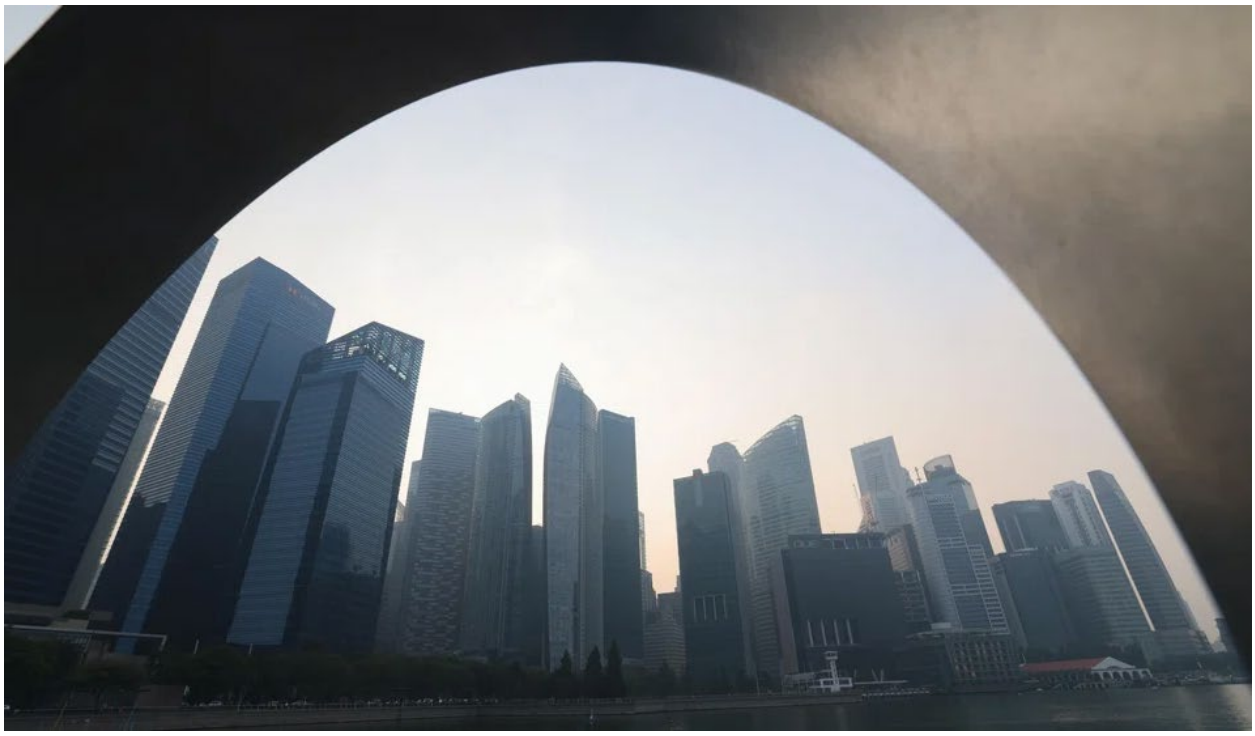
THE BUSINESS TIMES

Private equity's liquidity crunch fuels growth in secondaries, alternative fund structures



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Investors are looking for liquidity as fund managers seek to hold on to assets for longer. PHOTO: TAY CHU YI, BT

[SINGAPORE] Private equity fund managers are increasingly turning to secondary transactions and more flexible investment structures, as prolonged holding periods intensify pressure to return capital to investors.

Liquidity remains top of mind for investors as they seek to free up capital for new opportunities, while grappling with volatility arising from geopolitical tensions and policy changes.

Scott Hayward, CEO of GMO Asset Management, said: "There is a need for liquidity in an environment where investment opportunities require you to be more nimble in capturing them."

The challenge for private equity managers lies in finding a balance between holding on to high-performing assets and the need to return capital to investors.

But without the distributions from existing funds, limited partners – investors who commit capital to private equity funds – have less capital to reinvest into other funds.

Hold periods within private equity no longer follow the traditional five years of deployment and five years of realising investments.

Funds are now holding significantly higher remaining value at year 10 than a decade ago, said **Blake Heston, partner at secondary solutions provider W Capital Partners, a division of BNP Asset Management**'s alternatives business.

"You have limited partners putting some pressure on private equity managers to figure out ways to generate more consistent flows of liquidity back to them," he added.

Private equity firms have evolved to meet this call for liquidity by forming capital markets teams to explore options for portfolio companies; liquidity committees have been tasked with meeting distribution targets as well, said Heston.

These efforts reflect a broader shift towards alternative exit routes, particularly secondary transactions, which allow existing investors to sell their interests or fund managers to transfer assets into new investment vehicles.

According to consultancy Bain & Co, direct secondary type transactions and general partner continuation funds make up about 30 per cent of total private equity exit volume globally.

"So they are becoming a big part of the exit paradigm for private equity," said Heston. "These tools are being widely embraced as ways you can better optimise your investment and align stakeholders."

Yet, the secondary market remains undercapitalised, relative to the potential demand for liquidity.

Heston noted that the percentage of private equity net asset value distributed fell to 15 per cent in the last four years, compared to 20 per cent historically.

Increased initial public offerings and mergers and acquisitions could ease the liquidity squeeze, but other liquidity solutions can also fill the gap, he said.

Investor interest in secondary funds is also growing, driven by opportunities to acquire existing private market investments.

But it is still relatively new compared to private equity, and the industry still assessing how big it could eventually become, added Heston.

Greater demand for transparency

As investors seek more flexibility, fund managers are experimenting with new fund structures to address liquidity and transparency concerns.

Valuation is another challenge, particularly as private market investments are illiquid and more opaque than publicly traded assets.

Courtney Scharff, head of private capital indices and taxonomies at MSCI, said fund managers are under pressure to provide regular performance figures to investors.

This is especially pertinent as fund managers seek to attract wealthy investors, who may be more used to frequent valuations and greater liquidity.

"How do we preserve the return premium and also move towards a daily pricing mechanism? This is far and away the dominant conversation," said Scharff.

Now, fund managers are becoming more flexible in how they raise money, moving away from traditional blind-pool funds to offer single-asset deals, said Ann Ng, managing partner for Asia at law firm Maples and Calder.

More fund managers are setting up single-asset funds, lining up a few investors rather than raising a fund to invest into a portfolio of companies, she noted.

Investors are favouring such structures due to their transparency and flexibility, as they are able to see what the fund is buying. They also have a more direct path to capital distributions when the asset is sold, said Ng.

"Once this gets sold, you get all your money back, as opposed to the traditional blind-pool funds," she added.

Separately managed accounts, which are typically established for a single investor, are also attracting interest.

Limited partners in these funds allow fund managers to deploy capital according to the mandate, but can call for liquidity at any time.

Such funds give investors total control and transparency on what is happening, and fund managers need to work with only one investor in such a fund.

"You don't have to deal with a bunch of different people, so that's why general partners are now being a little bit more flexible so that they can fund-raise," said Ng.

Club deals are also rising in popularity, where a small number of investors put in money to invest in a single asset.

These deals can have a shorter-than-usual, 10-year tenure and can be flexible with termination should all the investors want to sell the asset.

With traditional exits taking longer and fundraising remaining challenging, flexibility is increasingly becoming a way for managers to attract capital and address investors' liquidity concerns.

This has fuelled interest in alternative liquidity solutions beyond continuation funds, including structures that offer greater flexibility over when investments can be sold.

"I do think there's going to be this increased attention around this part of the market, given the overlay that investors are looking for liquidity," said Heston.

Ng said: "People are gradually getting money (back), and how they're doing it is to be a bit more flexible."