

Private Equity Analyst

Secondary Firms Cook Up New Ways To Close Deals

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The majority of sellers trying to utilize secondary markets to free up capital - especially those looking at transactions worth \$100 million or more - are so far proving themselves unwilling to offload their private equity fund stakes at the dramatic discounts currently being offered by buyers.

Sellers think prices are too low and their investment committees won't approve sales, said Laurence Allen, chief executive of NYPPEX LLC. That's forcing would-be buyers to go back to the drawing board to figure out creative ways to get secondary transactions done.

Some players, like Landmark Partners, UBS Investment Bank and Credit Suisse Strategic Partners, are dusting off structured deals as one potential solution. Others are coming up with even more unusual products.

Structured transactions have been around for a while. UBS has executed 14 structured transactions since 2004. Credit Suisse Strategic Partners has completed about 30 of these transactions in the last six or seven years. But they hold more appeal in the current environment.

"It looks like O'Hare with secondary firms lining up to propose structured transactions to every pension fund," said Michael Hoffmann, president and partner at Probitas Partners.

Such transactions vary from deal to deal, but here is an example of how one might work. A limited partner is on the hook for \$100 million in uncalled capital. A secondary firm works out a deal to transfer funds worth \$300 million in net asset value, some of which might have uncalled capital, to a special purpose vehicle that finances future capital calls. All distributions go to the secondary firm until it gets 100% of its money back. Then, it receives 80% of returns until it gets two times its contribution, after which the percentage flips, with the original LP getting 80% of the returns.

Because the LP doesn't sell its fund stake, a structured transaction provides liquidity without forcing the investor to realize an accounting loss, said Colin McGrady, managing director at Cogent Partners. Such transactions can also minimize political concerns, if an LP doesn't want to sell a fund stake in a GP it might want to commit to in the future, said Tycho Sneyers, partner at LGT Capital Partners.

Structured transactions also mean secondary buyers can invest less in deals. "Buyers want to treat cash as dear right now because they are not sure when they will be able to raise capital," Allen said.

However, secondary buyers are offering somewhat onerous terms on these

structures at the moment, concerned about returns. One limited partner said it passed on a suggested transaction that included a 15% preferred return and a split of distributions beyond that.

"When pitched, the idea resonates with LPs that are dealing with liquidity issues, but when the economics are detailed most opt for other solutions," McGrady said.

Given these stumbling blocks, some secondary players are looking at other alternatives. Probitas has created a new security that separates funded assets from unfunded ones. The security could enable it to act as the general partner for a separate account vehicle that it would create for a limited partner - a sovereign wealth fund, for example - that wanted to invest in the unfunded portion of other LPs' fund stakes.

Under the structure, a state pension fund could decide that it wants to fund 60% of its remaining capital calls on the unfunded part of an interest, with the new LP funding the other 40%. The distributions from those capital calls would be split similarly. Probitas would charge a management fee to the new LP, and some sort of fee to the old LP. The structure could accommodate multiple counterparties, said a person familiar with it.

Meanwhile, NYPPEX is working on offering a type of derivatives contract called NYPPEX GICCO, or guaranteed capital call obligation, that would act a bit like insurance. For instance, an LP that wanted to get rid of \$1 billion in liabilities for future capital calls, but without selling its fund stakes, could purchase GICCO protection for a year. It might be charged a 2.5% fee by NYPPEX, which would then pass the majority of the fee on to a counterparty - potentially a secondary fund, fund of funds or large institutional investor with excess liquidity - that agreed to cover the risk of the capital calls for a year.

If 10% of the \$1 billion was called during the year, the counterparty would pay out \$100 million, and would get a preferred return of up to 1.5 times its money from portfolio distributions. At the end of the year, the LP could resume funding its capital calls if its situation had improved.

The benefit of these two structures, neither of which has actually been used in a deal as of yet, is that they keep intact the relationship between the original GPs and LPs. But like structured secondaries, whether or not they work will ultimately come down to price.

"We believe structured transactions can play an important role in the market, but only if they are structured and priced appropriately," McGrady said.