

Liquidity alternatives: securitisation

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The advent of securitisation of private equity has opened a number of new options for investors in the asset class. Although the technique is broadly used for other asset classes such as home mortgages, loans, and credit cards, it is still in its early stages of adaptation to private equity. A handful of transactions have been completed to date, which demonstrate all the necessary basic ingredients for broader application of the technique to private equity.

The principal underpinning securitisation is a differentiated measurement of risk-return of an asset, allowing a much broader range of financing sources to be employed in addition to the traditional illiquid equity that has been the backbone for the private equity industry up to now.

Mortgaging private equity

One of the many applications of the technique provides for novel ways to address the liquidity needs of investors in private equity. This article will address other applications later, but for now let us consider how to achieve partial liquidity from an existing portfolio through the use of securitisation: mortgaging the private equity asset.

Selling outright does not have to be the only option for a private equity investor to achieve liquidity. Using securitisation for an existing private equity portfolio is in many ways akin to taking out a home mortgage. If you own your house, but require some cash, you would not wish to sell your dwelling. Instead you would mortgage the property. Americans call this “home equity,” and cash thus generated is used to finance cars, education, vacations or whatever other needs there may be. “Home equity”

provides the freedom to release the value that is locked up in your house without having to move out.

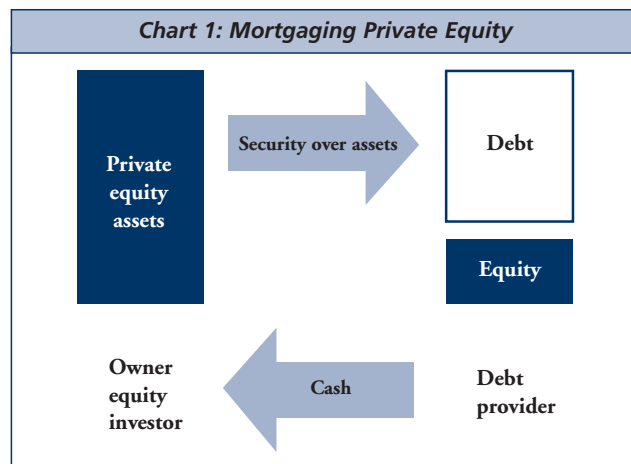
Securitisation can be used in much the same way to liberate cash from an existing private equity portfolio. The portfolio is pledged against a loan and the owner can both deploy the cash from the loan for other endeavours as well as continue to enjoy the benefits of the portfolio, namely the return potential (see Chart 1).

Mortgaging the private equity assets presents the investor with several new options to optimise the value of the holdings. It is also possible to structure a secondary sale as a securitisation to improve the terms for both the seller and the buyer. Some simple examples will help to illustrate these points:

- **Recapitalise the holdings.** Receive low cost funding while retaining the up-side potential of the assets (see Pine Street case study later in the book).
- **Stagger the sale.** Sell tranches of the holdings step by step, timing the sale to optimise price.
- **Increase price.** Use securitisation to optimise the cost of capital for the secondary buyer. Access to inexpensive leverage via rated debt can significantly increase the profit potential of the purchase.

Advantages of non-recourse lending

The securitisation of a private equity portfolio is based on the concept that not all the financing needs to be in the form of equity. There is a layer of lower risk in any portfolio that can be distilled out and refinanced at much more attractive rates. Today



it is possible to structure a layer of debt that can be rated as high as AAA/Aaa by major rating agencies.

Whilst lending against private equity assets is not new, the ability to receive a loan on a non-recourse basis is revolutionary for the asset class. Even if the asset value drops and proceeds from the portfolio are no longer sufficient to service the interest and pay down the loan, the borrower will not be asked to make up the difference.

With non-recourse lending the private equity assets become the sole source of recourse to the lender. The credit quality of the borrower is no longer relevant and the borrower can freely use the cash generated by the securitisation without regard to repayment obligations. Non-recourse lending should significantly expand the use of leverage against private equity portfolios since loans were traditionally only available to high quality counterparties.

It should be noted that the mere fact that securitisation transactions have been completed now gives rise to non-recourse lending without an actual securitisation. The techniques used to secure the loan are actually very similar to a securitisation, the only difference being a smaller group of participants (generally only one lender) and usually no need for explicit ratings.

Basic ingredients of a securitisation

For any securitisation to work one must start with a well-diversified portfolio. The current state of the art is based on the properties and predictability of the asset class, and less on the specifics of a particular asset pool (although the specifics should not be ignored). Since the inherent risk of any single private equity investment is high and the future liquidation value unpredictable, it is necessary to have a large number of investments in the portfolio. Generally, a portfolio with 20 or more private equity funds would exhibit sufficient diversification and the cash flows of such a portfolio are capable of being modelled with statistically significant confidence. Further, the

portfolio should exhibit diversification across industries, investment stages (buyout, venture capital, mezzanine) and vintages.

Next, a proper legal and financial structure is required to distil out the various risk levels. The cash flows from the assets need to be directed to various buckets, giving priority to the debt payments (principal and interest) according to seniority. The debt investor requires certainty that the priorities of the payment waterfall will hold up under any scrutiny – both financial and legal.

And finally, the securities thus generated must find buyers. After all, in most instances the purpose of a transaction is to sell risk. There is little sense in developing highly engineered structures that cannot find investors. Over-engineered structures have caused much early disappointment with the technique. For now, structuring the debt as cleanly as possible enhances the marketability of the paper.

Charts 2 and 3 provide an overview of the process and necessary parties in a securitisation transaction. The actual process involves much interaction between the players and the activities often run parallel until closing. One party may take multiple roles in a particular deal, depending on the composition of the team and the requirements of the situation.

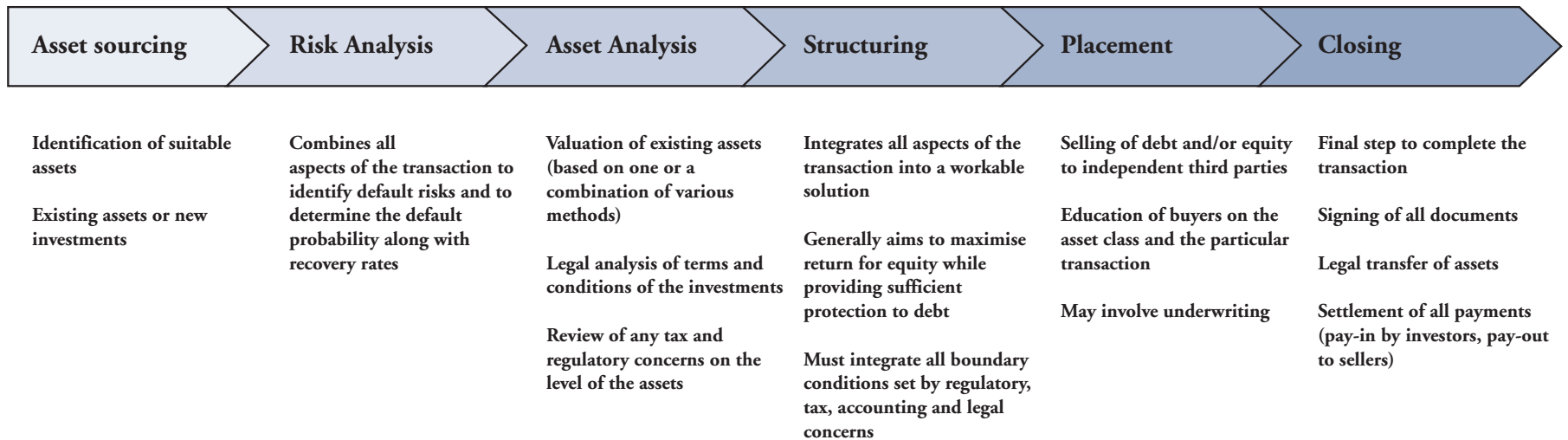
Benefits beyond leverage

Besides the financial attraction of the technique, there are legal, tax, accounting and regulatory issues with a private equity securitisation that may present both challenges and benefits.

Regulatory

Private equity assets tend to be comparatively small portions of the portfolios of most investors, particularly institutional investors. The prime focus of regulation tends to be on banks, insurance companies and pension funds. Because of the relatively small size of private equity allocations, the regulators tend to focus fairly little attention on the asset class, which generally

Chart 2: Process to complete a private equity securitisation



results in rules and regulations that inaccurately reflect the actual risks involved. Regulation tends towards the conservative, thus penalising the asset class unduly. Securitisation can be employed to reformat private equity assets to fit the mould expected by the regulator.

One prime example is the U.S. insurance industry. The NAIC (National Association of Insurance Commissioners), effectively the regulatory body for the industry, currently does not distinguish between a direct equity investment into a single, privately held company and a large, well-diversified portfolio of limited partnership interests. Thus securitisation may be employed to change the private equity assets into a series of bonds and equities, thus better reflecting the actual risks of the portfolio. Far from trying to circumvent the regulator, the technique is based on the good and prudent rules of the regulator.

Tax

In most jurisdictions, bonds and equities are taxed differently. Securitisation can be used to change the investment into a more tax favourable format. The specifics are highly dependent on the type of the investor, the jurisdiction the investor is subject to, and the jurisdiction of the underlying assets. In certain European countries, for example, the equity in a securitisation would usually be taxed under capital gains rules (if held for a sufficient length of time), while more straightforward limited partnership structures (e.g. funds of funds) would be taxed under income tax rules. As the former may have a tax rate of 0 per cent, while the latter a rate as high as 40-50 per cent, the advantages are compelling. Although tax structuring is an ancient art, adding securitisation techniques creates a business purpose that anticipates the need to demonstrate that tax advantages of the structure are ancillary rather than primary since the nature of the investment has been transformed through the use of leverage that is inherent in a securitisation.

Chart 3: Participants and their principal roles

Sponsor	Previous owner of assets or future majority owner of equity (depending on transaction)
Arranger	Overall project coordination, assures proper interaction amongst the players
Structuring Agent	“Designer” of the transaction, creates suitable solution within the given boundary conditions
Deal Counsel/Transaction Counsel	Lead lawyer, acts on behalf of the transaction (as opposed to the Sponsor or any other party)
Legal Advisors	Several firms as each party tends to have their own legal advisor
Rating Agencies	One or more rating agencies may rate the notes or debt issued
Valuation Agent	Values existing assets transferred into the SPV (Special Purpose Vehicle). Valuation may be required by investors, auditors, rating agencies.
Placement Agent	Sells the securities to independent third parties. Usually not required in private deals.
GPs	General Partners of the private equity fund stakes in the transaction
Accounting Advisor	Necessary in more complex regulatory situations, works together with Deal Counsel and Structuring Agent
Transaction Auditor	Audits the SPV going forward. May be used prior to closing to verify the asset pool.
Sponsor’s Auditor	May have critical input or set conditions for deal, especially if Sponsor is a regulated entity
Regulator/s	Any government or similar entity whose charter may involve scrutiny of the transaction (banking, insurance, pension, money laundering, accounting, securities oversight, etc.). Are not usually actively involved in the completion of a transaction.
Servicer/Manager	Manages the transaction post closing until maturity
Debt Investor / Senior Note Holder	One or more investors into the various debt securities issued
Equity Investor / Junior Note Holder	Investors in the junior tranches of the deal. Economic equity, absorbs first losses and benefits of the surplus.
Nominal Equity	Usually nominal amount to capitalise the SPV at founding. Not to be confused with Junior Capital (the actual risk taker). Will participate only very limited in upside.

Legal

Solid legal structuring may actually result in more secure holdings for the investor. Securitisation enforces the sound discipline of the debt markets on private equity. In particular, fund of funds structures (limited partnership, investment companies) are not usually structured to provide protection for the investors under adverse conditions. Securitisations enforce simple but powerful holds over the assets that give investors better liquidation rights. To achieve AAA/Aaa ratings, the legal risks obviously need to be small. These protections can be implemented without endangering the work of the professionals managing the underlying assets (GPs) or the other limited partners in a particular fund.

Retain relationships

The desire for a sale of private equity assets may be driven by changes in internal strategy regarding private equity or an internal reallocation of capital. A securitisation allows the investor to change the exposure of the particular asset while at the same time retaining the relationship with the general partners.

Examples of securitisations

The following examples illustrate the use of the securitisation technique in various situations. Other situations could lead to advantageous application of the technique as appropriate and will undoubtedly be explored.

U.S.-based insurance company – leveraged recapitalisation

The Pine Street case study illustrates a real life example of a closed transaction. A major U.S.-based insurance company (AIG) desired to improve the financing of its private equity portfolio, and sponsored the first successfully syndicated securitisation of a private equity portfolio. Pine Street distilled six levels of debt out of a \$1 billion portfolio, including a \$250 million layer of AAA/Aaa notes, rated on a standalone basis (there was no need for additional credit enhancement). Only the AAA/Aaa rated notes were sold to the market, with the remaining notes retained by the sponsor. Since the portfolio included \$350 mil-

lion of un-funded commitments, the insurance company was effectively able to raise close to 40 cents on the dollar of NAV at an attractive rate, significantly boosting the return potential of the holdings.

Although the sponsor was AAA/Aaa rated, its ability to raise money on a non-recourse basis achieved substantial enhancement in its asset liability position, which is also reflected by a significant decrease in its capital adequacy requirement.

See the case studies section of the book for further details on the Pine Street transaction.

Private individuals and small institutional investors – exchange fund

Smaller investors do not usually hold private equity in sufficient amounts to achieve the diversification required for an attractive securitisation transaction. However, by pooling the assets from several investors, a well-diversified portfolio may be built and securitised. Although an investor needs to share the risk/return of the individual holding with other assets, it can be shown that the benefits of additional diversification are already substantial, in themselves providing enough motivation to participate in an exchange fund. If in addition inexpensive funds can be raised via a securitisation, all the better. It is entirely possible to provide partial liquidity to the investor or completely remove the need for future capital calls (or a combination thereof) through such a transaction.

Secondary buyer

There is an obvious tension between sellers and buyers of secondary interests. The buyer is looking for high returns, while the assets in question may simply not have sufficient earnings power to achieve those returns. The classic way around the problem is to buy at discount.

The seller on the other hand tends to dislike discounts. With sufficient liquidity and an otherwise sound balance sheet, the potential seller may be better off holding on to the assets.

Being able to finance a substantial portion of the purchase price with cheaper capital can substantially lower the weighted average cost of capital (WACC), boost the return potential of the investment and close the gap between the seller's price expectations and the buyer's return requirements.

Seller financing is a particular form of extending loans for the purchase of a portfolio and has been successfully employed in secondary transactions before to achieve the above benefits. Securitisation adds the flexibility to realise the same benefits independent of the seller via the capital markets, or in the case where the seller still provides some or all of the financing, generally results in more attractive capital treatment of the loans.

General Partner/private equity fund

Some of the older and larger private equity firms manage several funds comprising dozens of companies, sometimes over a variety of geographies, investment stages and vehicles. The principle of securitisation can be employed by those funds to access capital markets directly and to provide a new and potentially very large source of funds.

The challenges for such single manager transactions revolve around the need for sufficient diversification in order to achieve acceptable ratings and thus lower the cost of capital. It can also be expected that this form of financing will initially only be available to well recognised brand name private equity managers.

A potentially very large market

Fundamentally all private equity assets can be securitised. Thus the potential market for the technique is theoretically the same as the entire private equity market – currently estimated at more than half a trillion USD of worldwide assets and open commitments. Properly structured, somewhere around 50 to 60 per cent of this amount could be financed with investment grade rated debt – a very large potential market indeed.

For comparative purposes, consider the U.S. mortgage market. It took 30 years for the mortgage-backed securities (“MBS”)

market to mature. In many ways, private equity assets are similar to real estate mortgages in as much as both assets are highly specific. Intimate knowledge of the property, location, and owner is required to ascertain the quality of the mortgage. Similarly, no private equity holding is like any other. Only the direct manager (usually the GP of the limited partnership) really understands the “property” and its value.

This specificity of the property makes the underlying assets illiquid. But large portfolios of these assets become more tradable as the portfolios are no longer driven by specific assets, but by the properties of the asset class. Although the properties of private equity (risk, return, correlation, volatility, etc.) are not yet widely understood by the capital markets, access to products based on the asset class and development of the private equity market in general should alleviate that deficiency over time.

Secondary liquidity

Securitisation is not only an alternative to a sale, but a fundamental improvement in liquidity for the same assets after closing the transaction. The notes or bonds generated by a securitisation would normally be created in a standardised format that allows exchange listing. Thus future trading of private equity risks and exposure will be greatly simplified compared to the traditional secondary model in private equity.

However, one should not expect the sort of liquidity that public stocks exhibit. The private equity investor tends to take a long-term view, but appreciates options when the need arises to rebalance the portfolio.

As a matter of fact, this feature of securitisations may significantly impact the traditional secondary market and may change the way investors access the asset class. The current illiquid nature of private equity would cease to be an impediment for investors as exposure can be traded on exchanges.

Challenges

Despite the many appealing features of securitised products, there are recurring issues that need to be addressed carefully. These revolve around issues relating to disclosure, the concerns of GPs, back-up liquidity facilities, risk management and administration.

Disclosure

There is an inherent conflict in securitisations when it comes to disclosure of the underlying assets. On one hand, the investors in the notes would like to receive as much information as possible to monitor and assess creditworthiness. On the other hand, there is the well-documented reluctance by the private equity industry to make information public. Because of the anonymous nature of the notes (typically in bearer form), any information provided to the noteholders may just as well be published on the Internet.

We have found it useful to strive for a balanced approach, where full information is available under tight confidentiality agreements to trusted participants in the transaction, usually the servicer and to a lesser degree the trustee. Noteholders do have basic information about the nature of the assets and portfolio performance. However, the information provided is not sufficient to draw conclusions about the individual funds or companies in the portfolio.

GP concerns

Besides the disclosure issue discussed above, GPs tend to be concerned about legal, tax and regulatory questions. In particular, U.S.-based partnerships need to be continually concerned about questions such as ERISA, publicly traded partnerships (PTP), and control over the investor universe (insuring QIB and/or QP status). Failure to comply with these rules and regulations can result in substantial financial penalties for the GP and other limited partners.

In general, all these concerns about securitisations are shared with traditional funds of funds. There exists today over

20 years worth of experience in dealing with these issues. As a matter of fact, after several transactions involving hundreds of partnership interests, we have yet to encounter an issue that could not be resolved between reasonable professionals.

Liquidity facilities and funding lines

The nature of private equity investments precludes structures that rely on steady cash flows, a fundamental feature of traditional securitisations. Distributions from private equity portfolios are chunky and the timing unpredictable. Although statistical methods can be employed to determine a minimum expected cash flow over a set period, the operative term is “expected” – very different from “guaranteed.” In order to assure timely payment of interest and the running cost of the product, as well as certainty that drawdowns from open commitments can be met, the addition of liquidity lines is often required. Given that the facilities are backing up investment grade debt, these lines or funding guarantees need to be provided by counterparties with strong credit standing.

This issue has derailed some transactions and pushed back the completion of some successful deals. We would expect that the market for these lines will develop with an increased understanding of the risk involved.

Hedging

Both forex and interest rate hedging may need to be added to a securitisation to lower the default risk of the debt issued.

Most private equity portfolios will include investments in currencies other than the issuing currency of the bonds or notes of the securitisation. The uncertainty in the timing of the cash flows from those investments makes a perfect hedge impossible. As a matter of fact, hedging can increase the default risk of a structure if an expected cash flow fails to materialise and the hedge is under water at the same time. However, a partial hedge is prudent and the level of hedging may be a significant element in the optimisation of a well-structured transaction.

Interest rate exposure is generated by the newly issued debt instruments. Unhedged floating rate debt may expose the structure to stress if interest rates increase, while fixed rate debt may become expensive in a deflationary scenario. In general, swaps should be avoided, while options and caps offer safer avenues to limit risks.

Careful analysis of current and future exposure and the development of a prudent hedge strategy are essential for the long-term success of a transaction.

Advantages and challenges compared with straight secondary sales

Although a securitisation may seem more complex than a straight sale, its advantages can outweigh the initial transactional complexities. As illustrated above, the technique provides:

- Potentially better sale price
- More flexibility on timing
- Allows partial sale of risk (e.g., only lower risk or levered exposure)
- Various side benefits for retained stakes, most importantly more advantageous regulatory treatment
- Continued relationship with general partners

On the other hand, the needs of many sellers may very well be served with a straight secondary sale. As a matter of fact, securitisations and secondary sales do not compete very often. Usually the sellers timing requirements, liquidity need, price sensitivity and long-term belief in the assets tends to steer a particular issue naturally down one path or the other.

Owners of assets who have access to sufficient long-term liquidity, who like to retain the exposure or who are highly price sensitive, tend to seriously consider securitisations. Sellers who wish to exit completely or who are highly time-sensitive (i.e., willing to trade price for time) will tend to prefer secondary solutions.

Securitisations certainly are more complex than straight or even structured sales. This complexity increases the transaction risk and can lengthen the time it takes to close a deal. On the other hand, experienced advisors can help mitigate those risks. The Pine Street transaction was completed in 14 weeks, comparing favourably with any large secondary sale.

Conclusion

Securitisation of private equity is only in its infancy. The above discussion is meant to illustrate some basic issues, directions of future development and the future potential of the technique. Given securitisation's state of development, executing a securitisation is still complex and requires in-depth understanding of the private equity industry as well as of structured finance and the capital markets. Securitisation of private equity is not expected to be commoditised for a while yet; nevertheless, the interest shown by many of the more sophisticated investors indicates that the novelty of the technology applied to private equity may soon wear off. Indeed one thing is readily apparent: the technique will develop and is here to stay. The fundamental advantages are just too compelling.

** 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 advice, portfolio risk management, asset allocation, restructuring and evaluation of liquidity options, including securitization and secondary sales.*