

## **Private Equity as an Alternative Source of Capital** *(with hyperlinks)*

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A presentation made at the live Pennsylvania Bar Institute program  
*12<sup>th</sup> Annual business Lawyers' Institute*  
The manual for that course is Pub. No. 4343, published November 2006

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**Private Equity as an Alternative Source of Capital**

■ **Julia D. Corelli, Esq.**

Recorded November 1, 2006 at PBI's  
12<sup>th</sup> Annual Business Lawyers' Institute

Outline prepared by speaker with additional notes  
and hyperlinks added by PBI law clerk.

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- The handouts referred to during the lecture are included here in these slides.

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
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 **Agenda**

- Private Equity Defined
- Private Equity Life Cycle Overview
- Types of Private Equity
- Recent Industry Statistics Funds
- Private Equity Structures
- PE's Legal Landscape
- Phases of Fund Formation
- Terms and Conditions of Private Equity Funds

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 **Private Equity Defined**

- Any investment strategy that involves
  - Aggregation of funds from diverse, unaffiliated investors
  - Purchase of illiquid equity positions in a diverse or non-diverse group of private companies
  - Investors owning a pro-rata "share" of the underlying portfolio companies based on committed capital
  - Returns on investment shared with fund management

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
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 **Private Equity Defined**

- Fund managers are General Partners (GPs)
- Providers of capital (investors) are Limited Partners (LPs)
- Partnership Agreements govern most of the actions and roles of the GP and LPs
- Typical investment period is 3-5 years, growing to 4-7
- Typical partnership term is 10-12 years, extendable by 2-3

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**Private Equity Defined**

- Typical fund formation documents include
  - Primary
    - Private Placement Memorandum
    - Partnership Agreement
    - Subscription Document
  - Secondary
    - Management Services Agreement
    - GP Operating/Partnership Agreements
    - Administration Agreement (back office)
    - Side Letters

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**Private Equity Defined**

- Private Equity is not the same as a Hedge Fund
  - Hedge Funds take all investor cash at once
  - Withdrawals permissible from a Hedge Fund
  - Most Hedge Fund securities are publicly traded
  - Valuations are typically based on public market value
  - Annual high water marks establish GP remuneration

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**Private Equity Life Cycle Overview**

- Concept
  - There is money to be made by investing in certain industries/segments/etc, or in other PE funds (a "fund of funds" investment)
  - Structure a fund with a specific target amount to raise to invest in these kinds of companies
- Commitments
  - Solicit investors, limited partners (LPs), to commit to a certain level of eventual investment

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**Private Equity Life Cycle Overview**

- Investment
  - Deal sourcing and evaluation
  - Capital calls
- Monitoring
  - Investments are tracked and managed by the GP
- Harvesting
  - Sale, IPO, dividend recap, etc. followed by distribution of proceeds

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**Types of Private Equity Funds**

- Fund of Funds
  - Fund the invests its capital in other PE funds
  - Diversification
  - Focused on single strategy or multiple (i.e. investing in just venture capital funds, or all kinds)
  - Less transparency since tougher to track/value underlying investments
  - Usually involve additional layers of management and carry fees

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**Types of Private Equity Funds**

- Secondary Funds
  - Fund buys interests in pre-built portfolios
  - At a reduced cost
  - Similar to a Fund of Funds, however some of the investments are already known
  - Portfolio company diligence is challenging
  - Specialists in the industry

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## Private Equity Structure

- Legal Fund Structures
  - Partnership
  - LLC
  - Corporation
- Typical Jurisdictions
  - Delaware (On-shore)
  - Cayman Islands (Off-shore)

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## Private Equity Structure

- Types of Investors
  - Taxable (High Net Worth)
    - Individuals
    - Trusts
    - Estates
    - Family Offices
  - Institutional
    - Insurance Co's
    - Banks
    - Endowments
    - State Pensions
  - Foreign
    - Governments
    - Pension plans
    - US tax haven seekers
  - Tax Exempt
    - CRT
    - IRA
    - Pension Plan

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## Private Equity Structure

- A picture is worth a million words

**ABC Capital, L.P.**

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graph TD
    T["T, R & T  
Investors  
99 beneficial owners"] -- LPs --> L["ABC Capital L.P.  
3(c)1"]
    G["ABC Capital GP, LLC  
GP"] -- GP --> L
    M["ABC Capital Management, LLC"] --- L
    M --- MS["Management Services Agreement  
(1.5% management fee)"]
    G --- IA["20% Incentive Allocation"]
  
```

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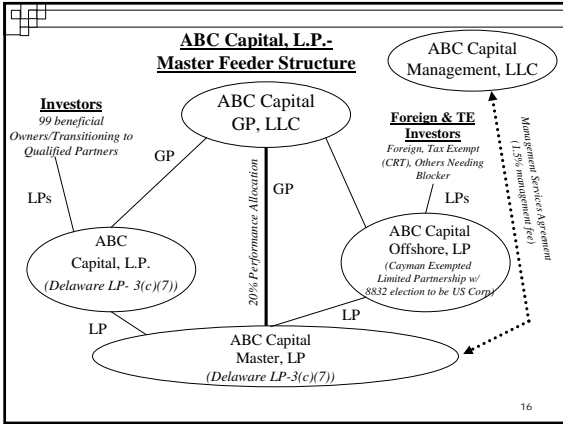
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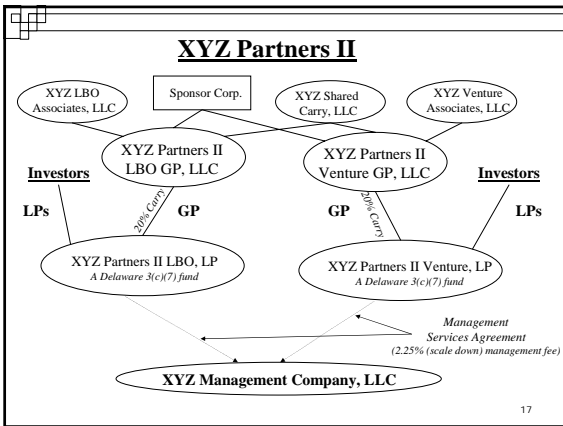
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- 2007 Topics – Driving IRR**
- Industry Convergence
    - Driving IRR
  - Exits
    - Driving IRR
  - Intra-Partner
    - Driving IRR
  - Spotlight on the Industry
    - Driving IRR
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**Recent Industry Statistics**

- Through 3Q 2006, global PE funds are at about \$300 billion (436 funds) vs. \$283 billion for all of 2005
- 2006 full year fundraising projections at \$400+ billion
- 821 funds actively fundraising with anticipated goal of additional \$343 billion
- US - \$199 billion/225 funds
- Europe - \$70 billion/70 funds
- Asia/rest of world - \$31 billion/101 funds
- Buyouts - \$160 billion/118 funds (\$100 billion from "mega" funds)
- Real Estate - \$40 billion/64 funds
- VC- \$35 billion/135 funds
- Mezzanine - \$15 billion/26 funds
- Fund of funds - \$13 billion/44 funds
- Distressed - \$6 billion/9 funds

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**Recent Industry Statistics**

- Overhang
  - From 1998-2004, the total "overhang" was \$237.5 billion, with \$234.5 billion of that in US funds
  - In the first half of 2005, \$88.9 billion was raised and only \$34 billion invested, adding to the overhang
  - Buy-out firms continue to raise more money than they invest, signaling a potential reduction in fund raising
  - VC firms are investing more than they are raising and there is still a \$60+ billion "overhang", signaling a potential reduction in investing and/or increased fund raising

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**Current Trends – MEGA funds**

- Megafunds/Megadeals
  - New funds are getting larger (\$15+ billion) and \$100 billion funds not far-fetched
  - Increased use of "club" deals among PE firms for megadeals
    - Increasing purchases of major "name brand" companies
  - Management fees for the Fund
    - Some LPs concerned there will be less carry incentive

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**Current Trends - Convergence**

- Driving IRR – how?
  - Structures of choice – UBTI insensitivity
  - Cross border transactions
  - Dividend recapitalizations
  - Clubbing
  - IPOs
  - Hybrid LPAs

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**Current Trends - Spotlight**

- Spotlight on the industry
  - Retail-ization
  - Profits interests & 409A regulations
  - Rate changes
  - PPA effects
  - Publicity
  - Regulation?

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**Legal Landscape**

■ '33 Securities Act	■ USA PATRIOT Act
■ '34 Exchange Act	■ Gramm – Leach – Bliley Act
■ '40 Investment Company Act	■ FOIA
■ '40 Investment Advisers Act	■ RULPA
■ '95 PSLRA	■ NASD Rule 2790
■ ERISA (PPA)	■ Withholding Rules
■ BHC Act	■ Tax Shelter Regulations
	■ FCC Regulations
	■ INTERNAL REVENUE CODE

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■ Click on the underlined text below to be directed to the listed websites:

■ **US Securities and Exchange Commission**  
 <http://www.sec.gov/>

■ **Goldstein et al. v. SEC**, No. 04-1434, decided June 23, 2006 by United States Court of Appeals for the District of Columbia Circuit

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**'33, '34 and '40 Acts**

■ SEC Chairman Cox's remarks 8/7/06:

■ "Instead, the Commission is moving aggressively on an agenda of rulemaking and staff guidance - some of which may be issued as early as this week - to address the legal consequences from the invalidation of the rule.

■ "Among the significant new proposals will be a new anti-fraud rule under the Investment Advisers Act that would have the effect of 'looking through' a hedge fund to its investors. This would reverse the side-effect of the *Goldstein* decision that the anti-fraud provisions of the Act apply only to 'clients' as the court interpreted that term, and not to investors in the hedge fund. At my direction, Commission staff are also considering whether we should increase the minimum asset and income requirements for individuals who invest in hedge funds."

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**USA PATRIOT Act - AML**

■ Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001

□ Treasury's Financial Crime Enforcement Network (FinCEN) adopted rules for "Anti-Money Laundering Programs for Unregistered Investment Companies

- 4/02: interim final rules for mutual funds and other financial institutions
- 9/02: proposed rule to apply to hedge funds, PE funds and VC funds
- 5/03: proposed rules for investment advisers

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**USA PATRIOT Act - AML**

- PE and VC funds' proposed rule
  - N/A to funds that do not provide liquidity within 2 years of investment
    - Applies if redemption "permitted" in 2 year window
  - NVCA guideline (4/03)
    - Emphasizes diligence, detection and reporting

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**USA PATRIOT Act - AML**

- AML statutes in place
  - OFAC sanctions: freezes assets in US from designated countries or individuals
    - <http://www.treas.gov/offices/enforcement/ofac/>
  - Currency transaction reporting rule: BSA and IRS

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**USA PATRIOT Act - AML**

- AML Program must
  - Develop internal policies, procedures and controls to detect and regulate laundering
  - Designate a compliance officer
  - Create an ongoing employee training program
  - Implement an independent audit function to test the program
- Rules not finalized yet

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**Three Phases of Fund Formation - Phase 1**

- Executive summary
  - Client develops investment strategy
  - Client and lawyers craft the economic terms in summary form
  - Testing with potential investors
  - Timeline

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**Three Phases of Fund Formation - Phase 1**

- Structure
  - Choice of entity for fund, GP and management company
  - (c)(1) or (c)(7)
    - Ability to split
    - Side by side
    - Integration
  - Offshore
    - Parallel or feeder
    - Now or later
    - Jurisdiction -- considerations
      - Likely source of investors
      - Ease of management
      - Experience of offshore local counsel/administrator
      - Taxation

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**Three Phases of Fund Formation - Phase 2**

- PPM
 

<ul style="list-style-type: none"> <li>□ Story               <ul style="list-style-type: none"> <li>■ Distinguishing factors</li> <li>■ Team</li> <li>■ Track record</li> <li>■ Industry / market</li> <li>■ Background</li> </ul> </li> <li>□ Terms               <ul style="list-style-type: none"> <li>■ Executive summary</li> <li>■ Full version</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>□ Conflicts of Interest               <ul style="list-style-type: none"> <li>■ Investment banks</li> </ul> </li> <li>□ Risk Factors</li> <li>□ Tax disclosures</li> <li>□ Regulatory               <ul style="list-style-type: none"> <li>■ Benefit plan investors</li> <li>■ Securities laws</li> </ul> </li> <li>□ Confidentiality/FOIA</li> <li>□ Privacy Policy</li> </ul>
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**PE Fund Terms and Conditions**

- Allocation-Driven Agreements
  - Allocations made in accordance with “Section 704(b) safe harbor”
- Distribution-Driven Agreements
  - Allocations made in accordance with “partners’ interests in the partnership”

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**PE Fund Terms and Conditions**

- Distribution-based partnership agreement
  - Allocations of income and loss are made to reflect each partner’s right to distributions
  - Liquidating distributions made in accordance with regular distribution provisions
  - Capital accounts generally irrelevant
    - Targeted capital accounts
  - Distributions control ultimate economics

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**Allocation- v. Distribution-Driven Agreements**

- Venture capital funds use allocation-driven agreements more often
- Buyout funds are about equal in their use of allocation-driven and distribution-driven agreements

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
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 **Private Equity Structure**

- Each set of fund terms will typically have the following components:
  - Carried interest
  - Preferred return/hurdle rate
  - Waterfall distribution
  - Management fees

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