Fund structuring: Evolving to meet market needs

There is a gradual yet discernible shift in the approach to private equity fund structuring, as some managers consider a move away from aspects of the traditional methodology. This is a pragmatic response to changing investor requirements and investee considerations.

The traditional and still the most common approach to fund structuring in private equity hails from the early development of the industry in the USA, UK and Europe, and entails managers raising third-party capital from large institutional investors, and structuring this capital into closed-ended funds governed by a partnership structure, and which have a typical life of ten years.

Managers globally and in Southern Africa have been looking in recent years to adapt aspects of this model, incorporating elements such as a longer investment horizon, increased liquidity for investors, and greater accessibility to private equity for investors other than those with sizeable cheques.

In practice, this has entailed managers structuring private equity partnerships with longer terms, and some exploring fund terms of up to 20 years. Others are using permanent fund vehicles that enable investors to come and go. There has also been a move, notable in developed markets and now a reality in emerging-market regions such as Southern Africa, to list fund entities or vehicles that feed capital raised on public markets into a traditionally structured fund.

The listing of EPE Capital Partners Ltd (Ethos Capital) during 2016 is the first example in the local market of the latter.

"Ethos established a new hybrid structure, in which it created its own limited partner (LP) through a listed vehicle, which reduces the need for capital from international LPs. The model creates access for smaller investors, who have the comfort of protection under the Companies Act," says John Bellew, head of private equity for South Africa at Bowmans.

Rohan Dyer, partner and head of investor relations at Ethos Private Equity, explains the motivation for this structure, which enables the industry to tap into a broader spectrum of investors: "The current market for fund raising is difficult given currency volatility and the sluggish economy. Private equity has been well supported by some of the big local pension funds for many years but there is potential for much more. We are trying to encourage more investment in the asset class as its merits are often under-appreciated and its ability to outperform the listed market is significant."


John Bellew

These innovative developments come at a time when swings in global investor sentiment have inhibited fund raising for many, and where concerns about currency risk have prompted managers to pursue more local investors into their funds.

Nicole Paige, partner and co-head for private equity at Webber Wentzel, led the structuring team on the Ethos Capital listing and its fund structures. Paige believes "there is a definite move towards permanent private equity vehicles, but we don't see these as necessarily replacing traditional private equity fund structures, but rather as an alternative structure suiting fund manager's investing in either very long-term investments or investments that generate high yields that will therefore provide liquidity for investors. Permanent vehicles tend to take the form of listed entities – in the form of SPACs or listed investment entities – or private investment holding companies that will look to implement an IPO once a portfolio of investments has been built up".


Nicole Paige

In addition, private equity managers are finding that, depending on market cycles or the stage of development of economies, a ten-year life of fund may not provide adequate time to take assets to the point of optimal returns. This is true in a range of industries in sub-Saharan Africa.

"The model is evolving to meet unique African needs and the needs of specific industry sectors. Generally, I think the industry continues to mature and, more importantly, continues to attract new entrants. Infrastructure, real estate and renewable energy have probably been the sectors where we have seen the most fund raising interest over the past year. In these sectors, where assets require time to reach the stage of delivering returns, it makes sense to adopt a longer-dated fund structure," says Bellew.

Paige notes that the majority of new funds currently reaching first close are still structured in a traditional manner, and believes that the private equity model is entrenched and will continue to be used. As she puts it, "the traditional private equity model is not dead, but simply evolving".

This evolution in fund structuring reflects an agility in the industry: It shows its ability to adapt pragmatically to changes in investor requirements and to circumstances in the markets and industries in which it transacts, thereby ensuring its continued success as an asset class.

FRAMEWORKS FOR FUND STRUCTURING IN PRIVATE EQUITY

Traditional private equity fund structure

In brief: *En commandite* partnership, ten-year life, 2-and-20 model. This is the vehicle of choice in private equity internationally. Most South African private equity funds are based on partnerships, with some older funds using a bewind trust

Pros: Familiarity; tax transparency; limited liability for investors; readily available capital to deploy when opportunities arise

Cons: The fund-raising burden; exit pressures – the ten-year life is not necessarily suitable in a sub-Saharan African context, where deals may need a longer holding period.

Section 12J VC Company

In brief: Tax incentive introduced in 2009

Pros: Tax benefit on amount allocated to a Section 12J fund

Cons: Various shortcomings still to be resolved, including fact that it relies on a company structure.

Special Purpose Acquisition Company (SPAC)

In brief: A SPAC is a publicly traded shell that has a specific mandate to acquire or merge with other companies or assets

Pros: Provides protection to shareholder funds raised, and a minimum liquidation value per share in the event that no viable asset is acquired; pre-funding an acquisition strategy and investing in a management team; quick process of raising capital; directors must hold 5% in the vehicle, locked in for six months post acquisition of the viable asset, to ensure alignment with shareholders

Cons: Inability to come to market with cornerstone asset(s) or investment portfolio, as the SPAC may not carry on any commercial and/or business operations at the time of application for listing to the JSE; first investment must be approved by shareholders (there is some execution risk); capital held in escrow pending approval of the acquisition of a viable asset (cash drag); directors' interest in the vehicle may be costly to finance in a large capital raise.

Permanent fund vehicles

In brief: Allows for a longer fund life than ten years, which may be appealing for certain asset classes (e.g. primary agriculture, real estate, infrastructure)

Pros: Can come to market with cornerstone asset(s) or investment portfolio; track record of financial information on assets (if already acquired); investment policy creates flexibility for future transactions; the investment manager must hold an interest in the vehicle, to ensure alignment with shareholders; lower capital requirement than a SPAC

Cons: Cash drag on returns; must accommodate any additional regulatory processes triggered by initial asset transfers as well as required disclosures and reporting in the pre-listing statement, including, potentially, *pro forma* financial information; timing – matching capital raised to investments; public disclosure of potentially sensitive portfolio company information (although information may be aggregated); investment manager must hold 10% in the vehicle (the JSE, after taking account of the relevant experience of the investment manager, may decide otherwise).

Hybrid models

Various models are possible, e.g.:

A. A permanent capital vehicle, with the initial tranche of capital raised privately. The portfolio performance is assessed after six to seven years, and a decision is made about disposal, maintenance or raising of additional capital. A listing may enable exits and partial exits; a rights offer would generate additional capital; an unwinding is feasible if the portfolio is not a success.

B. Establishing a listed vehicle to create a fund investor, which reduces the need for capital from international LPs. The model creates access for smaller investors, who have the comfort of protection under the Companies Act.

Sources: John Bellew, Bowmans; Nicole Paige, Webber Wentzel