Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

3 Alt PE Fund Types Attys Should Know Inside And Out

By **Benjamin Horney**

Law360 (April 19, 2018, 10:36 AM EDT) -- Private equity fund managers seeking an edge in a challenging and increasingly crowded fundraising and deal-making environment have found success trying unconventional strategies like secondaries and private debt, which promise stable and strong returns but can also present unique legal issues.

Even the most successful private equity firms have begun to realize that it is getting more difficult to rely solely on their bread-and-butter leveraged buyout funds, and while there is no shortage of those investment vehicles in the market, the difficulties involved in standing out among competitors has led to a significant rise in alternative fund types.

"We've seen a tremendous increase in the customization of investment products and vehicles for sophisticated investors," said Peter Gilman, a partner with Simpson Thacher & Bartlett LLP. "We've also seen the creation of entirely new fund paradigms, and strategies that are potentially more opportunistic, or provide a greater degree of flexibility in terms of the investment mandate relative to traditional PE buyout funds."

Here, Law360 explores three alternative fund types and the unique legal issues they bring with them.

Secondaries

The private equity secondaries market, which involves the sale or acquisition of investors' existing interests in investment vehicles, has seen an increase in popularity over the past few years, in part because secondaries funds provide limited partners with increased flexibility in their investment portfolios.

The practice is enticing for LPs because it allows them the opportunity to get out of investment commitments early in response to any number of issues, such as regulatory or strategic changes, and it is done for a variety of reasons, including a general desire for liquidity or the ability to rebalance a portfolio.

"We've seen kind of an explosion in secondaries market," Gilman said.

Attorneys wishing to be called upon for work on secondaries funds should ensure they are well-versed in both the areas of mergers and acquisitions and private equity fund formation, as one or the other won't always suffice, according to Kelly Labritz, a special counsel in Covington & Burling LLP's corporate group and a member of the firm's private equity and private funds practices.

"It's a blending of those two disciplines," Labritz said.

Since secondaries deals involve the transfer of investment interests that were already previously negotiated, the details of transferring such interests can sometimes be tricky, especially because fund agreements typically have restrictions and don't allow unfettered right to transfer.

Thus, it's important for attorneys to be prepared to navigate negotiation situations in which they are looking out for their clients' desires while also paying attention to the needs of the other side. It isn't just the selling party to deal with, it's also the other investors that contributed to the fund and the general partner of the fund itself.

Private Debt

The market for funds focused on private debt, or direct lending, has blossomed over the past decade, and despite a dip in fundraising during the first quarter of this year, the asset class is positioned to once again flourish in 2018.

Last year was particularly strong for private debt funds, which give fund managers the ability to step in and replace traditional banks as lenders, with every quarter of 2017 seeing fundraising totals exceed $20 billion, according to data from research firm Preqin. In the first quarter of this year, there were 19 private debt funds worth a combined $14 billion that held final closings, but attorneys that are dialed in to the state of the fundraising market should be advising clients that the first quarter slowdown is likely to be merely a blip on the radar when the year is through.

"This may simply be that the industry is pausing for breath before beginning another fundraising cycle," said Tom Carr, head of private debt products at Preqin.

The popularity of private debt funds seems to be particularly on the uptick when it comes to the middle market and lower middle market, in part because of the increased difficulty that fund managers in those parts of the market have had in getting traditional PE deals done as multiples have skyrocketed and the fundraising environment has gotten exponentially more crowded.

"Lending funds are therefore a great way to deploy capital, because there is still a great deal of demand for financing from smaller companies that are unable to get loans from the large banks and are also unable to access debt capital markets," said Jeffrey A. Legault, a partner at DLA Piper.

Additionally, lending deals are not subject to the auction process that often must be dealt with in M&A deals, meaning private debt transactions tend to be more proprietary in nature. Because multiple lenders are not frequently pitted against each other to get better terms, there is a higher probability that fund managers can get their desired deal done and less downward pressure on the return on investment.

"Lenders tend to get introduced to borrowers through smaller brokers or other resources such as law firms," Legault said.

The rising popularity of the asset class has also made way for the introduction of new types of private debt funds that are more opportunistic in nature and have the ability to exploit relative inefficiencies in the credit markets, geographic regions and capital structures to achieve attractive returns, Gilman explained.

"The spread between what these private debt funds can offer the typical institutional investor over a treasury of similar credit quality remains compelling and should translate into continued inflows into this asset class with private debt becoming a key part of any PE investor's asset class allocation strategy," Gilman said.

Infrastructure

There's rarely a time when capital for various infrastructure projects is not needed, and 2018 is no exception, especially considering the Trump administration's push for U.S. infrastructure upgrades. Attorneys can expect to hear plenty of client questions on the details of infrastructure investment vehicles.

That sentiment may not have been fully reflected when looking at the numbers from the first quarter — there were only five unlisted infrastructure funds that reached a final close in the first quarter with a combined $5.7 billion in investor commitments, according to Preqin — but as the year goes on, it is likely that the infrastructure figures will rise significantly.

"Infrastructure is poised to attract a lot of capital," Gilman said. "There's a tremendous need for private capital in the infrastructure space."

That bullish attitude makes sense when you look at the number of funds that are already in market looking to raise money. As of the beginning of this month, there were 178 funds in the market, up from 166 at the start of the year, according to Preqin, and those funds are seeking a total of $133 billion from investors.

Infrastructure is a very risk-average asset class and generally provides stable returns, according to Gilman, since they involve long-term contracted payments and cash flows that are secured by "very valuable assets."

Attorneys hoping to land work on infrastructure funds this year are more likely to be seen as attractive advisers if they are able to show a complete comprehension of exactly where the infrastructure market stands today and where it is heading. For instance, while clients are continuing to invest in traditional infrastructure assets, there is also a trend toward renewables such as solar, wind and hydropower.

As the definition of infrastructure continues to widen, there will be even more opportunity for those fund managers that would like to get in on the asset class. And while is opportunity for infrastructure investment all over the world, the current moment seems like an opportune time for fund managers to capitalize on the needs of the U.S., especially considering that the government has made clear that it hopes to pass a $1 trillion infrastructure plan sooner than later.

"North America is old," Gilman said. "There's a lot of money that needs to go into it, and these projects are capital-intensive. Infrastructure allows sponsors the opportunity to deploy a lot of capital."

--Editing by Katherine Rautenberg and Rebecca Flanagan.