Chapter 5

Alternative routes to liquidity: securitising private equity

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INTRODUCTION

Applying securitisation techniques to private equity has opened up a range of new and valuable liquidity and financing alternatives to investors in the asset class. With the success of the recent private equity securitisations, involved parties have gained experience and third party investors have increased appetite for these kinds of transactions, making the terms for securitising highly attractive. However, the advantages and practices of securitising private equity are still unfamiliar to a wide range of traditional private equity market participants. This article attempts to give an overview and some background on this emerging financing option.

Background to the securitisation market

Securitisation is a financing process in which a portfolio of financial assets is moved to a special purpose vehicle and refinanced through the issuance of various classes of notes. The history of securitising assets started in the 1970s in the US mortgage markets, as means to increase funding capacity to meet the rising demand for housing credits. Since then securitising assets has become a standardised commodity, with new yearly issuances of several trillion dollars per year.[1] Asset classes where the benefits of securitisation techniques are commonly employed include mortgages, various forms of both performing and non-performing debts and loans, auto and aircraft leases, as well as credit card receivables. However, assets as esoteric as champagne stock, music royalties, film libraries and future soccer spectator proceeds have also been securitised.

A significant advantage of securitisations is that they bring together a pool of financial assets that otherwise could not be easily traded in their existing form. By pooling together a large portfolio of these in isolation illiquid assets, they can be converted into instruments that may be offered and sold freely in the capital markets, thus allowing the owner of the assets to free up cash, to lower the cost of financing, improve future liquidity opportunities and increase investment capacity. Securitisations are also used to achieve regulatory relief and off-balance sheet financing.

Given the very specific characteristics of the private equity market, and especially due to the volatile nature of the cash flow streams of private equity partnership investments, private equity was long perceived as an asset class that could not be securitised. While it is indeed challenging and complex, a number of attractive private equity securitisations have been closed over recent years, demonstrating not only the feasibility of such transactions, but also the great benefits that can be achieved.

Examples of private equity securitisations

The following examples illustrate how securitisation techniques can be applied to different situations and achieve various objectives. The flexibility of this financing method can of course also be useful in other situations and to achieve other goals, as described further below in this article.

Astrea[2] is a securitisation of a diversified portfolio of limited partnership interests in 46 different private equity funds with a total exposure (reported value plus open commitments) of $810 million that closed in 2006. As a consideration the owner of the portfolio received cash on a non-recourse basis equalling approximately the portfolio's reported value and about half of the junior securities issued. The senior debt was structured into two classes of notes that were rated AAA and AA respectively and sold to cap-

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ital market investors. A novelty with this transaction was the cash efficiency of the structure as well as half of the junior securities being sold to third parties. The rationale of the owner, an experienced institutional investor with several billion US dollars in historic private equity commitments, was to free up cash to increase its investment capacity and to more efficiently finance its private equity holdings to maximise its return on investment.[3]

Pine Street[4] is a securitisation of a diversified portfolio of interests in 64 different private equity funds with a total exposure of $1.0 billion that closed in 2002. Similar to Astrea, the rationale of the owner was to free up cash for new investment opportunities and to reduce the cost of financing. Six classes of notes with various levels of seniority were issued, but only the most senior Class A notes with a principal amount of $250 million and an AAA rating were sold to third parties. As a consideration the sellers of the portfolio received cash on a non-recourse basis equalling approximately 40 percent of the reported value of the portfolio and all junior securities (Class B through F notes) to retain the upside potential of the portfolio. It was the first time an AAA rating was achieved for notes backed by private equity.

While Pine Street and Astrea are examples of refinancings of fixed, pre-defined portfolios (such transactions are called portfolio securitisations or closed-pool securitisations),[5] securitisations have also been undertaken where the issuance proceeds are partly or completely used to purchase unidentified assets post closing. Such transactions are called managed securitisations or blind-pool securitisations.

Examples of such managed securitisations are the three Diamond transactions[6] with closings in 2004, 2006, and 2007, the Tenzing CFO[7] with a closing in 2004, as well as Prime Edge Capital[8] with a closing in 2001. In these cases the portfolio that was securitised consisted of only partly existing investments, along with investment capacity reserved for new investments and reinvestments to be determined after closing. These transactions thus require larger liquidity reserves, and the investors have to take into account the additional risk that no good investment opportunities will arise in the future. The reason for these transactions is primarily to optimise return on invested capital for the equity investors and to increase investment capacity.

A number of non-public loan financings of private equity portfolios have also been undertaken, structured similar to a securitisation but with a single bank as the lender. The advantage of using a bank loan instead of issuing securities is that it may enable you to negotiate more elaborate terms to fit certain portfolio anomalies and that it is feasible for smaller transaction sizes as well.

Differentiating securitisation from secondary sales and structured sales

Private equity securitisations are often compared to secondary sales. While it is true that a securitisation is an attractive alternative to a secondary sale, a securitisation is more flexible and is mainly undertaken in situations where the owner wants to generate an early cash payment, but does not want to exit from its private equity investments as it believes in the future profit potential of the assets.

If the objective is to generate early liquidity, a securitisation can help the owner achieve an initial, non-recourse cash payment of up to an amount equalling approximately the reported NAV of the portfolio and at the same time participate in the future up-side potential of the portfolio through the retention of the junior securities.

Further, it is important to differentiate between a securitisation and a structured sale. A structured sale is basically a secondary sale with additional conditions, such as seller financing, deferred purchase price payments, splitting of future distributions and/or draw-downs, earn out clauses, etc. It is possible to structure these conditions to accomplish similar benefits to a securitisation. Securitisations are not suitable for small portfolios with insufficient diversification and a structured sale is the only functional alternative.

RATIONALE OF SECURITISING PRIVATE EQUITY

Similar to other asset classes where securitisation is widely spread, the main rationale for securitising private equity is to more efficiently finance assets that are not creditable in isolation due to their illiquidity and relatively high risk. By forming diversified portfolios of private equity investments, more predictable and more stable future cash flows are achieved. Then transferring these diversified portfolios to stand-alone finance vehicles that are unrelated to the owner's credit quality allows the issuance of rated and standardised debt securities that can be sold to and traded by conventional capital market investors. Opening up the possibility of refinancing private equity portfolios with non-recourse debt gives the owner the opportunity to optimise the use of its financial resources and achieve a wide range of benefits.

Benefits of securitising private equity

The most obvious accomplishment of a securitisation is that it generates a non-recourse cash payment to the owner upon closing of the transaction, without having to surrender the ownership or up-side potential of the investments. Technically, the cash payment is part of the consideration for selling the portfolio to the securitisation vehicle, and the payment is financed by selling part of the newly issued securities to third parties. The initial cash payment to the owner can be up to 100 percent of the portfolio's reported value, without having to sell the equity or junior securities to new investors.

Less obvious is that a securitisation does not only generate an early cash payment, but by repackaging the private equity assets, which are illiquid in isolation, into standardised notes that can be traded freely, a fundamental improvement in liquidity alternatives can also be achieved post closing. The securities created have ratings and are in general listed on an exchange. Thus the trading of private equity linked risk and exposure is greatly simplified and available to a broader market compared to the traditional secondary model.

A securitisation can also help to substantially increase the expected return on investment for the owner. With the success of the recent private equity securitisations, capital market investors have become more familiar and comfortable with securities collateralised with private equity. Today notes with a principal value of up to 80 percent of reported value can be issued with AAA and AA ratings and to average interest costs of less then LIBOR plus 0.6 percent. This source of inexpensive debt financing can be used in the same fashion that buyout investors use to maximise value by utilising leverage. If the future private equity return is greater then the total costs of financing of approximately 5 to 6 percent (including all transaction costs, servicing fees and interest costs), an increase in return on invested capital can be realised.

Further, by opening up the debt markets to private equity partnership investing, the investment capacity can be materially increased. New investments can either be made with the cash received by the owner at closing or by including reserves for new unidentified future investments and re-investments in the securitised portfolio. Increasing investment capacity is often a driving factor of any securitisation.

Further advantages of securitising private equity

Besides the financial attraction of the technique, there are regulatory, legal, tax, accounting and other issues that may present both challenges and opportunities.

Regulated investors such as banks and insurance companies have to hold equity reserves in an amount that corresponds to the risk level of their investments. Because of the relatively small size of private equity allocations, the regulators tend to focus fairly little attention on this asset class, which generally results in rules and regulations that inaccurately reflect the actual risks involved. For instance, neither the Basel II regulatory framework for banks nor the NAIC (National Association of Insurance Commissioners) regulatory framework for US insurance companies distinguish between a direct equity investment into one single company and a well diversified portfolio of limited partnership interests. Today a securitisation can be structured so that it is treated off-balance sheet according to international accounting standards (IAS) and US

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GAAP, with the effect that a securitisation can transform the private equity assets into various classes of notes that better reflect the actual risks of the portfolio, and thus allow for a significant reduction in required risk-based capital reserves for the owner. Far from trying to circumvent the regulator, the technique is based on the fact that the regulator prefers investments into assets with a clearer defined risk profile.

In most jurisdictions, bonds and equities are taxed differently. Securitisation can be used to change the investment into a more tax favourable format. The specifics are highly dependent on the type of investor, the jurisdiction the investor is subject to, and the jurisdiction of the underlying assets. In certain European countries, for example, the equity in a securitisation would usually be taxed under capital gains rules (if held for a sufficient length of time), while more straightforward limited partnership structures (e.g. funds of funds) would be taxed under income tax rules. As the former may have a tax rate of 0 percent, and the latter a rate as high as 40–50 percent, the advantages are compelling. Although tax structuring is an ancient art, adding securitisation techniques creates a business purpose that anticipates the need to demonstrate that the tax advantages of the structure are ancillary rather than primary, since the nature of the investment has been transformed through the use of leverage that is inherent in a securitisation.

Solid legal structuring may actually result in more secure holdings for the investor. Securitisation enforces the sound discipline of the debt markets on private equity. In particular, fund of funds structures (limited partnership, investment companies) are not usually structured to provide protection for the investors under adverse conditions. Securitisations enforce a simple but powerful hold over the assets that give investors better liquidation rights. To achieve AAA ratings, the legal risks obviously need to be small. These protections can be implemented without endangering the work of the professionals managing the underlying assets or the other limited partners in a particular fund.

The desire for a sale of private equity assets may be driven by changes in internal strategy regarding private equity or an internal reallocation of capital. A securitisation allows the investor to change the exposure of the particular asset, while at the same time retaining the relationship with the GPs.

Rational of investors of private equity securities

Investors of securities issued in connection with a private equity securitisation can be divided into three groups: (i) senior investors, i.e. the investors that buy the notes that will be redeemed first and thus have the lowest risk, (ii) mezzanine investors, i.e. the investors of notes ranking junior to senior debt but senior to the junior notes, and (iii) the junior investors, i.e. the investors of the most junior notes.[9]

The senior investors consist of traditional capital market investors focused on fixed income instruments with predictable cash flows and investment grade ratings.[10] Previously, these investors have been unable to invest in securities collateralised with private equity. Thus the offerings from recent private equity securitisations are attractive, as they allow the investors to diversify their portfolios with a new asset class. As long as the terms of the senior debt are not abnormal, the placement is straightforward and can be completed within a few weeks once the offering documentation is ready. This is highlighted by the attractive pricing and the low interest rates that are demanded from the senior investors.

Potential mezzanine investors are a diverse group, including conventional private equity investors, hedge funds, banks, insurance companies, etc., with the common denominator that they are all relatively flexible investors looking for a good deal. The attractiveness of mezzanine notes is that they offer relatively high interest payments at relatively low risk, as they do not have to carry the first loss in case of a portfolio decline. However, the market for mezzanine debt is not as liquid and predictable as for senior debt, so the advantages of raising somewhat more debt at closing have to be carefully weighted against the additional interest costs and particularly the additional placement risk. In most cases, it

seems more favourable to issue mezzanine notes as a package with the junior notes at closing and sell them only when additional liquidity and leverage is desired as the senior debt is redeemed.

There is a difference between the equity investors of portfolio securitisations and those of managed or blind-pool securitisations. Junior investors of portfolio securitisations are predominantly experienced private equity secondary investors, such as large pension funds, secondary funds, banks and insurance companies. In case of a portfolio refinancing, investing in junior securities can be compared with a secondary investment: in both cases you effectively purchase an equity stake in a diversified and mature portfolio. However, quality portfolios are today often priced at a premium, implying that the only way to make high returns through a conventional secondary purchase is to hope that the private equity fund managers will continue to do an outstanding job with the underlying investment companies. Investing instead in equity of a portfolio securitisation generates a higher return on investment through the usage of efficient leverage which can also be provided by banks. The more sophisticated secondary investors have recognised the advantages of debt financing, and there is a high appetite for such offerings.

Investors in junior notes of managed or blind-pool securitisations are often investors that are seeking diversified exposure to private equity in an efficient way. The rationale for investing in blind pool securitisations is predominantly that it enables the investor to get invested faster through an over-commitment strategy and to realise enhanced return through use of leverage. Tax and regulatory benefits can also be achieved for certain investor groups.

THE PROCESS OF SECURITISING PRIVATE EQUITY

Securitising private equity is a relatively complex and work-intense process. However, the transaction risk has decreased significantly since the first securitisations in 2001. The reason for the reduced transaction risk is mainly the increased level of experience by all participants, from advisors to placement agents to investors. Today the difficulty is not closing a transaction, but making it as efficient as possible.

Theoretically it is possible to divide the transaction process into four key phases: (i) the exploration phase; (ii) the structuring phase; (iii) the implementation phase and (iv) the closing phase. In reality however, it is difficult to clearly distinguish the phases, since the different parts of the project are interdependent and the circular nature of most issues impacts the process.

Exploration phase

The exploration phase starts with obtaining an understanding of the objectives and constraints of the clients. That might sound obvious and self-evident, but since there is a large degree of flexibility in how to structure a securitisation and to accomplish a wide range of different purposes, not discovering the relevant particularities during the exploration phase will lead to changes and complications later. To ensure that there is clarity on what should be achieved from the outset, it is vital that the arranger help the sponsor understand the process and options available, so that issues and additional requirements are identified as early as possible.

As a basis for developing the financial structure, a rigorous analysis of the portfolio must be undertaken, so that the terms of the issued notes can be efficiently matched with the expected cash flow scenarios and value development of the underlying assets. As part of this analysis, diversification is tested, the historic returns of individual investments and the portfolio as a whole are benchmarked, and most importantly various scenarios for contributions, distributions and value development are forecasted through the Monte Carlo simulation. As there is always the option not to include all available funds or to add additional future investments in the portfolio, different portfolio alternatives are examined and compared. To construct an optimal portfolio the requirements of both the senior and junior investors have to be taken into consideration.

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Structuring phase

The goal of the structuring phase is to find a baseline financial structure that meets the financial objectives of the sponsor. The risk/return profile and cash flow characteristics of the various classes of notes are determined by setting the terms of the notes and composing the priority of payment. Noteworthy is the fact that the terms of the notes and the priority of the payments predominantly determine the efficiency of the financing. In this respect, the direct interest costs are of secondary importance.

To ensure the marketability of the notes, it is vital that the arranger know the preferences of the potential senior investors while defining the terms of the notes. It is often alluring to structure complex terms to better fit the expected portfolio cash flow; however it is always essential to accurately consider the trade-off between making the terms more complex and efficient and the effect on the pricing and marketability of the notes. Other issues to consider while structuring the transaction are the hedging strategy for foreign currency and interest rate risk as well as how to optimise cash management.

The forecasted cash flow scenarios are run through models of the contemplated securitisation to assess the viability of the baseline financial structure, by comparing the effect on net cash flow to investors, IRR, multiple and risk of the various alternatives. The result will be a summary of the analysis explained above, together with a detailed term sheet, time schedule and budget to facilitate the decision by the sponsor.

Implementation phase

Transaction counsel and rating agencies are mandated in the implementation phase with the purpose of creating a legal structure, drafting transaction documents and obtaining indicative ratings, as these are prerequisites to launch the marketing of the newly created notes.

The legal structure is important for many reasons. First, the vehicle used for the securitisation has to be bankruptcy-remote, meaning that the assets cannot be seized in a bankruptcy proceeding against any of the equity investors, to ensure that their credit quality is irrelevant for the issued notes. The legal structure also has to be tax efficient, so that no taxes arise through the transfer of the portfolio and to minimise future taxes (including VAT and withholding taxes) for the vehicle itself as well as for the investors. Furthermore, the legal structure must be familiar to the potential investors and meet their regulatory requirements. Finally, the structure has to be suitable to hold the underlying assets to facilitate the transfer process.

The drafting of transaction documents is an intense process, and it is crucial to conclude the documentation process as much as possible before other parties are invited into the process. Here the arranger has the responsibility to lead the processes and coordinate input from all effected parties, such as the legal counsels from the various jurisdictions involved, accountants and the owner, as well as anticipate the requirements from GPs, potential investors, rating agencies and placement agents.

The rating agencies are formally engaged during the implementation phase, so that indicative ratings can be attained before the marketing starts. Today rating agencies have experience with private equity transactions and are familiar with some of the arrangers, which make the rating process more predictable.

Closing phase

Once the documentation is principally finalised and the notes have indicative ratings, the closing phase begins. The placement of the newly issued notes and the transfer of the underlying assets from the former owner to the securitisation vehicle are most important in this phase. To ensure a smooth process and competitive pricing for the sale of the notes, investment banks are commonly selected through a beauty contest. In most transactions so far, the notes to be placed into the capital markets have been underwritten by the placement bank to further reduce the placement risk.

Convincing and comforting the GPs and their respective legal advisors that the securitisation will

Exhibit 5.1: Participants and their principal roles

Participant	Role
Sponsor	Previous owner of assets or future majority owner of equity (depending on transaction).
Arranger	"Designer" of the transaction, creates suitable solution within the given boundary conditions, overall project coordination, assures proper interaction amongst the players.
Transaction counsel	Lead lawyer, acts on behalf of the issuing securitisation vehicle (as opposed to the Sponsor or any other party).
Legal advisors	Several firms, as each participant tends to have their own legal advisor.
Senior investor	One or more investors into the debt securities issued with high seniority.
Junior investor	Investors in the issued junior securities. Often the junior securities are not actually equity, but notes that have the similar economic rights and risk/return profile as equity.
Placement agent	Sells the securities to independent third parties. Usually not required in private deals.
Rating agencies	One or more rating agencies may rate the notes or debt issued.
GPs	General partners or managers of the private equity funds in the portfolio that is securitised.
Accounting advisor	Necessary in more complex regulatory situations, works together with Transaction Counsel and Arranger.
Transaction auditor	Audits the securitisation vehicle going forward. May be used prior to closing to verify certain information regarding the portfolio.
Sponsor's auditor	May have critical input or set conditions for the deal, especially if sponsor is a regulated entity.
Regulator/s	Any government or similar entity whose charter may involve scrutiny of the transaction (banking, insurance, pension, money laundering, accounting, securities oversight, etc.). Are not usually actively involved in the completion of a transaction.
Servicer/manager	Manages and administers the securitisation vehicle post-closing until maturity.
Valuation agent	Values existing assets transferred into securitisation vehicle. Valuation may be required by investors, auditors, rating agencies.

not adversely impact the GP or the partnership and obtaining the necessary transfer consents are labor-intense parts. To make this process efficient, it is important that the arranger and transaction counsel can competently inform the GPs about the transaction and subjects such as the consequences regarding credit quality of the new owner, reporting and FoI[11] issues, investment company act issues, tax consequences for the partnership and ERISA issues. While the transfer process is time consuming, it is rare that partnership interests have to be excluded from securitisations for this reason.

At last, the management and servicing of the securitisation commences. The tasks undertaken by the servicer include reporting to the various investor

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classes, administrating contributions and distributions, accounting and auditing, tax filing, exercising voting rights with respect to the underlying assets, preparing and controlling interest and other payments due on the payments days, and, if applicable, performing portfolio and risk management and executing the foreseen investments program.

MARKET OUTLOOK

Recent transactions have proven not only the viability of securitising private equity, but also that the various participants have accepted and understood these kind of deals sufficiently enough to make this financing alternative very attractive to a wide range of investors. It is unlikely that there will be a massive increase of securitisation in the coming years, but it is probable that this type of financing will continue to grow steadily and become more and more common.

The largest growth potential for portfolio or closed-pool securitisations seems to be for transactions including large institutional investors seeking additional investment capacity and regulatory capital relief, as well as traditional secondary investors in search of enhanced return on invested capital. There is also the possibility for additional growth of managed securitisations that provide smaller investors additional value like improved liquidity options and financial engineering.

Successful deal structuring will continue to depend on experienced parties which combine extensive expertise in both the private equity industry and the capital markets.

[1] Total global mortgage-backed securities issued in 2006 equalled $1.4 trillion and total global asset-backed securities (excluding mortgages) issued in 2006 equalled $1.5 trillion. *Source:* Thomson Financial, *Debt Capital Markets Review*, Fourth Quarter, 2006.

[2] Capital Dynamics acted as arranger and servicer.

[3] For further discussion on Astrea, please see the case study on Astrea at the end of this book.

[4] Capital Dynamics acted as arranger and servicer.

[5] Further examples of portfolio securitisations include Silver Leaf arranged by Deutsche Bank and Aon PEPS arranged by CIBC World Markets.

[6] SVG Advisers acted as arranger and servicer.

[7] BNP Paribas acted as arranger and Invesco as servicer.

[8] Capital Dynamics and Deutsche bank acted as arranger. Capital Dynamics, Hamilton Lane and Cogent acted as servicer.

[9] Junior investors can also be referred to as the equity investors. Even though the junior securities are most commonly structured as notes, economically they have same risk/return profile as true equity.

[10] Investment grade is a rating ranging from AAA to BBB.

[11] Freedom of Information.

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