FUND FORMATION

VC fund managers innovate to keep pace

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Activity levels in the venture capital (VC) and growth equity market in 2021 show no signs of slowing down. In this environment and with the size, frequency and pace of later stage venture and growth equity financing rounds increasing steadily, VC fund managers have been forced to adapt. We have observed three significant developments in the Canadian VC fund market over the last 12 months: the rise of "opportunity funds," the emergence of "continuity funds" and an increased focus on permanent capital (or "evergreen") funds. We summarize these developments and also outline some of the key considerations that fund managers and investors should take into account when pursuing or evaluating an investment in one of these funds.

Opportunity funds

An opportunity fund is a new fund formed by an existing manager to provide additional capital to be invested in high performing portfolio companies of one or more of the manager's existing funds. As the name implies, these funds seek to capitalize on opportunities that a fund manager may not have been able to pursue because the current fund does not have sufficient available capital to invest. This could include leading an investment round or participating on a pro rata basis in subsequent financing rounds of a portfolio company. While the concept of an opportunity fund is not new, we have seen an increased focus on this type of vehicle in the past 12 months, with several Canadian VC fund managers raising their own opportunity funds.

An opportunity fund serves as an alternative to forming multiple special purpose vehicles or co-investment vehicles for one-off investments. This can be beneficial to managers, who will have fewer vehicles to form and manage, allowing them to move faster to close a deal. Opportunity funds can also be beneficial to investors, who may thereby gain access to a portfolio of promising companies rather than having to make individual investment decisions.

These are some of the key considerations for investors and sponsors evaluating an investment in an opportunity fund:

- While terms vary, opportunity funds typically have a lower management fee and/or carried interest rate. This is intended to reflect the reduced workload of the manager as the universe of investee companies is generally limited to existing portfolio companies.
- Fund managers considering raising an opportunity fund will need to take into account any expectations that existing investors may have regarding co-investment rights alongside the existing funds. This is particularly the case where large institutional investors have already negotiated preferential co-investment rights on a no fee/no carry basis.
- In circumstances where both the "main fund" and the opportunity fund invest in the same financing round, attention must be given to how to fairly allocate the investment opportunity and how to manage potential conflicts. In our experience, investors in the main fund will expect that the main fund's allocation will not be adversely impacted by the existence of the opportunity fund.
- If the expected financing rounds never materialize, fund managers may find themselves sitting on large amounts of available capital. In that case, parties need to consider whether the opportunity fund should have the ability to invest beyond existing portfolio companies and, if so, on what conditions.

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Continuity / continuation funds

A continuity fund (also known as a continuation fund) is a vehicle raised by an existing manager to purchase either a single asset or a portfolio of assets from one or more of the manager's existing funds. Most private equity funds have a maximum duration both for investing capital and for the overall life of the fund. Establishing a continuity fund provides flexibility to the manager at the end of a fund's life. Limited partners seeking liquidity at the maturity of the fund are able to participate in the wind-up of the fund, while other limited partners that are seeking longer-term exposure to the underlying asset or assets are able to do so through the continuity fund. This can be structured either by providing for a cash out event in the original fund and new investment in the continuity fund or an ability to "roll" their existing fund investment into the continuity fund.

While continuity funds are more common in the U.S. private equity market, these types of funds have come to Canada in the VC and growth market in the last 12 months. Inovia Capital closed its first continuity fund this year.

These are some of the key considerations for investors and sponsors evaluating an investment in a continuity fund:

- As the continuity fund and original fund are controlled by the same fund manager, the sale of existing fund assets to the continuity fund will be a related party transaction. As such, the fund manager must navigate the inherent conflicts of interest between funds, particularly around the valuation of the transfer. External valuators and investment bankers are often involved in the process to help deal with this issue.
- Because of the potential for conflicts of interest, transparency is key. It is important that existing limited partner advisory committees be kept informed throughout the process with respect to deal terms and expectations regarding the long-term viability of the asset or portfolio of assets.
- Investors in the new continuity fund will similarly need full and transparent disclosure regarding the assets being sold in the transaction.
- The sale transaction may present an opportunity for the fund manager to realize an accrued carried interest or to "roll" it into the new continuity fund. The tax impact of the transaction to the fund manager needs to be considered in either case.
- Portfolio company shareholder agreements need to be analyzed to determine any consent or waiver requirements in respect of the proposed transfers. This may be a time consuming and complex process, depending on the structure of the transaction.

Permanent capital funds

A permanent capital – or evergreen – VC fund is an open-ended fund with no fixed term. This structure allows a fund manager to continuously raise new capital from investors and to reinvest capital from exit transactions. These funds attempt to address the issues discussed above with a single vehicle (i.e., missing potential investment opportunities given lack of available capital, as well as balancing the desires of certain limited partners for liquidity with the desires of other limited partners to remain invested in promising companies for a longer term).

While evergreen VC fund managers remain rare in the VC marketplace (both in Canada and globally), over the last year we have seen increased interest from managers considering alternatives to the traditional 10-year VC fund. Sequoia's announcement of the launch of its own permanent capital strategy through the creation of a single Sequoia fund garnered significant attention. Similar conversations have been occurring throughout the market.

These are some of the key considerations for investors and sponsors evaluating an investment in an evergreen fund:

- As there is no termination date for an evergreen fund, investors need a mechanism to withdraw their capital. Fund managers need to consider how they will provide investors with liquidity from an inherently illiquid asset base. One option includes having redemption windows connected to material exit transactions or new fundraisings.
- Any redemption right construct should be limited so that the fund does not inadvertently become subject to regulation as an "investment fund" under Canadian securities laws. Additionally, because an evergreen fund typically raises money on a continuous basis, the issue of whether the manager needs to be registered as a dealer or advisor under securities laws needs to be considered.
- Valuation of private companies is an inherently difficult exercise. Valuation becomes an even more important issue in a structure where the fund manager seeks to issue new units based on the fund's net asset value from time to time and where redemptions are based on the fund's net asset value. Fund documents will need to articulate clear valuation principles that balance existing investors' desires not to be unfairly diluted on the one hand, with new investors' desires not to overpay for value that only exists "on paper," on the other.

  Traditional VC fund economics must be adapted to suit the construct of an evergreen fund. Rather than the classic distribution waterfall, managers may be better compensated in evergreen funds using structures borrowed from hedge funds. This may include annual performance distributions based on a "high-water" benchmark or other different methods for calculating a preferred return.

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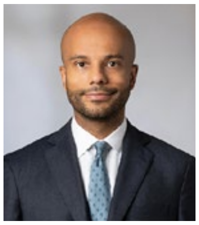
What to expect in 2022 and beyond

As long as markets remain active, VC fund managers will continue to explore ways to keep pace with market dynamics and to balance the desires of investors and portfolio companies. If conditions continue to remain receptive to the VC market, we expect that we will see more opportunity funds, continuity funds and permanent capital strategies in the year to come. Each of these models presents its own benefits and challenges, which investors and managers will need to continue to navigate. The extent to which these models remain a feature of the Canadian marketplace and not just a temporary reaction to the current state of affairs remains to be seen.

AUTHORS



Chima Ubani
Partner, Corporate

cubani@osler.com
514.904.5803

Shahir Guindi, Ad. E.
National Co-chair

sguindi@osler.com
514.904.8126 (Montréal)
416.862.6650 (Toronto)

Ed Vandenberg
Partner, Corporate

evandenberg@osler.com
613.787.1110