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Permanent Capital: The Essentials

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The permanent capital model avoids the need to harvest investments at artificially created time horizons and to dedicate immense resources to fund formation every several years.

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For many years, permanent capital was an aspirational concept in private equity. It is gaining momentum, however, and is becoming a reality in today's investment platforms. By leveraging the optionality and understanding the limitations of permanent capital, managers may seamlessly use it to enhance their business.

Permanent capital is an investment for an indefinite period of time in an underlying vehicle. The vehicle can be any form – a corporation, trust or partnership. The investment entity could be publicly traded or privately held which we focus on here.

The most recognised, and perhaps most successful, example of permanent capital may be Berkshire Hathaway. In simple terms, Warren Buffett created a pool of investments where new capital could be added, capital could be withdrawn, management incentivised and the investments within the pool could change. Family offices have been doing this for years, so why don't more private equity managers adopt permanent capital techniques?

How Permanent Capital Works

Permanent capital vehicles, or PCVs, utilise principles of traditional fund structures. They are often limited partnerships with a governing general partner, a carry-owning special limited partner and a separate management company as manager. They also integrate valuation and redemption concepts of hedge funds and incentive concepts more familiar in a single perpetual holding company.

For ease of understanding and communication and to track all the special investor calculations, a PCV will often have a capital structure stated in units rather than percentages. The units can be designated in classes. For example, class A units may evidence investor (or manager) capital, and class B units could reflect the manager carry. 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.

One key to a fund manager's success is maintaining the rhythm of fund formation without being out of the market, on either a brand recognition or deal consummation basis. This is much less of an issue if the fund manager is managing PCVs. The PCV will have a designated long term, often as much as 25 years, or a perpetual term that ends only when the last investor has redeemed its interest or the manager decides to liquidate after the entity has disposed of each of its investments. While it may be the vehicle's most differentiating factor when compared to private equity funds, the term receives little negotiation.

Adding Capital

Investors in perpetual vehicles do not want to hinder the diversification of the portfolio by always having the same investments in them. They also often want to add more capital to the funds under management either to broaden portfolio diversity, increase deal size or continue making new investments. To add more capital requires that the manager determine a unit value derived from the vehicle's net asset value. It is the price paid to acquire more units in the company.

An example is illuminating here. Let's say investor #1 joins PCV Partners, LLC at its initial closing. Capital is represented by class A units, issued in $1,000 increments. Investor #1 makes a $10 million commitment and receives 10,000 class A units. PCV Partner's founders contribute two warehoused investments at the initial closing in exchange for class A units equal to the agreed value of the warehoused investments. The NAV of each unit is thus $1,000 immediately after the initial closing. Investor #1 is required to contribute 20 percent, or $2 million, in cash at the initial closing. This can either be retained or distributed to the contributors of the warehoused investments – just like a private equity fund. (Caution is warranted here as to the tax consequences that distribution may cause to the in-kind contributors.)

Investor #11 comes along in the second closing 12 months later and also commits $10 million. As with a private equity vehicle, one of the design points of the PCV is to decide (1) how long the initial fundraising period should be at which additional capital is guaranteed the same NAV upon admission; (2) whether an interest factor should be charged to the latecomer for the period of time that it did not contribute capital – in this case 12 months (the "interest amount"); and (3) whether the pre-existing investments should be revalued. For convenience, unless there has been a spectacular appreciation, it is rare to revalue investments in the initial fundraising period (which may be as long as 24 months in a private equity fund or in a permanent capital entity).

Assuming PCV Partners had a 12-month initial fundraising period, investor #11 would also receive 10,000 class A units. At this point, PCV Partners has the capital it wanted to build its initial portfolio.

Roll forward three years, and PCV Partners has deployed all of the initial capital (or reserved). It issues class A units to investor #12 at $1,000 divided by the NAV in effect at the time of the issuance. If the NAV is $2,000 at the time, investor #12 receives 5,000 class A units for a $10 million commitment.

Investor #12's commitment is new and the prior investors' commitments are fully drawn. PCV Partners may choose to draw #12's cash disproportionately or to return cash to pre-existing partners and restore their commitments. Notably, if it is not returned, investors #1-11 and #12 could be at different tiers in the distribution waterfall when there is cash available for distribution.

Striking a net asset value in privately held investments is not easy. As NAV is the basis on which transactions in units occur, NAV provisions in the governing documents are often highly negotiated and detailed. Determining an NAV frequently involves third-party appraisers, which can get expensive. Hence, the PCV is likely to require limits on when unit-based transactions can occur.

THE KEY ADVANTAGES

- A permanent capital vehicle affords an investment manager enhanced stability, the ability to invest in longer-term growth strategies and a tool for sophisticated co-investment structures, all without diminishing fees and carry.
- Managers can avoid dedicating time and money to fundraising every four or so years.
- Investors, especially family offices, welcome the reduced investment costs and the increased investment options, primarily because permanent capital avoids the artificial holding terms imposed by private equity fund models.

Skin in the Game

The same alignment of interest considerations apply to private funds and PCVs. Investors expect the management team to invest their own “skin in the game” in the same amounts as in a private equity fund (between 1 percent and 5 percent). The questions arising about manager investment in a PCV relate more to when the manager can withdraw their investment. Investors look to keep the original alignment by limiting manager redemptions. For example, manager redemptions may be limited either in size or by a percentage of the capital account, or they may be subordinated to investor redemptions if gates are triggered.

To solve the liquidity conundrum, PCVs offer controlled redemptions after some period of years, where the investor has a put right for a portion of their interest in the vehicle. The redemption rights and the right to add more capital to the vehicle receive the most attention. Usually, though it does not have to be, this is a “horizontal slice” of the whole portfolio, not a vertical slice, ie, where their interest in one or more companies is sold. The right may be exercised after some period of years, which is set based on the design of the investments held in the vehicle required to pay the redemption price. Similar to hedge funds, there are often “gates” on the amount that can be put in any one year.

Manager Compensation

The basic tenets of private equity activity are investors making capital available and paying a management fee and carried interest in exchange for the fund manager locating, vetting, acquiring and disposing of portfolio companies.

Permanent capital is no different. Its investors (other than the managers) bear a management fee that is comparable to that borne by investors in a private equity fund. With permanent capital, however, the management fee may be designed just to cover the operating budget of the investment manager. There may be investor approval rights over the budget or caps on aggregate fee amounts. In a budget-based system, the budget must be “allocated” among the PCV and any other investment vehicles or separate accounts which the manager manages.

Since investors can come in at any time (based on NAV), the management fee is calculated on an investor-by-investor basis. The management fee may be a percentage of contributed capital or of NAV, or a combination of both. It is usually payable for between five and nine years. As new capital comes in, it bears a management fee, even while a pre-existing investor’s obligation may be winding down. The management fee’s budgetary underpinning and its finite life mean that it needs to be carefully designed to align with the ability to add additional investors, or to realise carry, which will depend in large part on the investment strategy of the company and the success of its implementation.

WHAT ARE THE TOUGHEST ISSUES?

While the time horizon for a PCV may differ from that of a typical private equity fund, many of the PCVs toughest issues are largely the same as for PE funds:

- Conflicts of interest, valuations, fees and costs remain integral to the due diligence process for the investor and the disclosure process for the manager.
- Investment advisor registration, broker-dealer, securities law and investment company issues are largely the same.
- Valuations are complicated by the long-term nature of the PCV. To implement a compensation structure for the manager that compares favourably with the private equity world, PCVs may set a fixed date or dates at the outset at which to set NAV in order to address perceived cherry-picking or other valuation issues. Alternatively, the PCV may utilise outside valuation services on a biannual or annual basis to assist the manager in the valuation process and insulate them from liability concerns.
- The manager must always be mindful of the perpetual, or long-term, nature of the PCV when creating its mechanics in order to ensure that the vehicle addresses perceived or potential issues addressed by shorter-term private equity funds.

Calculating Carry

There are three basic ways to calculate carry: (1) at the investor level on an investor-by-investor basis (akin to a hedge fund); (2) at the entity level on a deal-by-deal basis; or (3) at the entity level on a pooled basis (eg, by treating all investments made in a certain period, say five years, in the same pool for carry calculation purposes).

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. This can go on until the investment is sold, or the carry can be withdrawn through the same redemption rights as the other investors. Alternatively, the redemption rights may be different for converted carry (ie, allow for slower withdrawal) than for the redemption rights applicable to invested capital. For example, a conversion may be voluntary or required at year eight, but withdrawal is limited until year 10 or 12.

The ability to add more investors and more capital to the company complicates the calculation of the manager's carried interest. If the carry is represented by class B units, the PCV's designers need to consider whether the class B units receive a share of all profits on all investments, realised investments or a pooled group of investments and when that value is able to be "realised" through the conversion mechanism above.

The whole purpose of permanent capital is to avoid the need to distribute proceeds earned from investments, but to instead recycle them and grow by reinvestment. Accordingly, distributions are not mandatory. Rather investors reap the benefits of their investment through the redemption mechanism. Alternatively, the same effect, with even more optionality for investors, can be achieved with distribution of cash and voluntary "re-ups" on the commitment amount. This is essentially a first right to provide any new capital. If it comes with a break on carry it may be tracked in a new unit class.

Investor Appeal

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, in the absence of extraordinary events, permits the investor to plan year on 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 suitable for a PCV is specific to the investor. The sector of the vehicle combined with factors including geography, management team and risk profile will all be factors in the allocation process.

PCVs are frequently discussed within family offices. On the one hand, family offices do not want capital to be taken out of deployment at a time horizon suitable to a fund manager as opposed to when it is the best time to harvest the investment. On the other hand, they do not want capital locked up indefinitely. The manager therefore offers liquidity through redemption opportunities during designated windows (after a lock-up period), or sale of the interest. The manager may even be required to assist in that sale. The manager gains greater certainty with respect to income and affording the investor opportunities to invest in long-term strategies.

The percentage of a family office's assets that are allocated is particular to the demographic and investing profile of that family office. For many family offices, the allocation process can be both time-consuming and onerous, especially if there are a large number of constituents that must be consulted.

The longer term of the PCV allows the board or manager of the family office to revisit the allocations of the family office on a less frequent basis, without foregoing the ability to revisit it whenever it wants to. This is both efficient from a cost and time perspective. For example, a family office may determine that it would like to allocate a portion of its assets to a particular strategy. The family office would, depending on its governance terms, either consult with each constituent or implement a broad allocation across the family.

If the sector vehicle was a typical 10- to 12-year fund with a four- to six-year investment period, the family office would, potentially, be revisiting the allocation to that sector in three to four years, when it may be faced with evaluating new managers if it wants to continue that strategy. Whereas, with a PCV, it could leave the strategy allocation as is until it affirmatively decides to change it.

Permanent capital, individually or as part of a large multi-faceted investment platform, may offer a solution to managers and investors alike that are seeking a long-term and fee-stable vehicle. With longer investment holding periods being available, and with the comparable fee and carry results, albeit differently structured, the permanent capital model avoids the need to harvest investments at artificially created time horizons and to dedicate immense resources to fund formation every several years. The PCV provides a source of "ready" capital for the manager while, if successful, protecting original capital. It permits the manager and the investor to invest in a long-term relationship, which, if structured correctly, can be fruitful for the both the investor and the manager in the short term and the long term.