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CONVERGING MARKETS AID EUROPEAN INVESTMENT BUT CHALLENGES REMAIN

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Institutional investors throughout the Carolinas are allocating more assets to private equity, energy, and other alternative asset classes. Until recently, these investors focused primarily on U.S. markets, but Europe, Asia, and other markets have been increasingly attracting their attention – and dollars.

The European private equity fund market is no exception. One result is that offerings in Europe are becoming more similar to what investors see in the U.S. While this convergence has accelerated investment by U.S. investors in Europe, some differences remain, and investing overseas continues to present U.S. investors with some unique challenges. These differences and challenges are numerous and some cases very complex. This article describes just a few and by necessity is very general, and our comments do not apply to every fund or investor.

GP Carry Differences

The basic economics of most private equity funds in the U.S. and Europe are substantially the same: The fund manager will charge a management fee ranging from 1.5% to 2.5% of committed capital throughout the fund's investment period (with reduced management fees thereafter) and will be entitled to a percentage of the profits earned on the fund's investment gains, known to all as its "carried interest." Although highly successful managers were pushing carry percentages in the late 1990's as high as 25% to 33% of profits (and some are doing so again), 20% has been the market standard on both continents for a long time.

The economic provisions tend to diverge at that point though. Each region's model appears more investor-friendly than the other in different respects. For example, when it comes to distributions, a key question is how much of an investor's capital must be returned to the investor before the general partner can begin to take its 20% carry? The typical U.S. manager starts collecting carry as soon as the investors have been returned the capital they invested in the particular deals that the fund has sold. This is much earlier than his European counterpart. Most European funds require that investors be returned *all* their capital contributions before any carry distributions are made to the general partner.

Asserting Investor Rights

Fund termination and general partner removal provisions, by contrast, tend to be less investor-friendly in Europe than the U.S. Certain "no-fault divorce" provisions are common in both markets -- the typical U.S. fund allows a super-majority of investors to terminate the fund at any time; meanwhile, European funds often permit removal of the general partner without cause, a provision rarely seen in U.S. funds. Although the ability to remove a GP may give investors more options, usually the European fund must continue to pay management fees to the removed general partner for a period ranging from six months to two years, in addition to payment of any accrued carry. That sort of "tail" would be highly unusual in the U.S.

Similarly, U.S. investors in Europe should expect to see fewer limited partner and advisory committee approval rights than in U.S. funds. This may be due to more established partnership laws in the U.S. which give investors comfort that participation in certain types of decision-making will not cause them to lose their limited liability.

Other differences, including some relating to creative tax structures for management fees and other matters, continue to exist. Overall, though, these variations appear to be lessening, with the resulting convergence making the European marketplace a more familiar place for U.S. investors to deploy capital.

Uniquely American Challenges

Despite this convergence of terms, U.S. investors in European funds still face important issues that may go largely unattended by fund managers unless they are already accustomed to dealing with U.S. investors. For example, allocation and distribution provisions in a typical "U.K.-style" waterfall may not be valid under U.S. tax principles. In such cases, U.S. investors should determine whether the fund will file U.S. partnership tax returns or provide Schedule K-1s and, if so, whether they will be based on the allocation scheme in the partnership agreement or on allocation principles recognized as valid by the Internal Revenue Service.

In addition, offerings by foreign funds to investors in the U.S. must comply with U.S. securities laws and ERISA. This typically means accepting investments only from accredited investors in the U.S., either accepting investments only from qualified purchasers in the U.S. or limiting the fund to 100 U.S. investors, and either qualifying as a "venture capital operating company" under ERISA or ensuring that participation in the fund by benefit plan investors is not "significant."

Complying with a myriad of U.S. laws and regulations regarding trade sanctions, anti-money laundering, and the like is also important when investing abroad. While foreign funds are generally less familiar with the requirements imposed by these laws and themselves probably not subject to them, their activities heighten the risk of a violation, however inadvertent, that in certain circumstances could be attributed to the U.S. investor.

With European buyout funds producing significant positive returns, the advent of the Euro, and the increasing use of English as the primary language of business in Europe, the European market will continue to be increasingly attractive to U.S. investors. A convergence of documentation and economic terms is facilitating those investments, and U.S. investors are in perhaps their best historical position to take advantage of these opportunities, with an appropriate dose of understanding of market differences and U.S. regulatory concerns.
