deal sponsor can put in additional capital after a post-closing fundraising period. The established sponsor will buy the company outright and allocate a portion of it to the deal-by-deal fund post-closing, he explained, or the established sponsor will invest in the deal-by-deal fund – perhaps as the sole investor – through the closing and then sell a portion of its investment to new investors post-closing.

Doing so eliminates seller concerns about pre-closing deal uncertainty while also reducing the risk that the sponsor will get stuck with excessive broken deal expenses. An additional perk, Kittredge noted, is that a smaller deal-by-deal sponsor can often benefit from improved economics – either from the seller or the lender – by taking advantage of the negotiating leverage offered by the larger, established private equity sponsor. There are some wrinkles, however, as the deal-by-deal sponsor will have, in the best case scenario, a limited window post-closing to fundraise, he cautioned. "Worst-case scenario, the established private equity sponsor is able to cover the shortfall if the smaller deal-by-deal sponsor fails to show up with enough capital," added Thomas.

This structure is familiar to established private equity funds, Kittredge said, because they often bridge investments to enable their own limited partners to take up a co-investment in the syndication or to defer their funding requirements. Established private equity funds, however, do not typically offer this to third parties, he explained, so they need an incentive to front the acquisition costs. These are typically rooted in some form of knowledge or expertise the deal-by-deal sponsor brings to a niche industry, suggested Thomas, such as sourcing the proprietary deal, supplying a service to the portfolio company or otherwise playing an instrumental role in assembling the deal. See "Anatomy of a Private Equity Fund Startup" (Jun. 22, 2017).

While this solution to overcoming deal uncertainty is deployed occasionally, it is not common due, in part, to sponsor sensitivity around the perception that they are subjecting their investors to double carried interest or management fees, said Kittredge. The established private equity sponsor will typically invest its fund alongside, rather than in, the deal-by-deal fund, he continued. In any event, he stressed that there are key fee and structural considerations that need to be addressed before this solution is viable.

## Economics of the Venture

Sponsors in traditional, blind-pool private equity funds have long become accustomed to receiving "2 and 20" – a 2% management fee on committed capital and 20% carried interest from selling investments. In the deal-by-deal fund context, however, investor leverage and unique features of the fund structure have altered this approach. See "The Death of Alpha: A True Challenge or a Poor Manager's Excuse? DMS Summit Discusses Alpha Generation, '2 and 20' Fees, AI and Impact Investing" (Apr. 12, 2018).

### Management Fees

Although there are no unfunded commitments for future deals, Proctor explained, deal-by-deal sponsors are still able to charge a management fee – ranging from 1.25-2.00% – on invested capital. There can also be a modified management fee structure where a deal-by-deal fund has a buy-and-build strategy for its original target, noted Rife, where a portion of capital is committed but undrawn at closing and available to be drawn down to fund future acquisitions by the target. "It is structured so that the sponsor receives an X% fee on the committed-but-undeployed capital and Y% on the deployed capital," he added.

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The purpose of a management fee is for sponsors to meet their overhead expenses and manage the portfolio investments; thus, this reduced revenue stream presents a challenge for sponsors. "When you are putting deals together one-by-one, you do not always know if you are going to have enough management fees to keep the lights on at a management company," said Thomas. It can also create issues with retaining talent, Good noted, "because all the juniors and good people will leave if the sponsor cannot pay their wages."

With that said, the private equity industry is witnessing ever-increasing sensitivity among limited partners to ensuring management fees are scaled appropriately for sponsors to pay salaries, retain the correct type of talent and keep the lights on, said Rife, but not serve as sources of wealth creation. "Investors will obviously encourage you to cut your cloth and pick a number to make you highly incentivized to make the transaction work," Good added, "but they also recognize that it is no good screwing a sponsor into the ground on fees."

The result is that, although deal-by-deal sponsors may not receive traditional management fees, investors are often amenable to paying some sort of fees to ensure their overhead needs are met. One approach is for investors to agree to pay a budget-based fee to a deal-by-deal sponsor in lieu of a traditional percentage-based management fee, said Rife. "Investors will reach this figure by reviewing a sponsor's annual budget to determine its overhead costs," he explained, "and then determine what portion of the sponsor's overhead is being allocated to the deal." A sponsor's other revenue streams and how actively it manages, and provides value to, the underlying investment will also factor into this calculation, he added.

Another approach is for the sponsor to avoid explicitly charging a management fee because investors are sensitive to it, said Kittredge, but for it to cobble together a comparable amount from other fees charged to both portfolio companies and investors. For example, some sponsors with operational expertise will charge a consulting fee at the portfolio company-level, he explained, and the asset might even have the cash to pay that fee without having to draw the cash from investors. Other times, sponsors will receive an initial transaction fee, he added, and then a low-level monitoring fee thereafter.

## Carried Interest

Unlike with management fees, deal-by-deal sponsors will often get the same treatment – up to a full 20% carried interest – as their traditional private equity brethren, said Thomas. Just as with a blind-pool fund, he noted, that rate can still be negotiated where sponsors may receive variable carry from different investors. "Variations in carried interest seem to be more common in a deal-by-deal fund," he explained, "because sponsors cannot point to a single industry standard. Each deal is a one-off, unique project with bespoke treatment of how those profits will be split." See "Annual Walkers Fundamentals Seminar Highlights Trends in Investor Sentiment, Governance, Side Letters, Fund Structures, Investment Vehicles and Restructurings" (Jan. 11, 2018).

There are, however, a couple of unique features of carried interest in the deal-by-deal model that make the whole venture attractive – and potentially profitable – enough to make up for all the other difficulties the venture presents. In a blind-pool private equity fund, unprofitable investments are netted against winners to reduce the overall carried interest a sponsor earns from its portfolio.

This netting is often absent from the deal-by-deal model, said Thomas, introducing the potential for additional upside to the sponsor. "If you have five deals with some winners and losers, in a deal-by-deal structure you typically still get carry from the profitable ones and can ignore the

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losing investments, while in a blind-pool fund the losers may wipe out the ability to get carry from the winners," he explained.

This lack of netting of losers is structurally built into the deal-by-deal model, said Good, because a group of investors sign a partnership agreement to invest in one deal, and the sponsor's payouts to those investors are purely measured against that one asset, even if they are in other deals with the sponsor. This result also logically derives from the dynamics of the parties, noted Almond, because investors should absorb any losses from investments that they selected with their own judgement and information.

Another aspect of carried interest that is unique to deal-by-deal funds is the timing of its payment to the sponsor. Blind-pool fund sponsors are required to net returns across the entire portfolio, so early profits may be consumed by later losses. In the deal-by-deal model, however, carry is paid out as soon as a portfolio company is sold, said Proctor. The upside of getting large carried interest checks quickly – rather than delaying those proceeds and relying on a steady management fee income – can be truly addictive for certain sponsors, said Rife.

These unique treatments of carried interest in the deal-by-deal approach can be quite compelling for some sponsors. "There are a few people out there who have used a deal-by-deal approach and managed to make it work. They now almost prefer it to running a blind pool fund because the carried interest is so attractive," said Good.

The structure "can become quite addictive to some sponsors," added Rife, "because the prospect of immediate carried interest, regardless of the performance of other investments, really incentivizes investment professionals, particularly those at the more junior end of the spectrum."

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