Financial and Economic Crisis – Law Firms

The Place Of Private Equity In The Investment World

The Editor interviews ***Sean Hill****, Partner in the Corporate Department and Private Investment Funds Group of Proskauer Rose LLP's Boston office.*

Editor: Please describe your background and practice areas in the firm, including types of clients.

Hill: I have a general corporate practice representing both alternative investment managers and institutional investors through the full life cycle of their firms, funds and investments. My clients include sponsors of venture capital, mezzanine, buyout, distressed, credit opportunity, fund of funds and secondary funds. In our practice we work with both sponsors and investors. This gives us a great insight into the entire market, enabling us to provide more focused business and legal advice to our clients. We also do a substantial amount of work with fund sponsors and management teams in structuring their firms, including executive arrangements, which is critical to the success of a firm. Our clients are from all over the world, and as such, our practice is geographically agnostic – at any given time we work with clients to form funds, open offices and complete transactions across the globe.

Editor: What are you seeing in the pipeline in terms of new projects?

Hill: The pipeline is definitely coming back to life. While our business remained steady over the past year, the composition of projects certainly changed significantly for a while. For example, this year we saw a marked increase in secondaries, fund refinancings (whether through restructurings, annex funds or otherwise) as well as internal firm governance matters. We have also worked on a number of management spinout and new manager formation projects. Additionally, we saw an uptick in the number of mezzanine, distressed, credit and secondary funds that were in the market, some on-cycle and some that were taking advantage of the market opportunities. We expect that some of the managers who held back from fundraising in 2009 will be queued up to enter the market late this year, or in the first or second quarter of 2010. It's going to be a busy year!

There are still many people on the sidelines, but I think the money will start flowing again because investors will eventually need to do what they do best – invest. There is a general feeling that investors are going to pick their spots and perhaps alter their strategies – whether that means having greater concentration or diversification, picking funds that may be poised to take advantage of current market conditions, or investing with newer emerging managers or sectors that may have more relative upside potential.

Editor: Have you seen an increase in transactions in the secondary market?

Hill: Historically, our group has had a very large and dedicated secondary practice, representing the sponsor side for many years in fund formation and buy-side transactional matters. Over the past five or six years we have also developed a significant sell-side practice working with many of the intermediaries and sellers. Overall we have averaged over 100 secondary deals per year for the past couple of years. Even with the fall 2008 financial crisis, there was still a big rush to get deals done through the end of last year. Once January hit, the number of deals stayed fairly steady and may have even increased overall, but the size and the type of deals changed significantly. There were many distressed sale situations – publicly traded entities, financial institutions, high net worth individuals and others. The average deal went from a mid-size portfolio of 15 to 20 interests to "onesies and twosies," or sales of only a few interests at a time, typically on a compressed timeframe. Additionally, some of the buyers were nontraditional (not dedicated secondary specialists) who were looking to pick up more exposure to a manager they knew well, and many of the interests being transferred were lightly funded – less than 50 percent. Now the market seems to be returning to relative normalcy, with bid / ask spreads narrowing and valuations stabilizing.

Sean Hill

Editor: Can you tell me more about what types of secondary deals are getting done in this unusual time?

Hill: There are different aspects to the secondary market. The traditional secondary is the sale of a portfolio of limited partner interests. However, another significant and growing segment of the secondary market is referred to as secondary directs, that is, buyers who are purchasing securities in portfolio companies from an existing stockholder, not the issuer. We have also seen a number of "structured" secondaries where the parties, in essence, work out a structured cashflow return and profit split, but do not transfer an interest in its entirety. Another subset of the secondary market that has been very prevalent this year is the "young" or "green" secondaries – funds that have been lightly drawn down and where the buyer is principally taking over an unfunded commitment.

Before 2008, primary as well as secondary buyers had a reasonably consistent return expectation, looking out four or five years to the potential exit scenarios for the underlying funds and their portfolio companies. Until recently, portfolio company liquidity had largely dried up. Lack of liquidity, combined with NAV markdowns at the portfolio fund level, created more uncertainty for purchasers regarding when they could expect a return on their investment, which in turn led to downward pressure on pricing. This lack of liquidity at the company level and general market volatility was a big factor in pricing secondary deals because there was not much visibility on the liquidity horizon for the buyers.

Editor: What is happening with inbound investments by sovereign wealth funds and overseas investors? What are you seeing in terms of outbound U.S. capital outflows?

Hill: Both U.S. and non-U.S. fund sponsors were affected by the economic crisis, and the new capital committed by most institutional investors, whether U.S. or foreign, slowed significantly this year. There are now some newer entrants in the market just beginning to make investments in private investment funds – investors taking advantage of the market to build private equity portfolios. We have seen signs of life from all areas as the markets begin to recover, from sovereign wealth funds as well as domestic public pension funds or other institutional investors.

In terms of capital outflows from the U.S., we are working with a number of clients in setting up Asia-focused funds, both direct funds and fund of funds. U.S. managers have a sizable interest in investing in that region. The general opinion is that Asia is going to be a growth area for both investment capital and as a source of capital, especially if the various jurisdictions can lower the regulatory hurdles and come up with clear and consistent rules that promote a freer flow of capital.

Editor: How do you account for the fact that there have been few defaults among limited partners in spite of the funds' need for capital?

Hill: Despite our expectations, there has not been a flood of major capital calls for investments. Primarily we have seen normal capital calls to fund expenses and smaller transactions which has not been enough to tip most people over the edge and put them into a situation where they need to sell or default. A handful of people have been in or close to default situations, but the secondary market has been able to step in and purchase the interest in many of these situations. It is, however, tricky to get these sales done and to make sure that the defaulted interest is "clean" before transferring to the buyer. That was a very active area for a while particularly with high net worth sellers, but it has receded now that potential sellers have more cash.

Editor: What is the status of the SEC proposal to register hedge fund and private equity managers under the Advisers Act?

Hill: There have been various proposals (including a proposed exemption for venture managers), but there is a general consensus that something will get passed at some point – who will be covered is the real question. Many in the industry believe that the existing rules work pretty well without any further need to register all investment managers. Private equity and venture capital funds don't seem to pose the systemic risk that many people are worried about, and many of the larger fund managers are already registered as investment advisors.

Editor: The SEC has proposed a "custody rule" applicable to private investment advisors whereby an independent public accountant would review the privately placed securities and uncertified securities in that advisor's portfolio to verify the authenticity of the assets held. Do you think this will preclude situations such as that posed by the Madoff scam?

Hill: I don't necessarily think that the custody rule with the surprise inspections or audits is really going to prevent bad people from doing bad things. That said, there is nothing inherently wrong with surprise inspections but, like many of the proposed regulations, it will add more cost and complexity to the industry, which at some point will eliminate the ability of small managers who won't have means to compete, and ultimately will cost more for investors.

Editor: How are fund sponsors dealing with the need for additional funds to grow their portfolio companies?

Hill: There are a number of avenues to explore such as annex funds or various add-on structures. You can set up a preferred equity structure in a fund or borrow at either the fund or company level. A lot of managers are making tough choices about whether or not there are companies they should support. Most managers are really taking a hard look at their portfolios and managing their balance sheet just as they are asking their portfolio companies to do.

Editor: I suppose that they could sell off a company and raise cash that way.

Hill: Yes, you can also do secondary sales of a company or a strip of all your companies as a way to raise capital, but funds need the internal plumbing in order to be able to re-utilize that capital. Every situation is unique and depends on how much capital you need and for how long, when do you expect more liquidity from the portfolio and who your investor base is. You need to have a good understanding of the whole picture of why you need a capital infusion to be able to pick the right structure. In many ways your investors will tell you what the right structure is – at this point they have seen all the structures and will have a preference, and their tax or other status may also drive which structure is viable.

Editor: With the return of the Dow to 10,000 and the remarkable upsurge in values in the public market, do you think it is likely the private market will follow suit insofar as values will improve and there will be an increase in IPO's?

Hill: Yes. We have already seen a modest uptick in IPO activity. Venture-backed companies seem to have led the way so far, and that is going to drive returns for some of these managers who will return to the market with a new fund. For some, it will give them the ability to show a positive track record and liquidity in their portfolios even through a difficult period.

Editor: Do you think that the presence of greater regulation of the private markets will not only serve to curb abuses but also bring down their returns?

Hill: Regulation is not necessarily a bad thing. I think that the industry as a whole wants to be viewed in a positive light and would likely be comfortable with regulations that are sensible and consistent, rather than reactionary and unpredictable. Additional regulation may, to some extent, serve to curb some abuses and provide a greater sense of order and discipline. It is hard to predict but additional layers of regulation may increase expenses, and, as a consequence bring down returns, particularly to the extent that the cost of investing would be more expensive for everyone.

Private equity is a relatively modest but important part of the world financial system, creating considerable job growth and innovation. Alternative investment managers are all small businesses themselves, employing many people and providing a lot of innovation. The growth of these businesses and the related industries and portfolio investments can and does have a material impact. Congress, the EU and other regulators need to find the right regulatory balance that makes the most sense; a level and predictable playing field would be beneficial to everyone.

Please email the interviewee at shill@proskauer.com with questions about this interview.