Anchin Alert

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May 9, 2019

Financial and Other Considerations When Starting a Private Equity or Venture Capital Fund

Getting a private equity or venture capital fund off the ground takes more than a successful investment strategy. From the outset, you need to consider and plan for the lifespan of the fund, from concept to realization and eventual liquidation. These funds are far more complex and require significantly more financial planning than a typical long-short equity fund.

Virtually every private equity or venture capital fund has a natural life cycle:

- Legal formation
- Raising of capital
- Deploying a substantial amount of that capital to make investments
- Nurturing and watching those investments grow (or fail)
- Have a liquidity event for the successful investments either through private sale or IPO
- Receiving and distributing the proceeds of the sale
- Shut down and liquidation of the fund

The cycle is generally predicted in advance and incorporated into the Private Placement Memorandum and other formation documents. A typical life might be seven to ten years with longer anticipated duration for funds planning to make early-stage investments and shorter duration for those making investments in more mature companies. Generally, your fund documents should spell out how long you have to invest (which would typically limit the period during which you could call committed capital) and when you expect to liquidate those investments. At best, the initial estimate of the duration of the fund is just that, an estimate, so provisions should be made for possible extensions to both the investment period and the overall life of the fund, and further provisions if events require a prolonged period to effectuate an orderly liquidation.

You also need to cover expenses during that early stretch when you’re still raising capital and income is limited. Otherwise, you could run out of money before your investments have time to succeed.

Your agreement should take the cost of operations into account when describing the sources and uses of funds to be raised. The investors should be aware that all capital raised will not be invested; expenses will be paid out of capital called. Alternatively, some funds include provisions for a separate fee, or add-on capital commitment, to cover ongoing operating expenses.

As you develop your initial financial budget, there are three types of expenses for which you should anticipate and plan.

Fund Start-up and Administrative Expenses

Administrative expenses are the costs to set up and run a private equity or venture capital fund. These include paying for legal services, a fund administrator (record-keeper), tax preparation and audit.

When you set your budget, keep in mind that start-up and administrative fees are similar regardless of fund size. A $10 million fund will pay close to the same amount as a $100 million fund. In the New York City market, that's roughly $75-100,000 up front, and the same amount, or more, per year, thereafter. Of course, these costs are highly variable and are more impacted by the number and complexity of the target investments, than the amount of capital raised. This can put pressure on a startup fund that hasn't raised much capital. Your agreement should consider whether these costs will be borne by the fund and its investors or by the manager. Often a cap on the amount charged to the fund, with the excess paid by the manager is the answer.

Management Expenses and Management Fees

When you launch your fund, you will typically set your management fee between 1 to 2 percent per year of the fund's assets. This is supposed to cover the business costs of running your operation, including rent, salaries, insurance, IT, investor relations and other administrative (not to be confused with administrator) costs. As with start-up costs, the ongoing cost of operations is more closely related to the number, type, and complexity of the fund's investments (including the level of control over the investment), than the size of the deal. The initial and ongoing costs of any investment in the hands of the lead investor are typically far greater than those of a minority, passive investor. As noted above, funds don't always close out when anticipated at the outset. Your documents should also describe, and your budget should consider, whether management fees will continue to be charged in full during an extended wind-down period.

You should be diligent in documenting your methodology for allocating any shared expenses between the adviser/investment manager and among the various funds managed. This is an area of continuing focus by the SEC and other regulators which cannot be treated casually.

Personal Expenses

As the general partner of a private equity or venture capital fund, your investors will usually expect you to have a personal stake in the fund (skin in the game). Not only does this mean contributing a sizable amount of your own capital, it also means that you'll be the last one to get paid out of the fees. You'll need to cover all of your entity's other salaries and expenses before anything is left for you.

While your fund is maturing, expect to earn a limited amount. Will your remaining savings be enough to cover your personal expenses on a minimal salary?

Other Considerations

Since management fees are usually calculated as a percentage of committed capital during the investment period and invested capital, without regard to unrealized gains and losses, thereafter, it may be at its peak during those initial periods when you're charging on the full amount of committed capital. While this aligns nicely when the expenses of launching the fund front-load your costs, once investments mature and begin to be paid out, your fees, though not your operating costs, are likely to decrease. As a result, your fund may often be operating at a cash-flow deficit. You should calculate your run rate for start-up, administrative and management expenses. Then, subtract that from a conservative estimate of how much you will bring in from fees based on your expected assets under management. See whether there is a shortfall and how much. Careful cash-flow management is essential.

Waterfall calculations are often incorporated into fund documents to lay out the priority of payments on liquidity events. These vehicles may call for reimbursement to the manager for fund operating costs advanced before any distribution to the investors.

As most funds only generate performance fees (carried interest) on the realization of underlying investments, unless you want to plow your profits back into your operation to fund expenses, that revenue stream should not be counted on to pay the ongoing bills.

Often, private equity and venture capital fund managers look to various sources for bridging the cash-flow gaps; their own capital, which may take the form of loans from the management company to the fund, lines of credit, or other lending sources.

Make sure you have the cash reserves, or sources, to get through this initial deficit before your fund grows large enough to become self-sufficient and, ultimately, profitable.

Where fund managers get into trouble is by having overly optimistic views for the first years, both in terms of expecting lower costs and predicting that they will raise capital quickly. For your financial budgeting, take a conservative view. If you raise half of what you're targeting, can you still cover all these expenses?

By answering these questions before you launch, you can anticipate and budget for these costs until your new private equity or venture capital fund begins to bear fruit.

Your Anchin professionals have deep experience and expertise with start-up funds and can help you as you develop your budget. Please give us a call.

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