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Phoenix rising – restructuring as a solution for zombie funds

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Today's fundraising landscape for private equity fund managers is challenging. Many recent fundraising attempts have failed and other managers, with marginal track records, have chosen not to go to market with a successor fund. Of the more than 700 fund managers active before the financial markets crisis in 2008, almost 50 percent have not attempted to raise a fund in the four years since 2008. Many of these funds still hold substantial unrealised investment assets.

Private equity industry researcher Preqin defines 'zombie funds' to be private funds that are holding investment assets past their expected holding period with no short-term intention of liquidating such assets or raising a successor fund and in which the fund manager is continuing to receive a management fee. In June 2013, Preqin reviewed active private equity firms managing funds raised between 2001-2006 which had not yet raised a successor fund and identified over 1200 private equity

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zombie funds with total unrealised assets of about $116bn (Private Equity Spotlight, June 2013). This represents a material segment of the private equity fund market.

A fund's general partner (GP) controls decisions, including the timing of portfolio investment exits. However, when a fund approaches the end of its term, the sale decision becomes more complicated if the GP believes that it is premature to sell the fund's remaining investments and that an extension of the fund's term would allow for value maximisation. Investors in zombie funds may have conflicting views on the optimal timing for selling such remaining assets with certain fund investors desiring shorter-term liquidity and other investors hoping for additional capital appreciation in these remaining assets. As such, the issue was recently summarised from the zombie fund investor's perspective by an institutional investor: "No one genuinely signed up for private equity to have a 10-plus year fund with a big chunk of the portfolio still sitting there and a [general partner] charging [management] fees with no real end in sight." (Mario Giannini, CEO of investment consulting and investment firm, Hamilton Lane, *Pension & Investments, 'End may be near for zombie private equity funds,' 10 June 2013*.)

In many funds, before the GP is entitled to share in any profits, or carried interest, in a fund's remaining assets, that fund must first return to its investors both invested capital and a preferred return on such invested capital. As preferred returns have accumulated over time for many funds, the magnitude of these accrued preferred returns will result in many GPs not earning any significant carried interest on their respective funds' remaining assets absent a restructuring of the fund's economics. This is forcing the GPs of such funds to choose between: (i) seeking extensions of their fund's term (i.e., the period before the fund has to wind-up its existence and liquidate assets) to allow them to continue managing existing assets for potentially little or no profit incentive (but potentially still receiving management fees); or (ii) winding up the fund by either selling the zombie fund's remaining assets to a third-party or distributing the remaining assets to the fund's investors – leaving LPs to sort out the management of the underlying portfolios.

The private equity secondary industry has developed a way to restructure zombie funds where a secondary investor or investors agree to fund a 'cash out' option for a zombie fund's investors, typically coupled with an extension of the fund's term and incremental economics to the GP – thereby providing liquidity to departing investors while realigning the incentives of the GP with new long-term investors in the fund, and, in certain cases, permitting existing investors in the fund to continue to participate in the remaining assets on an 'opt-in' basis.

A successful restructuring requires that some of the fund's investors desire short-term liquidity. A variety of factors may affect an investor's liquidity needs, including regulatory constraints, a desire to rebalance to different strategies and/

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or short-term and long-term cash needs. On the other hand, investors may not want to be 'cashed out' in a restructuring if they perceive meaningful future upside potential in the restructured fund. This puts pressure on any restructuring solution to provide a meaningful 'exit price' for investors that will be acceptable enough to entice a critical mass of investors to transact. Typically, a realignment of the GP's economics (at least with respect to the new secondary investor's invested capital) as part of the restructuring facilitates a higher 'exit price' for liquidity-seeking investors than if a liquidity-seeking investor was to seek to independently sell its limited partner interest in a zombie fund on a standalone basis in the secondary market.

For both the new secondary investor and any 'rolling' investors, a successful restructuring should address issues of alignment between the GP and the fund's investors. Although there are many reasons that this alignment can break down, an internally led restructuring can be complicated by the tension between investors seeking short-term liquidity and investors seeking future capital appreciation. For a GP trying to determining how to resolve this tension, a fund-level restructuring led by a third-party secondary investor is an innovative solution. By providing the fund's investors with an option to sell their exposure in the fund or to remain invested on terms designed to increase the long-term value for the assets, liquidity-seeking and appreciation-seeking investors benefit.

In any transaction involving a fund's GP being on both sides of a transaction, care must be taken to address the inherent conflicts arising from the GP and its affiliates effectively representing both the 'seller' and the 'buyer' of the assets in such a transaction. The GP must act consistently with its applicable fiduciary duties to the investors of the fund as well as any conflict of interest provisions in the fund's partnership agreement and other governing documents. Assuming that an acceptable 'exit price' is agreed upon, in a typical fund restructuring, a secondary investor would provide the capital to take out all of the liquidity seeking investors of the fund, the fund's term would be extended and the GP would receive incremental economics – additional profit participation interest (i.e., carried interest) and an additional management fee from the new secondary investor. The GP's incremental economics often will be tied to a new vesting schedule to incentivise the GP to stick around and manage the remaining assets through liquidity.

The benefits of a restructuring for the various parties involved can be summarised as follows. For 'rolling investors': (i) the GP is incentivised and given flexibility to maximise value for the fund's remaining portfolio companies; (ii) most or all of the incremental incentive fees are paid by the secondary investor; (iii) the 'walk-away' management risk by the GP is strongly reduced by incremental economics for the GP and a new vesting schedule related thereto; and (iv) if incremental reserved capital for a fund's investments are

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needed, restructuring of such fund allows for an orderly raising of such capital.

For the selling investors, the benefits include: (i) immediate liquidity; (ii) sale of the majority of, or the entirety of, such investor's interest in the fund in one transaction; (iii) elimination of the risk of the investor's capital being trapped for an indeterminate holding period; and (iv) typically superior exit pricing in the restructuring compared to the non-restructuring pricing in a straight secondary market sale of the same fund interest.

Finally, for the GP, the benefits include: (i) the potential for incremental economics and profit participation (carried interest) on new money; (ii) the incremental economics improve the GP's ability to retain and compensate investment professionals; (iii) the mandate from 'rolling' investors and the 'new money' investors provides flexibility to maximise the value of underlying investments; and (iv) an opportunity to make organisational changes.

Conclusion

While GPs and investors must all keep in mind that the addressable market for fund restructurings is only a small percentage of the overall universe of troubled funds, fund restructurings will be an important theme in the private equity market over the next several years as fund investors and GPs seek a mutually acceptable mechanism to allow a zombie fund to rise from the ashes like the proverbial phoenix. ■

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