Pioneering Approaches for "Zombie" Funds

Daryl Cohen, Vision Capital

There is much talk about "zombie" funds haunting the world of post-crisis private equity but relatively few successful GP/fund recapitalization transactions have completed so far. The following Q&A with Daryl Cohen of Vision Capital considers the challenges and opportunities presented by zombie funds, provides a perspective on the scale of the opportunity, and considers the barriers and catalysts to transactions.

What constitutes a zombie fund and what fate do they deserve?

A zombie fund is one where the GP's principal economic interest is preservation of fee income. This can happen when carry is out of sight and fundraising off the cards - either because of market conditions, or by GP decision. As funds' divestment phase fees are calculated as a percentage of the residual cost of investments, the results often include lengthening hold periods - irrespective of asset performance - accompanied by GP team shrinkage to drive down costs. While it is common perception that all zombie GPs are bad, the reality is that the industry's supply-demand imbalance for new capital is impacting both bad and good managers alike, and their portfolios can contain exciting, albeit constrained, companies.

How big is the opportunity and when will it come?

Preqin data suggests that there is globally more than $40bn of NAV in buyout funds managed by GPs which have not raised a fund in the last five years. But, given the GP-friendly nature of pre-crisis limited partner agreements, the total market size is only an indicator of the presently addressable opportunity. To understand why, it is necessary to consider the inflexion points that drive transactions that unlock these potentially "stuck" situations.

As shown in Fig. 1, the critical phase begins as a fund approaches its 11th anniversary, when LPs get their first opportunity to renegotiate GP economics, and continues through the fund's anticipated final maturity. During this period, the GP's economics are likely to be reduced, putting direct pressure on costs – potentially to the point of making a transaction attractive to the GP.

Fig. 2 and 3 show the likely near term flow of buyout NAV into years 10-12 and the location of its GP. Two things are clear: firstly, the opportunity is just beginning and will expand exponentially through 2015 and 2016; and secondly, it is currently focused in the US.

What are the consequences for the different stakeholders?

The alignment of interest between LPs and GPs breaks down. Against the incumbent GP's desire to maintain fee income, LPs suffer reduced liquidity due to stalled disposals, as well as a growing gap between gross and net returns as fees continue to be charged. With no cash flowing back to LPs, the broken fundraising cycle affects the whole private equity community.

Extended hold periods also impact portfolio companies, where capital investment required for strategic projects may be denied or simply unavailable often resulting in an exodus by the best management. The result is that stultification can spread into investee businesses, harming returns and increasing risks.

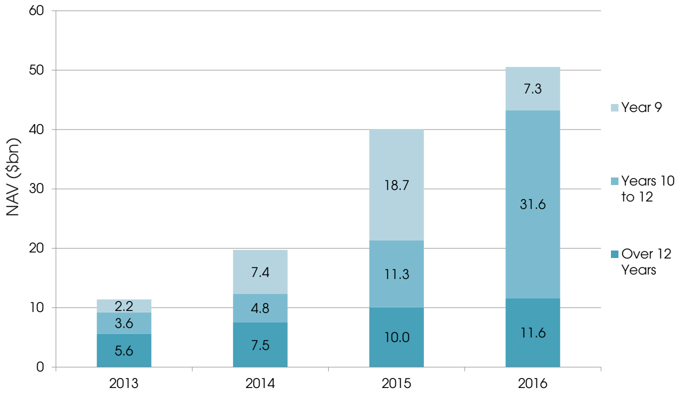
What does a solution need to deliver?

Pioneering transactions, such as Vision Capital's 2012 transaction involving a 2000 vintage buyout fund, demonstrate the importance LPs attach to the choice between cash or roll-over options when

Fig. 1: Life Cycle of Typical Private Equity Fund

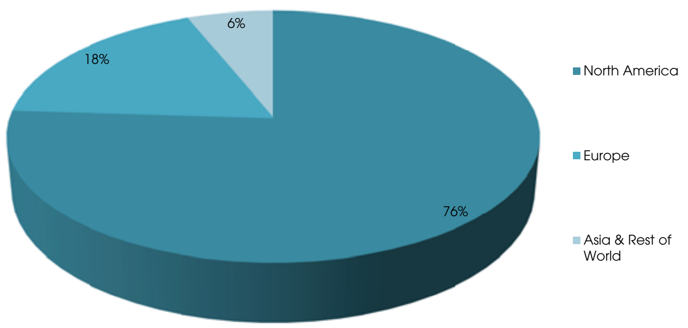
Source: Vision Capital

Fig. 2: Estimated NAV in Pre-2009 Vintage Buyout Funds Managed by GPs that Have Not Raised a Fund Within Five Years, By Age of Fund in 2013 - 2016



Source: Preqin

Fig. 3: Estimated NAV in 2016 of in Pre-2009 Vintage Buyout Funds Managed by GPs that Have Not Raised a Fund Within Five Years, by GP Location



Source: Preqin

considering a fund recapitalization. This can address varied opinions on valuation, helping with advisory board conflicts, as LPs can choose to retain exposure or take cash. The deal also demonstrates that LPs may welcome a new partner GP to work with the incumbent GP to drive upside in the portfolio. For the incumbent GP, any deal must deliver continuity, perhaps through a fee and carry participation going forward. While for the new GP and its LPs, the usual dynamics of risk, return and income or cost are determinative.

What is the way ahead?

The opportunity has only just started in the US and will grow as boom period funds reach years 10-12. However, the volume of deals that complete will depend on LPs acting together to drive change with incumbent GPs, as well as on thoughtful and tenacious execution from new GPs and their LP backers. Collective hard work will be required, and reason must prevail over emotion.

Resolution will be a positive force for existing LPs and for new investors interested in backing rejuvenation stories for companies and management teams currently working under constrained ownership. In some circumstances, it will also provide a new start for the incumbent GP team. What is clear is that the status quo benefits nobody.

Vision Capital

Vision Capital has a track record of executing and delivering in this space following a 2012 transaction with a 2000 vintage vehicle. The deal benefitted existing LPs by providing the option to exit for cash or rollover and take the opportunity to benefit from the growth potential of the three remaining portfolio companies.

Vision Capital is a specialist investor in private equity with AUM of €1.6 billion and offices in London and New York. The firm uses its understanding of private equity industry dynamics to create innovative investments in mid-market buyout companies and add value through active ownership.

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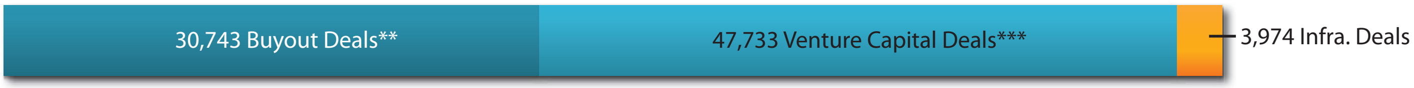

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