Pine Street I LLC: a case study in securitisation

*Filip Henzler, Principal, Capital Dynamics**

Summary

Pine Street is a $1.0 billion securitisation collateralised by a diversified portfolio of limited partnership interests in 64 different private equity funds. Nine subsidiaries of American International Group, Inc. ("AIG") sold parts of their private equity fund portfolios in exchange for cash and a majority of the subordinated securities issued by Pine Street. The transaction closed on December 31, 2002. AIG Global Investment Group, Inc. ("AIG-GIG"), a subsidiary of AIG, and Capital Dynamics acted as advisors to the sellers and as structuring agents.

The transaction is structured as a two-tier securitisation, with one special purpose vehicle acting as the intermediate purchaser of the assets and another special purpose vehicle acting as the issuer. Six classes of notes (Class A through Class F) with various levels of seniority were issued; Class A being the most senior. The $250 million tranche of the Class A Notes were sold to third parties, effectively providing AIG with 40 per cent leverage on fair market value on a non-recourse basis.

To improve the cash efficiency of the structure, both the Class B Notes and Class C Notes are structured as variable funding notes. These notes are not fully funded at closing, but rather, the principal can be drawn by Pine Street when additional cash is needed to service capital calls or to pay Class A interest. To further alleviate the potential mismatch of cash flows between Pine Street's assets (the private equity fund interests) and its liabilities (fixed income notes), a $90 million liquidity facility was made available to ensure the timely payment of Class A interest and certain expenses.

The risk segmentation and the seniority of the notes are regulated through a pre-defined priority of payments, which ensures that distributions are only made to subordinated note holders if both over-collateralisation tests and a specially constructed liquidity test have been met.

The portfolio consisted of limited partnership interests in 64 different private equity funds with a total exposure of $1.0 billion ($646 million of fair market value and $354 million of unfunded commitments). The portfolio is well diversified with its value split 61 per cent in buyout funds, 15 per cent in venture capital funds, 12 per cent in real estate funds and 8per cent in generalist vehicles. The commitments were spread over 11 different vintage years and had an average age of 5.5 years when weighted by asset value. The portfolio contained 910 underlying portfolio companies of which over $90 million were investments held in listed companies.

Chart 1: Capital Structure

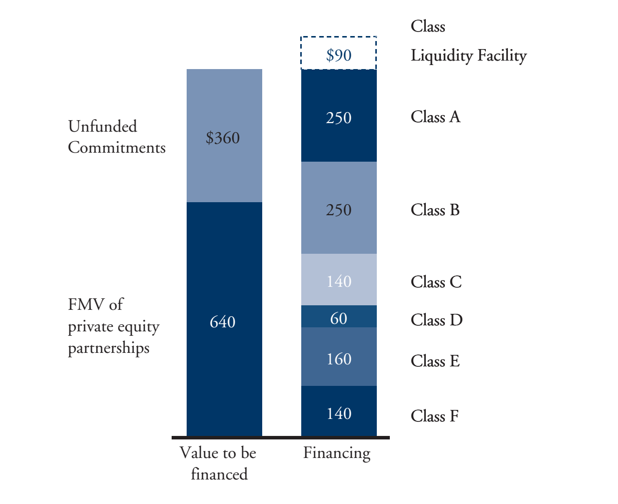
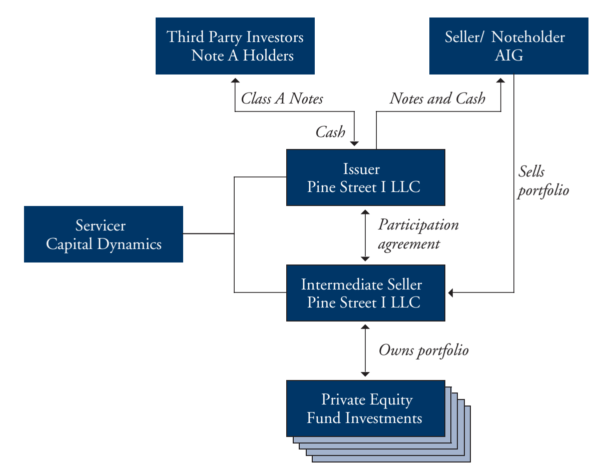


Chart 2: Transaction Overview



Transaction rationale

In mid September 2002 AIGGIC first contacted Capital Dynamics to explore the possibilities and benefits of securitising part of AIG's private equity fund portfolio. AIG, a large private equity investor with over 50 years experience in investing in private equity, has a portfolio of approximately $5 billion in commitments to roughly 400 third party funds. Capital Dynamics is a private equity investment banking and asset management firm that has specialised in creating and servicing innovative solutions for private equity investors.

AIG's objective was to more efficiently capitalise its private equity investments. Up to the present, AIG, like most other private equity investors, financed its private equity investments with relatively expensive equity. The securitisation route gave AIG the option to re-capitalise a portion of its portfolio through non-recourse low cost AAA rated notes, thereby significantly reducing the cost of financing of their private equity investment program.

In addition, the securitisation enabled AIG to partly monetise its private equity investments, thereby generating additional capital for investments in new private equity opportunities, while at the same time retaining the up-side potential of its existing portfolio.

Furthermore, by segmenting the risk of its private equity investments into various notes with credit ratings assigned by Moody's and Standard & Poor's, AIG improved the risk transparency of its assets, which is beneficial when determining risk-based regulatory capital charges.

It is important to note that AIG did not seek to exit its private equity investments and thus did not consider a secondary.

Execution

Pine Street was a highly complex transaction. Intimate knowledge of both private equity and structured finance was required to complete the transaction. Traditionally law firms, investment banks, tax and accounting firms have separate departments for these two very different finance disciplines. Since the two disciplines have little experience working together, it was critical to educate the structured finance and private equity professionals regarding the respective markets, transaction mechanics and terminology, and constantly making sure that the various team members did not misunderstand each other.

The transaction, from inception to closing, was completed within three and a half months. Theoretically it is possible to divide the transaction process into three key phases: (i) the exploration phase; (ii) the structuring phase; and (iii) the implementation phase. In reality however, it is difficult to clearly distinguish the phases, since the different parts of the project were interdependent and the circular nature of most issues impacted the process.

The exploration phase started with obtaining a deep understanding of the sponsor's objectives. Once these objectives were understood, Capital Dynamics worked out the baseline structure and Clifford Chance, the deal counsel, evaluated the viability of the structure from a legal standpoint. Besides generating a baseline solution, the most important step during the exploration phase of Pine Street was to build the portfolio. Since AIG did not want to securitise its entire private equity programme, Capital Dynamics worked closely with AIGGIG to select funds from AIG's balance sheet. A primary consideration was to form a well-diversified portfolio that balanced the necessary criteria of the rating agencies and the third-party investors with the stated objectives of the sponsor. At the end of the exploration phase, a detailed term sheet, time schedule, and budget was provided to facilitate a decision by AIG, as the sponsor, on whether to proceed with the transaction.

In the structuring phase, the final structure acceptable to all parties was defined and the intensive process of working out the details of the transaction and drafting them into the requisite legal and transaction documents began. It was during this phase that the rating agencies were formally engaged. Nevertheless it might be worth noting that the rating process actually began almost three years earlier when Capital Dynamics first started developing methodologies for rating the private equity asset class with S&P and Moody's for different but similar transactions. One of the major breakthroughs of the Pine Street transaction was achieving the first ever Aaa/AAA ratings from Moody's and S&P on notes that are collateralised solely with private equity.

To provide additional comfort on the quality and the value of the securitised portfolio to third-party investors and the rating agencies, the underlying portfolio company investments were valued by independent valuation agents according to a closely defined valuation methodology. Capital Dynamics consolidated the results from the valuation agents and made all necessary adjustments for carried interest and payments to and from the respective partnerships post valuation date.

Once the draft note indenture had been agreed upon, the implementation phase started. A labour-intensive part of the transaction was to comfort 44 different managers/GPs (represented by 14 different law firms) that the securitisation would not adversely impact the GP or the partnership, and to receive the necessary consents to transfer the respective LP interest to Pine Street. While the process was time consuming, none of the previously identified partnerships had to be excluded from the securitisation because of transfer issues.

Since prior to the Pine Street transaction there was no clear proof as to the marketability of private equity backed notes, an important task of the implementation phase was to select a suitable investment bank to place the Class A Notes with traditional fixed income investors and negotiate fair terms for the issuer and sponsor. Morgan Stanley placed all $250 million of Class A Notes with independent third parties at a spread of LIBOR plus 1.25 per cent.

Conclusion

A securitisation is a flexible financing technique that is frequently used in other asset classes. A transaction can be structured to address a variety of different requirements and objectives. This case study provides an example of the objectives achieved by one specific sponsor. A securitisation can also enable a sponsor to realise additional advantages such as (a) a restructuring of a private equity portfolio to adjust the cash flows, the risk/return profile, and regulatory treatment to meet the individual demands of a sponsor, or (b) to structure a secondary sale in the form of a securitisation to better accommodate the specific requirements of both the seller and buyer.

One of the most crucial points when pursuing a securitisation is to clearly understand the true objectives and constraints of the sponsor. This is something that is often assumed as a given, but often proves to be extremely difficult. In the Pine Street transaction, the structuring advisor had the important role of guiding the sponsor by clearly communicating the options and their respective impact on future performance, cash flows and risk. The various departments affected by a securitisation have to free themselves from any prejudices they might have on what is possible and actually focus on which issues need to be resolved.

** Capital Dynamics is a private equity firm with over $1.7 billion of assets under management with offices in Zug, Switzerland and New York. Capital Dynamics provides asset management and investment banking services for investors in private equity including strategic advise, portfolio risk management, asset allocation, restructuring and evaluation of liquidity options, including securitization and secondary sales.*