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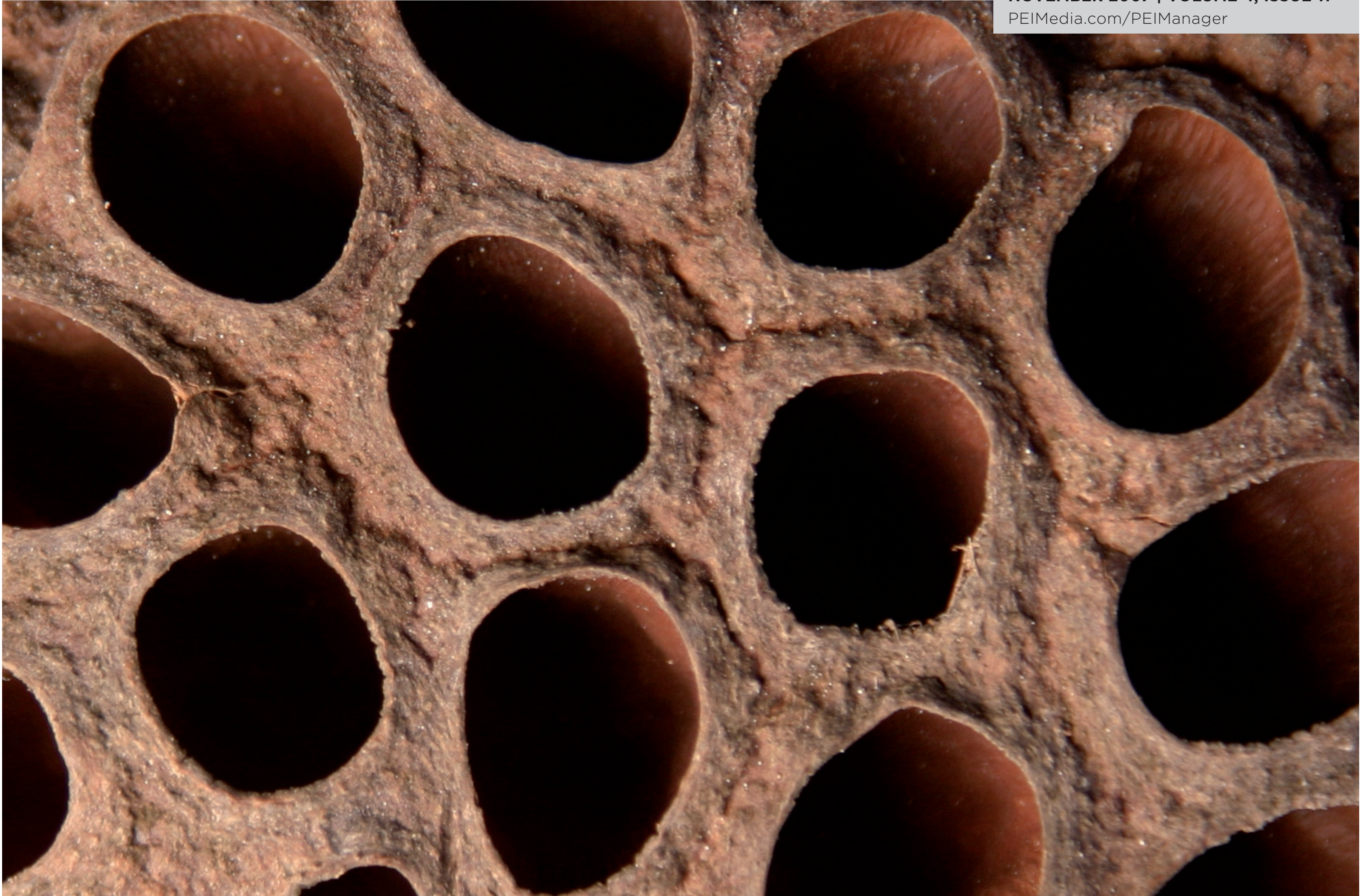

Focus
Budgeting & GP Management

Sell it forward
Succession planning in monetization events

Flying feeless
Budgeting for pledge funds

German by way of Jersey
Wellington Partners' pan-European push

End of taper relief
Darling ups UK carry tax to 18 percent

Bolstering defenses
Blackstone, Carlyle hire for stronger regulatory ties

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Pursing permanent capital

While the long term prospects of the publicly listed private equity vehicle remain open to debate, several firms are experimenting with the model. Conversus Capital, a fund of funds vehicle, recently listed on Euronext. Here's how this listed fund of funds differs from its classic unlisted counterparts.

By Raj Marphatia of Ropes & Gray

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In July 2007, Conversus Capital, L.P. (CCAP), a newly formed partnership, listed common units on Euronext. Conversus was organized by Bank of America Corporation (BAC) and Oak Hill Investment Management, L.P. (OHIM, and together with BAC, the "Sponsors"). The California Public Employees Retirement System (CalPERS) and Harvard University were strategic investors in the transaction.

This article first describes the basic structural differences between CCAP and an unlisted fund of funds. Next, it discusses areas in which these two types of funds are structured similarly, and concludes by examining the actual performance of CCAP.

CCAP differs from an unlisted fund of funds in five significant respects. First, CCAP has an unlimited life and access to permanent capital. Unlike an unlisted fund of funds, it does not have a fixed term and is not required to make any distributions (other than limited tax distributions). CCAP will be actively managed, and is expected to make primary and secondary investments in private equity funds, as well as direct investments in operating companies (CCAP intends to invest at least 80 percent of its assets in primary and secondary private equity fund interests, and up to 20 percent of its assets in direct private equity investments).

CCAP's owners are not required to make any further capital contributions to CCAP. Instead, CCAP will finance its investment program through the reinvestment of proceeds and borrowings under its collateralized fund obligation program (described below). Thus CCAP does not have to periodically raise a new fund to obtain fresh capital.

Liquid, to a point

Second, CCAP's common units are listed on Euronext, providing its investors far more liquidity than is provided by a typical unlisted fund of funds. It should be noted, however, that this liquidity has its limits. Even though CCAP's common units are listed, there are significant restrictions on the persons to whom they can be transferred.

CCAP will avoid registration under the Investment Company Act by restricting ownership of its equity by US persons to "qualified purchasers." In addition, to avoid CCAP's assets being characterized as "plan assets" for ERISA purposes, CCAP will not permit its common units to be held by benefit plan investors. Actual trading has been sparse – the average daily volume through September 28 was 8,626 units, or roughly 0.01 percent of CCAP's 73 million units outstanding.

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A mature menu of funds

Third, CCAP offers its investors immediate access to a seasoned portfolio of private equity funds. In contrast to unlisted fund of funds, which typically build a portfolio by subscribing to new funds over a three to five year investment period, the portfolio that CCAP acquired from BAC consisted of 171 fund interests managed by 105 managers, representing a fund NAV (as reported by the underlying funds) of $2.2 billion and unfunded commitments of approximately $672 million. The portfolio's weighted average fund life was approximately 6.5 years, and the weighted average investment duration at the portfolio company level was approximately 3.6 years.

Fourth, the fact that CCAP is just one of many lines of business conducted by the Sponsors raises some unique conflict of interest issues. BAC and OHIM are not restricted from pursuing other business activities that compete with CCAP, and have very limited obligations to refer deal flow to CCAP. Investment opportunities are to be allocated between CCAP, BAC, and OHIM's clients in a "fair and equi-

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The Conversus offering

The offering raised $1.835 billion for the firm. The proceeds from the offering and borrowings under a collateralized fund obligation program were used to purchase a seasoned fund portfolio from affiliates of BAC for $1.855 billion.

A total of 73.402 million units were issued at $25 per unit, for gross proceeds of $1.835 billion. The purchasers were as follows (figures in millions):

$ 225	Sponsors (BAC: $200: OHIM: $25)
$ 750	Strategic Investors (CalPERS: $500; Harvard: $250)
$ 400	Directed Investors (consisting in part of affiliates of BAC and OHIM)
$ 400	Global private placement
$ 60	Over allotment option to underwriters
$1,835	Total

table" manner.

BAC will allow CCAP to participate in certain of its direct investing opportunities pursuant to a specified formula, but CCAP will not have the right to participate in any direct investments available to OHIM or its affiliates. Neither BAC nor OHIM owes any duties to CCAP. Because CCAP is controlled by BAC and OHIM, there is a risk that the natural persons who make investment decisions for CCAP have divided loyalties and are not fully aligned with CCAP and its unitholders in the same way as the sponsors of an unlisted fund of funds.

Alignment through lockups

Perhaps recognizing the potential for misalignment, the common units acquired by the key players are subject to lockups. One-half of BAC's units are subject to a two year lockup, whereas the other half are subject to a one year lockup. OHIM's units are subject to a two year lockup. The units held by CalPERS and Harvard are subject to a one year lockup. The lockup for directed investors and the directors and chief financial officer of the General Partner is 180 days.

Furthermore, BAC and OHIM have each agreed that as long as the Manager serves as manager to CCAP, and BAC and OHIM, respectively, have the right to appoint members to the Manager's investment committee, they will maintain a minimum investment in CCAP of at least $50 million and $10 million, respectively. CalPERS and Harvard do not appear to have made any minimum investment commitment.

Fifth, CCAP intends to leverage its investment program, in contrast to unlisted fund of funds, which typically do not themselves use leverage. CCAP will enter into a collateralized fund obligation program pursuant to which it is entitled to borrow up to $650 million on a continuous basis. Borrowings under the program are secured by a first priority security interest in CCAP's cash accounts. The program has a term of five years.

Notwithstanding these important structural differences, CCAP is similar to a typical unlisted fund of funds in being organized as a limited partnership with a discretionary investment manager, the types of fees it bears, and on being a passthrough entity for U.S. tax purposes. Each of these terms is explored below, while noting the important nuances between the contours of these terms for the two types of funds.

Listed and entrenched

CCAP's limited partnership structure is similar to that of an unlisted fund of funds, but its managers are more entrenched than those of its unlisted counterparts. As a limited partnership, CCAP is

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nominally controlled by its general partner, but that general partner has delegated day-to-day management of CCAP to Conversus Asset Management, LLC (the "Manager") pursuant to a services agreement. The manager is owned by BAC, OHIM, CalPERS, Harvard, and certain of the Manager's employees (the majority of the senior staff of BAC's Fund Management Group became employees of the Manager).

All investment decisions are to be made by a six member investment committee, which is controlled by BAC and OHIM. The services agreement with the Manager has a term of five years, and is automatically renewable for consecutive three year terms if it is not terminated before the end of each term. CCAP suffers substantial financial penalties if it terminates the services agreement other than for cause, making it unlikely that CCAP would terminate the services agreement. There is no key person provision and no no-fault termination provision, both of which are common in unlisted fund of funds.

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The fee factor

Although CCAP will bear the traditional management fee and incentive fee, these terms are structured in a manner that is more favorable to the Manager than is the case with unlisted fund of funds. The Manager is entitled to a management fee of (a) up to one percent per annum of the value of CCAP's non-cash assets, and (b) up to 0.5 percent per annum of CCAP's aggregate unfunded capital commitments.

Of these amounts, one-third will be payable quarterly in cash, and two-thirds will be earned in the form of a profits interest to the extent of increases in net asset value. An affiliated entity (whose owners appear to be the same as those of the Manager), is entitled to a 10 percent performance allocation, based on increases in net asset value, subject to a seven percent preferred return. This incentive fee is paid quarterly, but is subject to a three year high water mark.

These terms are more favorable to the Sponsors than in a typical unlisted fund of funds, in which the management fee is based on a declining percentage of commitments, and the carried interest is only received as profits are realized and is almost always subject to a clawback (rather than just a three year high water mark). In addition to the management fee, the Manager is also entitled to be reimbursed by CCAP for the remuneration of the Manager's non-investment employees, and a pro rata portion of overhead expenses reasonably attributable to the management of CCAP's business. These arrangements are far more generous than those for unlisted fund of funds, where all compensation and overhead expenses are borne by the manager.

CCAP, like its unlisted counterparts, intends to be treated as a partnership for U.S. income tax purposes, but the manner in which it does so is likely to reduce its returns. As a publicly traded partnership, CCAP can avoid entity-level taxation if at least 90 percent of its income generally consists of passive income such as interest, dividends, and capital gains.

To satisfy this test, CCAP intends to invest through a corporate blocker in funds that are expected to generate UBTI and ECI. Investing through blockers is likely to reduce the after-tax returns of CCAP relative to investors (particularly U.S. taxable investors) that do not have to comply with the 90 percent rule.

The bottom line

The ultimate success of CCAP will of course depend on the performance of its units. CCAP's units were issued at $25 in July 2007. The price of the units on September 28, 2007 was $23.50, and had ranged from a high of $28.10 to a low of $23.50. As of August 31, CCAP had 73.402 million units outstanding and a market capitalization (at $23.78 per unit) of $1.745 billion. CCAP reported that the NAV of its investments on August 31 was $1.951 billion, representing a per unit NAV of $26.59. At present, therefore, CCAP is trading at a discount to the value of its assets and below its original offering price.

CCAP is an innovative product offering eligible investors access to the private equity asset class with far greater liquidity and a more seasoned portfolio from the outset than the typical unlisted fund of funds. The price for liquidity and a seasoned portfolio are economic terms that are more favorable to the Sponsors, and a structure that features a variety of conflicts of interest.

CCAP is also unique because it has access to permanent capital, and it will be interesting to see whether similar products are offered by other institutional investors that want to increase their balance sheet flexibility. The fact that CCAP is currently trading below its offering price and at a discount to the value of its assets is likely to delay similar offerings. ■

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