PEI: New Strategies for Risk Management in Private Equity

Risk in non-traditional secondary strategies

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Introduction

As the private equity industry has matured, the secondary market has grown and become an attractive space for investors to balance or improve the risk/return profile of their portfolios. This chapter aims to discuss risk considerations in *non-traditional* private equity secondary strategies by comparing the approach of traditional secondary buyers with two alternative approaches: preferred capital and debt financing.

Definitions and scope

Before going into the details of the topic, it is useful to define the key terms and the scope of this chapter in some detail.

Risk

By risk we primarily mean financial risk for the investment strategy in question. This involves two key parameters:

1. The probability of losing capital.
2. The uncertainty of returns.

Questions to be answered and considered in this respect are: What is the likelihood of losing the capital invested? How volatile are the returns? How volatile is the liquidity profile? Non-financial aspects of risk (for example, political or economic risk) are not considered in any detail in this chapter as such risks apply equally to any investment strategy.

Traditional strategies

By traditional strategies we mean investment strategies that are employed by a large number of similar players. These investors operate with very similar fund structures and investment criteria and as such have similar risk profiles. Within traditional strategies, funds may differ in terms of which segments of the markets they target, but will nevertheless have a number of competitors within their own segment. Traditional secondary funds are an example of an investment strategy that fits within this definition.

Non-traditional strategies

By non-traditional strategies we mean investment strategies, which are employed by a limited number of similar players. These may operate with a set-up similar to traditional funds, but may also be employed by balance sheet investors such as banks or family offices. Examples of non-traditional secondary strategies are:

- Portfolio debt providers.
- Preferred capital funds.
- Private equity-backed securitisations.
- Secondary directs funds.

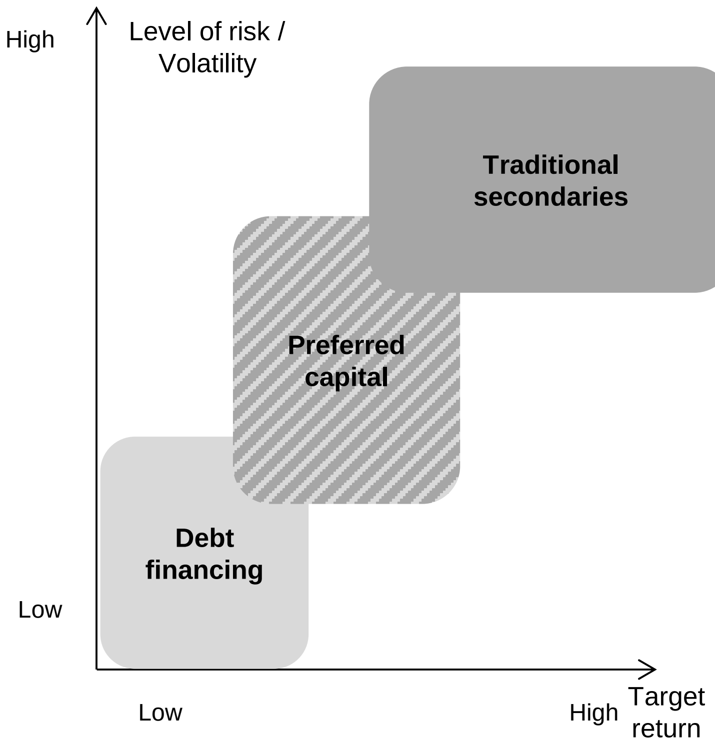
Scope

In terms of its scope, this chapter focuses on comparing risk/return considerations for three approaches to investing in the private equity secondary market:

1. Traditional secondaries.
2. Preferred capital.
3. Portfolio debt financing.

This gives an indication of how risk/return considerations vary according to the investment strategy within the market for investing in mature private equity portfolios (see Figure 3.1).

Figure 3.1: Risk-return profiles of different investment strategies



Source: 17Capital

How to measure risk

As with any investment strategy, there are a number of risk factors to be considered when investing in the private equity secondary market. These risks can be divided into **qualitative risks** and **quantifiable risks**. It should be noted that the following is not an exhaustive list of risks, and also that they are not fully separable and there is a degree of overlap between many of these considerations. Investors will also place different emphasis on each risk consideration depending on their risk appetite and investment structure.

Qualitative risks

Qualitative risks cannot be accurately and easily measured using objective data. These risks need to be considered through relative measures (for example, through a ranking), descriptive categories (for example, high/medium/low) or a scale (for example, one to ten). Even though some objective data may be available to support such considerations, they will involve a degree of subjective assessment which requires knowledge and experience of the market in which the fund operates. We consider three qualitative risks:

1. Manager quality.
2. Information available.
3. Investor base.

Quality of the manager

The quality of the manager(s) of the underlying portfolio is a key qualitative risk factor in secondary private equity investments, both in traditional and in non-traditional strategies. Key considerations in this respect include:

- Team experience.
- Team size and coherence.
- Deal sourcing capabilities.
- Deal analysis and execution capabilities.
- Future recruitment.
- Team incentivisation.
- Likelihood of continuing to raise funds.

In evaluating these, investors need to rely on relative and subjective measures based on their own experience. Some objective data is, however, usually available to support judgments: the team's historic track record, in terms of ability to raise funds, returns achieved and volatility of returns, gives an indication of performance relative to peer benchmarks. These are particularly important in investments where there is an element of a blind pool (uncalled capital) in the underlying portfolio.

Available information

Secondary investors also need to consider the risks related to the available information prior to making the investment. Key questions to be addressed in this respect are: Does the information available provide sufficient detail to identify the underlying risks? Is the quality of the information good enough to make risk judgements? Are the underlying fund managers transparent in their disclosure of information?

Investor base

A third qualitative risk is the investor base of the underlying funds/fund managers. Key questions here include: What is the risk of one or more of the investors defaulting on a capital call? Is the investor base concentrated in a small number of investors that can exert influence over the manager? This is difficult to measure, but the type of investors, number of investors and diversification of investors give an indication of the level of risk related to the investor base.

Quantifiable risks

Quantifiable risks can be measured and benchmarked using objective data. Three quantifiable risk factors are considered in this chapter:

1. Portfolio diversification.
2. Portfolio-company metrics.
3. Structure of the investment.

Portfolio diversification

Investing in portfolios which are diversified across parameters such as vintage/investment years, industries, geographies, managers and funds can reduce the risk in a secondary investment. A relatively simple measure of diversification is to assess the exposure in the portfolio to the individual parameters outlined above. A more sophisticated approach to measuring the impact of diversification would also take into account the correlation between the assets in the portfolio to factor in the possibility that funds or companies in the portfolio move in the same direction in response to the economic cycle, thereby reducing the impact of diversification, and stress test the portfolio's performance with this in mind.

Portfolio-company metrics

Portfolio-company metrics are also a key aspect of assessing the risk of a portfolio. By this we mean metrics at the individual underlying portfolio-company level. Financial performance, valuation and leverage of the underlying assets as well as the volatility within these parameters are important metrics considered by investors. These metrics can be compared to other portfolios and give an indication of the relative risk of the portfolio in question.

Examples of metrics, which can be used are weighted averages of:

- Sales growth.
- EBITDA growth.
- EBITDA margins.
- Valuation multiples.
- Leverage multiples.

Furthermore, average standard deviations of certain metrics over time, like sales growth and EBITDA margin, can give investors an indication of the volatility of the portfolio.

Structure of investment

The structure of the investment is key to assessing the risk of a secondary investment. By this we mean how volatile the performance of the investment is relative to the performance of the underlying portfolio. If the investment has priority on distributions (for example, through a debt or preferred equity structure) this gives a lower volatility than for the underlying portfolio, implying a risk reduction through the investment structure. On the other hand, a levered equity investment will have a higher volatility in returns than the underlying portfolio, implying a higher risk investment. Applicable measures of this risk are:

- The discount to net asset value (NAV).
- Asset cover (portfolio value accessible to the liquidity provider divided by the investment amount).
- Loan-to-value ratio (the inverse of the asset cover).

Key characteristics of investment strategies

This section discusses the key characteristics of and risk considerations for the three private equity secondary investment strategies which are the focus of this chapter: traditional secondaries, preferred capital and debt financing for private equity portfolios. The three differ on both their risk and return profile, with traditional secondaries targeting the highest returns but also accepting the highest risk and volatility, and debt financing targeting the lowest returns for the lowest amount of risk. Preferred capital, being an intermediate source of capital, is in between the two, as shown in Figure 3.1.

For each of the three strategies, this section first explains the typical investment structure followed by a discussion of the key risk considerations in the due diligence process for each strategy as well as their target returns. Finally, this section summarises and compares the key considerations for the three strategies.

Traditional secondaries

Traditional secondary investors (secondary buyers) buy existing commitments to private equity funds thereby providing a realisation option for owners of private equity fund commitments ahead of underlying portfolio realisations. Following the acquisition of a portfolio of one or more commitments, secondary buyers become a limited partner (LP) in the underlying funds on the same terms as other LPs. As such, secondary buyers take an equity risk with no preferential rights vis-à-vis other investors in the underlying funds.

Qualitative risk considerations

Manager quality

As passive investors, secondary buyers rely on the managers of the underlying funds to manage the portfolio. Assessing the quality of the manager is therefore key to any secondary buyer looking to buy a private equity commitment, particularly if the positions have significant uncalled amounts. The return of the secondary buyer's investment depends both on the valuation and timing of exits in the underlying portfolio, and key considerations in this respect therefore include the incentives for the manager to exit the portfolio and their ability to do so at the expected time and at the expected valuation.

Information available

Secondary buyers typically review reporting, capital accounts, limited partnership agreements (LPAs) and other documentation generally made available to LPs. In formalised processes run by a third-party adviser, sellers typically make this information available to all potential buyers through a data room. Some processes may also involve the opportunity to meet with the managers of the underlying funds, although this is not always a possibility. In privately run processes with fewer parties, secondary buyers may be able to receive more tailored information. Furthermore, some secondary buyers may also have primary investments in funds forming part of the portfolio, meaning they will have access to all information provided to LPs by those funds over a period of time.

Investor base

Secondary buyers also consider the quality of the investor base of the underlying funds, as they will become partners in the same partnership. However, this information is not always made available by the seller.

Quantifiable risk considerations

Diversification

Secondary buyers usually work on the full range from very concentrated portfolios with just three to four underlying companies to a highly diversified portfolio with several underlying fund positions. However, the level of diversification may impact the pricing and is therefore an important aspect of due diligence for secondary buyers.

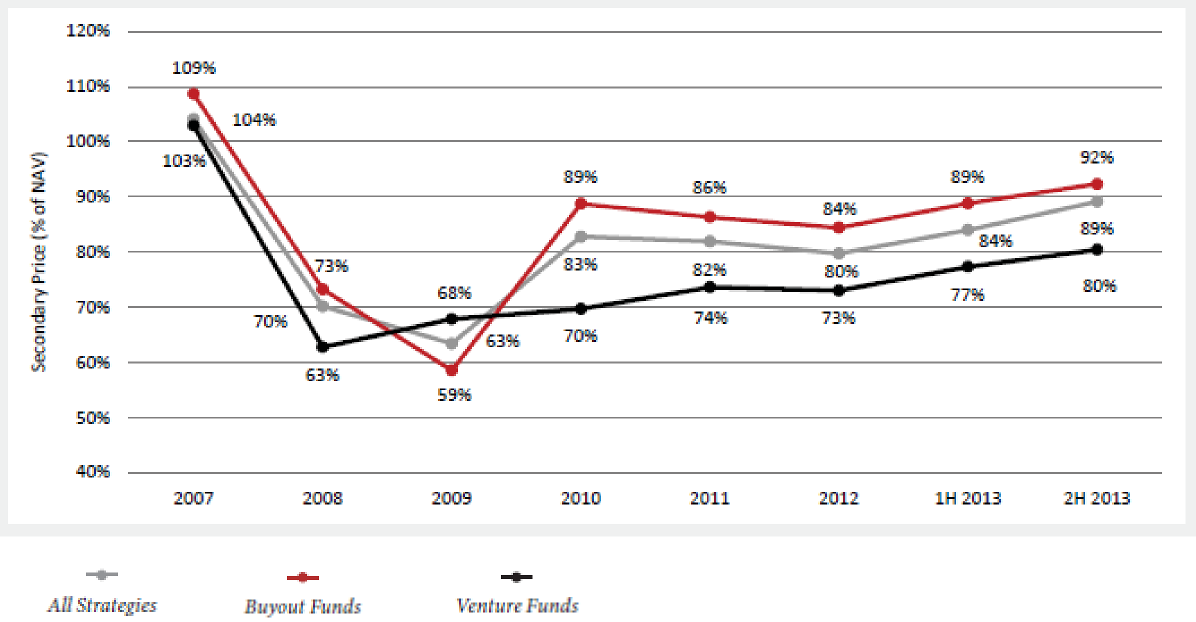
Portfolio-company metrics

The price secondary buyers pay for a portfolio in a secondary transaction is typically quoted as a discount or premium to net asset value, making portfolio valuations a key area of due diligence for secondary funds.

Other portfolio-company metrics such as financial performance, volatility and leverage in the underlying portfolio will also be taken into account when assessing risk and determining the purchase price. Portfolios with more volatile or uncertain performance or higher leverage will imply a higher risk in achieving future exit valuations and timing and therefore a larger discount to net asset value is usually applied to take this into account.

Although not all secondary buyers will bid for any portfolio, there is usually a secondary buyer willing to provide a price for a fund commitment, although the price may be a very large discount to net asset value in the case of a high-risk portfolio (for example, venture capital portfolios typically have a much higher discount than buyout portfolios). Secondary market prices relative to NAV will also vary over time depending on market conditions (see Figure 3.2).

Figure 3.2: Secondary market prices vary over time (average discounts, 2010 to 2013)



Source: Cogent Partners

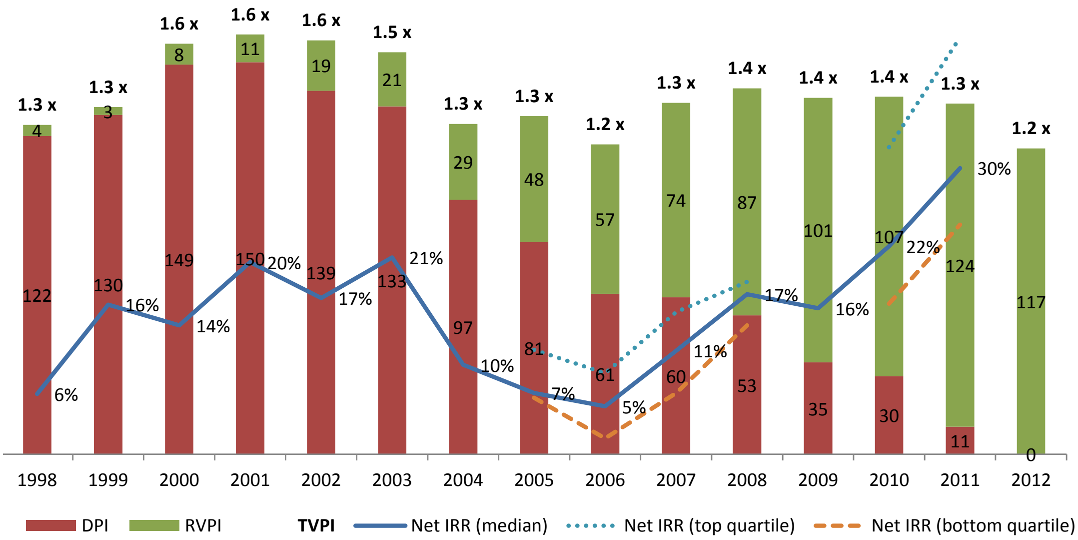
Structure

Most secondary transactions are paid in full at the transaction date, although some transactions may have a deferred element. Some secondary buyers may also do structured transactions where the seller retains a limited stake in the performance of the underlying portfolio after the transaction date or combine the secondary purchase with a primary commitment to the next fund (a so-called stapled secondary transaction). Some funds also use leverage either from banks or preferred capital funds.

Target return

Secondary funds have shown a median net performance of 1.3x to 1.6x cost across vintages, as confirmed in Figure 3.3, which shows the median performance of secondary funds globally by vintage year. As such, secondary buyers will target a gross performance that is slightly higher. Median net IRR is more volatile, ranging from 5 percent to 20 percent, with an average net IRR across vintages of 13 percent (excluding the most recent vintages). Figure 3.3 also shows the net IRR performance for top quartile and bottom quartile funds where available, giving an indication of the volatility of investing in secondary funds. More recent vintages show a higher IRR and this is primarily due to the impact of the discount which is more evident for recent investments. Secondary buyers' target return on individual deals will vary depending on factors including the risk of the underlying portfolio and the competition from other potential buyers.

Figure 3.3: Secondary funds' performance (median net return by vintage, globally)



Source: Preqin

Preferred capital

Preferred capital funds are more recent entrants in the secondary market but increasingly prevalent. These funds co-invest in an existing private equity portfolio on preferred equity terms. The portfolio can consist of fund positions or direct investments, or a combination of both, as long as they are managed by a private equity manager.

Typically, preferred capital funds purchase up to 50 percent of an existing portfolio. The fund thereafter receives more than its share of distributions until it has received its initial capital plus a preferred return and less than its share of subsequent distributions, effectively trading upside for downside protection when compared to traditional secondary buyers.

Qualitative risk considerations

Preferred capital funds' qualitative risk considerations are very similar to those of traditional secondary buyers.

Manager quality

Like secondary buyers, preferred capital funds are passive investors that rely on the managers of the underlying portfolio to deliver the expected portfolio performance. As such, assessing the managers is a key element of preferred capital funds' due diligence process. Key considerations will include the incentives for the manager to exit the portfolio (indicated by, for example, ability to raise additional funds and team financial incentives) with a particular emphasis on the first exits, and their ability to do so at the expected valuation and timing.

Information available

Preferred capital funds' level of information access is broadly similar to that of traditional secondary buyers and will typically include fund reporting and other documentation generally available for other investors in the underlying funds. However, preferred capital funds' transactions are typically negotiated on a private basis with no or a limited process. As such, preferred capital funds are often able to discuss the portfolio in more detail with the vendor/counterparty. If working on concentrated portfolios, they are also often able to meet with the managers of the underlying funds as part of the due diligence, in particular when working directly with the manager of the underlying portfolio. The level of information that can be accessed will be taken into account in the pricing to maintain the risk/return balance targeted by the fund.

Investor base

As secondary buyers, preferred capital funds consider the investor base of the underlying funds to the extent available to assess the risk of defaulting investors, undue influence by large investors or the ability of the manager to raise new funds. However, this information may not always be made available by the counterparty.

Quantifiable risk considerations

Diversification

Preferred capital funds can typically work across the range from very concentrated portfolios with four to five underlying companies to broadly diversified fund of funds portfolios with several underlying fund positions and managers. They can also work on a subset of existing portfolios. The level of diversification may impact the investment structure contemplated, with more concentrated portfolios considered higher risk and therefore requiring stronger downside protection.

Portfolio-company metrics

Preferred capital funds typically have a stronger focus on downside protection than secondary buyers and are therefore more reluctant to invest in portfolios with poor or volatile performance, high leverage or high valuations. Rather than adjusting the pricing, preferred capital funds usually only invest in portfolios where they can get sufficient comfort on these key portfolio-company metrics.

Structure

Preferred capital funds tailor the structure to each transaction, depending on the nature of the underlying portfolio and the requirements of its counterparty. However, in all cases, preferred capital funds become co-investors alongside their counterparties, which are typically current investors in, or managers of, private equity funds.

Preferred capital funds typically buy up to 50 percent of the portfolio in return for a preferred position. This gives them the right to the first distributions from the underlying portfolio until they have received their initial investment plus a preferred return, which is capitalised and similar to a fund hurdle in private equity funds. Unlike debt investors, they will not have any other security for their investment other than receiving a higher share of the first cash flows from the underlying portfolio. In most cases, preferred capital funds also receive a smaller share of the remaining cash flows.

Preferred capital funds can also take an intermediate position in the capital structure with priority behind a portfolio debt financing but ahead of the ordinary equity. In effect, when compared to secondary buyers, preferred capital funds trade access to portfolio upside for downside protection, ensuring less volatility of returns than, for example, traditional secondary funds. The asset cover, setting out the level of downside protection for the investment, is therefore a key measure for preferred capital investors. In most cases, preferred capital funds look for an asset cover of at least 2.0x to ensure that their investment is well protected in a downside scenario.

Target return

Preferred capital funds target 1.4x to1.5x on their investment on each transaction, with limited volatility in performance if the underlying portfolio outperforms or underperforms. In most cases, this corresponds to an IRR return in the mid-teens.

Debt financing

Certain debt providers provide debt financing for private equity portfolios. These investors secure their investments through financial covenants. They make their return through a combination of interest (typically cash) and repayment of principal at one or more maturity dates irrespective of distributions received from the underlying portfolio. They may also require additional security.

Qualitative risk considerations

Manager quality

Like traditional secondary buyers and preferred capital funds, debt providers are passive investors that rely on the managers of the underlying portfolio to create sufficient value from the underlying investments to repay its investment. However, unlike traditional secondary buyers and preferred capital funds that rely on the underlying portfolio distributions to make a return, debt providers, in most cases, make the counterparty responsible for the repayment of its principal and return irrespective of distributions from the underlying portfolio. For these debt investors, due diligence on its counterparty is therefore equally important and they will often have long-term relationships with the investors they provide debt financing to.

Information available

Debt providers' information needs are similar to secondary buyers and preferred capital funds and typically include fund reporting and other documentation generally available for other investors in the underlying funds. They do not typically seek to speak with the managers of the underlying portfolios, relying instead on the diversification of the portfolio and its preference in the capital structure.

Investor base

Like traditional secondary buyers and preferred equity funds, the investor base is part of debt providers' due diligence.

Quantifiable risk considerations

Diversification

Unlike secondary buyers or preferred capital funds, debt providers typically only invest in very diversified portfolios that include commitments to several funds and fund managers. Usually, they only provide debt financing to more concentrated portfolios in specific circumstances (for example, as part of a wider relationship with the counterparty) or for lower loan-to-value ratios.

Portfolio-company metrics

Like preferred capital funds, debt providers do not provide financing to all portfolios. They typically look for less volatile portfolios with low levels of leverage in the underlying portfolio companies and only provide debt financing to portfolios where they can get comfort on these portfolio-company metrics.

Structure

Debt providers typically have security on their investment and return in the underlying portfolio, and covenants usually do not allow any leakage to other parts of the capital structure. However, the responsibility for the repayment, in most cases, remains with the counterparty, which needs to repay the debt at the agreed time irrespective of portfolio distributions unless a refinancing can be agreed ahead of maturity. In some cases, debt providers allow more flexibility by being repaid through distributions from the underlying portfolio or allowing some leakage to the equity prior to repayment. The debt financing is usually structured with a cash interest and a fixed repayment date within one to three years. More flexibility and longer durations usually have implications for the pricing or loan-to-value ratio. To protect its return, debt providers may apply a pre-payment premium for repayments ahead of maturity. The key metric for how much financing debt providers can offer from a structure point of view is the loan-to-value ratio.

Target return

Debt providers target a return that is a spread over a reference rate of interest such as LIBOR or EURIBOR, or in some cases a fixed interest rate. The spread or interest rate depends on the loan-to-value ratio, market conditions and specific risk factors of the transaction. Debt providers' investments have strong downside protection and are not expected to show any volatility in performance if the underlying portfolio underperforms. On the other hand, they also do not benefit from any over performance.

Table 3.1: Key risk considerations: Comparison of traditional and non-traditional secondary structures

Risks	**Traditional secondaries**	**Preferred capital**	**Debt financing**
Quantitative			
Manager quality	Any	Top tier	Top tier
Information available	Formal process	Private process	Private process
Investor base	Considered	Considered	Considered
Qualitative			
Diversification	Concentrated to well-diversified	Concentrated to well-diversified	Well-diversified
Portfolio-company metrics	Valuations, performance, volatility	Volatility, performance, leverage	Volatility, leverage
Structure	Equity	Preferred equity	Secured loan

Source: 17Capital

Table 3.2: Key differences in risk/return profile: Comparison of traditional and non-traditional secondary structures

	Traditional secondaries	Preferred capital	Debt financing
Investment type	Equity	Preferred equity	Debt
Repayment	Portfolio distributions	Portfolio distributions	Fixed repayment date or portfolio distributions
Pricing	Equity	PIK + share of equity	Cash interest
Waterfall allocation	Last priority	First or second priority	First priority
Risk/volatility*	High	Medium	Low
Target return*	High	Medium	Low

** Relative to the other strategies discussed in this chapter.*

Source: 17Capital

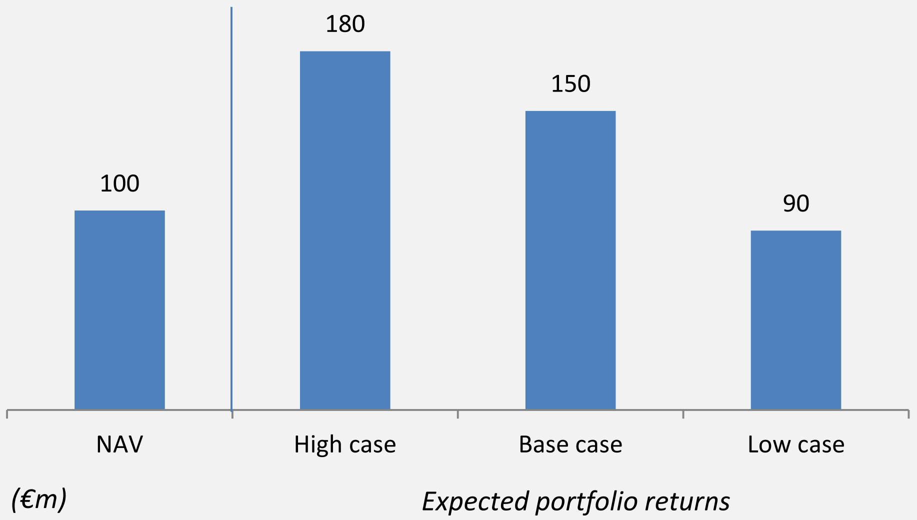
Case study

Expected return and return volatility: Non-traditional and traditional structures compared

This case study illustrates the difference in the expected return and return volatility for the three secondary strategies discussed in this chapter.

A limited partner (LP) holds a well-diversified portfolio across several funds managed by a variety of fund managers and is looking for liquidity ahead of portfolio distributions. As shown in Figure 3.4, the portfolio has a current net asset value (NAV) of €100 million, has no uncalled commitments and is expected to deliver a final return of €150 million (Base case) with some volatility in the expected performance. If the portfolio over performs, it could achieve a final return of €180 million (High case). Conversely, if it severely underperforms, the final return is likely to be €90 million (Low case).

Figure 3.4: Expected portfolio returns – sample



Note: This chart shows expected portfolio returns for the theoretical case study presented here. It is not an attempt to suggest an expected return in a real scenario for a typical diversified portfolio.

The portfolio illustrated in Figure 3.4 falls within the investment strategy of traditional secondary funds, preferred capital funds and debt providers and offers the following liquidity solutions for the LP:

1. **Secondary fund.** A secondary fund offers to purchase the position from the LP for €95 million, which is a 5 percent discount to net asset value. The secondary buyer subsequently receives all portfolio distributions.

2. **Preferred capital fund.** A preferred capital fund offers to become a co-investor in the portfolio by paying the LP €50 million on the transaction date and thereafter sharing the distributions from the portfolio as follows:
   - *Waterfall 1* – 100 percent of distributions to the preferred capital fund until the preferred capital fund has recouped its €50 million investment plus a preferred return of 7 percent.
   - *Waterfall 2* – 20 percent of remaining distributions to the preferred capital fund and 80 percent to the LP.

3. **Debt provider.** A debt provider offers debt financing of €20 million, equivalent to a 20 percent loan-to-value ratio, with a cash interest of LIBOR + 5 percent per annum, payable quarterly. The debt matures in two years with the principal repayable in full at maturity; the LP is not allowed to make any distributions to its investors until the debt and interest has been fully repaid.

Risk and expected return

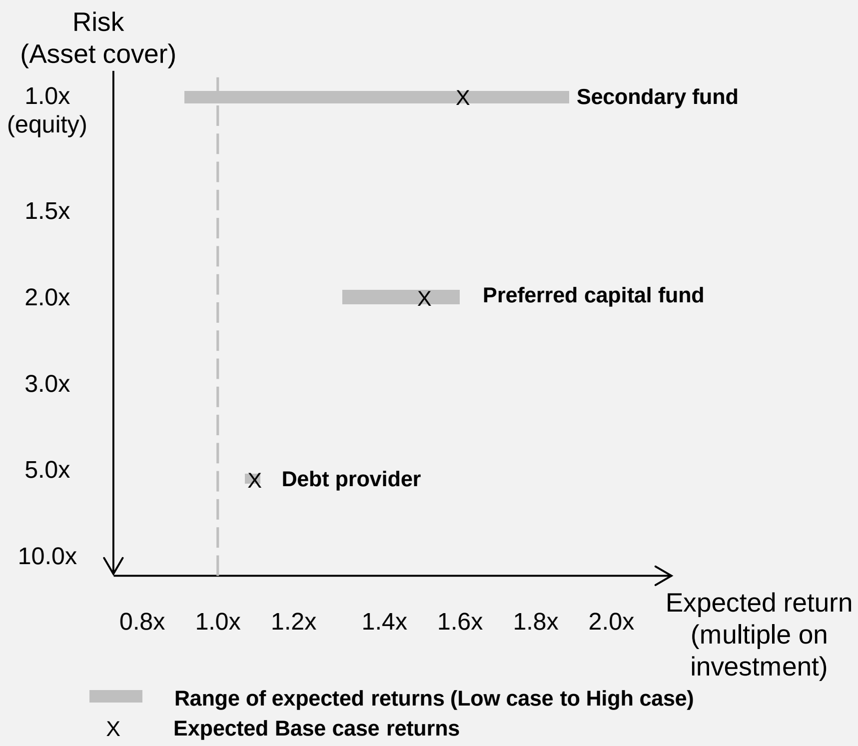
Table 3.3 summarises the key investment metrics for each investment strategy together with the expected returns.

Table 3.3: Investment metrics and expected returns - sample

	Portfolio	**Secondary fund**	**Preferred capital fund**	**Debt provider**
Investment	—	€95m	€50m	€20m
Investment type	—	Equity	Preferred equity	Debt
Asset cover*	*n/m*	1.1x	2.0x	5.0x
Base case return (multiple on investment)	*1.5x*	1.6x	1.5x	1.1x
Volatility (low to high case returns) (multiple on investment)	*0.9-1.8x*	0.9-1.9x	1.3-1.6x	1.1-1.1x

* (Net asset value * Priority on distributions) / investment amount.

Figure 3.5: Risk/return: Asset cover vs. expected performance for each investment strategy



Note: These are calculated on the basis of the theoretical case study presented here and not a real scenario.

As illustrated in Figure 3.5, the secondary fund takes an equity risk and its performance therefore systematically tracks the performance of the underlying portfolio, enhanced slightly by the 5 percent discount to net asset value applied at the transaction date. As such, there is considerable volatility in the expected performance, ranging from 0.9x to 1.9x multiple on cost against a target return of 1.6x.

The preferred capital fund’s 100 percent priority on the first distributions versus an investment of 50 percent of the portfolio value gives it more downside protection with a 2.0x asset cover and considerably less volatility in expected performance. The preferred capital fund achieves a much narrower range of expected performance of 1.3x to 1.6x its investment against a target return of 1.5x.

The debt provider’s high asset cover and financial covenants with no leakage of distributions to equity holders ensures full repayment at maturity after two years irrespective of the performance of the underlying portfolio. The debt provider in this case achieves a return of 1.1x its investment with no expected volatility.

Conclusion

This chapter has discussed risk considerations for one traditional and two non-traditional secondary investment strategies. It has shown that while many risk considerations are similar between the three strategies, they place different emphasis on the various aspects of risk and, importantly, their investment structure gives a different risk/return profile for each strategy. Traditional secondary buyers take an equity risk, with the highest return potential among the three strategies, but also the highest risk. Preferred capital funds achieve more downside protection through investing in a preferred equity structure, ensuring less volatility of returns. Such funds are also less willing to provide a price for poorly performing funds and fund managers. Debt providers are highly focused on downside protection and can often pursue repayment of its investment and return irrespective of the performance of the underlying portfolio. Investments in funds, therefore, have the lowest level of risk among the three strategies with no volatility in performance, but also generate significantly lower returns for investors than the other two strategies.

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