

FUNDS

Fund structures in the current climate

BY MUAZZIN MEHRBAN AND MARK WILLIAMS



Fund managers are facing an uncertain future. The financial crisis has brought unprecedented volatility to the alternative asset class and sent investors scurrying to reduce their risk exposure. The private equity industry has been hit by a lack of investor liquidity, limited access to bank financing, constrained leverage levels, and a tough exit market. Hedge funds, on the other hand, have been jolted by fraud scandals and a wave of investor redemptions. Returns are down. Write-downs are prevalent. Defaults and liquidations are on the rise.

A culmination of these factors has forced players in both industries to consider revising their fund structures. Some have done so to improve performance, others to repair or maintain relationships with investors, and some as a necessary step for survival. Capital inflows for private equity and hedge funds are expected to remain subdued for the foreseeable future. In response, funds are scaling back their operations and reducing their fees. Although activity is sure to pick up once the worst of the global recession is over, it may be some time before investor interest and fund sizes return to pre-crisis levels, if at all. In the meantime, the nature and structure of these funds may undergo significant alteration.

Developments in private equity

Two to three years ago, at the height of the buyout boom, the private equity industry was leaping from strength to strength. General partners (GPs) in the US and Europe were competing with each other to raise record multi-billion dollar funds. Larger fund sizes allowed them to generate higher management fees and complete individual deals worth tens of billions. Some general partners also placed addition charges on investors, including transaction fees and advisory fees, which met little resistance as funds continued to generate outsized returns. Buyouts, in terms of total value and volume, reached figures never before seen.

That all changed in 2007 in the fallout from the subprime crisis, and worsened in 2008 on the cusp of a global downturn. Limited partners (LPs) with broad exposure to financial markets were caught cold. Suddenly their portfolios were facing heavy losses and they needed to balance their risk ratios. In terms of their private equity interests, returns were sure to drop; exit options for private equity-backed companies were severely hampered, as trade buyers were preoccupied with internal problems and IPOs were virtually non-existent. The number of buyouts plummeted as banks scaled back lending, tightened credit analysis

and shunned high leverage multiples. On the fundraising side, general partners struggled to reach target sizes for new funds as LPs either did not have the capital to commit or found themselves over-allocated to the asset class and needed to adjust their portfolios accordingly.

In the current climate, relationships between GPs and LPs have become strained on a number of fronts. Versatile GPs have tried to preserve links by being proactive. Some have eased tensions by reducing or removing management fees – a source of discontent for investors – in return for higher carried interest. Other issues are also being discussed. “Investors are sensitive to fund size, key man and extra fee generation, which are issues that managers will have to acknowledge when altering their fund structures,” says Mounir Guen, CEO of MVision, “That said, although we believe there will be changes made to the partnership structures, these will be in the years to come, not at this particular time,” he adds.

General partners are also sensitive to the capital constraints of their LPs, as Peter Memminger, a partner at Milbank Tweed Hadley McCloy LLP, points out. “GPs understand that some LPs are not able to fulfil capital calls. Hence, the GP’s abstinence from looking at new deals and issuing calls to finance them has certainly sent the right message to LPs: that GPs are willing to listen and accommodate the LPs’ requests, even when not legally obliged to do so,” he says. In addition, as other asset classes decline in value, the relative exposure of many limited partners to private equity has exceeded their intended limits. The fact that GPs are reducing LP commitments helps investors to meet their original allocation percentages.

Although the vast majority of private equity fund documents lock in investors for several years, another issue surfacing between GPs and LPs is redemption requests. In rare cases there will be a legal requirement for general partners to fulfil a redemption request, but generally the response will be discretionary. There are several tricky considerations ▶▶

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here, according to Mr Memminger. “Not only may a fulfilment of the redemption request only be possible for a sale of assets at a fire sale price, but the GP also has to take into account the interests of the other LPs who may not have issued a redemption request and may be likewise affected by the sale at the fire sale price. On the other hand, LPs will not issue redemption requests out of blue sky – they may have a pressing obligation they need to honour, and the non-fulfilment of their requests may cause severe harm to them,” he says. How the GP responds will be an important business decision affecting long-term relationships with several parties, so the benefits and drawbacks need to be carefully weighed.

Looking ahead, private equity investors have altered their outlook and many are now reluctant or unable to invest in new funds. This could mean that both fund and deal sizes remain smaller than in previous years, although some experts are not so sure. “This is certainly a plausible scenario, but I would not be as negative as some surveys suggest,” says Mr Memminger. “I think the key question is whether a

fund can exploit the current undervaluation of some asset classes and make lucrative deals despite this tough market environment, made harder by the limited availability of debt and equity financing. If they achieve this, and make a successful exit in the next market upturn, they can show their investors returns as exceptional as before the onset of the financial crisis.” Funds that can generate substantial returns also have a better chance of attracting new investors and rebuilding mega funds at some point in the future, once negative market perceptions fade.

In the meantime, funds may struggle to survive if they completed transactions at the peak of the market, and overpaid for assets. The poor performance of their existing deals will not hold them in good stead as far as new investors in follow-on funds are concerned. Struggling funds will ultimately be forced to downsize, reducing their workforce and staff budget.

But out of this industry contraction the strongest players will emerge, those with a proven track record who will command the interest of LPs when the markets recover. If these players scaled back internal operations to ride out the downturn, they will need to position themselves to quickly increase their numbers and attract top talent when the markets become active again. With fewer fund managers in the market, those that remain can also hope to boost their fees in the long run. For now, though, the primary aim is to compete with other GPs for the dwindling number of LPs that have the financial resources to commit to private equity. There is a distinct lack of liquidity in the market, and it will take time for new-found confidence to translate into new LP investments.

In troubled times, strong communication can help to rebuild investor confidence. Educated investors who are kept informed about their investments are more likely to have confidence in their GP and reinvest when new funds are offered. For this reason, it is important that managers keep investors updated, since well-capitalised LPs are in high demand and will have a number of choices about which funds to invest in.

Hedge funds: response to the crisis

The hedge fund industry enjoyed explosive

growth in the last decade, reaching a zenith in June 2008 with around \$2.5 trillion in assets under management, according to the Alternative Asset Management Association. But the industry is still reeling from the shockwaves that have rattled fund managers since the beginning of the financial downturn. Although a lucky few managed to call the top of the market precisely, most have been burned in one way or another. Many have suffered direct losses or collapsed entirely. Others have been affected merely by association with an industry that has fallen out of favour with investors. Much of this lack of faith was sparked by the Madoff fraud. Even though the scandal involved a Ponzi scheme under the guise of a hedge fund, investors scrambled to withdraw funds in huge numbers across the industry, pulling out almost \$150bn in December 2008 alone.

Unlike in the private equity industry, redemptions have become a major concern for hedge fund managers. Usually the hedge fund will be required to meet these withdrawal demands – unless it can convince the investor to reconsider. Good communication between both parties can smooth this process. The manager may look to demonstrate to investors that holding on to a position and building value over time, rather than exiting at a fire sale price, will benefit all parties – although this requires cooperation. “Ultimately, the mantra that we preach to fund managers is invest in communication,” says Simon Dinning, a partner at Ogier. “A well informed, well educated investor who feels that they are being kept informed by their manager is far more likely to feel comfortable with that manager, meaning that they leave their capital in place or perhaps commit additional capital.” He adds that most investors invest with a multitude of managers in a multitude of funds. “If they have one manager in their portfolio that is not cooperating and they have others who are, they are far more likely to be looking to pull their cash out of the uncooperative manager and move it to the cooperative one,” he says. By sharing information more freely, investors will be more inclined to hold on than seek redemption at the bottom of the market.

Hedge fund managers have been revising fund structures in an effort to counter these li- ➤

quidity pressures. Side pockets, for example, have been introduced to separate illiquid assets from liquid ones. Gate provisions have been added to restrict the amount of withdrawals made during redemption periods. "Managers have also looked at tightening up suspension provisions, the flexibility that the suspension provisions offer and, where funds cannot amend their documents, how they can satisfy redemption requests by partial payments and payments in specie," says Mr Dinning. "New structures will undoubtedly be advised to build the mechanics described above into their documentation as a matter of course. It is clear that lessons have been, and are still being learnt, from the current financial crisis." Where such provisions do not already exist in the documentation, fund managers need to communicate their actions. Seasoned investors are likely to understand the rationale behind suspending a fund, which allows it to liquidate positions and investors to withdraw in an orderly manner. Remaining investors benefit from a controlled process that avoids implosion of the fund, bal-

ances the investment spread and is not seen to purely benefit the manager.

It seems that hedge funds need to take a new approach towards their investors. Generally, they need to improve transparency where possible and increase their dialogue with investors. They also need to adapt to the market by making an assessment of their internal operations and investment methods. This might include plans for generating returns with reduced leverage in the months ahead, and presenting different options to existing investors. Investors want to see such steps to help restore their faith and confidence in the fund manager.

Although the market is in a downturn, some observers believe that now is the time for managers to make investments, not fulfil redemptions. They point to opportunities for capital deployment in many sectors. "There is certainly a very strong argument that says market pricing at the moment is at a deflated level, that there will be a period of recovery and that there are opportunities across the spectrum of investments for above average returns to be

secured," notes Mr Dinning. "Although the capital outflow from hedge funds is at an all time high, the question that will be answered in the next six months is how much of that capital is simply repositioned within the hedge fund space and possibly supplemented from other sources." He adds, however, that a major issue for investors is their ability to generate their own leverage to multiply up their investments in the current credit market.

Although some of the changes made by private equity and hedge funds will be short- to mid-term solutions, others could easily be permanent. The extent of disruption in the alternative asset class will leave an indelible mark on fund structures and manager/investor relationships. Some cracks were simply papered over when liquidity levels were high and returns were flowing bountifully. Difficult conditions have brought them to the surface, and fund managers will need to pay more attention to investor demands and desires going forward, or risk losing them to more malleable competitors. ■



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Simon began his career in the corporate division at Herbert Smith where he worked from 1997 to 2001. In 2001 he left Herbert Smith, having been asked to set up the London corporate division of, Washington DC based firm, Shaw Pittman

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