The Mergers & Acquisitions Review

Eleventh Edition

Editor
Mark Zerdin

The Law Reviews

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Chapter 4

PRIVATE EQUITY: AN OFFSHORE PERSPECTIVE

Rolf Lindsay[1]

I GENERAL INTRODUCTION

Approximately 10 years ago, we witnessed an unprecedented period of fundraising as leviathan leveraged buyout funds gathered tens of billions in capital commitments. The immediate challenges that faced those funds, as markets collapsed in 2008 and leverage dried up, have been well documented. What is interesting now is that this generation of funds is coming to the end of their contractual terms, and are faced with the challenge of extracting as much value as possible from what remains of their burdened portfolios.

Within this context, during the past three years we have seen the re-emergence of fundraising for large institutions. Individual sizes are perhaps more modest than during the previous cycle, but there are also many more specialist funds in the marketplace, and the aggregate capital raised is impressive. There are many stark similarities between 2016 and 2008. The uncertainties may be more political than market-based, but they are two sides of the same coin. It is trite to say that with these uncertainties come opportunities that present themselves in no other time, but nonetheless true. For funds that are still relatively new, there is the chance to be nimble and to exploit these opportunities.

However, for funds at the end of an investment cycle, the uncertainties are less welcome. This is because one of the many unique factors about an investment in a private equity fund is that such funds are closed-ended and so, by definition, have an end point. Happily, there are sophisticated investors with recently filled war chests who are looking to exploit the availability of secondary investments in funds and their assets. That presents a rather unique set of challenges with which we anticipate the industry will be heavily occupied in the year ahead.

We consider below the key trends for both old and new funds.

i Restructuring end-of-term funds

Each year we run a rule over the funds that we help to raise. The relatively unique vantage point enjoyed by us as offshore counsel allows us to see the huge cross-section of funds that run the entire spectrum in terms of size, strategy and jurisdictional focus. One notable conclusion that emerges from our analysis is the degree to which the documentation for funds at the time of their launch is remarkably homogenous.

Whatever those similarities at the time of formation, however, by the time that a fund has reached the end of its life, the nature of its investors, their particular imperatives and concerns, the relationship between the investors and the fund manager, and the state of the

1 Rolf Lindsay is a partner at Walkers.

fund's investment portfolio are entirely distinct. All of this means that lawyers looking to advise their clients on how best to approach the end-of-life scenario need to have a number of tools at their disposal. In an industry so heavily influenced by arguments as to what is on-market or industry-standard, the need for creative thinking and the ability to consider and implement innovative structures mean that the year ahead promises to be refreshing for lawyers.

The most interesting funds to consider are those that are near to the end of their contractual terms but that retain significant assets that, either because of the state of the global markets or because of factors unique to the particular assets, do not lend themselves readily to disposal. Inevitably, there will be investors looking for end-of-term liquidity, and there will be those who prefer to exploit the prospect of the long-term generation of value. Assets may need significant additional investment before their value can be fully realised. In addition, fund managers may be in a position where the effect of the fund's contractual terms on their ability to generate fees for completing the work required simply means that interests are no longer aligned. Balancing those competing interests can be a supreme test for fund managers; however, managed properly, a fund restructuring can achieve that balance by providing liquidity for those that seek it without forcing a fire-sale exit from the assets themselves.

Not all funds lend themselves to restructuring transactions. The investor group may be too disparate in terms of interest, or the assets simply not suitable. Often, a simple extension of the fund's term will do the trick, affording the manager the extra time needed to tie up loose ends. Or it may simply be that allowing the fund to click over into winding-up mode is perfectly sensible: Cayman law does not impose timetables for winding up, and the process may take as little or as much time as makes sense given all of the circumstances. Fund managers may find the generation of fees is adversely affected, but where assets do not require particularly active management, that is of no great consequence. However, where there is a significant pool of assets, and in particular assets that will require active management and investment to achieve their value potential, then a restructuring offers the best solution for managers and investors alike.

Of course, in all of this the usual imperatives apply: for legal counsel, an understanding of the client's commercial context, the need to preserve and entrench long-term relationships with investors, and careful analysis of the likely effect of any proposed course of action. For fund managers, more than ever, communication in relation to a restructuring is critical: it is imperative to explain in detail the reasons for and objectives of the transaction, and to provide transparency as to the manager's motives and incentives. Fiduciary issues will be thrown into stark contrast. Cayman law does afford contracting parties the ability to manage those issues to an extent, but effective agreement between contracting parties relies on disclosure of the relevant conflicts. Provided that disclosure is full and fair, the risk that disgruntled investors may seek redress will be capable of management.

ii New fund trends

For new funds, a world of often baffling uncertainty abounds, and managers, replete from a successful few years' fundraising, are now tasked with deploying their capital to take advantage of volatility as it arises. When we compare the most recent round of fundraising with that of the previous generation, one of the clearest differences has been the institutionalisation of the industry. Again using the offshore counsel's perspective, we are able to view this trend by examining its effect on a broad range of funds.

Fund size

Apart from large leveraged buyout funds, we have witnessed effective fundraising for a number of smaller, more specialised funds. Historically, these funds would often have been formed by new fund managers looking to exploit a unique selling point. However, barriers to entry for new fund managers are now prohibitive: the regulatory compliance burden, the imposition of European-style waterfalls as standard, the narrowing of mandates by institutional investors and the broader context of volatility have meant that these smaller funds, many of which are brand new in terms of teams and very focused in terms of strategy, are being raised under the umbrella of the large institutional fund managers.

Fund strategies

Fund strategies show something similar, from a different perspective. Looking at the past two years side by side, we see what we would expect in terms of traditional large funds generating very predicable returns over the short to medium term for institutional investors. Of particular interest has been the growth in distressed debt and, more recently, the direct lending funds and the much-discussed displacement of ordinary banks as providers of credit continues. In part, these funds fill the holes left by traditional lenders. However, more positively, they look to leverage unique industry knowledge and more flexible balance sheets.

Some of the challenges presented by new strategies are well illustrated by the relationship between these credit and lending funds and the energy funds sector. There are significant transactions between the two, and this has generated a sort of microclimate within the funds industry, where exposure to the global energy markets and geopolitical uncertainty have been amplified as a consequence. What is encouraging for an industry that has had a consequential double exposure to the oil price drop is that energy valuations have been better than expected, and the long-term prognosis is more optimistic.

Fund geographies

In 2012, almost two-thirds of the funds that we helped to raise (by number of funds, not by dollar value) were focused on Asia and Latin America. In recent years, that picture has been entirely inverted, and we have witnessed a very clear return to investment in the developed economies.

There were always going to be challenges to the emerging markets when the US and Europe recovered, and competition for capital returned. While there continues to be strong, even growing, interest (particularly among domestic fund managers) in the emerging markets, international capital is focused elsewhere. Emerging markets simply do not offer international investors the same sort of returns that used to accompany the concordant risk factors.

Thinking in relation to what constitutes an emerging market is evolving: investors seeking a high risk/high return profile are investing in more industry-specific options, such as the biopharma industry in Boston and Cambridge.

iii Regulatory trends

The pre-eminent position of the Cayman Islands as the jurisdiction of choice for offshore private equity fundraising is long-established. Cayman offers a flexible statutory regime within a common law system renowned for its sensible approach to commercial disputes. Nowhere is this better illustrated than in the response to changes in the global investment

and regulatory context. Regulatory transparency and a robust anti-money laundering regime provide peace of mind to investors and regulators alike, but these are now a given for credible jurisdictions. The implementation of legislation to enforce intergovernmental agreements relating to US FATCA and CRS reporting has been well-documented and, with the first waves of actual reporting now in progress, these provisions have simply become an inevitable part of the investment funds landscape.

However, remaining relevant and innovative in response to market reality, as well as being credible, is critical to the world's most prominent financial institutions and international investors, which is why most see Cayman as the favoured tax-neutral jurisdiction for private equity funds. Key to this market is the existence of architecture that allows fund sponsors to structure and manage entities with many investors, a variety of strategies, and multiple layers of efficient and effective debt and equity in a multinational environment.

In this context, Cayman legislation and regulation continue to be responsive to trends and challenges in current market practice. An active partnership between the government and the private sector ensures the development of legislation, and recent amendments to the law have streamlined procedures for raising and managing Cayman-based funds, going some way to addressing longstanding concerns about the delineation of the lines of general partners' fiduciary duties.

In particular, Cayman is the first significant common law jurisdiction to offer a limited liability company (LLC) product. LLCs occupy an interesting jurisprudential territory somewhere between a company and a partnership, exhibiting properties of both in a way that affords a skilled and experienced draftsperson significant flexibility. The Cayman LLC is based very closely on the traditional Delaware model, although it leans more toward English common law when delineating fiduciary responsibilities, affording a degree of clarity and contractual certainty that many practitioners have welcomed.

In response to the anticipated trend for fund restructuring discussed above, Cayman will shortly be amending its Exempted Limited Partnership Law to provide partners with the tools that they need to restructure funds in new and innovative ways. In particular, the introduction of statutory processes to merge and amalgamate funds, and to propose schemes of arrangement, and exploit Cayman's position of being an English jurisdiction in an American context, will draw the best from both of those legal systems.

ABOUT THE AUTHORS

ROLF LINDSAY

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Rolf Lindsay joined Walkers in 2005, and is a partner in the firm's Cayman Islands office and a member of the firm's global investment funds group. His practice focuses primarily on private equity funds and their activities, and encompasses the structuring of fund sponsor vehicles, the formation of alternative investment funds and the consummation of transactions undertaken by them.

Rolf has extensive experience advising a broad range of clients in relation to the structuring, formation and management of general partners and the alternative investment funds controlled by them. A significant part of his practice involves advice in relation to mergers and acquisitions, initial public offerings of securities, secured financing facilities and derivative products, both within the private equity context and more broadly. Rolf also leads regular seminars in relation to the legal and practical issues affecting alternative investment fund formation and Cayman corporate and transactional matters.

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