Directed Investment Funds

Being Big Sometimes Means Starting Small For Unproven Fund Managers

Want to be a VC or PIPEs investor but don't have enough of your own capital or the track record to raise a traditional fund? Consider starting and building your track record through the use of "Directed Investment Funds" or "DIFs". What *is* a Directed Investment Fund? Sometimes referred to as a "pooled investment" or "pooled investment vehicle", it's essentially a fund just like any other venture or other private equity fund, but it's sole purpose is to invest in a single deal only. Rather than the general partner (GP) raising one large fund which then invests in and thereafter manages any number of portfolio investments, separate limited partnerships (LPs) are formed, and separate fundraising initiatives are pursued, for each target company investment. While, in practice, many of the same investors participate in the various funds of a single GP, they are not usually identical.

Directed Investment Funds are a particularly useful tool for aspiring fund managers. This is because the DIF structure provides the GP with the same basic economic deal that it would get if it were managing a large, traditional (*i.e.* multi-investment) fund (typically a 20% carried interest and a 1-2% annual management fee), but it affords the following distinct advantages over a traditional structure for the unproven fund manager:

- Much Easier to Sell. The DIF structure makes it a lot easier to sell by an unproven fund management group. This is because it provides a framework in which prospective investors in each case are able to decide for themselves what deals they actually invest in, rather than blindly leaving that decision to the unproven fund management team. What they're presented with in each case (that is, each newly proposed deal) is a full-blown private placement memorandum (PPM) for a prospective investment into a *fund* that has been specifically formed for the purpose of, and that has pre-negotiated a certain investment into (in terms of type of structured security, valuation, amount, registration rights, warrant coverage, board seats, consent rights, etc.) a target company. Although the GP in the fund maintains responsibility for managing the investment during the holding period (which, for these types of deals, can involve execution of any number of value-enhancing strategies along the way, and, eventually execution of an exit strategy), it's up to the limited partners themselves whether they want to participate based on the detailed information provided in the PPM about both the target company and the terms of the proposed investment by the fund into that company. Getting prospective investors to commit to such an arrangement, therefore, is a lot easier because they need not actually "commit" to anything more than a willingness to consider deals as they come along and are presented to them on a case-by-case basis. In this regard, they need not have to be convinced to trust the fund managers to make their ultimate iMnvestment decisions for them; if they like a deal, they can invest. If they don't, they can take a pass. And what makes this an even more attractive to these prospective investors, and therefore an easier sell for unproven fund managers, is that, even if they *don't* like a given deal and decide to take a pass, they can still get a look at the next one when it comes around. They don't have to participate, in other words, in every deal that the GP invests in. They can cherry pick their deals on their own out of those presented. And all the while, the GP's are building the track record that they're going to need to matriculate at some later date to a more traditional fund structure.

- *Allows Funds To Be Raised Over Much Longer Period*. A traditional VC, hedge, or other private equity fund with a well-established GP will ordinarily fully subscribe its fund over a 3-6 month period, even if the fund is raising a billion dollars or more. It just doesn't take them that long to sell their deal because they have an existing reputation and network of well-known investors to go to, and they're raising money in very large slugs from institutional investors that have a compelling need to keep their money fully invested. Since first-time fund managers, in contrast, not only are going to have a much harder time raising funds generally, but are also necessarily going to have to be doing so from high net worth individuals who will almost never invest any more than $500K at a time (and in most cases a lot less), the fund-raising process is going to take a long time (particularly for those who are not starting with a strong Rolodex of these types). By using the DIF structure, the fund-raising process becomes something an ongoing aspect of the fund operation that the GP's just continue to work at indefinitely.

- *Avoids Having To Provide High Returns On Uninvested Funds*. One of the biggest problems faced by large VC, hedge, and other private equity funds is that they need to generate very high returns for their limited partners, even when much of their money is at times sitting on the sidelines uninvested in any given deal. The DIF structure completely eliminates this issue because the fund generally only raises exactly the amount it needs to make the target investment and pay the annual management fee. The only exception is when the fund goes out to the same investors and raises more money for the same company for a later round. In that case, too, though, only the exact amount required is raised (including the management fee).

It is worthy of note that, for some, the DIF structure is desirable for a somewhat different reason: it allows them to effectively go out and raise money for companies (effectively acting as investment banker) without running afoul of the requirement of being a registered securities professional and/or being associated with an NASD member firm (*i.e.* a registered broker-dealer). This is because, in doing so, such individuals are actually raising capital for their own venture (the fund, in which they are a principal) rather than for the account of others.

Notwithstanding the advantages cited above, Directed Investment Funds definitely have certain drawbacks as well. Consider, in this regard, the following:

- *Highly Unlikely to Attract Institutional Investors*. As noted above, use of the DIF structure means that the fund-raising process will necessarily be focused (pretty much entirely) on high net worth "angel" type individuals, including doctors, lawyers, investment bankers, senior executives, entrepreneurs, and other country club types. This is because institutional investors are highly unlikely to invest in a company through such a fund, either because they (i) are simply prohibited from doing so under the terms of their charter or LP agreement, (ii) do not want to have to absorb the expense associated with the management fee or the dilution associated with the carried interest, or (iii) are uncomfortable with the degree of control retained by them inherent under such an arrangement. And although there are a number of so-called "funds of funds" out there these days, none of them are likely to consider a DIF because they invariably rely very heavily on the track record of the fund managers involved in making their investment decisions.

- *Smaller Deal Sizes*. As a direct result of having to rely on high net worth investors, fund managers that utilize the DIF structure are limited as a practical matter to relatively small deals. Since, as noted above, none of these types of investors are likely to ever invest any more than $500K at a time (and in most cases will invest considerably less), it is much more difficult for a Directed Investment Fund to make a sizable investment into any given target company. Except in the most unusual cases, investments made by Directed Investment Funds will generally range from $250K to $10MM.

- *Challenge in Selling Structure*. Even solely in relation to high net worth prospects, it is definitely a challenge to get investors to understand and appreciate the Directed Investment Fund concept and structure and to be willing to invest their money into a company, even if they like it, through something other than a direct investment of their own. This is particularly true when they learn that 1-2% will be taken out of the investment proceeds to pay the management fee to the GP, and 20% of the upside will be taken out and paid to them as well. The most effective way to overcome this, however, is to emphasize the much greater leverage afforded by the combined strength of the fund (as compared to any single individual) in making and controlling the investment, and the continuing role of the GP in bringing to bear value-enhancement over the life of the investment, protecting it from diminution in value, and maximizing return on investment upon exit.

- *More Work / More Management*. Without question, the DIF structure is considerably more burdensome and expensive in terms of legal and ongoing administrative management because each investment requires a new fund and each fund, at least potentially, has a different set of investors. While there is not much, unfortunately, that can be done about this, it is important to note that the expenses associated with this are generally passed along to the target company at the time of investment (*i.e.* payable out of closing proceeds).

- *Impossible to Compete With Traditional Funds*. Like it or not, it is virtually impossible for Directed Investment Funds to compete for deals with any of the big VC or PIPE funds, or even any other big single (non-institutional) investor,

because Directed Investment Fund operators can not possibly move as quickly as those other players can. Once they decide they like a target and negotiate a term sheet that they are comfortable with, the established funds can pretty much have their lawyers send over their documents with a check they cut. In sharp contrast, with a Directed Investment Fund, if you have your circle of go-to investors in place, putting your fund PPM together and going out to them to get subscriptions in each case will inevitably take some time. And if you *don't* happen to already have your circle of investors in place, well … it's going to take that much longer (at least the first few times).

- *Frenetic Pace*. It's a real scramble as a Directed Investment Fund a lot of times because, after you have identified a target, and negotiated and documented a term sheet, you have to prepare the fund PPM and documents and go out to sell the deal to your go-to investors as quickly as possible (at the risk of losing the deal if not locked up somehow in the meantime, which can be very difficult or impossible), all the while having to simultaneously conduct your due diligence review on the target company and negotiate the definitive investment agreements. This process can become extremely unwieldy if not managed effectively because, further complicating matters is the fact that, many of the go-to investors are likely to want to meet the target company management to size them up and ask questions directly. And you can only imagine how crazy this can all get when GPs are trying to tee up several deals at a time.

- *Never-Ending Sales Process*. Finally, and while perhaps obvious, for those that are far more interested in analytics, deal structuring, negotiating, creating value, and the like (common characteristics of effective fund managers), another disadvantage of the DIF structure is that it *does* actually require having to sell each deal to investors individually. This can be very frustrating for those who feel they are worthy of being entrusted with that responsibility and who could happily do without the sales process at all. For investment banking types who thrive on sales, however, this might not be considered a disadvantage at all.

- *No Meaningful Current Income*. Traditional fund managers have the advantage of being able to focus their efforts full-time on building and managing their portfolios because their annual management fee is sufficient to cover their overhead and pay them a reasonable salary while they wait to reap the rewards of their carried interest upon maturity and liquidation of their portfolio investments. Most traditional VC or hedge funds have at least $50MM under management, and, at 1%, that's a $500K annual management fee. Many, of course, have half a billion dollars or more under management. Because the aggregate management fees from Directed Investment Funds is unlikely to be significant, at least for some time, most DIF managers need to keep their day jobs until they are able to harvest some investments and realize any carried interest to which they may be entitled.

In the final analysis, and despite these disadvantages, for an unproven management group, the DIF structure provides a practical and realistic opportunity to build a track record and reputation with investors for picking good investments, managing them effectively and generating strong returns, thereby eventually putting them in a position, if they are successful, to move on and raise a traditional fund.

So, then, how does one get *started* with Directed Investment Funds? As a practical matter, it usually begins with a good target company. Once identified, the would-be GPs will typically pull in legal counsel to negotiate the terms of a structured investment and prepare the documents involved, including the fund PPM and the others to be used in the fundraising process. From there, it's about selling the deal to prospective investors and, once closed, managing the investment through to a profitable exit. After doing this a few times, and being able to evidence aggregate historic returns of 30+% per annum, it might be time to consider moving on to the big leagues.

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