

# Privcap/ CONVERSATIONS

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**WITH EXPERT COMMENTARY FROM:** Houlihan Lokey/ICG

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# PE Fund Life Cycle Challenges

As a private equity firm matures, many funds reach the end of their life. Jeff Hammer of Houlihan Lokey and Andrew Hawkins of ICG discuss the challenges presented when a firm gets long in the tooth, and how techniques from the M&A market have become useful for PE.



**Jeff Hammer**  
Managing Director  
Houlihan Lokey



**Andrew Hawkins**  
Director, Global Head of Secondaries  
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## → BIO

Hammer is a managing director and co-head of Houlihan Lokey's Illiquid Financial Assets practice, which is focused on customized transactions for holders of illiquid securities. Previously he was a senior managing director at Bear Stearns & Co. and co-leader of Private Equity Advisors, the fund-of-funds and secondary investing unit of Bear Stearns Asset Management. He also co-founded BDC Financial Inc. and founded Gotham Investment Group and Commonwealth Property Investors. He received a degree from Princeton University and an M.B.A. from Harvard University.

## → BIO

Hawkins has more than 16 years of experience investing in private equity and was formerly a partner and managing partner at Palamon Capital Partners and Vision Capital Partners, respectively. Most recently he was CEO and founder of NewGlobe Capital Partners. Hawkins received a law degree from Bristol University.

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**Privcap:** We are talking about a complex issue that is widespread in private equity, and that is the range of life cycle challenges that GP groups, private equity firms, and others like them face as they age. You are heavily involved in helping GP groups solve some of these issues. Can you summarize some of the challenges that a private equity fund might face as it gets into an advanced set of years?

**Jeff Hammer, Houlihan Lokey:**

The private equity business has been a vibrant part of the financial services sector for quite some time, but it has reached a sort of maturation. I wouldn't want to say it's at middle age, but there are a number of sponsors who had come into business in the '90s and the 2000s who successfully raised funds and have deployed capital.

Well, as you would expect, not all of [the funds] have been successful. And a number of them have held on to assets for quite some time, and funds have gotten aged. Funds have a finite life, typically a 10-year term, with five years as an investment period and five years as a disposition period, usually with option years on the end of that disposition period. If you look at the sponsors who got into the business in the 1990s and the 2000s and who raised funds during those periods, those funds are getting timed out. And unfortunately, if they aren't able to raise new capital, then the life of the funds tends to prolong, to the sponsor's benefit sometimes, and as well as they need additional runway to liquidate the investments.

So there are limited partners stuck in these funds that want liquidity. And there you have a challenge for the industry, which is: Investors who want liquidity in funds that are fairly long in duration need techniques in order to create liquidity, while allowing the sponsors to liquidate their investments at appropriate values and potentially to raise additional capital.

**What are some of the alignments that get out of whack when a fund enters its later stage?**

**Andrew Hawkins, ICG:** We've seen quite a lot, and the market has evolved beyond any recognition over the past [few years]. We started looking at [the idea of tail-end funds] in the middle of '07. Roll the clock forward post-Lehman, which really pushed out the time scales for disposals and also really hit the returns for many of these sponsors—they found that they couldn't raise another fund, because their returns weren't good enough. And there was no carry, because they were below the preferred rate of return.

So you have these rigid lives which were 10, perhaps 12 years, but no real prospect of the assets being realized at the end of the 12th year. And so the volume of capital at work mushroomed, and now we're looking at something well into the hundreds of billions of dollars of NAV [net asset value]. And when the LPAs (limited partnership agreements) were written for those funds, nobody really anticipated this as a problem. We had to invent a whole new toolkit to deal with this growing problem and to try to reset alignment between the GPs and their backers.

**Hammer:** Many of the techniques that we use with funds today were repurposed from the mergers-and-acquisition market, where they were used to deal with conglomerates or under-optimizing public companies. The audience for these types of tools is very large.

**Hawkins:** The way we think about these restructuring deals that we're involved with is very much one of the M&A market analysis. We think of these as management buyouts of the funds by the GPs, and we're backing the GPs to do that buyout. The management team is the GP, and the selling shareholders are the LPs.

**So these players might not have imagined themselves playing those roles in an M&A scenario, but in fact, for these circumstances, that's essentially what's happening.**

**Hawkins:** Exactly. And one of the other things that changed is that the LPs were not as conditioned to these kind of deals as shareholders in public companies were conditioned to receiving take-over approaches. So, for example, the LPs don't have a ready way of getting external advice. The GP does, because there's a system in place for the GP hiring advisers. But how do the LPs get advice? And so you get a slightly curious mix of expertise compared with what you'd get in public-company land.

**What are some of the more common approaches taken to address these challenges, and can you tell us about some lesser-known techniques that show promise?**

**Hammer:** What we've been talking about here directly and by reference are what we called fund restructurings. These are usually led by a general partner who hires an agent such as us to help crystallize the opportunity and to deal with the various stakeholders.

Other types of techniques for converting funds from stalemate status into something a little more vibrant include fund conversions, which would be a conversion into a public company, and fund mergers, in which the fund

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# The maturation of the private equity business has set the stage for fund M&A, a group of tools and techniques that can create new life for stalled managers, stranded funds and orphaned assets.

—Jeff Hammer, Houlihan Lokey

is merged onto another platform and the general partner may or may not be investing. And then, most recently and interestingly, there's an LBO of a fund, but where a general partner can actually borrow money from the credit markets to buy out limited partners and to accumulate his position or her position in a fund which is much greater than what might be a typical general partner ownership in a fund. We call those fund LBOs.

**In these fund LBO cases, there are selling LPs, but are there also LPs who come along for the next iteration of ownership?**

**Hammer:** The answer is that both can occur. Effectively, a general partner can make a tender for all limited partner stakes at a certain price and

can accumulate a position. And LPs are never required to do anything. In all cases, LPs can take the cash offer on the table. They can roll into the new fund, or they can generally maintain the status quo, depending upon the situation.

**Hawkins:** But status quo options are quite difficult, because from the perception of the people coming in, then the people who are staying put are getting a free ride. The other problem with the status quo is that if you're in year 12 and you have new money coming in, you're probably giving another four or five years of fund life to the GP to manage those assets out. And the existing LPs may not be able to do that.

**So the commonality across all of these solutions is that the underlying portfolio companies are not exited in the way that private equity typically exits. How do you get limited partners comfortable with the valuations?**

**Hammer:** The important driver is how the fund has been marked over time. And as an adviser coming in, we will present a point of view to a general partner as to how his or her mark would be received in the market. So there are two approaches: Establish a valuation formally in advance of a transaction, or allow a market process to run its course, and then a firm delivers a fairness opinion on the value at the point of transaction. These situations present like a Rubik's Cube, and you have to move the squares around so you can figure out how to solve the problem. LPs don't want to be taken advantage of, but they want liquidity. General partners really don't have to do that much until their time runs out.

**It sounds like there are a lot of people skills required, in addition to the M&A toolkit, because you're dealing with people who are disappointed or combative in their approach to negotiations.**

**Hammer:** It absolutely takes people skills, and that is the fundamental difference. It's even more important than valuation in bringing these transactions to critical mass.

**Hawkins:** There are a few people in the private equity industry who have something of an ego—you respect the fact that you're dealing with people who have strong opinions. And these are life-changing decisions for a private equity firm. What's good is that we've migrated away from this concept that these were zombie funds, that these were bad guys who blew up and were dying and so they're being taken out of their misery. Fortunately, the mood has shifted, and we're seeing more and more that this is an acceptable way of resetting a firm's economics so that the GP is aligned.

**Hammer:** The term “zombie fund” was misapplied, because there was a small segment of the universe that we would consider the walking dead, but most of the reasons that general partners cannot raise money or are stuck with fund assets has to do with the fact that they might have gotten off to a bad start and then recovered. We call those slow starters. Or they had disagreements within the partnerships, and some of the partners split. Or they have invested in a style that had become out of fashion, or they were sponsored by a hedge fund or a corporate entity that decided not to sponsor it anymore.

**Hawkins:** It's worth saying that a major catalyst of all this was the financial crisis, because it pushed out exits and it hit the valuations dramatically. So you probably had three to five lost years, and it's almost impossible to make that up in carry, except for in the most extraordinarily performing funds. So a lot of folks have been hit by the same thing. And even if they can raise a fund, it may be much smaller than they'd have liked, or smaller than the prior one. ■