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A Strategic Comparison of Private Investment Fund Models

WRITTEN BY

Julia D. Corelli | Irwin M. Latner

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Our law firm, Pepper Hamilton, regularly advises prospective private equity and hedge fund managers on the various legal structure options associated with launching a new private investment fund. In our experience, first-time fund managers often have preconceived notions of how their new fund should be structured and what economic and liquidity features, capital commitments, investment horizon and other terms the fund should have. Such preconceived notions, however, frequently evolve based on further exploration of the different fund structure options available and which structures better align with investor interests given the fund's underlying investment strategy and return objectives. The size and experience of the management team, their strategy and their ability to raise committed capital all play an important role in determining what type of fund structure the manager will deploy.

In this article, we outline a number of private investment fund models, both traditional and nontraditional, that new or emerging fund managers may wish to consider in determining which model is right for their needs and those of their investor base. From deal-by-deal financings (aka independent sponsors), pledge funds, "committed" independent sponsors and single-investor funds to traditional private equity and hedge funds and permanent capital vehicles, there are a number of structure options for a manager to consider and explore. In many cases, emerging managers will be targeting family offices, high-net-worth investors, funds of funds and other investors who are accustomed to emerging-manager investing but reluctant to invest in a traditional committed capital fund with an unproven manager.

Deal-by-Deal Fundraising — Independent Sponsors

Before establishing a committed capital private equity fund, many new or emerging managers typically focus on meeting the needs of their investors on a deal-by-deal basis, either as an independent sponsor or as an operator of a pledge fund vehicle.

The hallmark of an independent sponsor is deal-by-deal fundraising. Management firms in the private equity space without a committed capital fund structure often act as independent sponsors, sourcing deals and raising capital on a deal-by-deal basis to fund the acquisition. Independent sponsors typically have proprietary deal flow that is often associated with specialized industry or regional expertise and relationships. For example, many independent sponsors facilitate M&A transactions in the middle and lower middle market segments, as well as various types of real estate investment transactions. Once a target opportunity is identified and vetted, the independent sponsor typically seeks equity capital to fund the transaction from friends and family, private equity and hedge funds, and/or family offices, depending on the size of the deal and other characteristics. Compensation structures for independent sponsors typically include a closing fee (0 to 3 percent), a management fee ($100,000 to 6 percent of EBITDA) and a share of the net profits earned from the investment (referred to as the “carry” or “promote”) (this ranges from 7 percent to 50 percent and is usually after an 8 percent to 10 percent hurdle).[1]

Deal-by-deal fundraising poses many challenges, particularly for new asset managers. The first challenge is that the first deal needs to be a success, or the second one will not be funded. There is no magic bullet to this, but the factors generally critical to success are:

- You need a team.
- Your team must be dedicated and talented.
- Your approach must be consistent throughout, and it is critical not to be out of the market at any time. This impacts
  - deal flow
  - deal evaluation
  - deal structures
  - deal quality
  - deal tempo.
- You have to be able to articulate the advantages and disadvantages of investors investing with you and sellers selling to you.
  - That is what positions you for growth and offering more opportunities (see above regarding being consistently in the market).
  - Advise your sellers to look and evaluate what is being brought to the table.
- You need to carefully plan for the future in terms of follow-on investments and make sure you will have the capital to support the portfolio investment.
- You need to be on consistent, solid ground in terms of your system of reporting to investors.
- You have to know the rules of the game — *i.e.*, the difference between what can be done and what should be done (these may be different), particularly as it affects valuation, deal economics, legal structures and accounting issues.
- Use good advisers who know the rules and the difference between what can and should be done.
- Have patience, be resilient and align yourself with investors who are patient and resilient.

Deal-by-Deal Fundraising — Pledge Funds

A “pledge fund” structure may also be an attractive alternative for emerging private equity managers who want to move beyond pure deal-by-deal fundraising but have difficulty finding investors willing to commit their capital for 10-12 years to an unproven manager in a traditional blind-pool private equity fund model. The hallmark of a pledge fund is investor optionality, whereby investors retain the flexibility to elect whether to participate in each deal pursuant to a prearranged structure and terms. Pledge fund managers typically invest in the same middle and lower middle market M&A and real estate segments as independent sponsors, as well as in the venture capital space. Whether structured as an investment management agreement entered into with each investor or as a single umbrella limited partnership or limited liability company investment vehicle, a pledge fund typically has the following characteristics:[2]

- An agreement pursuant to which the manager agrees to provide investors with a first look at prospective deals, typically in exchange for a management fee (either fixed or based on a percentage of each investor's commitment amount).

- A process set out in detail in the pledge fund subscription materials for presenting information on proposed deals and permitting investors to opt in to (or out of) the investment. Investors are generally allowed only limited due diligence (often review of the written report from the manager and the opportunity to ask questions), and a defined timeline for investors to elect whether to participate or not in each deal. A manager should expect that not all investors will participate in each deal and that capital may be needed from other sources.
- A prearranged structure and terms for deals that get executed, including private equity fund-type management fees and carry, portfolio company fees, participation in co-investment opportunities and agreed-upon expense allocations. The fee structure generally includes an overall fee on uncommitted, *i.e.*, pledged, capital (often referred to as a participation or search fee), plus fee and carry economics on completed deals. Generally, the management fees on uninvested capital are lower in a pledge fund than a traditional private equity fund, though the carry tends to fall in a similar range (20 percent to 30 percent after an 8 percent to 10 percent hurdle).

Though not a blind pool or committed capital vehicle like a traditional private equity fund, pledge funds can allow emerging managers to be compensated for providing access to their deal flow and allay investor concerns about ceding discretionary investment authority to a newer manager with a limited track record. Moreover, if successful, a pledge fund structure can provide a manager with a nice stepping stone to launching a traditional private equity fund. One challenging feature of a pledge fund is that the documentation and ongoing operations can be complex (*e.g.*, deal-by-deal opt-in mechanics, investor-by-investor distribution waterfalls, equalizing management fee charges for subsequent investors, treatment of broken deal expenses, funding shortfalls, terminating investors for material nonparticipation, etc.). However, with sound legal and accounting guidance, a manager can mitigate some of a pledge fund's structural and operational complexity.

In addition, pledge fund clients who are looking for an alternative to a traditional private equity fund structure, are generally more successful when backed by informed investors (often knowledgeable about the relevant asset class) who pre-agree to most of the material fund terms, thereby enabling the pledge fund to be created and operated in a cost-efficient manner. This applies not only to the upfront pledge fund documents, but also to the execution and documentation process for each deal.

Pledge funds differ from independent sponsors in many ways

- Primary among these differences is that the pledge fund has a finite group of investors it is going to each time — the ones who signed up to participate in the pledge fund and who are paying the participation or search fee.
- Pledge funds generally are received better by sellers, *i.e.*, there is less uncertainty in the seller's mind about the ability to get to closing, particularly if the manager can demonstrate that the pledge fund participants have not opted out of prior investments.
- Some pledge funds can offer a class of interests that are just like a typical private equity fund for those investors who want to invest across the whole platform of deals that get done — allowing investors to hedge their bets by having some committed capital and some capital they can opt out of an investment.
- The manager's economics are set in advance and generally not customizable on a deal-by-deal basis.

But there are also many similarities

- Pledge fund managers need a dedicated and talented team that applies consistent methodologies to deal selection, evaluation and structure.
- The first deal has to be a success, or the second one will see a lot more investors opting out.
- Demonstrable deal flow capability needs to be shown in order to have investors pledge to participate and pay

the participation/search fee.
- Deciding how to deal with follow-on investments can be problematic because pledged capital may have been invested. At the least, a follow-on investment should not be subject to an additional opt-out right.

Single Investor Funds and Joint Ventures

Often an emerging manager will be seeded by an anchor investor (*e.g.*, a family office, fund of funds or other institutional investor that has an allocation to emerging managers) and must accommodate the investor's desire not to be commingled with other investors in a pooled vehicle. In the world of publicly traded securities, this would typically result in establishing a separately managed account (SMA) with a custodian pursuant to an investment management agreement negotiated between the manager and the investor. In the world of private equity investing (including real estate, private debt and other illiquid assets and even with certain institutional public securities investors), a manager may decide to establish a "single investor fund" (SIF) or "fund of one" to accommodate the negotiated investment authority, capital commitment, fees, expense allocations, withdrawal and termination rights, and other mutually agreed-upon terms between the manager and the investor. Though not really a "fund" in the technical sense since there is only one investor, many people in the industry use the above fund nomenclature since a SIF is typically formed as a limited partnership or limited liability company that contains many investment and economic terms similar to that of a typical commingled private equity or hedge fund. In practice, however, a SIF is normally more akin to a joint venture in which the investor has more leverage than a typical fund investor, and thus is often in position to negotiate customized investment terms and commitments. These can include rights that fundamentally change the way a manager may expect to manage investment activity, such as:

- restrictions on certain types of investments
- opt-in/out rights similar to a pledge fund
- special redemption or termination rights when certain events happen
- more extensive and frequent reporting undertakings
- rights to notice and information about (or even to be consulted and/or approve responses to) certain material events
- consent rights to certain major actions
- customized expense allocation policies
- tax covenants
- more explicit time commitment undertakings by the manager's principals.

Like a pledge fund, a SIF may not have a committed capital structure, or, if it does have one, it may be subject to conditions, exit rights and ongoing investor oversight. Nevertheless, as with a pledge fund, a SIF may be an attractive alternative to a traditional commingled investment fund because it can (1) enable a manager to build its track record and infrastructure under a single umbrella entity and (2) facilitate the manager's ability to grow its assets under management (AUM), attract more institutional investors, and eventually launch a traditional commingled fund down the road.

SIFs are highly negotiated vehicles and often are used to implement a lead investor's co-investment rights alongside a private equity fund. Caution is warranted in such structures. In particular, the manager needs to consider:

- whether the SIF should have the ability to exit prior to or hold longer than the fund
- whether the SIF economics are aligned with the fund's, and, if not, whether that creates incentives for the manager to favor the SIF
- if the SIF does not co-invest in all of the fund's investments, whether there are incentives for the manager to favor the SIF (*e.g.*, imagine where the manager spends its time if the fund is underwater on a cumulative basis but the SIF's investments are fine)
- the cost of setting up a SIF — which can be expensive because it is so customized — is often borne in part by the investment manager, which is essentially a reduction in first-year management fees
- having SIFs can create disclosure complexities when the manager goes to raise a committed fund, and privacy concerns of the SIF investor may compete with transparency goals of new investors.

Traditional Private Equity and Hedge Funds

Private Equity Funds. With a traditional committed capital private equity fund structure, a manager can generally call capital and execute deals on a discretionary basis in an expedited manner. The global private investment fund industry focused on equity or equity-like investments (including leveraged buyout funds, venture capital funds, mezzanine financing funds, distressed buyout funds and growth equity funds) raised a record $453 billion in 2017, leaving those funds with more than $1 trillion of "dry powder" to invest into companies and new business ventures.[3] As with independent sponsors and pledge fund managers, private equity funds generally invest in less liquid securities or physical assets, such as real estate. Recently, a growing number of private debt or direct lending funds have been established with structural characteristics similar to private equity funds. These funds buy or originate loans typically in segments of the market underserved by traditional banks. The private debt fund market raised more than $20 billion in each quarter in 2017 and $14 billion in the first quarter of 2018. This is in addition to the $1 trillion of private equity fund dry powder.[4]

These various types of private investment funds pull in the majority of institutional capital invested in the above asset classes and are managed by many of the biggest names in the industry — Carlyle, KKR, Blackstone, TPG, Apollo, Bain to name a few — as well thousands of smaller niche firms.[5] Many institutional investors are more comfortable investing with private equity firms that have an established track record and infrastructure and are sufficiently large to accommodate investments by large pension plans, endowments and other big-ticket investors. There are also many private equity managers who seek to raise smaller funds (especially in the venture capital, real estate and private debt segments) that primarily target family offices, funds of funds, high-net-worth individuals and other non-institutional capital sources.

Private equity funds may be set up using a "European" waterfall, which generally means the carried interest is determined on a net cumulative basis and distributable to the manager only after a full return to the investors of their contributed capital, or an "American" waterfall, which is a reference to deal-by-deal economics where carry is payable with respect to each investment that gets the fund to a net cumulative profits to date position. In the "American-style" deal-by-deal scenario:

- If the first investment is a gain, the carry percentage (often 20 percent) of the gain is distributed to the manager and the rest to the investors.
- If the second investment is a loss, and the third is a gain, the third investment's proceeds will return the loss on the second and any remaining profits will be split, with the carry percentage (*e.g.*, 20%) going to the manager and the rest going to the investors.
- And so on.

Net cumulative “European-style” distribution waterfalls are the norm for emerging managers and may be one of the reasons some emerging managers remain as independent sponsors. Certain types of funds, such as real estate funds, may have hybrid-type waterfalls, mixing an “American-style” waterfall for certain types of income (*e.g.*, operating income) and a “European-style” waterfall for other types of income (*e.g.*, sale proceeds).

Further, many private equity fund managers are able to offer investors a fuller platform with audited financials, third-party administration, institutional quality operational infrastructure and compliance, and sophisticated investor reporting and transparency, all of which facilitate increased investor comfort and willingness to invest in a traditional committed capital private equity fund vehicle. Though there is no clear benchmark as to when an independent sponsor, pledge fund or SIF manager has grown sufficiently large or has developed sufficient track record and infrastructure for investors to be comfortable making capital commitments to such managers through a traditional private equity fund vehicle, we are seeing an increasing number of sophisticated family offices and other investors capable of diligencing emerging managers and, under the right circumstances, willing to be first-time investors in the manager’s maiden private equity fund.

An additional benefit of managing a committed capital private equity fund is the ability to offer investors the opportunity to invest additional capital on a deal-by-deal basis through co-investment opportunities alongside the main fund. A manager may offer these opportunities to certain strategic fund investors on a case-by-case basis or as may be negotiated by an investor in connection with its investment into the fund. Indeed, some co-investment vehicles may themselves be set up as smaller commingled funds or pledge funds.

Co-investment rights are not for everybody. The manager, the co-investors, the fund and the portfolio company receiving the co-investment dollars should all derive specific, tangible benefits from a co-investment.

The obvious benefit is that the co-investment dollars can complete a financing round. The less obvious benefits are the potential strategic benefits to the fund manager or portfolio company.

- Negotiating definitive co-investment rights can be time-consuming and distracting to the main focus of raising capital.
- Granting definitive rights could become onerous in fundraising by creating a “haves” and “have nots” investor base, jeopardizing investor relations in the future.
- Granting all investors co-investment rights is neither strategic nor sane, as the process of implementing the rights would be weighty and leave any need for co-investment dollars impossible to fill.
- Identifying a highly strategic recipient of co-investment rights who can exercise the rights with alacrity and substantiate the ability to fund them (with an equity commitment letter, for example) may be sufficiently differentiated to warrant definitive rights.[6]

Hedge Funds. Though the hedge fund model is a different animal than the above types of fund models because of its open-ended structure without capital commitment drawdowns typically associated with closed-end private equity funds, it is an option for managers whose investment strategy focuses primarily on liquid assets (*e.g.*, publicly traded equities, debt or commodities) or semi-liquid assets that can be readily valued (*e.g.*, loans and other forms of private debt and asset-backed lending strategies). While fully detailing the differences between open-ended and closed-ended funds is beyond the scope of this article, the following are some of the important features of a traditional open-ended hedge fund that differentiate it from a closed-ended private equity fund:

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Continuous offering and admission of investors with periodic redemption dates, typically monthly or quarterly and, in many cases, after a one- or two-year lock-up period.

- Perpetual existence with no fixed term or investment period. Indeed, unlike private equity fund managers, hedge fund managers are typically not restricted from managing additional funds or accounts with similar strategies, provided they employ fair and equitable investment allocation policies.
- Net asset value (NAV) based economics, which underlie the valuation mechanics for the fund's subscriptions and redemptions, as well as the fund's management fees and incentive allocations. In a typical hedge fund, performance-based incentive allocations are akin to carried interest distributions in a private equity fund, but are
  - based on unrealized as well as realized gains since appreciation of the fund's portfolio can be readily determined without selling the fund's assets
  - determined and allocated on a periodic (usually annual) basis
  - determined on an investor-by-investor basis as opposed to at the fund level, and
  - not subject to clawback but establish a high-water mark allowing for future performance incentive to be earned only to the extent net profits earned by the investor exceed the high-water mark.
- For those hedge funds that wish to invest a portion of their assets in illiquid investments (typically between 10 percent and 20 percent, akin to a mini-private equity bucket), many funds establish a "side pocket" account mechanism, whereby the illiquid asset bucket is placed in one or more separate "side pocket" accounts for accounting purposes, investors are not permitted to redeem the portion of their investment held in the side pocket account, and no incentive allocations are taken on a side pocketed investment until the investment is sold or otherwise becomes capable of being valued.

Further, hedge funds have their own set of structural options in addition to the fully documented, continuously offered outside investor vehicle, typically formed as an onshore-only fund, an offshore-only fund or as an onshore/offshore master feeder fund. These options include:

- a SIF or SMA structure with customized terms for a strategic investor, including first loss platform arrangements[7]
- a proprietary trading vehicle for the manager's own capital for the purpose of building track record and infrastructure for future rollout to outside investors
- a friends-and-family vehicle with scaled-down fund documents and limited disclosures, also for purposes of building track record and infrastructure
- a multiclass vehicle with different fee classes, strategy classes, liquidity terms and/or other variables is not uncommon for hedge funds, as many hedge fund managers seek to incentivize early-stage investors to subscribe to the fund and/or provide different options to meet the needs of different types of investors.

Finally, hedge fund managers often have an easier time attracting early-stage capital (and launching with lower AUM) than private equity fund managers due to, among other things, their increased liquidity and shorter lockup periods, their ability to launch with a more streamlined operational infrastructure due to the nature of their underlying assets, their ability to take in non-U.S. investors with less complex tax structuring, and their increased ability (generally *vis-à-vis* their private equity manager counterparts) to offer preferred economic terms to early-stage investors.

The fee economics to a manager of a hedge fund are much more immediate for the manager than the economics of a private equity fund, even those private equity funds that offer deal-by-deal economics.

Use of Online Platforms — Crowdfunding

In both the private equity and hedge fund arenas, there are an increasing number of online investment or crowdfunding platforms that are being formed to facilitate capital-raising efforts with respect to both deal-by-deal financings and traditional hedge and private equity fund offerings (*e.g.*, Hedge Connection, Alternative Capital Advisers, DarcMatter, Axial, AngelList, Realty Mogul, ManagerMatch and numerous others in various different liquid and illiquid asset classes). Many of these platforms are structured as crowdfunding/distribution vehicles in order to raise capital from investors seeking to invest directly or through a feeder fund in otherwise inaccessible deals, strategies or managers that are vetted or curated to varying degrees by the platform sponsor.

From the manager's perspective, these online platforms are often sponsored by broker-dealers or other third parties for the purpose of promoting emerging fund managers and facilitating introductions to family offices and other early-stage investors. These platforms are a good way for emerging managers to increase their exposure and communicate their message directly to a wider body of potential investors, often bypassing traditional brokers and intermediaries. However, we have found that using such online platforms is more productive in conjunction with live interactions, relationship building and effectively managing the overall investor due diligence process. While many of these platforms facilitate deal-by-deal fundraising, an emerging private equity or hedge fund manager may find them particularly useful to generate connections to early-stage investors when attempting to reach a first closing or grow AUM.

Permanent Capital Vehicles

A permanent capital vehicle (PCV) is an investment entity that exists and invests for a long or indefinite period of time. The vehicle can be any form — *e.g.*, company, trust or partnership — and is generally privately held, though it could be publicly traded. PCVs utilize the principles of traditional fund structures by integrating valuation and redemption concepts of hedge funds and incentive concepts more familiar in a single perpetual holding company. They are often limited partnerships with a governing general partner, a carry-owning special limited partner and a separate management company as manager. They are often offered on a continuous basis (sometimes after an initial "stable" period where no new investors are accepted), or they may simply recycle all capital into new investments and never take in new investors.

PCVs have some other distinguishing features

- To track all the special investor calculations, a PCV will often have a capital structure stated in units rather than percentages, with the units designated in classes. For example, class A units may evidence investor (or manager) capital, and class B units could reflect the manager carry.
- PCVs may have capital commitments or only take in capital as needed, calling from the next subscriber at NAV for that next investment.
- Units represent commitments to contribute capital when called. Because units can be issued over the life of the company, special attention is needed to distributions based on units where some may be fully funded and others not yet so.
- The PCV manager is continually in the market for new investors, never succumbing to the break in the rhythm of its operations that traditional private equity managers experience every few years when they risk being out of the market due to the need to form a new fund — this affects not only deal sourcing but also brand recognition.
- Over time, the PCV can build a larger, more diversified portfolio, which it can hold or sell at any time and does not risk being caught in a long down economic cycle.
- They are highly customized, and some say complicated, vehicles so they trigger somewhat larger organizational costs, but the organizational costs are lower as compared to forming three to four funds over a 20-year period.
- PCVs are best utilized for yield-producing investments or investments that can be sold to generate liquidity for redemptions.

PCVs are generally viewed as a way to avoid what some view as the flaws in the private equity fund model — primarily the artificial deadlines to sell companies and disincentives that come from management fee stepdowns — and to build long-term alignment of manager /investor interests. PCVs generally offer some, but limited, liquidity and periodic NAV-based valuations that serve as the basis of the mechanics for admitting new investors and redeeming existing investors. The whole purpose of permanent capital is to avoid the need to distribute proceeds earned from investments, and instead recycle them and grow by reinvestment. Accordingly, distributions are not mandatory. Rather, investors reap the benefits of their investment through the redemption mechanism.

What happens to carry, regardless of how it is calculated, is one of the things that makes PCVs unique. Since NAV is determined periodically, the carry value can, relatively easily, be converted at designated times into “permanent capital” and continue in the company in the same way as investor’s capital. If structured at the outset, this conversion is not a taxable event and the manager can then be an investor just like any other. Carry is then monetized either when the investments are sold or the carry can be withdrawn through the same redemption rights as other investors have. Alternatively, the redemption rights may be different for converted carry (*i.e.*, allow for slower withdrawal) as compared to the redemption rights applicable to invested capital. For example, a conversion may be voluntary or required at year eight, but withdrawal of it limited until year 10 or 12.

While it may be readily apparent why managers would like to implement a long-term vehicle with predictable management fees, what does it offer to the investor? Many investors, both individuals and family offices, are often looking to invest a percentage of their assets in a cost-controlled and longer-term vehicle. The longer-term vehicle, with a perpetual reinvestment cycle in a particular sector, permits the investor to make a one-time allocation and build its portfolio around the allocation. The cost-controlled structure, absent extraordinary events, permits the investor to plan year over year for an extended period of time with some degree of consistency. Similar to any other allocation, the percentage of an investor’s assets that are suited for a PCV is specific to the investor. The sector of the vehicle, combined geography, management team and risk profile, will all be factors in the allocation process.[8]

Takeaways

Managers seeking to manage outside investor capital should become familiar with the various fund structure models available and consider the model that best fits them and their investor base, even if the right approach may involve a nontraditional structure. Private investment fund models are constantly evolving as new capital-raising techniques, such as crowdfunding; new asset classes, such as cryptocurrencies; and new types of investment strategies, such as various nonbank lending programs, are being developed.

The optimal private investment fund model may differ from manager to manager and may result in a combination of products developed by the same manager for different groups of investors. Moreover, a given manager often may commence operations using only one fund product or structure, which subsequently evolves over time as the manager builds trust with investors and investors become more familiar with the manager’s investment program and operations.

Endnotes

[1] Joe Burkhart, Saratoga Investment Corp., “What Are Independent Sponsors, and Why Are They

Relevant," *Axial Middle Market Review* (Sept. 6, 2017).

[2] Mark Proctor & Christopher Rowley, "A Close Look at Pledge Funds," *Law360* (May 20, 2014).

[3] *Reuters Business News* (Jan. 4, 2018).

[4] "Private Debt Fundraising May Have Peaked in 2017," *Institutional Investor* (Apr. 4, 2018).

[5] "Number of active PE firms up 143% since 2000: A global breakdown," *Pitchbook* (June 10, 2015), https://pitchbook.com/news/articles/number-of-active-pe-firms-up-143-since-2000-a-global-breakdown.

[6] Julia D. Corelli, "Best Practices in Structuring Co-Investments," *Private Fund Manager* (Apr. 2013).

[7] A first loss platform (*i.e.*, where the manager co-invests with the platform provider to leverage its own capital and earn a higher incentive fee on the platform provider's capital) is an example of an early-stage customized SMA mandate that can be used to build a manager's track record.

[8] Julia D. Corelli & Stephanie Costantino, "Permanent Capital: The essentials," *Private Fund Manager* (Apr. 2017).