Understanding the Impact of Company Creation Fund Structures

Structure is one of the most important elements to understand when investing in company creation funds, especially with regard to how it could affect your outcomes as a general partner or limited partner. This paper explores the nuances to each structural model and how they affect the main stakeholders differently.

Included in this paper:

- Detailed descriptions of each type of fund structure
- Summary of pros and cons for each
- Key takeaways and observations from extensive research and conversations with over 200 global company creation funds

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As an investor in company creation funds, one of the major areas where we spend a lot of time is on structure. It's one of the most common questions for GPs and LPs investing in the space. Is the structure fair and balanced? What are the consequences on net returns? As we've taken deep dives into different structures, we've learned there is not a benchmark here yet. Structure is very dependent on the size and role of the company creation fund. Therefore, the topic deserves the time and attention we are giving it to understand the impacts of different variables. We wanted to provide some of our learnings below:

Introduction

Structure is one of the most important elements to understand when investing in company creation funds, especially with regard to how it could affect your outcomes as a general partner or limited partner. At Vault Fund we have talked to nearly 200 company creation funds around the world and have seen almost as many structural nuances. The questions we receive most often from general partners and limited partners alike is "what structure is best?" and the answer is "it depends" because, as we outline below, there are nuances to each model that affect the main stakeholders differently.

There are two main stakeholders within venture capital structures: general partners and limited partners.

- The **general partner(s)** are responsible for the daily management of the fund and in most cases must dedicate most of their time to the fund. This team usually has a background as seasoned operators and investors with expertise in creating and growing new companies.
- The **limited partner(s)** are typically passive investors in the fund, which provide most of the fund's investible capital. These tend to be pensions, endowments, family offices, and high net worth individuals.

Just as in traditional venture capital, company creation funds maintain the same stakeholders across different structures. Those stakeholders are connected in different ways through different structures.

For simplicity, we've categorized company creation funds into three main structures: 1) traditional fund, 2) holding company, and 3) dual-entity models.

Traditional Fund Structure

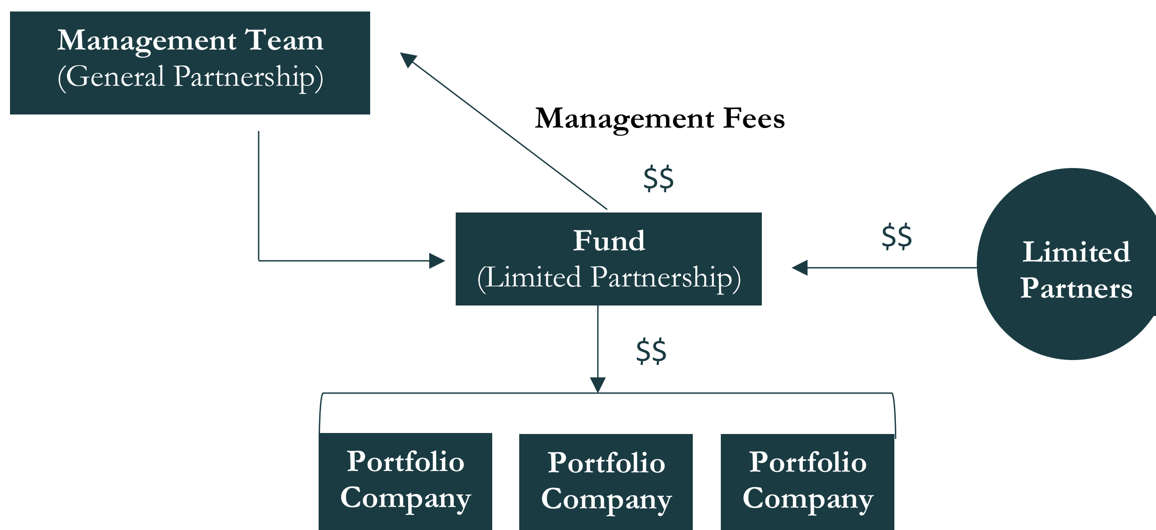
Within venture capital, the most recognized structure is a time-bound fund that takes 2% management fee and 20% carried interest on gains, largely known as a 2/20 fund. We view this as a traditional fund structure.

Even though this is a traditional and well-known structure in venture, there are several nuances among studios using this structure. We see modifications such as step-ups in carried interest when performance hurdles are met; accelerated fee schedules, where fees may be higher in the early years and decreased in later years; or an American waterfall, where the GP carry is applied to each individual portfolio company, instead of over the entire portfolio. The common trait of this structure is the fee and carried interest paid by the investors (limited partners) in exchange for the asset value accretion created by the management team (general partners).

In this structure the management fee is used to resource the team and to cover the operating expenses of the studio as it begins to create new companies, which can often times be expensive due to the number of team members needed early in the creation cycle. In this model, the management team is

incentivized by the 20% carried interest that it receives on the investment gains it creates. It is what aligns the general partners and limited partners. Typically, limited partners will receive 100% of distributions until full return of their capital (often plus a preferred return) and, from that point forward, distributions will be split 80% to limited partners and 20% to the general partner(s).

Because the 2% management fee is used to cover operating expenses and early teams, company creation funds that pursue this structure are typically larger ($50MM+) and will use the management fee to resource the studio with all remaining capital used to invest in the companies that are being created. Many established, mature studios leverage the traditional fund structure because it is most familiar to limited partners and allows for successive pools of capital, or funds, to be raised with clear start/end points.



Pros

- Familiar to most LPs
- Allows LPs to participate in 80% of the gains
- Time-bound
- Fee structure is transparent
- Fees are value accretive

Cons

- Typically higher % of capital used in post-formation investing
- Requires higher AUM
- Limits upfront operating expenses
- Limits GP incentivization to 20% carry

Holding Company Structure

Some company creation funds structure themselves as a holding company as opposed to a fund. A holding company structure is akin to that of a direct investment, where successive equity rounds are raised at set valuations.

In the holding company structure, there is no traditional management fee or carried interest; however, this structure has ownership splits which usually range from 25-50% ownership by investors (quasi-carry). This structure can also have operational expenses, which may exceed the 2% management fee of a traditional fund. As an example, a holding company could raise a $10MM round with a post-money valuation of $20MM where capital now owns 50% of the company. Under this example, the firm would have $10MM to resource the team, cover expenses, and build companies. Any distributions would be split 50% to the management team and 50% to the investors in the holding company. This structure is incredibly nuanced with factors such as valuation, use of operational expenses, share

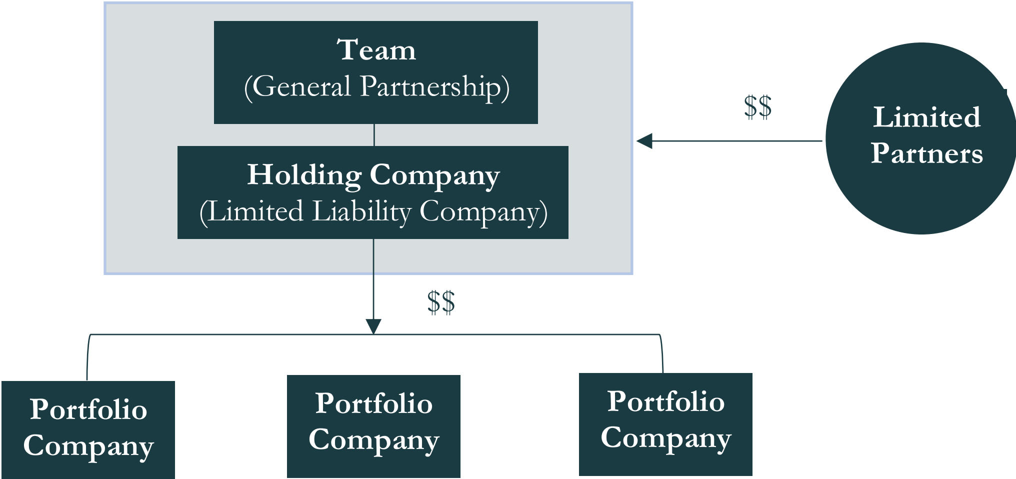
classes, waterfalls, and many other variables affecting the attractiveness of the opportunity. However, these nuances are exactly what make this model so interesting. If the structure is equitable to the general partners, limited partners, and founders alike, then it provides an opportunity to underwrite to significant returns.

Holding companies can be timebound like a traditional fund with the typical 10 to 12-year duration, or they can be evergreen, where limited partners will continue to participate in distributions and maintain their holding for as long as the holding company operates. In evergreen models, there are typically successive rounds raised, so dilution from future rounds is a critical consideration.

Company creation funds often pursue this structure if they are executing smaller raises typically ranging from $1MM to $50MM with the ability to be larger or smaller as the firm sees fit. The fundraising into holding companies usually covers 3 years of operating expenses and 10-12 builds. This range fluctuates however depending on the team size and category.

Perhaps the most debated point within the holding company structure is ownership and valuation. How much should limited partners and the management team own and at what valuation, given these entities are usually starting from a blank slate? There is no magic number regarding valuation. This figure is usually dependent on several variables including team track record, round size, LP appetite, and market factors. There is typically a target range for investor ownership of between 35% and 60%. When considering investor ownership, limited partners need to make sure that there is still enough upside for the management team to be incentivized; and the management team needs to make sure that limited partners and founders alike are appropriately compensated and incentivized for the risk and effort.

Another significant consideration of the holding company structure is the value-accretive nature of their operating expenses. Unlike the management fees of traditional venture, operating expenses in a holding company structure are used to create new asset value through resourcing the teams that build companies, conducting early testing and research, and growing the pipeline of ideas and talent. Holding companies receive equity for this early expense input and that equity generates capital-efficient value within the portfolio. So, while operating expenses are an important consideration to understand the proportion of value accretive expenses incurred, they should largely be an asset to the organization if used effectively.



Pros	Cons
No traditional fee	Less transparency on fees/expenses
No traditional carried interest	Limited participation in gains
Higher capital efficiency	Blank check valuation at entry
Capital is more concentrated at formation stages	

Dual Entity Structure

A dual entity structure utilizes both the traditional fund structure and a holding company structure. In the dual entity structure, the holding company typically serves as the company creation engine, housing the team, executing the builds, and taking inception stage ownership. The traditional fund portion typically provides follow-on capital for these builds, often taking the holding company's pro rata and investing additional dollars at the post-formation round of funding.

This structure is the most flexible in enabling the creation of new companies from inception and ongoing support of those companies deeper into their life cycle. It provides enough capital to cover the initial operating expenses of a company creation studio without requiring a significant capital raise, while also providing a traditional fund vehicle that LPs know and are comfortable with. The strategy can be complex in both fundraising and executing on two different entities but is the most flexible for investors and management teams.

Dual entity structures have two frameworks: 1) a captive holding company that is funded exclusively by the fund, and 2) an independent holding company that raises external capital from the fund with a separate investor base.

Dual Entity with Captive Holding Company

A captive holding company is usually funded exclusively by a portion of the committed capital of the traditional fund vehicle. This means that limited partners would have the ability to invest in the traditional fund but would not be able to invest separately into the holding company.

Management would raise capital under a traditional LP/GP fund structure and would then provide capital to resource the studio. The fund would, then, own a portion of the studio similar to their ownership in portfolio companies.

There are many successful company creation funds that have built around this model, and it provides limited partners with diversified exposure to inception stage as well as the follow-on rounds that are deployed through the traditional fund. However, LPs only have a direct ownership interest in the traditional fund vehicle and the capital used for formation stage development is diluted significantly. This model tends to result in more traditional venture performance than what we see in other structures.

Pros	Cons
Single raise process	Dilutes stage exposure
Provides reserves to support newcos	Cash returns can be elongated due to flow through of recycling
Covers operating expenses for smaller sized vehicles	Potential adverse selection
	Reduced transparency

Dual Entity with Independent Holding Company

Independent holding companies raise money from a separate investor base. This means the management team must conduct two capital raises (one for the holding company and one for the fund), which may or may not be simultaneous. The two entities will have different target raises, portfolio construction, and share ownership, which often leads to unique limited partner pools for each vehicle. A dual entity with an independent holding company allows investors to invest in either vehicle or both, depending on the investor's interest.

This model allows for each vehicle to be self-funded and operate with a certain degree of autonomy from one another.

Pros	Cons
Allows more targeted stage exposure	Separate raise process
Provides options to limited partners	Potential conflicts of interest
Additional reserves to support newcos	Potential adverse selection
Covers operating expenses for smaller sized vehicles	Structure can get complicated

Structure Learnings from Vault Fund

The team at Vault has evaluated company creation funds across all three of the structures outlined above, with many of these structures represented by our current portfolio. Here are our key takeaways:

- First, structure is a by-product, not a first principal. It should not distract a team from their core superpower of building great companies. While structure is a critical part of underwriting returns, great ideas and execution are what create legendary teams. Ideas are free and are not impacted by structure.
- The structure needs to be fair and equitable for all stakeholders. Everyone at the table needs to have a partnership approach for continuous iteration and improvement.
- The management team and support staff of the firm need to be incentivized beyond fees. Building from inception is hard, and all members of the fund need to be aligned to drive to scale and outsized returns.
- Operating expenses should be transparent regardless of structure. Building governance and reporting is essential for long term sustainability.
- The structure should be simple enough to understand on the first pass. Elements like separate share classes, build by build carried interest, or varied fees create unnecessary complexity.