Co-Investments

With SRZ's leading fund formation group

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Bespoke not boilerplate offering documents

Historically, and perhaps pre-crisis, the attitude of fund managers towards investors was 'take it or leave it' and negotiated terms were rare. Now, "the influence and sophistication of limited partners (i.e. investors) is growing," says Stephanie R. Breslow, Schulte Roth & Zabel (SRZ) partner and co-head of the Investment Management Group. She has been selected as one of *The Hedge Fund Journal's* '50 Leading Women In Hedge Funds' in all four biennial surveys (2009, 2011, 2013 and 2015). Breslow, whose practice spans both private equity and hedge funds, says: "Some go for private equity style terms and conditions, borrowing heavily negotiated terms and porting them over to hedge funds."

Adds Steven J. Fredman, SRZ partner and co-head of the Investment Management Group, "the more savvy limited partner already has a term sheet prepared that may require half of the prospectus to be rewritten."

Founder's classes offering discounted fees can be popular as a variant of the concept that those seeding a new fund or firm or both, get a discount. SRZ partner David J. Efron says, "We are seeing lock-up periods again. An initial one-year lock-up is not uncommon these days. Some hedge fund managers are offering longer lock-ups in exchange for fee discounts, whether it's through a founder's class or in a class that's continually offered."

Extensive Most Favoured Nation (MFN) clauses drafted by SRZ lawyers, including Breslow, are also sought after by some investors. These are intended to ensure that concessions granted to certain investors are extended to those (often large) investors that have secured the MFN clause.

Yet a balance needs to be struck, as Efron points out: "With an increasingly demanding investor base, hedge fund managers today are faced with the pressure to offer compelling fund terms to investors and prospects, and are balancing that pressure with the need to offer terms that are consistent with their investment strategy and further the commercial interests of their business."

In all of this, SRZ partner Daniel F. Hunter sees investors "wanting to learn from their past mistakes, when fund terms could be tilted in favour of managers." Some investors may draw inspiration from various industry codes and standards, including recommendations of best practices from the Alternative Investment Management Association (AIMA), the Managed Funds Association (MFA), the Hedge Fund Standards Board (HFSB), OICV-IOSCO, or others. But Breslow finds the importance of these templates can be exaggerated because each investor has his or her own specific requirements.

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So, investors are increasingly negotiating bespoke terms and conditions, rather than relying on boilerplate or standardised documents, and this is very germane to co-investments. Sometimes the terms around these are embedded in, or 'stapled', to offering documents, but more often co-investment conditions are agreed to at a later date. The only useful generalisation that can be made about co-investment terms is that they are even more heterogeneous than those for offering documents. "Co-investments are becoming more popular partly by default – because side pockets are less acceptable," says Breslow. Co-investment vehicles or 'sidecars' can also be faster to set up than funds or mini-funds, Hunter adds.

Strategies offering co-investments

A variety of hedge fund strategies invite investors to participate in co-investments. "Activists need to get to scale if they want to take control," says Breslow, and distressed debt investors may have similar motives in terms of gaining critical mass 'fulcrum' securities or other pivotal parts of the capital structure. Fredman notices direct loans being syndicated, and "very large packages of asset backed securities or structured credit" can also be shared with external investors. Hunter sees real estate being divested by banks parcelled into co-investments all the time. In contrast, opaque, or 'black box', quantitative strategies are amongst the least likely to do co-investments.

Fees run the gamut

"Fee structures range from zero to parity with funds," says Breslow, who states the range is so wide because "it depends on who needs whom." If funds are desperate to get people on board, co-investments may be entirely fee-less, whereas if deals are very sought-after the fees may be the same as for funds. In between these two extremes there can be any combination of varying amounts of management fees and performance fees. "We have seen smaller management fees with realisation based carry, half management fees with no carry, or zero management fees with normal carry," states Hunter. He finds investors will try to negotiate for fees on co-investments to be completely offset against other fees paid to a manager, but this bold request is summarily declined.

SRZ partner Jason S. Kaplan believes some investors view co-investments that offer discounted fees as "an opportunity to lower their blended rate of management fees." There is also a perception from some investors that managers have higher conviction in those opportunities offered as co-investments.

Maturities run the gamut

Maturities of co-investments vary almost as much as fees. Says Kaplan, "if activists are seeking co-investments based on the next proxy contest, their time horizon might be shorter than that of the fund." Breslow feels that time frames are triggered by realisation

horizons, and might be longer for some distressed investments. Hunter has noticed some of the longest durations, of five, six or seven years, for Italian non-performing loans that need to be worked out through the courts. Fredman has also structured deals where there can be options to exit at different dates.

Pari passu is rare

Co-investment opportunities, terms and conditions may differ between investors. Kaplan will often negotiate co-investment rights specific to particular limited partners. Fredman elaborates that this can entail showing opportunities selectively to investors inside a fund or even to third parties not invested in any other vehicles run by a manager.

Disclosure is paramount

These differences must be disclosed (though the identity of those investors receiving preferential treatment need not be disclosed). Breslow notes that "SEC speeches got people concerned about disclosure." Though the main focus has so far been private equity, the principles involved could be relevant to all kinds of funds, including hedge funds.

Apportioning concessionary fees

Hunter observes that expenses on successful deals are usually shared pro-rata amongst investors. It is on unsuccessful, or 'broken', deals that there is more debate over what to do. Where third parties have negotiated concessions involving lower or no sharing in expenses on broken deals, all else being equal, the implication is that other investors would bear a disproportionate share of these costs. Fredman warns that SEC guidance is in fact that, in the absence of disclosure to and consent from investors, the management company should bear the burden of these under-allocated or un-allocated broken deal costs. This might make managers think twice about granting such concessions.

Fredman has found that management companies did not think through the implications of expense concessions, and attempts at ex-post rationalisation did not go down well with investors or regulators. Says Breslow, "you can disclose your way around it but only in advance."

Potential trading restrictions

The potential benefits of co-investments do not always come without at least opportunity costs. Investors in co-investments are rarely restricted from trading due to becoming privy to inside information, Breslow observes, but Kaplan notes that they may be restricted for other reasons – as Non-Disclosure Agreements might include non-trading clauses. **THFJ**

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