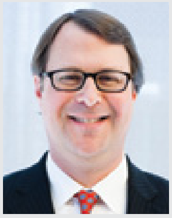
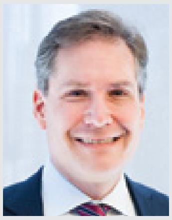
MEET THE ROUNDTABLE



DAVID TEGELER
PROSKAUER ROSE

David Tegeler is a partner in the corporate department of Proskauer Rose and global co-head of the Private Investment Funds Group. He concentrates on representing private investment funds, including fund formations, secondaries and restructurings.



DAVID WACHTER
W CAPITAL PARTNERS

David Wachter is a founding partner of W Capital Partners, a liquidity provider for private equity investments. Prior to W Capital, David worked for 15 years as an investment banker and private equity investor.

CHASON BEGGEROW
ALTIUS ASSOCIATES

Chason Beggerow is a partner at Altius Associates, a global private equity advisor and fund of funds. He is primarily responsible for leading the firm's secondary investing efforts, and has 17 years of private equity and real assets experience.

SECONDARIES

Unlocking value

The secondaries market, which has seen record activity levels in the past two years, has enjoyed a busy start to 2013 – especially around the restructuring of ageing private equity funds, writes Christopher Witkowsky

The restructuring of ageing private equity funds – those funds that are in their 10th or 12th or even 14th year, still holding assets that have not yet been exited – is potentially the biggest opportunity in the secondary market currently.

There are hundreds of funds that are in this situation (or will be in the next few years) – including some where the manager will not be raising new funds, creating issues of misalignment between LPs and GPs. However, out of that universe of ageing funds, perhaps only a few dozen will actually go through a restructuring process, according to a group of secondary professionals who sat down with *Private Equity International* in New York in April to discuss the state of the market.

THE $100BN PROBLEM

There was a clear consensus that this kind of restructuring can have substantial upsides for firms willing and able to work through such deals. It's not at all clear, however, just how easy it will be to get these transactions done. Rife with conflicts of interest and potentially antagonistic partners, many of these potential deals could turn out to be more of a headache than a boon, according to several of our roundtable participants.

"In our view, there are several dozen very interesting fund recapitalisations – and hundreds and hundreds of other funds that will be asked to do the best they can to wrap up those partnerships," says David Wachter, founding partner of W Capital Partners, which has been working out liquidity

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solutions for LPs and GPs in mature funds since 2001.

"Those couple dozen are very interesting to everybody, because they're the ones with portfolios of multiple interesting assets – and there's just a sequence of time or company-by-company variables that have basically put a good GP in a position where they're just not liquid. Those will get re-capped by very large secondary funds, and other funds that have less size, diversification or portfolio attributes that are attractive to the large secondary buyers . . . they just have to work their way out of those assets," he says. "It's going to be a huge business for the lawyers."

Estimates of exactly how much net asset value resides in funds that are 10 years or older vary, but typically range from $75 billion to $100 billion. More and more firms are having a hard time finding exits for their investments; on average, hold periods have extended to about eight years, having previously averaged about four years, Wachter says. This is partly because of an increasing glut of product on the market. Six years ago, there were about 2,200 private equity-backed companies; today, there are about 6,000, according to Wachter.

As more portfolios age – including those buyout funds from the credit bubble era, from 2005 through 2007, when many investments may have been overvalued – those funds will have to be closed one way or another.

GETTING LP SUPPORT

A major challenge in pushing through a restructuring is convincing LPs to support the plan, especially in cases where the investors are frustrated with the manager. Often such agreements will give existing LPs the ability to roll their interests into a new investment vehicle with new terms, or to cash out their fund stakes.

"From an LP perspective, they've been paying the manager fees for 10 years or more and believe a certain amount of goodwill has accumulated in the relationship over that period," says David Tegeler, co-chair of the Global Private Investment Funds Group at Proskauer Rose. "In that context, the LPs believe it is reasonable to request that the managers finish what they started, often at a lower management fee."

Pricing, as always, can be a major sticking point.

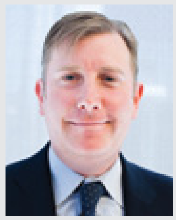
"There's a real need to get this done, but the fly in the ointment is often the LP's pricing expectations," says Joseph Marks, managing director and co-head of secondaries at Capital Dynamics. "You do what you think is right and appropriate, the GP may be on board; but at the end of the day, if the LP has the perception that the liquidity is not worth it at the price they're being offered, then the LPs won't make the trade."

After more than a decade as an investor in a fund, most LPs will usually accept a slight discount on a restructuring cash-out of their interests. »

MEET THE ROUNDTABLE

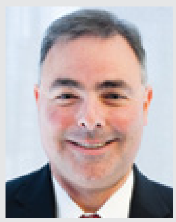
JOSEPH MARKS
CAPITAL DYNAMICS

Joseph Marks is a managing director and head of secondaries at fund of funds Capital Dynamics. He has 14 years of experience. Prior to Capital Dynamics, he was a principal at Coller Capital.



JONATHAN COSTELLO
MORGAN STANLEY ALTERNATIVE INVESTMENT PARTNERS

Jonathan Costello is a portfolio manager for Morgan Stanley Alternative Investment Partners Private Equity Fund group, focusing on secondaries. Costello has 20 years of experience. He previously worked at Susquehanna International Group.



HUGH PERLOFF
PORTFOLIO ADVISORS

Hugh Perloff is a managing director at Portfolio Advisors, a fund of funds and separately managed account manager. Since 1998, Perloff has been an integral member of Portfolio Advisors' investment research and diligence teams.

PORTFOLIO ADVISORS, PROSKAUER ROSE, W CAPITAL PARTNERS

» "If you are buying LP interests in a venture fund and you propose paying 60 cents on the dollar, you get a lot of LP push-back," says Hugh Perloff, managing director with Portfolio Advisors. "If an LP owns interests in buyout funds and buyers are paying 90 cents or 100 cents on the dollar, the LP can generally live with that if they've been in the fund for over 10 years."

Another sticking point in these negotiations can be a fund's preferred return, especially if a GP has collected carried interest on some early profitable deals that LPs need to "claw back" to be made whole.

"There really is a time element to having to address this, because an 8 percent [preferred return] on assets that have been held for a longer period of time is really going to come into play," Wachter says. "With long duration and a flat economy for multiple years, it will be very hard for GPs to clear that preferred. And that's a whole other economic element that will be very significant over the next five years."

A potential clawback situation is one example of how a GP's interests can diverge from that of his LPs toward the end of a fund life, according to Perloff.

"In some instances, with managers who aren't going to be able to raise subsequent funds, they look at it as a way to extend their management fee," Perloff says. "Most LPs are happy if they've held an asset for a long period of time, and they've finally found a way to get out of the asset. It's not always possible in every part of the cycle, but most LPs believe that exiting their assets over a 10-year period is fair."

Interestingly, these end-of-life issues have begun creeping into negotiations when LPs are considering committing to a new fund, Tegeler says.

"When making a primary investment into a new fund, increasingly LPs focus on what happens during the later years of the fund's life, including management fee ramp-downs and clawback mechanisms. For example, some LPs have proposed an interim clawback at the end of the investment period or on an annual basis, rather than waiting until the fund's liquidation," Tegeler says. "In addition, LPs are now more focused on governance and control issues, with the goal of increasing their options in those later years."

This is a marked contrast to limited partner agreements of the early and mid-2000s, when many of the contracts were "completely silent on many of these important issues that are now at the surface", Marks says. "10 or 12 years ago they were silent or tended to favour the GP, particularly for stronger managers, or [these provisions] were just non-existent in terms of what can be done or who can do what [at the end of a fund's life]."

Restructuring deals don't follow one set of rules; the forms of such transactions change from case to case. One variant seen recently involves creating a new vehicle to house existing portfolio companies, into which existing LPs can roll their interests or cash out. In cases like this, potential buyers have to balance the attractiveness of the assets against manager risk, according to our roundtable participants.

"It's hard to price both of those risks. It's rare where a buyer feels that it has virtually no GP risk and that it likes the »

» asset," says Jonathan Costello, executive director with Morgan Stanley's Alternative Investment Partners group.

That type of transaction represents one way to get a restructuring done, but there are many others.

"It doesn't necessarily have to be a solution with one set of buyers. The team and portfolio can be split up by different exposures. A buyer can do that by picking out specific assets potentially from funds to provide a complete solution for LPs; so the fund kind of goes away, but the assets and the team get broken up. [That kind of structure might] allow there to be more of these [restructuring] deals, so maybe it's not limited to just 12 or 24; maybe a buyer can get into [those] other 800 or so funds," Costello says.

GONE MAINSTREAM

But restructurings are just one aspect of a market that has steadily evolved to become a more conventional way for LPs to manage their portfolios, and for GPs to find solutions for investors that, for whatever reason, need or want to sell their interests in the fund.

Gone are the days when a GP's feelings would be hurt if an LP requested a sale of his fund stake.

"In those days, LPs were a bit concerned with the stigma attached to being a seller; [about] being excluded from investment opportunities and whether GPs would let them back into their funds if they were known as sellers," Perloff says. "These days that stigma is completely gone. That's one reason why it's an attractive time to be in the secondary market. The secondary market is now a very acceptable way to actively manage your portfolio."

The portfolio management aspect of the secondary market has made it an essential tool for dedicated LPs who are looking for a more active approach to handling their private equity investments, according to Chason Beggerow, partner at advisor Altius Associates.

"A lot of our clients are looking for different and unique ways to access private equity," Beggerow says. "Certainly a primary programme is a good base; but many are then looking at secondaries and co-investments to complement that. Secondaries are becoming more of a mainstream tool for investors to use to manage their programme and get allocations they haven't had before, as well as to get the returns and shorter hold periods you would target with secondary investments. Many of our clients have at least a conceptual interest in secondaries now."

LPs can access this market in various ways. They can either commit straight to a secondary fund, or (as more and more institutions have been doing) they can look on an opportunistic basis for chances to either sell interests in funds that have become non-core or buy interests in new funds. Harvard's $35 billion endowment implemented this type of strategy in 2010, when it announced it was paring down the number of relationships in its portfolio, in favour of committing more capital to its best-performing managers. Part of its strategy included opportunistic buying and selling on the secondary market, Harvard Management Company chief executive officer Jane Mendillo said at the time.

"Many investors are interested in secondaries, but struggle with the execution," »

» Beggerow says. "It takes a different skill set to develop a secondaries programme compared to investing in primaries – the response times are quicker, you are analysing existing holdings versus investing in a blind pool. Many investors still need to look to advisors or dedicated funds to execute."

"Investors that have more resources, and where the decision process is a little quicker, do like to take that opportunistic approach to the secondary market, perhaps targeting managers or funds that they know well or have a relationship with," he adds.

Opportunistic sellers generally aren't as pressured to complete transactions and therefore can be choosier on price, he adds. "The mindset of many sellers is that they would like to sell, but they don't have to sell, and if they don't get the right price, they're more than happy to hold that asset."

Stanford University's endowment is a good example of this. In 2009, it called off a $1 billion auction of private equity fund interests, for which it had received 15 to 20 bids. John Powers, president and chief executive officer of the Stanford Management Company, told *PEI* at the time the bids were not "on par with the value of the assets". Harvard also pulled an auction of private equity interests when bids didn't meet its expectations, though the endowment did manage to sell off fund interests in smaller, quieter sales in subsequent years.

"We have seen some large institutional investors currently in the secondary market simultaneously buying interests in some funds and selling interests in other funds," Tegeler says. "There are different reasons for the decision to buy or sell a particular asset, and the secondary market provides another way for the institutional investor to execute on their overall allocation strategy."

Seller motivation has changed since the early days of the secondary market, Tegeler argues.

"In the early deals, there were unique buyers and sellers and only a few auctions or intermediaries. It was an immature market. Fast forward to today: it's much more developed. There are a wide variety of reasons why people look to sell on the secondary market, including a need for liquidity based on something else happening in the seller's business, a declining interest in expending the resources to follow a particular group of managers, or regulatory limitations imposed on the seller by the SEC or other governmental entities.

"In many cases today, selling activity is driven by basic financial and allocation strategies – as compared to how the industry started, where the decision to sell was less frequent and often driven by a particular event or series of events," Tegeler says.

NEW SELLERS, NEW DEALS

As the secondaries stigma has faded, more sellers have entered the market, including organisations at the smaller end of the LP universe, according to Marks.

"One of the big changes we've seen over the years is the breadth and diversity of the number and types of sellers," he says. "We are seeing an increase in the number of sellers with smaller LP stakes accessing the market and becoming comfortable with it. Today we're seeing, particularly in our business at the small end of the market, family offices, small endowments and foundations, and other smaller institutions regularly accessing the market. And there are many more of those by number of transaction than there are banks, or sovereign wealth funds."

That stigma has reversed to such an extent that some GPs use a sell request as an opportunity to court new investors, Costello says.

"Clearly there are attractive funds that a fund manager cannot put into a given fund it manages. A GP will contact a fund manager and say, 'an existing LP is selling'; that may be an opportunity for the fund manager to get interested in the GP again. It's a good way to start a relationship – maybe they've addressed some of the concerns the fund manager has, and maybe that sets the fund manager up to have a more meaningful conversation when they come back to market."

But different sellers have different needs, and so not every deal will be a straightforward sale of fund interests. The forms that deals take in the secondary market range from the massive fund portfolio brokered auctions (which in recent years have often gone to only one buyer), to spin-outs from parent organisations, to restructurings , to one-off opportunistic acquisitions. »

» AXA Private Equity has been involved in several huge portfolio sales, including buying an $850 million portfolio of 11 fund interests and related unfunded commitments from the Ontario Municipal Employees' Retirement System last year.

However, large portfolio deals like that OMERS transaction have largely dried up on the secondary market since last summer.

"There was a bit of a lull in the market at the end of last year, beginning of this year," Beggerow says. "The public markets have done well so some investors that were on the fringe of being over-allocated to private equity and were looking to the secondary market may be less interested in selling immediately. Capital calls overall have been reasonable, distributions have been fairly robust. If you were in that position where you were slightly over-allocated to private equity and were thinking of selling, it's been a calm environment right now. There are still motivated sellers, but some urgency has eased in the last four or five months."

STRUCTURING FOR SUCCESS

The market today is dominated by smaller, quieter deals – and structured transactions.

"The conversation has evolved and allowed structure to come into the market. Over the last 18 months the market has seen discounts compress, and market participants have had to look for more creative ways to generate returns," Costello says.

"It's about trying to come up with something other than just paying cash at closing," he explains. "There is some relationship between buyer and seller that continues for some period of time. Other terms to think about: deferred payment, so the buyer will give a seller its price but the buyer won't pay it to the seller today; [and] the concept of back-end share – maybe the buyer and seller don't agree with the GP on what the potential future return is, so the buyer can pay a lower price potentially today . . . but if the fund performs in line with GP expectation, maybe the buyer shares a part of those proceeds with them at some point in the future."

"We have advised on several billion dollars' worth of private equity transactions, which were historically called securitisations and are now called structured transactions," Marks adds. "Some had public notes, some had private notes; some had several tranches of leverage, some fewer; some involved letting equity players take earlier distributions, others were more traditional waterfall structures. The sky is the limit in terms of creativity."

Sometimes the concept of structure enters a negotiation if the two sides can't come to an agreement on price, according to Perloff.

"When we approach a deal with sellers, we try to do a cash deal first," he says. "Many times, especially in an environment where sellers have high expectations and you can't come to an agreement on price, that's when you start discussing a structure. The first thing we'll consider is a deferred payment, where we'll have a higher price but not have to pay 100 percent of the cash up front. If that doesn't work then we'll talk about a waterfall, and ask if the seller wants to share in the back end."

Deals have become more creative in part because sellers have become more sophisticated about the secondary market.

"A lot of sellers are repeat sellers," Costello says. "They've done this before – maybe [they] sold portions of their interests and saw how performance actually happens for the secondary buyer – and they realised they left money on the table. They've gotten much smarter in how they conduct themselves in these transactions."

As sellers have become more sophisticated, they are also increasingly trying to sell assets that have traditionally been harder to transact, like interests in real estate and infrastructure funds.

"There's been interest in real assets funds, infrastructure funds," Costello says. "There's a big desire from LPs for yield, so there are some strategies that are non-traditional strategies per se in private equity that LPs are looking for. [And] they're trying to find those opportunities in the secondary market."

All told, deal activity on the secondary market has reached about $25 billion for the past two years, and estimates for this year suggest it will be around the same level.

No matter what form it takes, private equity secondaries activity will become an ever more vital part of the industry as the concept of portfolio management – and the need for greater liquidity and flexibility – drives more LPs to the market. ■