Trends towards active portfolio management in private equity

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INTRODUCTION

The private equity market as an asset class has come of age. The private equity sector is characterised by tremendous growth over the past 15 years. Where private equity used to be a small investment "side pocket" for many institutions, it has now become one of the main pillars of their investment strategy. Therefore, the active management of an increasingly large and complex private equity portfolio has become an integral part of any institutional investor's portfolio management strategy, particularly programmes with larger and more mature private equity portfolios. In a maturing and increasingly efficient market, top-down, strategic portfolio allocation decisions in private equity have become as important as manager selection in explaining performance. These decisions include sub-asset class allocations between buyout, venture (early and late), mezzanine, special situation, energy, infrastructure or other, allocations between domestic and international, between country-specific and pan-regional, or between developed and developing country/region opportunities, allocations by vintage year, and allocations across industry exposures. Active portfolio management implies the need to buy and sell to re-weight and re-balance across target and actual allocations on some regular or consistent basis. Active portfolio management can take place incrementally with a few funds or positions, or as a component of a larger sweeping restructuring.

In the past, the main challenge of constructing a dynamic portfolio was the illiquidity and the long horizon of private equity commitments. In general, these characteristics prohibited active portfolio management whereby one rebalances the portfolio according to strategic or tactical shifts in asset allocations or exogenous market factors. Traditionally, rebalancing occurred only through adjustments to new commitments. However, times have changed due to a well capitalised and burgeoning secondary market with experienced buyers and sellers. The previous challenges of rebalancing a private equity portfolio have been alleviated by the competitive pricing, attitudinal changes of both limited partners (LPs) and general partners (GPs), process efficiencies and the utilisation of more sophisticated financial engineering tools (e.g. leverage or securitisation) in the secondary market. Therefore, we believe strongly that secondary transactions as a result of active portfolio management are a sustainable growing trend and will continue to be a significant part of the private equity market.

We would like to explore in this article the reasons for the increase in activity in portfolio management and how developments in the secondary market have facilitated that trend. The following case study provides a typical portfolio management situation and illustrates how the secondary market facilitated a rebalancing of the portfolio.

A CASE STUDY OF PORTFOLIO MANAGEMENT

A secondary transaction can be a win win situation for the seller, the buyer and the affected GP. Adams Street recently acquired a portfolio from a sophisticated endowment. The endowment had recently performed a strategic asset allocation study of its private equity portfolio. From this study, they had discovered three principal problems: (1) far too many GP relationships for the staff to properly monitor; (2) significant capital committed to funds that if an investment decision was made today, commitments would not be made; and (3) as the endowment has grown and as fund sizes in general have grown, average commitment levels have grown five fold, thereby making the impact of many of the older

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commitments negligible. With a private equity staff of two professionals, it was impossible to appropriately monitor and maintain relationships with over 100 GPs. Further, this endowment had a number of "inactive" GP relationships: firms they had decided to no longer support and did not commit to the latest fund. A sale of these inactive GPs would allow the endowment to right size the endowment staff to GP ratio and would also allow a realignment of capital from inactive GP relationships to active ones where the expected return of the investment is higher. Finally, as many of these inactive GP relationships were a few years old, the commitment levels per fund were smaller and less meaningful to the overall portfolio economically, but with meaningful administrative burdens. The endowment determined it would be able to meet all three objectives through packaging a group of funds together to sell.

Although the seller wanted to refocus its portfolio, it had to have a sound economic rationale for the sale. After assembling an initial list of likely funds to sell based upon current relationship status, the endowment spent some time analysing the characteristics of the portfolio. The funds were largely six to ten years old, nearing the end of their term. The seller determined that the ultimate liquidation value of the portfolio would only be at or perhaps just slightly above the current net asset value. However, hold periods for the underlying companies were already fairly extended, no liquidity was expected in the near future, and it was time to exit the investment.

The seller had expectations of achieving more than a two times return on its money on new primary commitments, and with their expectations of NAV being closely approximate to terminal value, if the endowment was able to sell the portfolio for a modest discount or better, they would be better off on a net present value basis selling today rather than waiting several more years until liquidity may be found. When figuring in the opportunity cost on no further gains to value against a redeployment of that capital into another fund where value increase expectations are more than two times, there was an easy economic rationale for a sale. Finally, as the funds in question to be sold were relatively small in context of the overall portfolio and had already performed, selling at any price (even zero) would have a negligible impact on either the terminal return for any particular fund in the sale or on the overall portfolio. And with the added gain of a significant administrative burden relief and the ability for the smaller investment staff to refocus more on its core relationships, it became a very obvious decision to sell, even at a modest discount.

Now that the portfolio for sale was assembled and basic pricing expectations understood, the endowment had a couple of important considerations when contemplating a sales process: (1) they continue to be quite active in the private equity space and did not want the transaction to impair their ability to continue to get access to the very best GPs; (2) the GPs whose funds they were selling were still considered by many to be of the highest quality and who were extremely selective as to whom they would admit as LPs. These considerations required that the endowment find the right buyer that would be viewed by the market as an acceptable substitute LP, and that the GPs would consent to a transfer. The seller needed a quiet, confidential process with a select list of pre-qualified buyers – ideally buyers who were already LPs in these funds allowing for faster and more thorough due diligence and no transfer risk.

After a few phone calls to the GPs, it became quite apparent that the list of acceptable buyers was very narrow. And in fact, only one potential buyer was an acceptable substitute LP for all the GPs. The seller either needed to break the portfolio up into several pieces, or go with a single buyer. The seller then contacted three potential buyers to bid on the portfolio who were reputable, well capitalised and had the highest overlap with GP acceptance across the portfolio. As the bids came in a fairly tight range, the portfolio sold to the bidder able to obtain consents from all the GPs.

The seller was able to meet its objectives and receive a fair price for assets that it could then redirect into active relationships. The GPs were able to exchange an inactive LP relationship with another positive,

supportive LP. And the buyers were able to pay a fair price for a portfolio of assets they believed had value and increase commitments to active GP relationships. This was a win win transaction for all parties.

The profile of the above seller and the resulting transaction is a fairly recent phenomenon, and is becoming increasingly common. Next we will explore what has contributed to the trend of dynamic portfolio management within the private equity asset class.

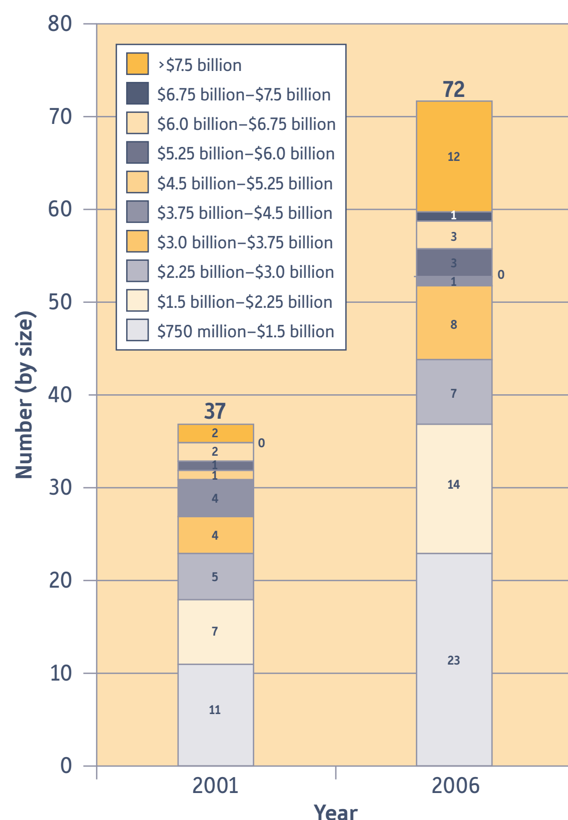
LARGER PRIVATE EQUITY ALLOCATIONS DRIVE INCREASES IN ACTIVE PORTFOLIO MANAGEMENT

The active management of a private equity portfolio is a difficult task due to the reduced liquidity of the asset class, the long-term investment horizon, the sheer number of private companies within a portfolio of funds, and the relative lack of transparency of underlying portfolio company information. Therefore strategic portfolio management is fairly resource intensive and usually needs dedicated investment professionals to manage the process. The size of the private equity allocation within an institutional investment programme is often a good indicator of the maturity and complexity of the private equity portfolio thus requiring or benefiting from active portfolio management.

In the past 10 years, the private equity sector experienced the emergence of very large private equity investment programmes managing more than $500 million in private equity investments. In looking at institutional investor data, the alternative asset allocation is usually a rough proxy for private equity allocations. According to the Dow Jones *Directory of Alternative Assets Programs*, the number of alternative asset programmes with greater than $750 million expanded from 37 to 72 over the last five years (see Exhibit 4.1), which represents a compounded annual growth rate of 14 percent translating to an increase in overall commitments of approximately $164 billion. Furthermore, last year alone, large scale US-based LPs made 22 individual commitments of more than $300 million into a single fund. This accounts for $15 billion of the $400 billion raised in 2006.

The emergence of "mega-size" LPs necessitates more sophisticated and active portfolio manage-

Exhibit 4.1: Number of alternative investment programmes > $750 million, 2001 and 2006 (by size)



Source: Directory of Alternative Investment Programs, 2001 and 2006.

ment of the private equity allocation. Private equity portfolio managers are now spending more time on the construction of their portfolio and top-down asset allocation. They have become more sophisticated due to the increase in available data as well as the increase in breadth of the private equity investment opportunities. The comparison between North America and Europe highlights that active portfolio management is mainly driven by the maturity and size of private equity programmes. Until recently, secondary transactions due to active portfolio management have been entirely a US phenomenon, where the private equity programmes

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are substantially larger and more mature (i.e. more "inactive" GP relationships). However, European institutional investors' asset allocation to private equity have grown significantly in the past ten years and we have started to see, particularly in the past twelve months, more transactions driven by a strategic portfolio rebalancing in Europe.

As we have seen, portfolio managers of private equity portfolios have a variety of motives to rebalance their portfolios. Large and mature programmes frequently rebalance their portfolios because they would like to reduce the administration burden. Often these large programmes have invested in over 100 manager relationships, but only 50 or fewer of these GP relationships are considered "core". Since most private equity funds have 10-year terms, and in practice don't liquidate for 15 or 20 years, a large portfolio can easily contain over 50 "inactive" relationships. No matter the number of "inactive" relationships, active portfolio management is an effective way to refocus and optimise a portfolio.

The expansion of private equity investment programmes amongst institutional investors has also initiated a very high turnover rate of professional investment staff. The turnover has been exceptionally high in the past few years due to the unprecedented amount of institutions starting new private equity investment programmes and looking for experienced private equity investment managers. As these investment managers change organisations, they often face legacy private equity portfolios that do not fit their own personal investment strategy. Often private equity programmes were initiated as an ad-hoc investment programme without a dedicated team of investment professionals. Many times the investment professional responsible for the private equity investments has other investment responsibilities within alternatives (real estate, hedge funds, infrastructure, etc). The result can be a very opportunistic portfolio, which needs restructuring when a dedicated team of private equity investment professionals is hired. Furthermore, the newly recruited private equity investment professionals frequently have new and fresh ideas about how to construct a portfolio. An opportunistically-constructed legacy portfolio can be, in many cases, a difficult fit for the newly-developed strategy. Finally, the new team often likes to establish their own track record, which makes management of a legacy portfolio less attractive.

FACILITATING ACTIVE PORTFOLIO MANAGEMENT

Several conditions exist which allow institutional investors with more mature private equity programmes to actively manage their portfolios in a much more efficient matter.

The secondary market is competitive and efficient

The secondary market itself has undergone a process of substantial development as the overall private equity asset class has expanded. The growing acceptance of secondary sales as a viable liquidity option for holders of LP interests and the large influx of capital into the secondary market have both influenced the deal flow entering the market and the pricing of these opportunities. It is estimated that a minimum of $20 billion is currently held in fund structures formed for the purpose of making secondary investments. The total amount of capital available for secondary investments may be much greater as certain larger institutional investors and fund of funds also participate opportunistically in the market. There has also been a steady increase in new entrants into the secondary market, including newer categories of investors such as listed private equity trusts and hedge funds.

The result of a more competitive environment has been the increased sophistication and price efficiency of the secondary market. The sophistication of the market is demonstrated not only by the variety of deals executed by secondary buyers, but also by the increased complexity of the transaction structures. The resulting increase in pricing efficiency can be clearly demonstrated by industry data, which shows that on average, portfolios of LP interests sell at a small premium to their underlying net asset value. In the past, secondaries were typically priced at a dis-

count to net asset value and the portfolio manager had to often accept a fairly steep illiquidity discount. In many cases today, a portfolio manager is able to sell assets anywhere from a small loss to NAV to a modest premium. This liquidity allows the portfolio manager to reinvest in other more strategic or more promising opportunities.

Attitudinal changes in the GP and LP relationship

In the past, certain institutional investors perceived that a stigma was attached to a secondary sale, which caused some to think twice about a sale. It was further believed by some that institutional investors who sold their limited partnership interests would be accused of being either an unreliable LP or an institution in distress. Many prospective sellers are particularly sensitive to protecting their reputations because they would like to ensure that a secondary sale will not limit their future access to top quartile funds.

However, with the growth of the secondary market touching all GPs at one point in time or another, and the existence of sophisticated institutional investors with large allocations to private equity, the GPs have become more familiar with the practice of actively managing a private equity portfolio. In fact, GPs often work closely with their selling LPs and interested buyers as an opportunity to control, refresh and improve their LP base. A secondary sale allows the GP to replace a short-term investor base with a more long-term committed investor base. The enormous growth of the LP investor base has given the GP much more comfort that their LPs are replaceable, and that they need to think strategically about managing their own "portfolio" of LPs.

The emergence of specialised secondary intermediaries

In the past, the only option an institutional investor had to manage a secondary sale process was to do it themselves. With many institutional investors short-staffed, the prospect of managing a sales process can be daunting. Many institutions with private equity allocations do not have the resources or the expertise to engage themselves in a sales process. The GPs need to be contacted; information collected, organised and put in distributable form; a short-list of prospective buyers identified and contacted; and most importantly, understanding is needed of what price to sell the portfolio for. Therefore, many private equity portfolio managers contemplate a sale but don't engage in one. However in the past five years, several firms have identified the opportunity to offer their services to institutions with large private equity portfolios and assist in the sales process. Although still accounting for a minority of all transactions, intermediaries have provided critical services to certain institutions unable to run their own sales process.

KEY CONSIDERATIONS IN A SECONDARY PORTFOLIO SALE

The decision to rebalance a portfolio of private equity interests is complex and there are many variables to consider. We have tried to highlight some of the most important considerations for a secondary sale here below.

Top-down portfolio construction

Portfolio managers who would like to rebalance their portfolio usually start the process reflecting on their top-down asset allocation. Portfolio construction is usually an iterative process trying to find the right mix between sub-asset class, vintage year, industry and geographic diversification. A systematic and disciplined portfolio construction process will identify non-strategic relationships that need to be pruned.

After identifying the scope of potential interests for sale, the portfolio manager then needs to decide how to construct the portfolio basket or baskets. The manager has several options on how to package a portfolio for a secondary sale. The motives and the allocation strategy usually determine the "packaging" options. The portfolio manager needs to determine if they want to package a portfolio by vintage year, sub-asset class, geography or quality of manager. The right mix is crucial in order to create strong interest from buyers and hit certain pricing targets with respect to net asset value. The manager may even consider including in the package certain interests not necessarily in the "for sale" basket in order to attract interest or sweeten pricing.

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Transaction structure

Another important consideration when evaluating portfolio rebalancing options is the structure of a potential transaction. The structure of any particular transaction is completely dependent upon the objectives that a portfolio manager has in pursuing the transaction. For example, a portfolio manager may want to reduce its private equity exposure while optimising price in a sale. However, this institution may not be as concerned about when it receives sales proceeds. As such, the portfolio manager may offer to receive deferred payments in order to reach a higher purchase price. In another scenario, the portfolio manager may want to reduce their overall private equity exposure but want to maintain relationships with the GPs. As such, the portfolio manager may offer to sell a "strip" of their entire portfolio, for example selling a 25 percent interest in a basket of fund interests, thereby maintaining relationships and sub-class weightings, but reducing exposure overall. Alternatively, a portfolio manager may want to sell down their portfolio but is concerned about the headline risk of a subsequent large winner in the portfolio that they did not know about. The transaction could be structured such that the buyer shares a portion of all proceeds after it has received back two times its invested capital. There are many ways a transaction can be structure to meet individual institutional objectives beyond a straight sale of assets.

Transaction process

As important as the transaction structure is the transaction process. Portfolio managers often have specific needs or objectives when it comes to designing the right process. Some portfolio managers are severely short-staffed and need to completely outsource the transaction process to an intermediary. Other portfolio managers may be quite familiar with the secondary market and their own portfolio, so comfortable inviting a tight group of pre-qualified bidders. Some portfolio managers may need to document for specific internal purposes that they ran a wide auction; others want to balance resources allocated to the sales process with very small incremental gains in purchase price or terms. Some portfolio managers may be highly concerned with confidentiality while others are most concerned about their reputation with the GPs of the funds sold. There is not a correct or incorrect process; it depends upon the facts and circumstances of the situation.

Specifically on the subject of auctions, the advantage of a large auction process is that in theory an auction is more competitive and should therefore produce the highest possible bid. However, the disadvantages of an auction are often a long drawn-out and unwieldy process with a large number of "thrown-in" bids and a complete loss of confidentiality. Furthermore, a carefully selected group of buyers can achieve the same pricing result with less effort and a more discreet process. Large auction processes may actually discourage the buyers most qualified to bid on assets due to low probability of closure in relation to the resources required to bid aggressively.

GP relationship management

The management of the GP relationship is crucial during a secondary sale since the LP is very dependent on the goodwill of the GP in order to achieve the best outcome. The GP needs to give consent to most transfers and they have learned to use the secondary sale process as an opportunity to manage and improve their investor base. Working with the GPs to identify the best suited buyers for the assets is an important part of an effective secondary sale process, preserving the relationship with the GPs and achieving a better price.

Additionally, the cooperation of the GPs during the sale process is crucial for the prospective buyers to obtain the best available information on a given portfolio. In general, private company information is sparse and therefore, secondary buyers rely heavily on the information provided by the GPs. It is fair to assume that the more transparent the information, the better the price for the secondary transaction as buyers are not pricing in additional uncertainty.

Furthermore, the private equity industry is still restrictive in its access to the best funds. Selling an interest in a private equity fund may mean that the LP loses access to future funds by that GP. Therefore,

it is very important that the LP communicates clearly the motives in order not to lose access to strong fund performers.

CONCLUSION

The maturation of a growing number of institutional investor private equity portfolios, the emergence of increasingly large private equity allocations and the greater sophistication of the secondary market have created an environment where investors can utilise the secondary market as an efficient way to rebalance and actively manage their private equity portfolios. In the past two to three years, especially in the US, we have seen a large increase in portfolios sold on the secondary market coming from long-term, committed private equity investors, principally pension plans and endowments. In the past, large portfolio sales occurred principally during economic downturns and/or from institutions who withdrew completely from investing in private equity. The current competitive pricing environment facilitates and motivates portfolio managers to apply similar active portfolio management techniques in their private equity portfolios as they would in their marketable securities portfolios. As such, we observe that rebalancing and actively managing portfolios through a secondary sale has become an integral part of the portfolio management process of many mature institutional private equity programmes. Therefore, active portfolio management will remain a sustainable trend and will continue to be an important segment of the private equity secondary market.

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