Financial and Economic Crisis – Law Firms

The New Face Of Private Equity

*The Editor interviews **Robin Painter** and **David Tegeler**, Co-chairs of Proskauer Rose LLP's Private Investment Funds Group.*

Editor: Robin and David, would you both briefly describe your backgrounds in the private equity arena.

Tegeler: I am a partner in the corporate department of Proskauer Rose LLP, practicing in the area of private investment fund formation. My practice includes the formation of private equity, venture capital and special situation funds and the representation of sponsors of and investors in those funds. I've also worked on many transactions and clients related to the private investment fund world, including the transfer of interests in funds on the secondary market, the spin-out of private equity teams, and the representation of placement agents, back-office service providers, banks and individual general partners. The private investment funds group at Proskauer includes over 100 attorneys in many different practice areas, including private equity, venture capital and hedge fund practices, tax, ERISA, investment management, labor and litigation.

Painter: Dave and I have almost identical practices and co-manage the private investment funds group at Proskauer as we did at our prior firm, Testa Hurwitz. We represent every kind of sponsor in the alternative class – whether it be venture, buyout, distressed, real estate, timber, hedge, mezzanine, infrastructure, fund-of-funds or secondary funds. Similarly, we represent over 100 of the larger institutional investors in the asset class. Our practice is a global practice with clients in Asia, Europe and the U.S. We've grown the practice quite significantly since joining Proskauer and now have teams not only in Boston and New York but LA, London, Paris, and Hong Kong.

Editor: As with so many other types of transactions, private equity is not as much in the headlines today as it once was. In fact, we were recently attempting to edit a piece called, "The Failure of Private Equity," Would you say that this title has any merit?

Tegeler: Our team works on fund formation and related matters. Proskauer also has teams that do transactional work for private equity and venture capital firms. This particular question targets more the transactional aspect of the practice and the viability of the private equity deal model. One cannot ignore that tightening of the credit markets has had a significant impact on traditional private equity LBO deals. We represent managers who are not just making traditional LBO investments, however, but also managers engaged in mezzanine and distressed debt investments, infrastructure investments, secondary purchases, natural resource investments, etc.. Managers are looking for relevant

Robin Painter

David Tegeler

opportunities in today's environment, up and down the capital structures of their portfolio companies. Notwithstanding that LBO deal activity has slowed, there are still a large number of very smart people out there forming pools of capital to make investments in promising areas, and to form those pools of capital they come to us.

Editor: Are fund-of-funds deals still as attractive to investors as they were last year?

Painter: We have an incredibly deep penetration in the fund-of-funds business in the private equity space. Some have questioned the viability of the business model of fund-of-funds since they represent a second layer of fees over and above the fees that the underlying funds charge. We certainly have not seen a decline in interest in the fund-of-funds model. They serve a number of needs of the investor community, ranging from the relatively small institutional investor who has a 10 percent allocation to alternatives and who doesn't have the staff of analysts to perform the research to a very large investor who has certain suballocations such as geographic or industry requirements that require specialized expertise. One can make the argument that after the Madoff scandal, professional management is more important than ever – particularly in an asset class where the delta between the top performers and the bottom performers is much broader than you would see in the public markets. I'm very sanguine on the future of fund-of-funds.

Editor: Where are all the leveraged buy-out funds today?

Painter: I think the mega buy-out funds are under some pressure either not to draw down capital at the moment or to reduce their funds' size. On the other hand, there are LBO funds being raised right now that are getting a very positive reception in the market although the size of the fund and its strategy, particularly reliance on leverage as well as its track record, are determinative as to which funds are going to be able to raise and deploy capital in this market. Regardless, LBOs are certainly not dead.

With the dislocations in the market on the institutional side, unless the firm has a stellar track record and really hits the sweet spot of what people are looking for, now would not be the time to raise new capital.

Tegeler: In addition to their traditional activities, our clients are forming different types of funds today, such as distressed debt or credit opportunities funds, to take advantage of what they perceive to be a window of opportunity in a particular investment area. Those types of funds, to the extent that they address an investment opportunity that investors agree with, are gaining some traction in a very tough fund-raising environment.

Editor: Are the sovereign wealth funds active at all?

Tegeler: Certain sovereign wealth funds have pulled back, especially those that got in at the top of the market. Other sovereign wealth funds see this as a once-in-a-lifetime opportunity to invest and have a long enough time horizon that they can wait for the cycle to come back around. Those investors will be in the great position of having invested when valuations were low.

Editor: How are your clients, the funds and their portfolio companies, contending with the tightening of the credit markets and the absence of the former exit strategies?

Tegeler: With respect to the venture capital realm, a venture capital fund is expected to make follow-on investments over time to support their portfolio companies until exit. The time horizon to that exit is much longer today, however, because the IPO market has dried up and M&A activity has slowed. Venture capital fund managers want to make sure that they have enough reserve capital to make such follow-on investments, so they can see their companies all the way through to exit. Unfortunately, certain funds have reached the point where the capital that they had previously reserved for follow-on investments is inadequate to continue to provide follow-on funding through this difficult period. Such funds are exploring different strategies to come up with additional capital, including forming annex funds, borrowing money from a bank or another fund manager, or selling off select investments to other venture capital firms or secondary buyers.

Editor: How do they get financing for the annex funds?

Painter: Instead of raising another large fund the fund managers raise a much smaller fund that is going to be available only for add-on acquisitions. We have structured these annex funds with the same group of original investors or arranged a rights offering which might extend beyond the original investors to new investors. The other thing that managers are doing is extending their funds' termination dates to give themselves a little more time to realize on the investment. We've seen a rash of these amendments coming through over the past few weeks.

Tegeler: As an alternate to annex funds, managers have been very creative in coming up with new exit strategies. One of these strategies is through a "secondary direct" sale where, rather than waiting for a portfolio company to be sold in an M&A transaction or go public, a fund will sell their interest in that company to a secondary direct buyer who then takes that company into its portfolio and takes care of the follow-on funding required to take the company through to its exit. We represent a number of these secondary direct buyers in their fund formation and acquisition of assets.

Editor: What particular aspects of the Obama program do you foresee will have the greatest palliative value in bringing us out of the current recession?

Painter: There is an expectation that under the Obama regime health care and the environment are going to be a very favorable subjects for innovation and investment.

Tegeler: Over the past several months Congress has proposed legislation that would raise the tax rate on capital gains income. That legislation, if and when it passes, would clearly have an impact on the industry, certainly in terms of how managers structure funds and the types of incentives that managers receive for doing their deals. It is very unclear at this stage whether this legislation will be approved or, if approved, what form it would take.

Editor: What regulatory changes do you see being put in place by the Obama administration that will affect private equity? Do you think more transparency will be required?

Tegeler: Changes put in place in response to the Madoff situation could have an interesting impact on the industry. It is unclear how the administration or the SEC is going to react to the scandal, but it is possible that more transparency will be required with respect to the makeup of fund and fund-of-fund portfolios, which could have a broad impact in the private investment funds world, especially with respect to public plan investors subject to freedom of information laws.

Painter: I think that running parallel to the regulatory concern is the industry's determination to get on top of this deficiency on their own. In Europe there is a lot of focus on transparency and self-regulation as we are seeing more and more in the states. Just on an industry basis there was more thought and attention being given to this issue even before the Madoff scandal. Watching the industry and regulators work in parallel should be quite interesting.

Please email the interviewees at rpainter@proskauer.com or dtegeler@proskauer.com with questions about this interview.