Single-Investor Products Assume Leading Role in Private Equity Capital Raising

09/27/16

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

John M. Caccia
New York
212.735.7826
john.caccia@skadden.com

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

Since 2010, asset managers using private, single-investor structures have raised around $128 billion, according to Bain & Co.'s Global Private Equity Report 2015. This figure rivals — and for some asset managers, may exceed — capital raised in commingled private fund products during the same period.

Single-investor products (SIPs), such as separately managed accounts or funds-of-one, can take many legal forms. But at their core, they bring together a single investor and a single asset manager in a negotiated transaction. As a private, bilateral deal, an SIP can offer parties mutually advantageous opportunities that are elusive in commingled fund transactions.

Additionally, SIPs offer exceptional opportunities for asset managers, including opportunities for strategic growth and to forge stronger relationships with important investors that can, in turn, be advantageous in commingled fundraising and for a range of broader business objectives.

SIPs Since 2008

SIPs played a critical role in fundraising during the financial crisis of 2008, when not all limited partners enjoyed liquidity. Investors with access to cash deployed billions of dollars through SIPs to a wide range of core hedge and private equity strategies offered by leading managers. These transactions bridged the gaps in a challenging fundraising environment, and the difficulties that commingled vehicles encountered during the crisis — such as issues related to redemptions and illiquidity of investors — helped highlight the merits of SIPs for both investors and managers. Investors also were reminded that certain problems originate from other investors, and SIPs may offer relatively simple ways to protect against such risks.

SIPs have not only survived the conclusion of the financial crisis, they've thrived. Today, they are used by many more types of managers, and for an even broader range of investor strategies.

The leading role SIPs have assumed in asset managers' capital-raising efforts reflects key trends in the private funds world. The largest investors still dominate negotiations of terms in both commingled funds and SIPs: Pension plans continue to deploy large amounts of capital, while sovereign wealth investors have significantly increased their allocations to private equity. The gap in negotiating leverage between the largest investors and other, smaller investors is reflected in co-investment allocations and side-letter terms that provide large investors with economic, deal flow and other advantages, and regulators have directed attention to the resulting disparities.

Setting aside legal requirements for disclosure of SIPs, information about SIP terms are not reported to the same degree as large, pooled funds, a feature that may appeal to investors and managers alike.

Managers and their largest, most liquid investors are typically highly cognizant of the tensions that may exist between a manager's work on SIPs and for commingled fund clients at a business and legal level, including conflicts of interest. At the same time, SIPs sit alongside commingled funds on many manager platforms, and not just for co-investment or "overage" opportunities. It is not uncommon for a larger investor to be both an SIP investor and a limited partner in the same manager's commingled fund. This pattern reflects the important, distinct commercial objectives served by SIPs, including the ability of the SIP to help deepen a manager-investor relationship by capturing "core-adjacent" opportunities (as noted below).

Single-Investor Products Assume Leading Role in Private Equity Capital Raising

Unique Opportunities for Investors and Managers

Managers and investors tend to approach SIP negotiations distinctly. A number of special dynamics in these negotiations highlight the unique opportunities SIPs offer:

Terms Allowing for Large Commitments. Large investors seek terms that duly reflect their ability to make very large commitments. These terms include breaks on fees, priority access to co-investments and other opportunities, as well as a range of other, softer benefits such as enhanced reporting. On balance, managers generally see a win-win despite such requests on terms, as long as fees are not driven too low and an SIP structure for a large investor sits comfortably with other products. What is "comfortable" will depend on many factors, including contractual and statutory obligations pertaining to allocations of investment opportunities.

The benefits of SIPs with large commitments often outweigh the risks for managers. By offering SIPs to larger, liquid investors, managers can clearly communicate to those investors the special value they bring to the table (while avoiding the risks of marketing to other limited partners who are not in a position to commit). Ultimately, because SIPs offer truly bespoke arrangements, they give managers the ability to do larger deals that would not be achievable without quick, responsive capital.

Direct, Hands-On Investing. Sophisticated investors focus increasingly on direct deals in which they can have a more active, hands-on role. They may view the manager as more akin to a joint venture partner. This requires governance structures and levels of investor control that can be customized for an SIP and therefore work well in that context but not always outside it. For example, in a commingled fund context, other, smaller investors may not share the same preferences. By contrast, SIPs can provide managers with substantial committed capital from investors who might otherwise pass on a manager's strategy due to the terms of the commingled fund arrangements.

Extensive Interaction. Typically, the largest investors have the greatest interaction with managers over the years. They often have a well-developed sense of what investment opportunities managers hear about or consider that are not strictly within the investment guidelines of the manager's existing products. Therefore, such investors are well positioned to recognize the value of a neglected core-adjacent opportunity stream, and that could help a manager build a relatively low-risk, strategy-expansion platform. Investors benefit because the extensive interaction — a function of factors like enhanced reporting and information flows or enhanced government rights — and transaction history of discretionary co-investment can generate trust and instill the desire to expand their working relationship with a manager.

Conclusion

SIPs have become critical to preserving and enhancing the relationships between established managers and their largest investors. SIPs will likely grow in significance in the investment management landscape in years to come.