



Alternative
Insight

PRIVATE MARKET FUNDRAISING

World-class techniques for raising private equity, debt,
real estate and infrastructure funds

Edited by
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Contents

Figures and tables	ix
About the editor	xi
Foreword	xiii
By Jay Fewel, Investment Division of the State of Oregon	
Introduction from the editor	1
Section I: Getting ready	5
1 Roundtable: Is this the new normal for raising private market funds?	7
Moderator: Kevin K. Albert, Pantheon	
Andrea Auerbach, managing director – head of private investment research, Cambridge Associates	
Barry M. Miller, head of private equity, New York City Retirement System	
David I. Landau, vice president – alternative investments, YMCA Retirement Fund	
John C. Robertshaw, managing director and co-head, Credit Suisse Private Fund Group	
Introduction	7
Current fundraising environment	9
Portfolio construction	14
Evolving fundraising formats	19
Defined contribution plans	23
2 Evolution, not revolution	25
By Bob Brown and Andy Lund, Advent International	
Introduction	25
Brief history of private equity's evolution	26
How this evolution is playing out in the current private equity environment	29
Deciding what to do	30
Conclusion	31

3	Getting your house in order	35
	By Mounir Guen, MVision Private Equity Advisers	
	Introduction	35
	Preliminary stage: 12 months before launch of fundraise	35
	Six months prior to fundraise	38
	Three months prior to fundraise	39
	Summary to the close	42
	Conclusion	43
4	Using a placement agent	45
	By Erick Bronner and Christine Croissant, The Riverside Company	
	Introduction	45
	Services provided and assignments	45
	Key benefits	48
	Fees and expenses	48
	Considerations in choosing an agent	49
	Maximising the relationship	51
	Terminating the relationship	52
	Conclusion	52
	Appendix: Questions to ask a prospective placement agent	54
	Section II: Active fundraising	57
5	The marketing process	59
	By Christophe de Carmoy, Meridiam Infrastructure	
	Introduction	59
	Managing the marketing process	59
	Positioning a fund in the marketplace	60
	Initiating the marketing process	62
	Managing the roadshow	64
	Commercial due diligence: the turning point of the fundraising process	65
	Negotiating terms and conditions	66
	Conclusion	67
6	The legal process	69
	By Howard J. Beber and John K. Kelley, Proskauer Rose LLP	
	Choosing the right law firm	69
	Role of the law firm	70

7	Working with investment advisors and consultants	77
	By David Fann and Tom Bernhardt, TorreyCove Capital Partners	
	Introduction	77
	What is a gatekeeper?	77
	How to approach a gatekeeper	79
	What is of interest to gatekeepers?	81
	How gatekeepers assess GPs	84
	Conclusion	86
	Section III: In between fund marketing periods	87
8	Best practices in existing client services	89
	By Tanya Carmichael, Ontario Teachers' Pension Plan Board and Jennifer Morais, Canada Pension Plan Investment Board, on behalf of the Institutional Limited Partners Association	
	Foreword	89
	Introduction	90
	ILPA perspective	91
	Evolution of investor relations	92
	Elements of good investor relations	94
	Towards standardisation	99
	Conclusion	100
9	Pre-marketing: Paving the way to new investor commitments	101
	By Susannah Carrier, Silver Lake	
	Introduction	101
	Mapping a target universe of LP prospects	102
	Designing the specifics of the approach	103
	Determining interest of a prospective LP	105
	Content for the first and subsequent meetings	107
	Who from the GP should pursue new LPs?	108
	Incorporating new LPs into the fundraising projection model	108
	Ongoing communication guidance	109
	Concluding pre-marketing	109

10 Inspired use of annual meetings, secondary and co-investment opportunities	111
By Jessica Hoffman Brennan, The Carlyle Group	
Introduction	111
Annual meetings: Maximising the impact with investors	111
Co-investment and secondary opportunities: Building goodwill and more	115
Conclusion	118
Section IV: Other selected topics	119
11 Raising first-time funds	121
By Sonny Kalsi and Julie Wong, GreenOak Real Estate	
Introduction	121
Contemplating a first-time fund	121
Preparing for the first fundraising	122
Where to find capital	125
Improving the odds	125
Conclusion	127
12 Fundraising for Asian GPs	129
By Wen Tan, FLAG Squadron Asia	
Introduction	129
Focus on truly differentiating a fund offering	129
Size a fund offering appropriately	130
Ensure that the strategy, team and track record are closely intertwined	131
Avoid geographical overstretch	133
Highlight key lessons from track record errors	134
For captive funds, identify and address issues around alignment and conflicts of interests	136
Ensure appropriate alignment of parallel USD/RMB China funds	137
Be cognisant of cultural/behavioural biases	138
Conclusion	139
13 Fundraising in Latin America	141
By Ricardo Morales Lazo, HMC Capital Management Group	
Introduction	141
Latin American investor profile	143
Technical issues in raising capital in Chile	145
The market for alternative investments in Brazil	148

Contents

Other alternative investments	151
Latin America trade associations	152
Conclusion	152
14 Common legal issues in raising capital from non-traditional sources	153
By Laura S. Friedrich, Shearman & Sterling LLP	
Introduction	153
Global regulatory change	153
Sovereign wealth funds	155
Development finance institutions	159
Non-US pension funds	161
Private wealth management vehicles	162
Currency considerations	163
Conclusion	164
15 Can you raise money by doing good? Principles of responsible investment and diversity practices	167
By Dushy Sivanithy and Yokasta Segura-Baez, Pantheon	
Introduction	167
Responsible investing in private equity	168
How GPs can implement RI	169
Questionnaires	172
What is diversity and inclusion?	173
Why should GPs care about diversity?	173
The emerging manager fundraising opportunity	174
Conclusion	177
Section V: Case studies	179
16 Deal-by-deal financing model	181
By Buchan Scott, Duke Street	
Background	181
The Lehman Brothers shock	181
Where did this leave Duke Street?	182
The first deal	182
Our fund investors	183
Impact on the team	184
Deal structure	184
Lessons learned	185
Going forward	185

17 Fund restructuring	187
By Edward Keith, Landmark Partners	
Introduction	187
Fund restructuring overview and rationale	188
Candidates	190
Restructuring process	191
Avoiding pitfalls and maximising success	192
Conclusion	194
18 Partial fund restructuring	195
By Francesco di Valmarana, Pantheon	
The perfect storm	195
Options	196
Decision time	197
Putting the pieces together	198
Lessons learned	200
Section VI: Appendix	203
The problem with presentations	205
By Jerry Weissman, Power Presentations	
The five cardinal sins	205
The power presentation	206
Persuasion: Getting from point A to point B	207
Start with the objective in sight	208
Audience advocacy	209
Shift the focus from features to benefits	209
Understand the needs of your audience	210
Getting Ahahs	211
About PEI	213

Figures and tables

Figures

Figure 2.1:	Private equity commitments, 1988-2012	27
Figure 2.2:	Dynamics of a maturing industry	28
Figure 2.3:	Private equity commitments by geography and investor type	32
Figure 3.1:	How to create a tailored fundraising timeline	41
Figure 5.1:	Overview of the marketing process	59
Figure 10.1:	Investors' expectations of their direct investment and secondary market activity in 2013	115
Figure 10.2:	Investors' intentions for GP relationships, 2013-2014	117
Figure 12.1:	Justifications for fund size step-ups along various dimensions	132
Figure 12.2:	Examples of inter-relationships between strategy, track record and team	133
Figure 13.1:	Typical structure of a Chilean feeder fund	147
Figure 15.1:	Growth of Principles of Responsible Investing signatories	168
Figure 17.1:	GP fundraising problems	187
Figure 17.2:	Fund restructuring mechanics	189
Figure 17.3:	Measuring the restructuring opportunity	190

Tables	Table 3.1:	Will investors be able to ‘check the boxes’?	37
	Table 7.1:	The changing role of gatekeepers	78
	Table 7.2:	Gatekeeper questionnaire document request list	84
	Table 7.3:	How gatekeepers make decisions	85
	Table 8.1:	LP characteristics and conflicts	94
	Table 8.2:	Implementing alignment of interest principles	96
	Table 8.3:	Implementing governance principles	98
	Table 12.1:	Examples of turning lessons from past mistakes into positive fundraising tools	135
	Table 13.1:	Latin American pension fund investments in international securities	142
	Table 13.2:	Latin American pension fund investments by type	143
	Table 13.3:	Latin American pension fund investment growth in international securities	144
	Table 13.4:	Chilean pension fund capital available to invest in private equity	148
	Table 15.1:	Example of an Equal Employment Opportunity Commission data request from a plan sponsor to its managers	176
	Table 17.1:	Restructuring benefits	188
	Table 17.2:	Challenges and their mitigating factors in fund restructurings	193

Introduction from the editor

Just when we thought it would be safe to go back into the water, a sinister new force has reared its ugly head!

Back in 2009 when PEI published its last book on private equity fundraising, the prevailing wisdom was that the private equity industry was in the midst of a typical cyclical downturn. In the dog days after the 'golden era' of private equity, general partner fundraising efforts were further stymied by more rigorous due diligence from investors, who were shell-shocked by the global financial crisis. These conditions will pass in time, we thought – equity markets will recover, memories will dim and things will eventually return to 'normal'. This, in turn, would re-establish the virtuous circle of private fund investment realisations and liquidity would return to our market so new funds could be raised. In short, the good old days would return just as they always had before.

Therefore, the industry's perception was that all that needed to be done was to buy a little time, focus on existing portfolio holdings in order to generate a few more exits and improve the investor relations infrastructure and approach. Accordingly, investment period extensions were sought (and obtained), portfolios were stabilised and eventually refinancings, dividend re-caps and even full realisations followed suit. At the same time, almost every firm invested additional resources in the ability to be more transparent and investor-friendly, both during the due diligence process and on an ongoing basis. Those firms that did venture out into the market to raise new funds offered more attractive terms as an added inducement.

In the meantime, central banks in the US and around the world were at work creating unprecedented levels of liquidity in the financial markets, driving interest rates down and the stock market up. This had more than a salutary impact on our industry. It made possible the aforementioned refinancing of several large buyouts previously thought to be unavoidably doomed; at the same time, dozens of healthy investee companies were able to refinance their debt on extremely favourable terms, which dramatically improved their investment prospects. In addition, the stock markets' recovery to new record levels reversed the damage the 'denominator effect' had brought about during the crisis. Indeed, by 2012, the virtuous circle of a rising stock market and improved private equity portfolio realisations had substantially increased the amount of capital available for new fund commitments.

Unfortunately, the rest of the script has not played out according to expectations. For the vast majority of the almost 2,000 firms currently out in the market trying to raise funds at press time, fundraising is a lengthy, discouraging and uncertain process that will, in many cases, result in failure.

This edition of PEI's fundraising guide has been completely updated and revised. It explains why the current environment is so difficult for most GPs (Chapters 1 and 2). It includes several case studies that illustrate what a GP can do if it cannot raise a regular committed capital fund, but wish to keep the option open in the future (Chapter 16), or, if it needs to take even more drastic action to save the firm (Chapters 17 and 18). As in the past, the bulk of the guide focuses on what GPs need to do to maximise their chances of success during the fundraising process, from getting ready (Chapters 3 and 4) to managing the fundraising process (Chapters 5, 6 and 7), to what to do in-between fundraising campaigns (Chapters 8, 9 and 10).

To reflect the new private equity world, several new topics have been introduced in this guide. Private equity firms that want to survive should understand how to raise capital in new geographical markets (Chapter 13) and from new sources (Chapter 14). A topic that is of growing importance to investors – responsible investing and diversity – is also addressed (Chapter 15). Finally, one common dominator in many of the chapters on fundraising execution revolves around the need for superior presentation skills to get your story across when you are fortunate enough to secure an investor meeting. Therefore, we include a piece on this topic, by the man I consider to be the best presentation coach in our industry (Appendix).

In my opinion, fundraising success has almost always been predictable. It has always been a function of an attractive investment strategy, a team qualified to execute the strategy, superior investment results and persistence (even in the good old days it was hard and took a long time!). In today's world, however, those are no longer enough. The bar is set higher on the strategy (now a GP must be relatively 'unique and differentiable'), the team needs to be more capable (specifically incorporate more operating capability) and the track record stronger (more realisations, and more consistent and controllable sources of returns). In addition, mere persistence is no longer enough. GPs now need to focus on this aspect of their business with as much time and attention as they do on investing. This task is not intermittent, it is perpetual. There is no longer any margin for error; pre-marketing, planning and superb execution of the fundraising process is critical. Moreover, the former commoditised market of LPs has become a market of individual needs and preferences. To be successful, GPs must respond by studying and understanding their clients (desire to co-invest, focus on responsible investment, attraction to segregated account formats, etc.) and then work with them to satisfy these non-investment needs.

This is the second book that I have edited for PEI. While at times it has been difficult to fit my amateur editing responsibilities into an already very busy day job, I am grateful to have had the opportunity to work on this guide. First of all, our industry is changing so rapidly that it is easy to get lost in the details. Stepping back and looking at the big picture is absolutely important. What better way to do this than by listening to industry colleagues who are the world's greatest fundraising experts? The best part of this project is the opportunity to witness up close the dedication and professionalism of my colleagues. There is a saying (which I just learned is attributed to Lucille Ball): "If you want something done, ask a busy person to do it." The authors of this guide are some of the busiest people around. At the same time they were drafting their chapters, they were closing successful fundraises (Advent, Silver Lake, The Carlyle Group), orchestrating annual meetings and advisory board

Introduction

presentations (all of them) or advising clients on these matters (HMC Capital, MVision, Proskauer Rose, Sherman & Sterling, TorreyCove). The evidence is that much of this work was done during weekends, since I received most of their drafts on Monday mornings. I am in awe of their willingness to sacrifice their personal time, and grateful for their willingness to share their expert knowledge.

Finally, I would like to make a prediction about the future. I have been helping private fund managers raise investment capital since the mid-1980s. Over that period I have seen enormous changes in the composition of the investor base that backs private investment strategies as well as a half-dozen or so financial crises. Based on this experience and my current reading of the 'tea leaves', I believe that in another five years, if not sooner, this guide will need to be rewritten yet again and the revisions will be even more dramatic. I am reasonably certain that we are entering the most interesting era for raising private investment funds that we have seen thus far. This will be brought about by trends that are currently barely detectible, but which will flourish and overwhelm the traditional funding sources. The first of these trends is the creation of platforms which will allow defined contribution plans (US 401(k)s and IRAs and their international equivalents) to participate in private investment strategies. The second is a revolution in the re-packaging of private equity products into more liquid formats (such as open-ended 'evergreen' funds and listed vehicles), which will expand the target investor base even further. These changes will require GPs to further adapt – perhaps a painful process, but it will be well worth it. Just imagine the opportunities (and challenges) if the amount of capital that becomes available to private fund managers doubles or even triples!

Thank you for reading on.

Kevin K. Albert

Pantheon

2

Evolution, not revolution

By Bob Brown and Andy Lund, Advent International

Introduction

All industries experience the same cycle of events: innovation, growth, maturity and then decline. During the innovation phase, a small number of firms with simple organisational structures, often lacking in significant teams or capital, develop a new product or service through experimentation. The growth phase is distinguished by the rapid development of an established product or service and an influx of new customers, leading in turn to increased competition. The maturity phase occurs when product sales reach a steady state and competitors begin to leave the market. At this point in the cycle, the remaining players must compete to gain market share. Failure to do so effectively will result in margin erosion on existing products; protecting or growing margins often entails diversification into adjacent or new products. The decline phase is signalled by a reduction in sales as a result of the product, service or brand falling out of favour with the customer.

The private equity buyout industry has followed a similar trajectory. After achieving a compound annual growth rate of 33 percent since 1988, inclusive of the 2005 to 2007 'golden era', the private equity industry has now entered its mature phase. The catalyst for this transition from growth to maturity was the challenging post-crisis macroeconomic environment. Private equity returns have historically been generated from three key drivers: (i) leverage, (ii) multiple expansion and (iii) operational improvements. Post-crisis, investors are focusing on managers who can demonstrate an ability to drive returns from operational improvement without relying on leverage or market expansion. In essence, the 'product' has had to change, albeit subtly, in response to a changed market.

Amid the change in market conditions, many limited partners have evolved. Certain categories of investor, such as banks, insurance companies, fund of funds and endowments, have had to reduce allocations. Pension funds, which provide the significant majority of private equity funding, have rationalised the relationships they support by making larger allocations to fewer managers. In addition, more and more investors are allocating capital to the asset class via co-investment or direct investment programmes, or by acquiring secondary interests. Although new investors continue to emerge, most notably sovereign wealth funds, the net funding situation is negative (see box article titled 'Changing LP dynamics').

The consequence of this activity is Darwinian in nature. As private equity general partners consider ways to maintain market share, a significant number of private equity firms that raised funds in the good times are no longer in favour with LPs. This comes as a result of lacklustre returns or an investment approach in the 'new normal' that will cause them lose

Brief history of private equity's evolution

share; indeed, some firms will cease to exist. Other firms will be able to continue to raise capital albeit on less favourable terms, essentially a form of margin compression. Some GPs have moved away from a traditional private equity focus and raised funds in new areas such as real estate, debt and infrastructure in an attempt to keep growing overall assets under management. Finally, a minority of GPs have managed to maintain or increase share in the current environment without deviating from strategy or changing terms. These are the managers who are demonstrating to LPs that they have the team and approach to continue to generate outsize returns despite the challenging market conditions.

While the implications are real for industry participants, we must keep in mind that these issues are evolutionary, not revolutionary – some managers will win and others will not. We therefore find ourselves at an inflection point where managers will need to make key strategic decisions in order to survive.

The earliest organised private equity activity can arguably be traced as far back as the 18th century through trading and investment organisations such as the Dutch East India Company. However, the asset class we recognise as private equity today is generally believed to have started life in the second half of the 20th century through a small number of pioneering financiers who developed the leveraged buyout investment model. This approach became synonymous with the initial development of private equity in the late 1970s and early 1980s. The asset class quickly established itself as a generator of high absolute and relative returns that attracted the attention of institutional investors seeking to boost portfolio returns. By the end of the 1990s, private equity was an established asset class in its own right.

During the early 2000s, a combination of cheap, abundant debt and a favourable regulatory environment set the stage for unprecedented levels of private equity investment activity and investor commitments. This period spanning from 2003 to 2007 was the so-called 'golden age' of private equity. During this period, the industry saw major expansion and maturation of the leading private equity firms (see Figure 2.1).

However, the financial crisis that began with the fall of Lehman Brothers in late 2008 ushered in a dramatically different and challenging period for private equity. That environment has remained to this day. The key aspects of the market dynamics facing private equity managers in the current market are outlined below:

- Investors have focused on fewer relationships due to a realisation that they 'over-diversified' during boom times. Many LPs have reduced the number of GP relationships in their portfolios.
- The crisis has provided a clearer insight into manager performance. LPs are much more focused on finding GPs that can deliver 'alpha' versus those that rely on leverage for investment performance.
- The situation has been exacerbated by dramatically reduced levels of capital returned to LPs due to a persistently poor M&A environment. As a result, there has been significantly less capital for commitments to private equity since the crisis began. These reduced levels are not expected to improve for the foreseeable future.

4

Using a placement agent

By Erick Bronner and Christine Croissant, The Riverside Company

Introduction

The decision to use a placement agent to assist in a fundraise is one of the most important determinations a private equity firm can make as it gears up to raise its next fund. Placement agents offer a variety of services, from a full array of deal management and sales functions, to merely serving a specific function such as facilitating investor introductions. The selection of the right agent, or the decision not to select an agent at all, can make the difference between a smooth and successful fundraising process and one that falls short of the fundraising goals.

For many firms, the right answer is to not select an agent at all. For a firm that has an internal investor relations team that can capably deliver the desired results, using an agent may not add meaningful value and the cost of an agent may not be consistent with the value provided. However, the selection of the right agent can result in the raising of incremental capital, a faster and more efficient process, and ultimately meeting or even exceeding the fundraising objectives.

Riverside has brought funds to market in conditions that ranged from fairly easy to the double black diamond of the fundraising world. We pride ourselves on our strong internal fundraising capability and investor relationships developed over the years. As a result, we have for the most part not required a third party to help us raise funds. However, with the advent of the Great Financial Crisis and the continuing residual impact on investor balance sheets and investment appetites, as well as the increasing power of institutional investors to demand more favourable terms, we began to utilise placement agents to capitalise on relationships that were new to Riverside or who had access to investors in regions that were less familiar to us. We have hired a spectrum of advisors, from agents serving only in an advisory capacity, to finders and full-service placement agents.

There are several broad categories of placement agents. These categories are by no means exhaustive and differences in service, sometimes substantial, exist from firm to firm.

Full-service agents offer a full range of services, from deal management to sales. They are often affiliated with an investment bank or other financial institution. A key advantage of using a full-service agent is access to investor capital globally. Full-service agents often have teams of sales professionals 'on the ground' in North America, Europe, Asia and increasingly, in the Middle East and Latin America. These professionals identify prospective investors, set up

Services provided and assignments Full-service placement agent

and attend meetings with the GP, and assume the primary responsibility for following up with investors after initial meetings to arrange subsequent due diligence meetings and ultimately obtain commitments. The sales team should have established investor relationships borne of previous sales of fund products for which they are responsible. The deal manager typically develops the marketing strategy, manages the roadshows and assists in the preparation of marketing materials, including the private placement memorandum (PPM), meeting slide presentations, due diligence materials and data room.

Due to the volume of transactions these professionals work on, full-service agents are often able to provide both strategic and tactical advice throughout the fundraising process. In many cases, they actually lead the effort. Occasionally, certain full-service agents will provide elements of their offerings, for instance deal management, as an independent service. Because they tend to market an average of 8 to 15 funds on their platform at any given time, there can be concern on the part of some GPs that their funds will get 'lost' in the crowd.

Example: Using a full-service firm

Need: In 2012, Riverside was planning to raise several funds simultaneously, putting a tremendous drain on the firm's resources.

Solution: To assist our US-based fundraising team and to broaden our distribution capabilities, Riverside decided for the first time ever to hire a full-service placement agent. By interviewing a number of firms, we developed a sense that we would be best served by a global agent that had local teams in various regions. We also wanted to find an organisation that would genuinely value us as a client. We believed this would translate into the best effort deployed for our fundraising objectives.

We chose an agent that thoughtfully assessed our position and presented us with a detailed analysis of our prospects. The analysis depicted our existing investor base along with the likely universe of investors who would consider investing in our new funds, and a clear road map of how to achieve our fundraising goals in a reasonable amount of time. The agent had solid relationships across a wide swath of institutional investors around the world and a successful track record especially in regions in which we had less experience.

In working with this group, we have indeed felt that we were a special client. We have benefitted from the insights of the sales professionals who are in regular contact with institutional LPs, many of whom we also know well. The agent provided us with valuable back-channel insights and guidance that have resulted in some very big and important wins.

Boutique placement agents

Boutique agents generally have a small team and a defined area of focus, such as a specific geography or function. Often, deal management and sales functions may be handled by the same individuals, the former of which tends to be limited to organising the sales effort

13

Fundraising in Latin America

By Ricardo Morales Lazo, HMC Capital Management Group

Introduction

Over the last three decades, Latin America has become a pioneer in the introduction of compulsory pension systems. These pensions, which are based on individual retirement accounts known as 'individual capitalisation', exist in countries like Chile (1981), which leads the process, Peru (1992), Colombia (1993), Uruguay (1996), Mexico and El Salvador (1997), Costa Rica and Nicaragua (2000), Ecuador (2001) and the Dominican Republic (2003)¹. These pension systems have accumulated a large volume of assets and are growing at a mid-teen annual rate. Demographics support this trend as most of these economies have young populations; for example, the average age of beneficiaries in Chile is only 32 years old. The main rationale for establishing this type of pension scheme is to support a fully funded retirement for beneficiaries. In order to do so, governments have increased compulsory contribution rates and length of contribution, and raised the retirement age. With this approach, Latin American governments are avoiding underfunded defined contribution pension plans and the potential for huge public deficits in the future, as is the situation in other developed markets like the US and Europe.

On the finance front, regulators and participants have been consistently improving the investment framework and approving reforms to encourage savings by introducing a supplemental voluntary scheme. Countries at the forefront of these developments are Chile, Colombia, Mexico and Peru. In general, pension fund administrators in these countries operate under strong regulatory supervision of, and oversight by, entities such as central banks and ministries of public finance.

The biggest market in the region, Brazil, operates with a different pension system which uses a combined government and private strategy (notional systems). The system is more similar to the US in the sense that it is structured around corporate pension funds, of which there are more than 300 separate plans.

In addition to a general improvement in savings, the researchers Vittorio Corbo and Klaus Schmidt-Hebbel have found that the individual capitalisation system has boosted financial markets, improved productivity, enhanced labour markets and positively impacted long-term GDP growth in local economies.

¹ Argentina and Bolivia reformed their pension systems in 1994 and 1998, respectively, but nationalised the systems, reverting to a 'pay-as-you-go' model, in 2009 and 2011.

These pension funds are becoming large in terms of assets under management compared to the GDPs of the economies in which they are based. For example, the AUM/GDP ratio in Chile was 63 percent in December 2012. The entire region has high growth expectations for these tremendous pools of savings (see Table 13.1).

Table 13.1: Latin American pension fund investments in international securities

	Total AUM (\$ bn)	Total assets % of GDP	Max legal offshore limit	International investment capacity (\$ bn)	Alternatives offshore limit	Alternatives investment capacity (\$ bn)
Brazil	300	14%	10%	30	10%	30
Mexico	145	12%	20%	29	0%	0
Chile	170	63%	80%	136	20%	34
Colombia	60	16%	40%	24	5%	3
Peru	38	19%	50%	19	15%	5.7
Total international investments	713			238		72.7

Source: Latin Asset Management, December 2012.

As a result, pensions are influential in local financial markets, both in fixed income and equities (see Table 13.2). Because local capital markets are somewhat restricted due to size and the lack of initiatives to encourage investment in both financial instruments and new companies in order to avoid potential local 'bubbles', Latin American governments have responded by increasing offshore limits for international investment and diversification. This was a gradual process that in most cases began with limits of between 5 percent and 10 percent and was restricted to plain vanilla instruments like global equities and bonds. Over time, as investment teams and regulators gained knowledge, the limits were loosened and investors were allowed to invest higher amounts in more sophisticated products abroad.

As a result of these policy changes, Latin America has developed a sophisticated, fully funded pension system that is continually growing and accumulating resources from a young population. Most countries in the region are now rated investment grade; over the last decade, GDP growth and macroeconomic stability reduced both poverty levels and 'off-the-books' employment, bringing more participants into the fold of the pension scheme.

These developments have resulted in an ideal setting for the introduction of alternative investments in the region. Due to the young population, there is no need for liquidity in the short term, but beneficiaries require above-market returns to maximise the size of their pension. The risk-return characteristics of alternative strategies, particularly private equity, make this asset class a good match from the long-term return perspective.

17

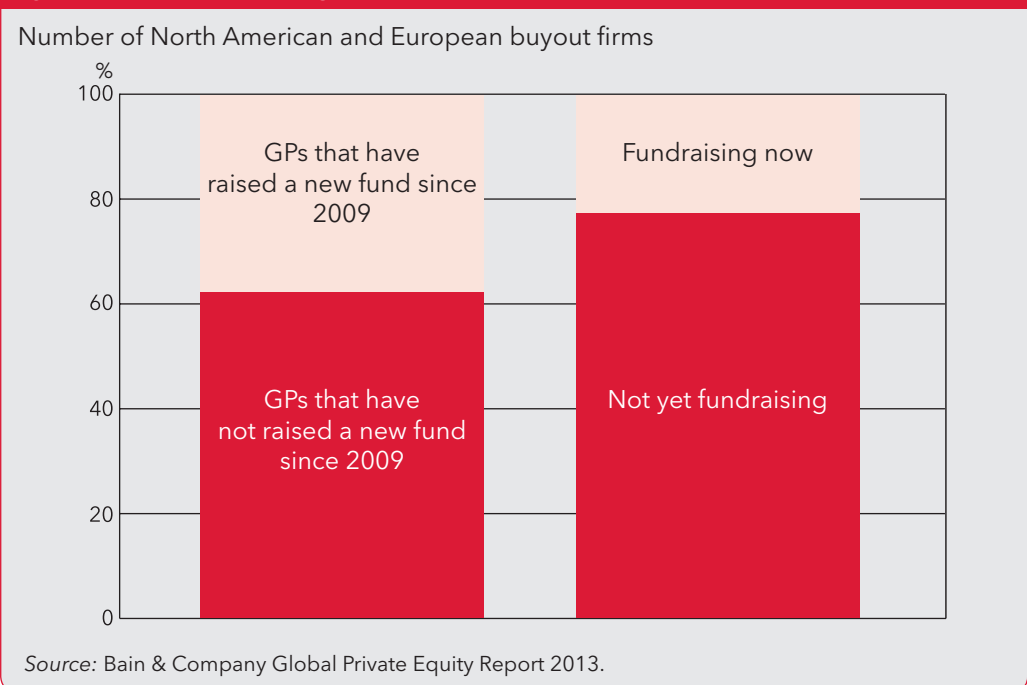
Fund restructuring

By Edward Keith, Landmark Partners

Introduction

The rapid growth and equally rapid contraction in private equity fundraising is placing the traditional fund model under significant pressure. Buoyed by unprecedented levels of limited partner commitments between 2006 and 2008, private equity firms grew rapidly. General partners increased headcount, opened offices in new geographies and increased employee compensation. The 2008 financial crisis and ensuing recession ended that trend. Many GPs that once thrived have experienced failed fundraises or chosen to delay the inevitable by not going to market with a successor fund. Of the more than 700 GPs active before the crisis, almost 50 percent have not attempted to raise a fund in the four years since 2008 (see Figure 17.1).

Figure 17.1: GP fundraising problems



To exacerbate the problem, the prospect of earning any carried interest for GPs' efforts is diminishing, as an unforgiving preferred return accumulates on an asset base that is still recovering from the financial crisis. Many GPs are now forced to choose between continuing to manage existing assets for little to no profit incentive or walking away – leaving LPs to sort out the management of the underlying portfolios. LPs are also under

Fund restructuring overview and rationale

pressure as portfolio company holding periods have increased and zombie managers (that is, managers that are unable to raise new capital and have no incentive to liquidate mature companies while they are still collecting management fees) have become more common.

The secondary industry has developed a way to restructure private equity funds by providing liquidity to departing investors, while re-aligning the incentives of the GP with new long-term investors in the fund. This chapter provides an overview of fund restructuring mechanics, discusses which funds are good candidates for restructuring and advises on how to increase the chances of success for these complex transaction process.

The primary goal of a secondary-led fund restructuring is to resolve alignment issues between a fund's GP and its LPs (see Table 17.1). Although there are many reasons that this alignment can break down (in an end-of-life fund), an internally led restructuring can be very difficult as LPs are usually divided between those who want liquidity immediately and those who are willing to wait for future appreciation. For a GP stuck in the middle, determining what is in the best interest of LPs is no longer a straightforward task because the answer may diverge dramatically among various LPs. In these situations, a restructuring led by a third-party secondary manager can resolve this conflict by providing LPs the option to sell their exposure in the fund or to remain invested on restructured terms designed to maximise value for the assets.

In a fund restructuring, a secondary fund or another unaffiliated capital provider will make a tender offer for the limited partnership interests in a fund. The offer may be at, below or above fund NAV. Existing LPs have the option to take cash for their position or to 'roll'

Table 17.1: Restructuring benefits

Party	Benefits of restructuring
'Rolling' LPs	<ul style="list-style-type: none"> • GP is incentivised and given flexibility to maximise value for remaining companies • Most or all of new incentive fees are paid for by secondary buyer • 'Walk away' risk of manager strongly reduced • If new unfunded capital is needed, restructuring allows for an orderly raising of capital
Selling LPs	<ul style="list-style-type: none"> • Immediate liquidity • Majority of, or the entirety of, LP position sold in one transaction • Eliminates risk of assets being trapped in zombie fund • Premium pricing compared to non-restructuring price
GP	<ul style="list-style-type: none"> • Potential for carried interest on new money • Mandate from LPs provides flexibility to maximise value of underlying investments • Opportunity to make organisational changes