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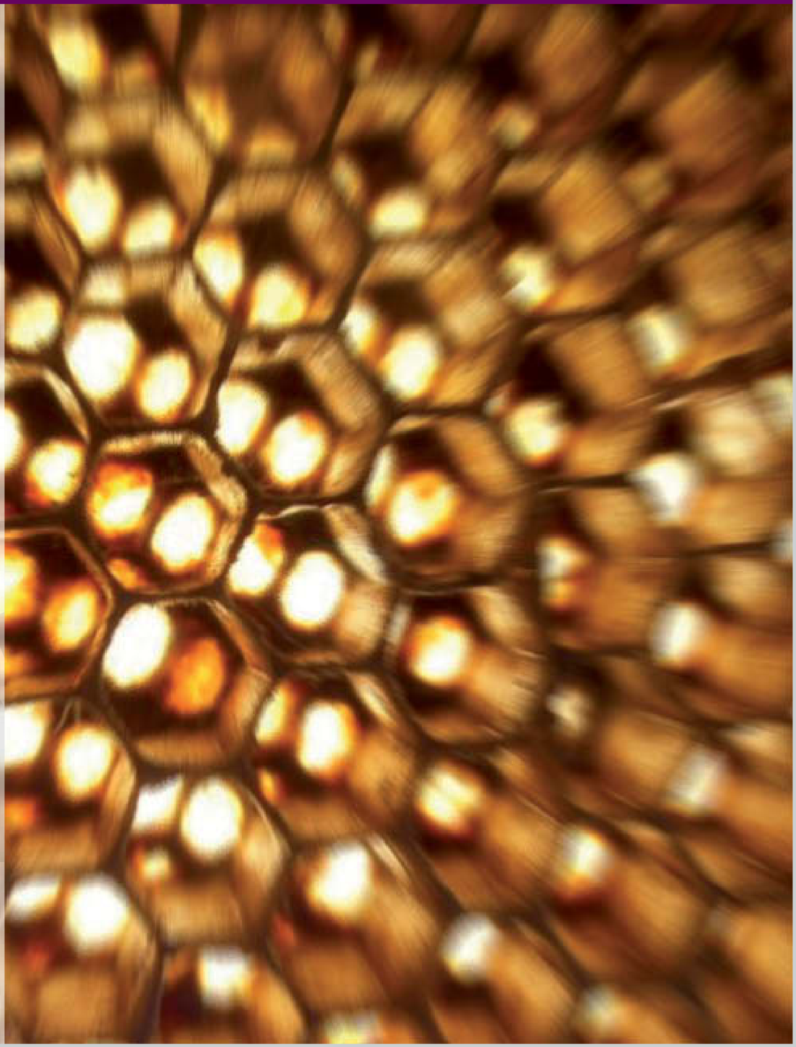

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EXPERT COMMENTARY **CAPOLINO-PERLINGIERI & LEONE**

Investing under pressure

General partners' investment choices at the end of the investment period are critical, yet complex, writes Dante Leone

As the net asset valuations of private equity funds for the last few quarters have showed, the global financial crisis of 2008 and 2009 has failed to bring the private equity world to its knees[1].

However, available data on dry powder at private equity houses of all dimensions proves that the crisis has had a rather chilling effect on the pace of investments[2].

As a result, a large number of managers of private equity funds of the vintage years 2006 to 2008, with a standard four- or five-year investment period, are being confronted with a looming deadline to their funds' investment period, at a time when they have been able to invest a relatively low percentage of their funds' total commitments.

> "By involving limited partners in the thought process underlying their investment decisions, managers treat them as an internal – rather than external – sounding board"

In this commentary[3], we are going to analyse some of the issues raised by such a scenario, highlight certain structural intricacies and suggest possible tweaks to fund agreements that would be conducive to the lessening of tensions originated by the impending deadline.

Limited partner perspectives

On this subject – as on many other ones – different constituencies of limited partners may have very diverse views.

There are those who may feel strongly that the fund manager should do its best to deploy as much as possible of the funds' commitments prior to the end of the investment period, at the risk of accepting somewhat lower returns.

Limited partners would take such a position for various reasons: from institutional demands to deliver on asset allocations that had been set at times when the financial crisis was not taken into account; to pressure for their own fundraising cycle; to the general inconvenience of redeploying commitments to different managers. Other limited partners may simply be relieved that the fund manager has not been able to deploy much capital, as they may have had liquidity problems of their own in the past few years, and would have had difficulty in honoring large capital calls for funds to which they had committed in the years 2006 to 2008.

Finally, many other limited partners will take a very hard position on maintaining investment discipline, and not straying away from tested and proven strategies in order to make up for a slower pace of investments at the beginning of the investment period.

This diversity in opinions among investors is actually quite important, because – as we will see later on – modifying the deadline for the expiration of a fund's investment period could require approval by a high percentage of the fund's limited partners, and a small group of motivated limited partners might be successful in preventing any such modification.

Fund manager concerns

Fund managers will typically have several concerns of their own about the looming deadline.

Some of them will be confronted with the negative perception of their failure to use the capital that they had been expected to deploy upon receiving the original mandate from investors.

Others will be concerned that, as a result of the deployment of a smaller amount of capital, the total carry pool will also likely be smaller.

Yet another group of fund managers will be alarmed by the fact that the end of the investment period would bring about a significant decrease in the flow of management fees payable by the fund to them. And, because they are not yet ready to go back to fundraising, the drop in fees will make it quite difficult to support the team. (Think a significant portion of good managers of funds of vintages 2006 to 2008, with few or no exits having materialised and a portfolio that is not mature enough for the performance to be assessed by new potential investors.)

In fact, most private equity fund agreements stipulate a change in the basis for the calculation of the management fees after the end of the investment period, from a percentage of aggregate commitments to a percentage of the aggregate cost of the investments held in the fund's portfolio.

At times, the calculation takes into account other factors such as changes in the value of the portfolio (write-ups, write-downs and/or write-offs) or whether the manager has already started advising a successor fund. The norm, however, remains a significant step-down in management fees.

While this would not be a noteworthy problem for managers that are part of a large franchise that is able to keep them going in spite of a drop in management fees, it will be an issue for smaller fund managers.

As a result, small and mid-sized fund managers may be confronted with stark choices regarding the survival of their teams after the end of the investment period.

Some fund managers could decide to cut the salaries of the principals. Others could resort to reducing headcount at a more junior level. Either scenario would have the significant disadvantage of making the fund managers ill equipped to extract the best possible performance from their current portfolio or to complete a successful fund raising in the future.

Leone: *GPs have options*

> *"Small and mid-sized fund managers may be confronted with stark choices regarding the survival of their teams after the end of the investment period"*

Limited partners in independent, small or mid-sized funds may be sensitive to the issues of management fee flow. And they may also be amenable to accommodate the needs of the managers by delaying the step-down in management fees or increasing the amount of fee income from portfolio companies that may be retained by the fund managers.

Fund manager options

Private equity fund managers do have a number of options in addressing the rapidly approaching investment period deadline.

A first course of action could be to continue investing exercising the same investment discipline displayed in normal times, thus risking to have invested less than an optimal percentage by the time the investment period comes to a close.

A second course of action could be to ramp up the pace of investments, trying to make up for the ground lost in 2008 and 2009.

Assuming deal flow does not simply increase to the benefit of fund managers, one way to augment the investment pace would be to pay a little more for companies, to the extent that possible returns are still attractive, or to deploy more capital per single deal (whether by structuring a smaller portion of the price as debt or by going after larger opportunities).

Another way to achieve the same result would be to expand their investment targets – at the risk of departing somewhat from the original investment thesis – and invest in different sectors of the economy, in companies at different stages of development or in different geographic areas. Although in certain instances this may be possible without the need to consult limited partners (to the latters' chagrin), a fund's governing documents quite likely condition a similar expansion of the manager's investment scope to a consent obtained from the limited partners or at the very least from the fund's advisory committee.

A third possible course of action would be similarly subject to consent: asking for an extension of the investment period beyond the original termination date.

Fund agreements

In a typical private equity agreement, the investment period lasts five years from the initial or final closing. After the end of the investment period, the manager may continue to draw down commitments to fund expenses and management fees, but new investments are prohibited.

Typical exceptions to this general prohibition are investments that have been negotiated or closed prior to the end of the investment period and further investments in the same portfolio assets held by the fund at the end of the investment period (so-called "follow-on investments").

In some cases, the responsibility to waive these limitations and to extend the investment period, or to avert a decrease in the manager's fee flow (e.g., by allowing the managers to retain a higher percentage of fees from portfolio companies) is vested in the fund's advisory committee. In which case, the composition and functionality of the advisory committee will be crucial.

In a majority of cases, however, prolonging the investment period or changing the basic economics of a fund - for example, by increasing management fees post-investment period - will require the consent of most or all of the limited partners. Consequently, a strong principled position by limited partners holding a relatively small percentage of the fund's commitments could be enough to prevent any such changes to fund agreements.

Lessons learned

Most of the times, fund managers are acutely aware of the necessity to engage with limited partners, well in advance of the actual deadline, in an open discussion regarding the possibility of protracting the investment period or tweaking the economics of the fund.

By involving limited partners in the thought process underlying their investment decisions, managers treat them as an internal – rather than external – sounding board.

However, as we have noted above, these discussions may be somewhat hampered by the rigidity of the fund's governing documents, which often require approval by special majorities and, when basic economics are affected, may even demand consent by each single investor.

This is the main reason why a growing number of limited partners are realising that, while it is paramount for fund agreements to contain very clear limits setting forth the managers' possible area of action – such as a precise definition of the investment scope or the type of targets – building flexibility in the agreements (e.g., through a smart use of the advisory committee) is extremely advantageous.

Being able to cope with varying economic circumstances throughout the life of a fund may make all the difference between an anxious or demoralised manager and a properly incentivised one.

Which is to say, between a fund with a low chance of success, and one with very good odds. ■

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1. Prequin's Private Equity Performance Report of February 2011 notes significantly better performance for private equity, as compared to public indices, for 1-, 3- and 5-year periods as of 30 June 2010 (private equity returns for 1 year, 3 years and 5 years stand at 17.6%, -1.9% and 15.7%, in all cases considerably higher than returns for the same period from Standard & Poor's 500 or MSCI Europe; MSCI Emerging Markets would have outperformed private equity only in the 1-year horizon).

2. Bain & Company's Global Private Equity Report 2011 showed global buyout deal value for private equity of only $170 billion for 2008 and $81 billion for 2009, as compared to $479 billion for 2006 and $503 billion for 2007. That makes for over $1 trillion of dry powder by private equity funds at the end of 2010.

3. This piece is based in part on a panel discussion held in Berlin in February 2011. Thanks go to Laurence Zage, Philippe Roesch and Jan Johan Kühl for providing much of the fodder for the thoughts underlying this commentary.

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