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MATURE FUNDS

Extracting liquidity from tail-end assets

The secondaries market is an efficient way to restructure maturing funds, but managers and LPs may need to consider other options, say Finbarr O'Connor and Gavin Farrell of BRG's Alternative Investment Advisory group

What are the alternatives to liquidity for mature funds that are struggling to access the secondaries market? Finbarr O'Connor, leader of BRG's Alternative Investment Advisory, which specialises in the management and resolution of tail-end fund interests, and Gavin Farrell, its director of business development, discuss the options available.

Q What are your views on the current state of the private equity market, particularly as it relates to maturing funds?

Finbarr O'Connor: The wave of capital that was raised by PE funds between 2003 and 2008 has been maturing. Currently it is estimated that approximately 25 percent of the PE fund universe has reached maturity.

As these funds mature, GPs need to assess the available options and which of these are in the best interests of their LPs. A significant portion of the mature fund market will go through a restructuring process, facilitated by the strong appetite and creativity within the secondary market, and deliver LPs with liquidity or subsequent investment options.

However, this is not always feasible or indeed may not be the best option for LPs. Some maturing funds, particularly those with distressed, out of favour or small remnant positions may be unable to attract decent bids from the secondaries market or the GPs may be struggling to raise capital for a continuation fund, so LPs are left with the status quo – ie, a GP with no incentive and an investment with no end in sight.

Q Why haven't these smaller maturing funds been able to take advantage of the secondaries market?

FO: A theme we encounter is the existence of some form of structural issue either at the portfolio level or at the GP level that may prevent many smaller funds from executing a restructuring or outright secondary sale. For example, we have dealt with situations where the GP is out of the carry and lacks any real incentive to lead a restructuring, or where the portfolio assets are distressed and only deemed attractive to deep discount buyers. We've also had mature situations where there are consent issues or legacy litigation preventing transfers on residual assets.

Today, we're dealing with some older funds facing a range of these sorts of issues. Some have assets that require time for us to work through asset level changes or restructuring and exit plans. But there's often a reason mature fund assets haven't been exited – those assets are either unattractive or need attention. For the potential buyers of such assets, it comes down to a balance of the ability and attention required to resolve the structural issues, a pathway to liquidity and also pricing. So, smaller tail-end funds and assets tend not to be attractive to a wide community of buyers in the secondaries' market. LPs of those funds can be left with limited options. If I'm an LP in that situation I am looking for a plan to deliver liquidity with someone who will be focused and drive execution.

Q What should these fund managers and their LPs do in the current environment ahead of a possible downturn?

FO: If I am the private equity owner or asset manager, I would be beginning to think in terms of stress tests at the asset level. What happens if prime goes above 6 percent (where the Fed seems to be headed within 12 months), and what does that do to portfolio company performance and cashflow alongside a dip in sales or activity, or if something happens to global trade or in the Middle East? I think understanding how those, or similar assets, performed in prior downturns, as well as assessing the impact of any leverage constraints, should form part of the investor's cushion analysis.

Gavin Farrell: We believe the private equity market is approaching an inflection point, if it's not already there. There are decisions that are going to present themselves to LPs in terms of liquidity or the rolling over of mature funds. There will be a portion of that mature fund market that may not be either possible to roll over or restructure in a traditional way. Or it may not be in their best interests that a traditional approach be followed. Not many GPs, or LPAs for that matter, contemplated end of life scenarios when the funds were being established and there are now alternatives to a secondary sale, but that alternative doesn't necessarily mean accepting the status quo. As Finbarr mentioned, some GPs aren't in a position to complete an orderly wind down. Others may be very good GPs with a very solid business, but the time and effort required to focus on winding down a late-stage fund may not be the best use of their talents when they could be raising a new fund or managing existing portfolio assets on behalf of their LPs.

O'Connor: *many mature funds will be restructured*

Farrell: *GPs lack incentives*

Q How does BRG fit within the secondaries market?

FO: We see ourselves as complementary to other participants in the secondaries market. We do this in two main ways. In the past we have worked alongside secondary buyers to assist with the management and optimisation of troubled assets that have been acquired as part of a secondary deal. Secondly, as a replacement manager, we are an alternative to a secondaries transaction where we take on the fiduciary responsibility for management of an orderly run-off and wind-down process and distribute capital back. LPs and GPs introduce us when they are looking for a plan to deliver liquidity and someone to who will be focused and drive execution. We devise a plan for each remaining portfolio asset to optimise value and drive the process to deliver liquidity to the LPs. As our compensation is linked to the value of returned capital, the approach is completely aligned with the interests of LPs.

Q Can you describe different paths to liquidity?

FO: Liquidity can come in the form of a fund restructuring, a secondaries asset sale, a secondaries fund transaction or a collection of asset sales, and then a distribution to investors. Of the mature funds we're managing currently, we are working through a fund restructuring on one, while the other funds are at various stages in the secondaries market or in direct asset sales. The largest fund we manage is a hedge fund with illiquid private equity style assets where we're working through to a deliberate asset-by-asset exit process returning capital as we close transactions.

Q How can you ensure such transactions are LP friendly?

FO: As I mentioned, we are economically aligned with LPs, but in addition to that we operate with complete transparency and communicate openly and regularly with LPs to ensure that they are fully informed at all times. We see this as a key pillar of our fiduciary duty to LPs. Good stewardship begets more stewardship and, as a result we have repeat institutional clients that view us as a practical solution to work through their tail-end interests.

One of the things that is, of course, a hot point with both the SEC and LPs when it comes to fund restructurings is what are the exchange terms and how to avoid any conflicts of interest. The SEC has rightly scrutinised these transactions in the past few years. Likewise, the Institutional Limited Partners Association has promised to issue guidance to its members on the topic in 2019. In any exchange of value, there's a potential for conflict and a potential for a breakdown in trust. It can be an extremely complex process to provide liquidity optionality to LPs that will also satisfy the LPs that want to stay invested. Five years ago, fund restructurings were almost unheard of. Therefore, as a relatively new form of transaction, a success factor is that the process be well documented and communicated to LPs.

GF: In a GP-led restructuring, you are transferring assets from one fund to another that is being partially funded by a new set of LPs. There is no actual realisation event, therefore you're determining the value of a portfolio and transferring a portion of that value to the second fund and providing liquidity to some initial investors with the other. It's critical that there's an independent opinion of value provided to confirm the fair value of that portfolio of assets, and that this is well communicated to the LPs.

Furthermore, among the LPs, there's a real sensitivity around the reset of carry. LPs rarely object to sharing the upside with GPs when they get paid. But when there's a restructuring they will be likely to pay close attention to fee terms and when transparency is lacking, suspicions and concerns can grow. At all times, there must be a clear alignment of interests and full transparency to avoid any conflicts of interest. ■