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Warehouse fund structures – an alternative capital source for sponsors managing COVID-19 affected fundraisings

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The market disruption brought about by the COVID-19 pandemic has caused particular challenges for private capital sponsors fundraising. We understand that various first-time fund sponsors have been postponing fundraising due to the uncertainty of gaining sufficient traction with limited partners (LP) to achieve a smooth fundraising.

Sponsors seeking to raise funds that are seeded with identified assets are not immune from fundraising challenges given the practical difficulties for fund investors in respect of undertaking their due diligence (in particular, face-to-face meetings) and the complications of execution risk on the investments going ahead at the values communicated to LPs.

As a result, some sponsors are without a source of dry powder to consummate pipeline deals temporarily. Nevertheless, some sponsors with an attractive investment opportunity can capitalize on this additional time between fundraisers to stay in the market whilst growing their funds under management.

One option is to establish a warehouse fund structure for a new transaction. Under such structure, the sponsor may raise a new blind pool fund in parallel so that the warehousing counterparty has effectively warehoused the identified assets for the blind pool fund.

Sponsors may find it is possible to find warehousing counterparties on terms that afford attractive economics and that are additive to the fundraising process. The warehousing investor is sometimes paid a coupon for its cost of capital, for example, six to eight percent per annum as a cost of capital. In some cases, the warehousing investor may bear a management fee and/or performance fee to the sponsor. A warehousing investor may also invest on terms that provide a stapled capital commitment to the blind pool fundraise.

A possible warehouse fund structure could operate as follows:

1. The warehouse investor commits to provide the equity required for the identified targets (with various customary conditions precedent to funding).
2. The warehouse investor may provide some cost coverage to allow the sponsor to secure exclusivity on the identified assets and progress the acquisition process.

3. The sponsor may raise a blind pool fund (having regard to disclosure requirements in respect of the warehoused assets) without restriction, i.e., there is no exclusivity associated with the warehouse structure.
4. The warehouse investor will invest in the identified assets via a special purpose fund managed by the sponsor.
5. The warehousing terms contemplate that the sponsor procures that the blind pool fund commits to invest in the identified assets. The blind pool fund acquires its interest in the warehoused investment(s) via a secondary acquisition from the warehousing structure at a price agreed with the warehousing investor at the outset – typically cost plus an interest yield equal to the warehousing investor's cost of capital (e.g., eight percent per annum). After a specified period has passed, the blind pool fund may acquire a position in the warehoused assets, subject to an independent valuation.
6. The warehousing investor may provide a stapled commitment to the blind pool fund and, if it does so, there is usually "no carry" payable to the sponsor in respect of the warehousing structure. Sponsors may agree to other preferential terms with the warehousing investor in respect of its participation in the blind pool fund such as a fee rebate, management fee holiday, and right of first refusal in respect of future underwriting opportunities.
7. If the sponsor fails to raise the blind pool fund (or the blind pool fund is not raised to the expected level), the warehousing structure is effectively a "fund of one."

Sponsors should document warehousing structures with careful consideration of the fund agreements governing the to-be-raised blind pool fund. These terms should cover the identified assets, transfer mechanics including price, valuation, and timing requirements, and relevant carve-outs to investment allocation principles and affiliate transaction restrictions. Finally, suppose the sponsor already has a prior fund. In that case, the investment allocation principles of such prior fund will need to be carefully worked through, particularly if the investment period of the prior fund has not yet expired or if the sponsor wishes to allocate the warehoused investment between two or more fund vintages. In this regard, the sponsor may need to obtain certain consents in respect of exclusivity provisions of prior fund vintages.

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