

SECONDARIES

Seeking structure

Structured private equity solutions may appear complicated, but the benefits can far outweigh any initial transactional complexity, write Rainer Ott and Ivan Herger



Ott: structured secondaries allow tailor-made solutions



Herger: cash flow forecasts are critical

Today's private equity investors often find themselves holding mature private equity portfolios. And administering those mature portfolios or creating immediate liquidity is often challenging. The administrative burden can be particularly onerous, especially if the mature portfolio includes a high number of partnerships relative to the portfolio's net asset value.

Selling partnerships on the secondary market in a straight secondary sale is one way to solve the challenge of creating liquidity – but prices are dictated by the market environment. Thus, even though a straight secondary sale can generate early liquidity, it is often an imperfect solution. In some cases, the limited partner (LP) may harm or even end a relationship with the general partner (GP), especially if the LP sells all of its interest in the fund and is not invested in another of the GP's funds. In other cases, it may simply be an undesirable course of action if the LP believes in the portfolio's upside potential.

Implementing structured solutions, however, can bring both administrative relief and the creation of liquidity. Structured solutions can release cash that is locked up in a portfolio without losing the upside potential of the underlying assets. To create the optimal structured solution, a client's specific objectives need to be prioritised and adapted to the current market environment. Different structured solutions should be employed to satisfy different client objectives. We examine two in further detail below.

STRUCTURING SECONDARIES

A structured secondary sale is a more sophisticated version of a straight secondary sale. In a straight secondary sale, the buyer and seller negotiate solely on the portfolio's price. A structured secondary sale, however, allows

for more elaborate and tailor-made terms and conditions such as 'staggered upside' sharing mechanisms or deferral of payments. These terms and conditions can be quite intricate and depend on the various objectives of the seller and the buyer. As a result, pricing structured secondary transactions can be tricky. A precise valuation of the underlying assets and strong modelling tools can go a long way toward alleviating any opaqueness surrounding pricing.

Despite the initial investment of time and resources required to establish a structured secondary transaction, the benefits are substantial – as structured secondaries are tailor-made to satisfy client-specific requirements.

THE BENEFITS OF SECURITISATION

Securitisation, a widely-applied technique in finance, is the process of transferring a portfolio of assets to a special purpose vehicle (SPV) that issues various tranches of debt and equity securities collateralised by the underlying assets. These securities are sold to third-party investors, giving rise to a substantial up-front cash payment to the asset's sponsor.

In a private equity securitisation, a large and diversified portfolio of private equity partnerships – illiquid in isolation – is pooled and converted into debt and equity securities that can be traded in the capital markets.

Depending on risk appetites and return expectations, a sponsor either retains debt tranches or stakes in the equity tranche. Investing into the equity tranche means assuming the highest risk/return profile, as the equity tranche has the lowest priority in the cash flow waterfall; while investing into the debt tranches means assuming

lower risk/return profiles. The cash flow waterfall defines the priority of payments made by the SPV: the payment of interest to debt holders and the redemption of debt generally occur prior to any payments to equity holders. Similar to other members of the collateralised debt obligation (CDO) and collateralised loan obligation (CLO) family, all proceeds generated after the debt redemption are fully distributed among the equity holders. Thus, equity holders are the sole recipients of the entire upside of the underlying portfolio. On the flip side, equity holders have to absorb the possibility of underperformance by the underlying assets.

Another benefit of securitisation is the opportunity to capitalise private equity investments more efficiently. Investors with a high cost of capital can reduce their financing costs by recapitalising a portion of the portfolio through low-cost debt. Furthermore, a securitisation can reduce a sponsor's regulatory risk-weighted assets, thanks to the segmentation of the private equity portfolio into various rated debt tranches. Also, the administrative burden of the sponsor can be significantly reduced, because the sponsor would no longer need to process multiple cash flow notices and financial statements from each individual GP in the portfolio. Instead, the sponsor would receive consolidated quarterly cash distributions and reports from one structure.

However, these benefits do come with challenges. One challenge of a private equity-backed securitisation is managing the sheer number of different parties involved in a transaction: the sponsor, the debt and equity holders, the trustee to whom the underlying private equity assets are pledged in order to provide security to the creditors, the rating agencies and a

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placement agent/investment bank placing the notes. In addition, there is a structuring agent whose task is to maximise the return for equity investors while providing sufficient protection to the debt investors. Managing this balancing act requires sophisticated risk modelling tools, extensive skills and significant experience.

During the last few years, securitisations with underlying private equity assets have been scarce. Nevertheless, with the recent boom in CLO markets, private equity-backed securitisations may be set for a revival in the near future.

THE IMPORTANCE OF MODELLING

Creating effective structured private equity solutions begins with modelling cash flows for the underlying portfolio. Cash flow forecasts are particularly critical since the size and timing of distributions and drawdowns are largely unknown. A bottom-up forecasting approach may provide fairly reliable short-term predictions, but a structured product can span from six years to a decade and therefore requires accurate longer-term cash flow forecasts. A sophisticated longer-term cash flow forecast should capture not only the most likely case, but also the extreme cases. This is typically done by creating thousands of cash flow scenarios that take different market circumstances,

different fund performances, and a variety of other parameters into account.

Next, the payment waterfall must be established. Waterfalls are engineered to satisfy the preferences and constraints of all parties. Ideally, a waterfall is conservative (to ensure the chance of non-payment or default is slim) and aggressive (to optimise the return for equity investors). Further, it is vital that the waterfall also functions flawlessly in scenarios with extreme yet still realistic cash flow patterns. The credit rating of the different debt tranches depends on the behaviour of the waterfall under extreme cash flow scenarios. The actual rating reflects the default probability of the tranche.

To summarise: structured private equity solutions offer attractive alternatives for investors who seek immediate liquidity, regulatory relief, enhanced returns or alternative ways to administer their portfolios. Nevertheless, structured solutions are not standardised products; nor are the models and tools that underpin customised structured solutions. Therefore, working with an experienced party who possesses the appropriate modelling tools, understands a client's specific needs and constraints, and has the expertise to effectively construct a solution to fit specific criteria is instrumental in the successful creation and subsequent execution of a structured private equity solution. ■

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