At first sight, a set of sun-soaked islands in the Caribbean may not seem the most obvious candidate as a global trendsetter. But for the private equity industry, at least, the Cayman Islands is at the cutting edge of innovative new fund models.

Long established as the foremost jurisdiction for the formation of offshore private equity structures, the Cayman Islands has seen 17,967 exempted limited partnerships – the typical vehicle used for the formation of private equity funds in Cayman – registered between January 2009 and October 2016.

As advisors to more than three-quarters of Private Equity International’s top 50 private equity firms, we have a ringside view on how fund terms are developing. Whilst our role as Cayman Islands counsel is generally to facilitate the evolution of the industry rather than to drive trends in the marketplace, it is increasingly important for legal advisors and the jurisdictions in which they operate to recognise the need for products and services that match the innovation among our clients.

We have to adapt to the demands of sponsors and investors so that we can provide the best structure for our clients, refining the legal architecture where necessary to meet developing needs in a changing market.

In 2016 alone, the top 20 fund managers in the PEI 300 fund managers raised over $400 billion in funds (33 percent of the PEI 300 total). On one level the industry is becoming far more concentrated – the 10 largest fund managers were responsible for 23 percent of all capital raised by the PEI 300 in 2016. Yet this masks a significant diversification of fund strategies.

In this article we look at two important trends that we have seen in our practice area and that relate to this diversification: first the move towards longer term and “evergreen” funds, and then at some interesting developments in relation to the secondaries market generally and investment managers specifically, and we consider the historical context of these trends and potential future developments.

**THE LENGTHENING OF FUNDS**

The duration for which a private equity fund is established has traditionally been fixed, the specific duration being determined broadly by reference to the investment strategy: four to six years for credit funds, eight to 10 years for LBO funds, and longer for real estate and infrastructure funds.

For some time, though, we have observed lengthening durations. Our analysis of fund terms shows that private equity funds are increasingly including provisions for the ability to extend the prescribed duration of a fund for two years and sometimes, subject to consent thresholds, up to three or four years. Some funds now permit extensions for an indefinite number of successive one-year periods.

In 2016 alone, the top 20 fund managers in the PEI 300 fund managers raised over $400 billion in funds (33 percent of the PEI 300 total). On one level the industry is becoming far more concentrated – the fund managers bringing their investment strategies into a closed structure more familiar to private equity funds. By eliminating the ability of investors to withdraw their capital at will, hedge fund managers can at least reduce volatility associated with constant fluctuations in capital under management and focus instead on their investment strategies. Hedge funds bring with them a culture of evergreen structures that have no defined end date, and the perpetual nature of these structures has some attractions in turn for private equity funds.

At the same time, though, we have observed lengthening durations. Our analysis of fund terms shows that private equity funds are increasingly including provisions for the ability to extend the prescribed duration of a fund for two years and sometimes, subject to consent thresholds, up to three or four years. Some funds now permit extensions for an indefinite number of successive one-year periods.

In the same context, we have witnessed an increasing number of traditional hedge
The rise of long-term and evergreen private equity funds can be seen as another choice on the ever-increasing menu of options available to limited partners. Managers have expanded their offerings to provide investors with a variety in terms of market sector, geographical location and fund size and the desire to add in funds with a longer term investment horizon seems a natural progression.

To provide some context to this development, it is instructive to look at the historical rationale behind the terms of private equity funds.

Early investors viewed the holding period for investments of three to five years as an appropriate length of time, giving managers around 10 years to make investments, build their portfolios and make disposals. This provided early investors such as insurers, public and private pension funds and endowments with a sufficient timescale in which to lock up their capital and assess managers’ performance. Likewise, the model worked from the perspective of the managers, providing sufficient time to invest capital, improve the assets and realise the proceeds and, of course, earn their carried interest. As is evident from the lengthy holding period of many investments made at the height of the market prior to the financial crisis, this time period – to some degree at least – also provided managers with the opportunity to pick the right point of the market in which to dispose of the assets.

Originally, investors may have been reluctant in the infancy of the industry to commit their capital for such long periods. However, the industry is now dominated by many long established sponsors that have built up enough of a track record to provide assurances that they, and the asset class, will perform over a longer period of time. Indeed, for those who experienced the deal frenzy, competitive auction processes,
The ability of funds to provide further debt or equity to their portfolio companies or to extend the time horizon of their investments, and to seek operational improvements rather than financial solutions to their businesses, was something that stood the industry in remarkably good stead – relative to other areas of the finance industry. In addition the amount of committed capital that was available to refinance or purchase investments, despite the difficulty of obtaining traditional debt funding, meant that in many cases private equity funds were able to take advantage of distressed pricing and asset disposals by those seeking to raise funds.

**INVESTOR DEMANDS**

These longer term models also fit in with the investment horizons of many limited partners, sovereign wealth funds, public and private pension funds and endowments who need to find long-term commitments for their capital and may also be content with the lower levels of yield that these investments provide.

Much has been written about the increasing amount of dry powder chasing investments in a competitive environment. Preqin reported a record level of $839 billion at the end of the third quarter of 2016. In many cases, strong returns from their private equity investments over recent years have attracted increased allocations to the asset class from investors, who have overwhelmingly positive perceptions of the private equity industry, according to Preqin.

This can create difficulties for limited partners who wish to re-invest their returns into the asset class. We have experienced situations where one private equity fund sells an asset to another and limited partners are committed to both funds. While the exit may be an excellent return for the seller, this might not be such a positive result for the limited partner who is effectively both a buyer and a seller.

From a manager’s perspective, adapting the traditional private equity model to longer term funds raises new challenges. Predictable long-term income streams are all very well, but investors will want increased protections on suspensions, termination and exit. Dilution and re-balancing for incoming investors becomes challenging, and adopting the hedge fund style NAV-based approach is not straightforward because these assets do not lend themselves so easily to valuation.

Fees are necessarily lower, and management fees in particular tend to be closer to 1 percent than 2 percent. Target returns are more modest, meaning that expectations around carried interest are diminished and require greater patience: not always the best recipe for attracting ambitious young professionals to the fund manager. For evergreen funds, there is the additional challenge of providing some sort of liquidity point: either permitting periodic redemptions (assuming that income streams are capable of funding that option), listing the fund to improve liquidity in a secondaries market or permitting the forced liquidation of the fund.

While there are some specialists in this area it is interesting to note that it is the larger and more diversified fund managers such as Carlyle, Blackstone and CVC that have tended to launch these structures. These sponsors, through their broad coverage of geographies and sectors, are able to provide access to opportunities in the widest range of investments, many of which may otherwise have been rejected as unsuitable for the traditional private equity model.

A key focus of long-term ownership will be the active management of the businesses in which they are involved. Again, the experience and resources available to larger sponsors will stand them in good stead. In our own practice we have seen our clients increasingly turn to their roster of seasoned industry executives and advisors to drive operational improvements, provide industry insight and contacts as well as board-level involvement of their firms.

Other challenges facing managers of these sorts of funds include adopting an asset-allocation model and fee structure that will be suitable for the longer term. As we know from our experience, certain fee structures that may be appropriate...
in today’s market will not necessarily be suitable in 10 or 15 years’ time. Likewise management of conflicts and allocations to these structures given the difference in fees will be a key focus for limited partners. Those seeking to invest with a sponsor on a long-term basis will need to have a trusted relationship with their chosen sponsor and deal collaboratively with bumps along the road without a natural time horizon. In that regard, we would expect investors to focus keenly on the control mechanisms that they have in fund documentation in order to ensure that the fund structure and the personnel remain within their original investment case.

LIQUIDITY FOR ALL

It is interesting to note that private equity funds have for many years sought permanent sources of capital through listed vehicles. However, in contrast to the long-term funds, these vehicles have often been viewed as a route for smaller investors to obtain access to investment funds that have the liquidity benefits of a market listing.

In recent years we have also seen liquidity solutions developing at both the fund and investment manager level. The rise of secondary funds from something that initially had negative connotations due to the perception of forced sales or underperforming funds has now given way to the acceptance of secondary funds in the market representing $32.3 billion of target capital – more than at any point in the past five years.

As the industry comes of age and the first generation of fund managers seek to monetise their investments, an increasing number of options have become available. Many of the largest and most established players have sought listings. For example, Blackstone, Carlyle and Oaktree are now tradable. In some cases sovereign wealth funds or pension funds have also taken stakes in management companies. From the sponsors’ standpoint, this is likely not only to provide some liquidity but also to deepen their relationships with key investors in their funds.

Likewise, we have seen private equity funds formed for the purpose of investing in management companies. These funds will be able to offer liquidity for those managers for whom listing on public markets may not be desirable or achievable. In addition, raising capital from a source that operates within the industry may be attractive strategically for managers seeking to partner with an investor that is able to offer both capital and expertise. These funds are in many cases likely to take part in general partner commitments to the funds and in addition provide capital for co-investments.

We believe that sources of liquidity including secondary funds will continue to increase, offering further liquidity to both investors in funds and management companies.

Over the years the private equity industry has matured and developed to meet the needs and demands of the investors as well as the purposes of the sponsors. From the hundreds of offering memorandums that we see every year, the need to find points of differentiation and new niches providing investors with greater degrees of choice and opportunity is constantly apparent.

Longer term funds, secondary transactions and investments in management companies are just a handful of the trends that we have noted. The growth of the asset class over the years, its expansion outside of the traditional leveraged buyout model and its ability to weather and take advantage of economic cycles stands the industry in good stead. This is of course good news for the Cayman Islands as a jurisdiction. We remain committed to providing a robust and trusted legal framework and will innovate where necessary to provide the tools that the industry requires for the next stage of growth.

Rolf Lindsay joined Walkers in 2005 and is a partner in the firm’s Global Investment Funds Group. His practice focuses primarily on private equity funds and their activities, and encompasses the structuring of fund sponsor vehicles, the formation of alternative investment funds and the consummation of transactions undertaken by them. He has extensive experience advising a broad range of clients in relation to the structuring, formation and management of general partners and the alternative investment funds controlled by them.

Andrew Barker joined Walkers’ Cayman Islands office in 2012 and is senior counsel in the Global Investment Funds Group. He regularly acts for leading investment managers and private equity houses advising on the structuring and formation of their funds as well as downstream transactions. An integral part of his practice involves advising in relation to joint ventures, acquisitions, disposals and restructurings. He also has significant expertise in undertaking listings on the Cayman Islands Stock Exchange.