Sidecar Funds: A New Battleground in the GP/LP War

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The private equity (PE) industry has seen a number of innovations since the days of the first leveraged buyout (LBO) boom 25 years ago. Along with the proliferation of innovation in deal-making, structuring, and financial engineering, the private equity fund-raising model has developed a new wrinkle. North American and European PE funds have begun raising committed co-investment pools (CCPs), known colloquially as "sidecar funds", alongside their primary (LBO) fund-raising activities. CCPs have common sponsorship and management with the primary funds, and provide the General Partner (GP) a bypass on restrictions against operating multiple funds concurrently. Many times the fund's initial investors can deploy capital in the CCP on a pro-rata basis (though this is not always the case).

There is reasonable and logical justification for the proliferation of CCPs. They allow sponsors to access capital beyond primary fund commitments for attractive investments on a short-term basis, instead of having to go through a formal fund-raising process. For example, if a sponsor reaches its concentration or committed capital limit in a given fund, they can use a CCP to deploy additional capital in attractive opportunities in which they would otherwise be precluded from participating in. In addition, CCPs also offer deal structuring flexibility. Large syndicated or "club" deals, which involve a number of sponsors and typically arise from situations where the lead sponsor does not have the committed capital or concentration space in their primary fund to take the deal themselves, can be particularly complex and arduous. CCPs are a good way of getting around this complication as they technically do not count against concentration limits. Finally, from a psychological perspective, it also allows sponsors to raise more money from their Limited Partner (LP) base at a given time (it helps reduce the "sticker shock" of large fund raising activities).

However, as the private equity industry battled through the recent economic downturn the purpose of these CCPs began to fundamentally change. They became less about reducing the need for club deals or making new investments after the main fund had run dry, and began to focus on bailing out poorly-performing portfolio companies (previous investments). The buyout euphoria leading up to 2008 had left many recently acquired companies with too much debt. This, combined with the economic downturn, pushed these companies right up against their banking covenants. While the private equity industry as a whole was performing poorly (particularly the 2005 vintage funds), several GPs saw an opportunity: raise a CCP (in some cases 4 years after closing their main fund), use the funds to provide much needed equity to their own troubled portfolio companies (at all-time low valuations), and then earn "carry" on the sure-to-perform CCP (while the primary fund would be lucky to restore its original capital base).

Key Terms

Private Equity An asset class that involves investments in companies that are not publicly traded or buyouts of publicly traded companies in order to make them private companies.

Leveraged Buyout (LBOs) LBOs involve a financial sponsor acquiring a controlling interest in a company's equity where a significant percentage of the purchase price is financed through leverage (borrowing) in order to increase returns to equity-holders.

Club Deal (Syndicated Investment) Refers to an LBO or other private equity investment that involves several different financial sponsors.

Carried Interest A share of the profits of an investment partnership paid to the manager as compensation.

Covenant A promise in a formal debt agreement, that certain activities will or will not be carried out.

Dilution A reduction in the proportionate equity stake that occurs through the issuance of additional shares or the conversion of convertible securities.

Financial Sponsors A term commonly used to refer to private equity investment firms.

Fairness Opinion A professional evaluation by an investment bank or other third party as to whether the terms of a financial transaction are fair.

Limited Partner (LP) A provider of capital on a limited liability basis to an investment partnership which is subsequently managed by a General Partner (GP).

General Partner (GP) An operator of an investment partnership to which one or more Limited Partners have contributed capital. GP's hold agent authority for the entire investment partnership.

The first mega-fund to pitch this idea to its investors was the "grand-daddy" of U.S. private equity, Kohlberg Kravis Roberts & Co. (KKR). During the summer of 2009, KKR asked investors for □730 million to prop up its second European fund (KKR Europe II, currently tracking at a -13% IRR), which held high-profile investments such as UK-based pharmacy chain Alliance Boots. The target fund-raise for this CCP represented 16% of the €4.5 billion main fund. KRR's proposal has prompted a number of other PE shops to adopt a similar strategy, giving rise to several critical and closely related issues.

The first interesting issue deals with who is allowed to participate in these funds, and to what extent. Forgetting for an instant the quandary of throwing good money after bad, and making the assumption that any LP would want to invest in these CCPs, an important problem arises when some LPs can't invest due to their own liquidity problems. This sets the scene for a corresponding misalignment of interests between the committed LPs, the non-committed LPs, and the GPs. The question then becomes two parts: 1. to whom/how do you offer the CCP; and 2. what happens when some or all of the main fund's LPs can't commit.

Both questions are relatively simple to address. A rights offering, a staple of non-dilutive corporate financing, is arguably both simple and fair to all parties involved. The main fund's LPs would be offered the opportunity to deploy capital in the CCP on a pro-rata basis. It is the LPs' capital which the main fund has impaired, and thus they should be given first opportunity to earn compensatory returns. Should one or more LPs not commit to the CCP, the remaining capital should be re-offered to the committed LPs on a pro-rata basis to their existing CCP commitments. This cycle would then be repeated until either the fund-raising was complete or no LP was willing to commit additional funds. It is only after this process has been exhausted that fund-raising should take place outside the main fund's LP base. Although some would identify a "free-ride" problem (why would any LPs pour more equity capital into bailing out their investment when others might?), this should be mitigated by the ultra-low valuations (and commensurately high internal rates of return on the marginal capital deployed) the LP would be offered.

Related to the above in its application to cases where the primary fund LP base is not identical to the resulting CCP LP base (either in absolute identity or ownership %), is the question of what valuation the CCP should make its investments. GPs will say the purpose of their sidecar is to provide some level of recovery for the main fund's investments, however the underlying driver is all about earning returns by any means possible (to please their current LPs, so that they can pay themselves, and for future fund-raising purposes). The best way to earn the largest possible return is to ensure the investment is entered at the lowest possible valuation (i.e. be as dilutive as possible to the main fund). This is fine when the main fund's LPs are identical to the CCP's LPs, but when they differ, and the GP has a contractual obligation to both, how are their competing interests with respect to valuation balanced?

Arguably, the best way to handle this second issue is to start by valuing proposed CCP investments as stand-alone operating companies (using public trading comparables or discounted cash flow analyses). Next, the operators need to determine how much equity capital the company needs to keep it clear of any possible covenant breaches. Knowing the amount of equity needed, and the fair valuation, the CCP will then make its dilutive investment. While there are two critical inputs to the above equation ("fair" valuation and required equity), the biggest issue of these for the LP is the valuation. As noted above, the GP (and in this case the CCP LP base) is incentivized to be as dilutive as possible. To balance this, the main fund LPs should be given the opportunity to obtain an independent fairness opinion on any proposed cross-fund investment (where in this case cross-fund refers to investments originally made by the main fund). From a fairness perspective, should the valuations differ materially the main fund LPs' valuation should be accepted. While any GP will seek to maximize returns on their CCP, those returns won't mean anything in a fund-raising cycle if no LP will give you an audience. From a fiduciary point of view, this issue needs to be clearly discussed in any future CCP agreements.

Sponsor compensation may be the most contentious CCP issue. However, for some GPs who marketed CCPs over the past year, there is only a very slim possibility of earning carry on their main fund. While each agreement will differ, it is not unimaginable that the GPs who raised these funds would try to include language permitting them to earn carry on a separately calculated basis from the main fund. If this were the case (as we assume) then the CCP would represent an extremely lucrative opportunity for the GPs to achieve phenomenal returns (and thus phenomenal compensation) in a period when the GP might otherwise see nothing until their next main fund was raised and harvested. This would provide significant incentive to focus a disproportionate amount of time on the CCP's performance while possibly neglecting the main fund.

An important problem arises when some limited partners can't invest due to their own liquidity problems.

One potential solution to deal with this issue would be to introduce a "high-water mark" incentive structure for the fund managers (an idea borrowed from hedge fund incentive structures). In order to earn carried interest on CCP investments, managers would have to ensure that the total investment value and commensurate IRR exceeds the fund's hurdle rate and high-water mark. For example, assume a PE fund bought out a company for $10 billion at a 10x EBITDA multiple, financed with 70% debt. If the fund was forced to deploy CCP capital into the investment (for example, $1 billion at 5x EBITDA), the carried interest would be calculated on the overall returns including both funds (the CCP would act more like a direct extension of the initial fund) and not awarded until the main fund had been restored to its high-water level. Another way to accomplish this idea, although without the high-water mark requirement, would simply be to judge carry on an overall fund (main fund plus CCP) basis. In this case, proceeds from the harvesting of the CCP would flow directly to main fund LPs until their original capital was restored. At that point, returns would be divided pro-rata between the main fund and the CCP. Only after both LP bases had received their original capital commitments plus their preferred return would the GP be entitled to carry. This structure would no doubt be favourable to main fund LPs and encourage them to deploy additional capital through the CCP.

While the issues raised above are not exhaustive, they do provide a glimpse into the multi-level complexities which GPs will be forced to deal with when considering potential future CCPs. Until the economic downturn has been safely navigated, GPs and LPs will be provided yet another battleground on which they will wage their perpetual war.