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Article

Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities

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The use of managed accounts as an investment vehicle has been widely publicized of late with institutional investors such as the California State Teachers' Retirement System and the New York State Common Retirement Fund (referring to such vehicles as "separate accounts"), and the Teacher Retirement System of Texas and the New Jersey Division of Investment (referring to such vehicles as "strategic partnerships") making sizeable investments with high-profile private equity firms such as Apollo Global Management, LLC, Kohlberg Kravis Roberts & Co. and the Blackstone Group.[2]

Regardless of name, these tailored investment vehicles represent a significant trend, with 32% of surveyed fund managers indicating they were intending to invest more from separate accounts during 2013.[3] And although structurally divergent from commingled real estate or private equity funds ("Funds"), these separate accounts share a common objective with Funds: to produce strong returns with respect to invested capital in the most efficient manner possible.

In many situations, accessing a credit facility can facilitate achieving investment objectives. This is quite clear in the context of Funds establishing subscription credit facilities, also frequently referred to as a capital call facility (a "Facility"). These Facilities are popular for Funds because of the flexibility they provide to the general partner of the Fund in terms of liquidity and the efficiency associated with consolidating the number of capital calls made upon limited partners. These benefits would equally apply to institutional investors establishing separate accounts with private equity firms and, despite fundamental differences between separate accounts and Funds, a separate account may be structured to take advantage of the flexibility afforded by a similar credit facility.

Definition of "Separate Account"

The term "separate account" has been used generically to describe an arrangement whereby a single investor provides virtually all of the necessary equity capital for accomplishing a specified investment objective. It is important, however, to distinguish a "separate account" from a joint venture or partnership in which there is an additional party (frequently the investment manager) with an equity interest in the owner of the investment. The equity provided (or earned) by the investment manager may be slight in comparison to the equity capital provided by the institutional investor. However, despite the imbalance of economic interests, these joint ventures and partnerships involve two or more equity stakeholders and generally require careful consideration with respect to many of the same issues which arise in the context of Funds (whether such Fund includes just a few, or a few hundred, investors). And confusion arises when these joint ventures and partnerships are incorrectly referred to as a "separate account."

In fact, a separate account ("Separate Account") is an investment vehicle with only one (1) commonly institutional investor ("Investor") willing to commit significant capital to a manager (which may also simultaneously manage a Fund or Funds ("Manager")) subject to the terms set forth in a two (2) party agreement (commonly referred to as an Investment Management Agreement or the "IMA"). The IMA is structured to meet specific goals of the Investor, which may be strategic, tax-driven or relate to specific needs (such as excluding investments in a particular type of asset or market). As a result, it is not atypical for a Separate Account to be non-discretionary in terms of investment decisions made by the Manager (with Investor approval being required on a deal-by-deal basis). Separate Accounts can also be tailored to match the specific investment policies and reporting requirements of the Investor.

Separate Accounts vs. Commingled Funds

Aside from fundamental differences such as the number of investors and the potential lack of Manager discretion in making investment decisions (described above), several key distinctions exist between Separate Accounts and Funds. Notably, fees paid to the Manager under Separate Account arrangements are typically lower than those paid to a Manager operating a Fund (in part because of the leverage maintained by an Investor willing to commit significant capital to a Separate Account), and any performance fees must be carefully structured to ensure they do not violate applicable law relating to conflicts of interest.

The popularity of Separate Accounts may be attributable to the greater flexibility they provide to the Investor. In addition to Investor input related to investment decisions, IMAs are sometimes structured to be terminable at will upon advance notice to the Manager (although there may be penalties associated with early termination), while termination of a Fund Manager ordinarily requires the consent of a majority or supermajority of the other limited partners, and oftentimes must be supported by "cause" attributable to the action (or inaction) of the Manager. However, there are also significant costs and trade-offs associated with this flexibility, including that the Investor must identify and agree upon terms with a suitable Manager, and the time commitment and expertise required by the Investor to be actively involved in analyzing and approving investment recommendations made by the Manager. Likewise, the Manager will require a sizeable commitment to the Separate Account to overcome the inefficiency of a Separate Account as compared to operating a Fund with a larger pool of committed capital, more beneficial fee structures, and discretion over investment decisions.

Benefits of Credit Facilities for Separate Accounts

Notwithstanding the differences between Separate Accounts and Funds, Investors and Managers alike would benefit from access to a credit facility in connection with a Separate Account. To begin with, credit facilities provide a ready source of capital so that investment opportunities (once approved) can be quickly closed. Timing considerations are critical in a competitive environment for quality investments, particularly if internal Investor approvals are difficult to obtain quickly. The liquidity offered by a credit facility can decrease Investor burden and shorten the overall investment process by eliminating the need for simultaneous arrangement of funding by the Investor. The closing of an investment through a credit facility minimizes administration by both the Investor and Manager, as funding of the obligations to the Separate Account can be consolidated into a routine call for capital (instead of multiple draws taxing the human capital of both the Manager and Investor executing the objectives of the IMA).

And, perhaps most importantly from the Investor's perspective, a credit facility may eliminate the need to continually maintain liquidity for the capital required to fund investments contemplated by the Separate Account.

Although alternatives exist (including asset-level financing arrangements), many Funds have established Facilities for purposes of obtaining liquidity, flexibility and efficiency in connection with portfolio management. The most common form of Facility is a loan by a bank or other credit institution (the "Creditor") to a Fund, with the loan obligations being secured by the unfunded capital commitments (the "Unfunded Commitments") of the limited partners of the Fund. Under a Facility, the Creditor's primary and intended source of repayment is the funding of capital contributions by such limited partners, instead of collateral support being derived from the actual investments made by the Fund. The proven track record of Unfunded Commitments as collateral has generally enabled Creditors to provide favorable Facility pricing as compared to asset-level financing, although many Funds utilize both forms of credit in order to increase overall leverage of the investment portfolio.

Assuming the Investor is a creditworthy institution, the IMA can be drafted to take advantage of the flexibility afforded by a Facility by including certain provisions found in most Fund documents supporting the loan.[4] More specifically, the IMA should expressly permit the Manager to obtain a Facility and provide as collateral all or a portion of the unfunded commitment of the Investor (the "Required Commitment") to supply a capital contribution for approved investments ("Account Contributions") contemplated by the Separate Account. Then, as part of the Investor's approval of an investment under the IMA, the Investor may elect to authorize the Manager to make a draw upon the Facility for the relevant investment(s) and cause the Required Commitment to be pledged, along with the right to request and receive the related Account Contribution when called by the Manager (a "Capital Call"), to the Creditor. If so, the Investor retains discretion with respect to both investment selection and Facility utilization and, when drawn upon the Facility, would be supported by a pledge of: (a) the Required Commitment; (b) the right of the Manager to make a Capital Call upon the Required Commitment after an event of default under the Facility (and the right of the Creditor to enforce payment thereof); and (c) the account into which the Investor is required to fund Account Contributions in response to a Capital Call. Creditors may also require investor letters from the Investor acknowledging the rights and obligations associated with this structure from time to time. As mentioned above, most Investors and Managers are familiar with these terms and recognize the benefits afforded by establishing a Facility for purposes of flexibility, efficient execution, and administration of private equity investments.

Conclusion

The number of Funds seeking a Facility is steadily increasing due to the benefits these loans provide to Investors and Managers in terms of liquidity and facilitating investment execution, while simultaneously decreasing the administrative burden associated with numerous and/or infrequent capital calls. Likewise, Creditors have benefitted from the reliability of unfunded capital commitment collateral and the low default rates associated with these Facilities.

These same attributes apply in the context of Separate Accounts and, with careful attention to Facility requirements at the onset of Separate Account formation, similar loans may be provided for the benefit of parties to an IMA. Please contact any of the authors with questions regarding these issues and the various methods for effectively establishing a Facility in connection with Separate Accounts.

Endnotes

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2 "CalSTRS Joins Chorus Favoring Separate Accounts Over Funds", Pension & Investments, March 5, 2012.

3 "The Rise of Private Equity Separate Account Mandates", Preqin, February 21, 2013.

4 In the context of a Separate Account structured so the Investor does not maintain any form of commitment (and instead merely funds individual investments with equity capital in connection with approval and closing thereof), this Facility support structure would not apply.