Opalesque
Private Equity Strategies

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In This Issue

Welcome to the latest issue of Private Equity Strategies. This month we're opening with a brief update on a new survey Opalesque conducted, sponsored by Intralinks. The survey, entitled "Let's Be Clear," examines how LPs view the disclosures they're getting from GPs and what is still missing from those reports.

We are also looking at new trends in how the smaller parts of the credit landscape are being impacted by the change in regulations as well as how private capital is stepping into help them out. Two stories in this issue look at different ways private funds are putting their weight behind small bank loans and even smaller peer-to-peer loans. Both of these areas are heating up, and have significant cross-over appeal between hedge funds and private equity. Check out our Movers & Shakers column for more there.

Our Insiders View features a conversation with the Textron CIO about how he sees the merger between hedge fund and private equity interests. The conversation is notable for GPs, as this investor hits on some key areas GPs may be falling behind hedge funds.

As usual we've also included our monthly Regs Watch and Quick Hits columns for brief updates on regulatory changes as well as new transactions, people moves and events.

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Let's Be Clear - Transparency is Still Lacking in Alternative Investments

Even as investors push more capital into alternative investments, and regulation seeks to improve transparency, work remains according to a new survey from Intralinks and Opalesque. The report, entitled "Let's Be Clear: A Common View on Transparency," shows that only half of investors who responded think they are getting enough transparency from their managers.

Hedge fund industry assets are now hovering just under the $3tn mark, a big comeback from post-crisis lows. Private Equity also raised some $98bn in aggregate in the first quarter, highlighting a return to the asset class. Taken together, data shows that investors aren't shying away from the industry even if operational reporting isn't where it should be. Yet, hedge fund performance has been tepid lately, leaving open the question of how long investors will stick around on little information or returns.

According to data in the report, managers may want to reconsider holding back information. 89% of investors in the survey said they wouldn't invest in new funds due to transparency concerns, and would instead stick with their existing allocations. Given the already challenging asset raising environment for funds, this response should catch the attention of managers looking for a competitive edge.

"How fund managers communicate with investors hasn't changed much in the past 10 years. Only more recently has the industry started to realize that a good investor communications program can actually be a competitive advantage," said Andre Boreas, Director of Alternative Investments, Intralinks.

Despite how slowly managers are adapting to transparency demands, there do seem to be some positive changes on the horizon. 85% of investor respondents said they would prefer to get fund disclosures in electronic (and presumably machine readable) formats to facilitate in-house analysis. As Opalesque has previously reported, technology spend is going way up inside funds as they work to meet regulatory and investor compliance demands.

In addition to format, content of disclosures is equally important. 96% of investor respondents said that beyond performance, they want to see both leverage and exposure metrics. Leverage and exposure were cited as the two items following right behind performance for how hedge funds are evaluated. On the private equity side, 93% said that valuations and financials were most important behind performance. Funds willing to highlight these metrics in a format that investors can slice and dice on their own, will see a distinct advantage in asset raising.

The other theme in the survey was consistency of those disclosures. Respondents note that if they ask for a specific piece of information, they usually get it but they do have to ask which raises questions as to whether all investors in a given fund are on a level playing field in terms of information. As alternative investments mature and attract institutional dollars, it is likely that those investors are getting more from a fund than a family office.

An alphabet soup of standards groups including ILPA, OPERA, and HFSB have all tried to set up disclosure standards for hedge funds and private equity with mixed success. Data in the report shows investors taking matters into their own hands with 25% requiring daily or weekly reports from managers, but without clear standards inequality of information will rule the day.

"There is a fundamental shift underway in what information the investor community now requires from their fund managers," Boreas says. "GPs that realize this and make the meaningful investment in their operations to support this shift will ultimately win in the end."

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Movers & Shakers: Private Capital Lines Up Behind Community Banks

Community banks across the world are facing a barrage of changes as new regulations come into force. However, those regulations weren't originally aimed at them, they were aimed at the too big to fail multinational banks. For community banks, which by their nature have smaller resources meeting compliance requirements, cleaning up toxic assets and managing non-performing loans is a daunting task. Observers of the industry have also noted other factors including a wave of retirement from top management of many of these banks, and growing consolidation.

Taken together, it may well look like we could be facing a world without community banks. But new financial firms are stepping in to line up private capital behind community banks in a variety of ways. These companies are buying portfolios of non-performing loans, acquiring community banks as management retires, and setting up joint ventures to help manage the load.

Signature Group Investments is one such firm, it recently purchased a pool of non-performing and performing loans from a New York City based community bank. When firms like Signature step in, community banks can remove portfolios of business that could keep them from being in compliance with new financial regulations or could just be a drag on the overall profile of the bank. In turn, firms like Signature can use their expertise to deal with the non-performing loans and rebuild returns. In this purchase, Signature joined with a private equity firm to complete the transaction. In other cases Signature has directly partnered with community banks. And most recently, Signature decided to secure more permanent funding from family offices and high net worth individuals by engaging the GrowthCap team to manage its capital raise on the GrowthCap platform.

Deals like this are likely to become more common as private capital providers like private equity and hedge fund firms, along with specialty finance shops step in to provide capital where the big banks won't. As new regulations like Dodd-Frank, and Basel III have come into force worldwide, making small loans is no longer economical for the big banks and the compliance burden for community banks means resources are tight for them as well. The advent of this reality prompted some industry sources to note that there is a greater incentive for community banks to just close up shop in the face of new regulations, especially if retirement was already imminent for top management.

Capital and margin requirements for banks also forced an early sell off of certain loan types that banks used to lend to each other, and non-performing parts of bank balance sheets have readily come up for sale. For private capital firms, they've capitalized on the opportunity to provide capacity and buy up that paper.

Now, regulatory relief for community banks may be on the horizon. New Fed Chief Janet Yellen said earlier this month that there should be a tiered regulatory structure in place that takes into account the size and loan profile common to a community bank. The Independent Community Bankers Association (ICBA) has been pushing for changes to the rules to reflect a more realistic picture of banking since Dodd-Frank was passed. So far, the ICBA has been successful at getting community banks exempted from the Volcker Rule and setting up differing tiers of compliance could be another victory for the organization.

"Community bankers know we can't rest on our laurels. We have to strike while the iron is hot – whether it is a loan to a local small business or grass roots outreach on important legislation," ICBA President and Chief Executive Officer Cameron Fine wrote in a blog post on April 11.
The add-on investment went to Towncare Dental which is now part of the Dental Care Alliance, another Quad-C company. "DCA has been growing by acquisition and Towncare represents a significant addition there," Burns adds.

So is it the end for community banks? Not yet. But, times are tight and community banks may look wholly different when the dust settles. Watch this space.

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Regs Watch: Brief Updates on Changes in Regulation for Private Equity

As journalists like us and lawyers have written ad nauseum, new and ever more regulations are in the pipeline for private equity and alternatives as a whole. Here we will hit on some of the cases of note and provide links to new guidance over the past month.

N.Y. Tightens Rules On Private Equity In Insurance Deals

New York regulators are aiming to strengthen policyholder protection governance of private equity and other acquisitions of insurance companies, especially annuity companies, according to a report in Insurance News.

Private-equity scrutiny deepens after SEC finds illegal fees

Private-equity firms, after decades of operating with limited regulatory scrutiny, are facing possible sanctions and tighter oversight after the Securities and Exchange Commission uncovered improprieties at most firms.

Three Signs the Best Days of Private Equity Are Over

The bits of information that have trickled out about the SEC's findings so far haven't reflected well on private equity, Bloomberg BusinessWeek notes. Could this spell the decline of the industry?

FATCA: why European GPs should beware

At first glance, upcoming regulation FATCA (Foreign Account Tax Compliance Act) appears to have no relevance to those European private equity firms without US investors. However, on closer inspection, the new rules could be more troublesome than ever imagined.

New York considers changes to proposed ERM and ORSA regulation

Based on industry comments, the New York Department of Financial Services is strongly considering making a number of changes to its proposed Regulation 203, concerning Enterprise Risk Management and Own Risk and Solvency Assessment.

Structuring Private Equity Co-Investment Opportunities In Bermuda

Co-investment rights give an investor the ability to make a minority investment, directly or indirectly, in a portfolio company, say offshore specialists from Appleby.

Oregon to Examine Private Equity Fees

The Oregon Investment Council, which manages the state's $87.5 billion in retirement assets, said it is taking a serious look into the matter as the SEC continues to investigate.

Q1 Deal Volume Declines

New data from the Private Equity Growth Capital Council shows that US private equity investment deal volume declined 24% in the first quart of this year. Total volume for Q1 came in at $110bn, compared to $144bn in Q4 of 2013.

Riverside's 100th Exit

The Riverside Company completed its 100th exit with the sale of Retail Zoo, an Australian restaurant franchisor. Retail Zoo owns Boost Juice Bars, Salsa's Fresh Mex Grill, Cibo Espresso and Hatch concepts. Riverside acquired Retail Zoo in 2010. The company was sold to Bain Capital, financial terms of the deal were not disclosed. Private Equity Strategies spoke with Riverside in our May issue last year, learning more about their extensive deal origination process. 100 exits seem to suggest they're just as good at selling as buying.

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Insiders View: Textron CIO Forecasts Great Merger Between PE & Hedge Fund Managers

Benedicte Gravrand
Opalesque Geneva

Charles Van Vleet, Textron's private pension fund CIO, gives his perspectives on why benchmarking against the HFRI is a mistake in a rising S&P environment in a recent Opalesque TV interview. He also forecasts a great merger between private equity and hedge fund managers, explains why the latter may be better at managing structured debt and what hedge funds can do to facilitate investments by allocators.

The wrong way to use hedge funds

His predecessor took on a 3% allocation in hedge funds and benchmarked it against the HFRI, he says, but he thinks it is the wrong way to use hedge funds. "My observation of hedge funds is that they are increasingly, particularly in the rising S&P environment we've had in the last two or three years, taking on – just like the HFRI in general – more and more equity beta. There are a lot of less expensive ways that I can get equity beta," he comments.

Mr. Van Vleet agrees that the HFRI is a great index, and a "slow rabbit" in which one can pick some select funds. His objective however is not to create a slow rabbit benchmark internally but to "carve out something that truly looks different to rate beta, equity beta, curve currency."

He wants to find hedge funds without the beta characteristics, and benchmark them to LIBOR +200. If he can make a basket of such funds – with various strategies – he will "stack that on top of" his S&P 500. He could never justify, he claims, tying up capital at LIBOR +200 unless he was going to use it as leverage to port it on top of his other bond and equity and other investments.

However, other plan sponsors may not think that way, he adds later on, as not all might wish to use leverage in this way. But he thinks it is going to be impossible to get a 7.5% rate of return without leverage. "The objective is to use smart leverage."

"I think that's the best way to use hedge funds," he continues. His program is to shift the allocation to L+2 some time this year, although "it's a 12-month project."

Hedge funds better at managing structured debt

Mr. Van Vleet sees a "great collision" between traditional private equity managers and traditional hedge fund managers, as they both bring "tremendous insights and brilliance to investing."

As part of his plan to increase allocation into private debt structures (such as bridge loans, capital expansion loans, asset-back receivables, factoring, lease financings, etc.), he has looked at the likes of KKR, Bain Capital, Carlyle on the private equity side, as well as hedge funds such as Avenue Capital, Anchorage Capital, and Tilden Park that are coming into that space.

Those hedge funds coming into the structured debt space might have been those that inappropriately invested in a three-year liquidity idea, had a 90-day liquidity vehicle, and learned their lesson in 2008, he continues. These funds might still be investing in the three-year liquidity ideas, but they need a three-year liquidity vehicle - so they are looking to build private equity structures.

He thinks hedge fund managers will be better at managing structured debt. "There are fantastic opportunities for hedge fund managers who are thoughtful about creating a new vehicle for those type of ideas."

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Advice to hedge funds

The first thing that hedge funds could do to help corporate plan sponsors such as his, is to have the right vehicle for the right idea. The second thing they can do is present clean numbers, "an honest assessment of your Greeks," with returns, Sortino, Kurtosis, drawdown, recovering drawdown, hit rate, etc. in a single column spreadsheet, so "I can do my own Greeks."

Indeed, Mr. Van Vleet found that hedge funds in general are not giving a good menu of typical Greek analysis.

Background

In this Institutional Investor Series interview, Michael Oliver Weinberg, Adjunct Associate Professor of Finance and Economics at Columbia University and CIO of family office, MOW & AYW LLC, profiles Charles Van Vleet, CIO and Assistant Treasurer of Textron, Inc.

Textron is a Providence, Rhode Island-based multi-industry company with plants in Texas and Kansas. With around 33,000 employees, the company produces many well-known brands, some in the defense sector, including Bell, Cessna and E-Z-GO. It is ranked 225th on the FORTUNE 500 list of largest U.S. companies.

Scivantage Launches FinTech Incubator Program in Collaboration with Stevens Institute of Technology

The Scivantage FinTech Incubator Program aims to support and accelerate the launch of next generation financial technology products, enabling entrepreneurs and early-stage startups to drive a new era of financial services innovation.

The Incubator will be a 12-week program that empowers entrepreneurs and early-stage startups to develop dynamic and disruptive technology that will transform the Financial Services industry.

Through a competitive process, entrepreneurs will be selected to participate in the incubator program during each cycle, with each receiving:

- An investment of up to $25,000 in seed capital.
- Office space in Scivantage's Jersey City, N.J., office.
- Sales, marketing and design support.
- Mentorship from a group of seasoned executives
- The opportunity to recruit students & alumni from Stevens Institute of Technology.

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Blue Elephant Goes In on Non-bank Lending

The recent explosion in peer-to-peer lending these days can be hard to explain to the general public, but the story behind the tremendous growth is a simple one: peer-to-peer lending became popular as a means of making small interest-bearing loans to individuals who typically would not receive a loan at a regular bank as credit and lending terms tightened. The accelerated growth in these P2P lending platforms has drawn the attention of both banks and specialty finance industry heavyweights who view it as a new vertical for loan assets. Early on it looked like financial industry biggies were going to squeeze out smaller lenders, but as the space grows it appears there's enough demand for everyone.

For consumers, the allure of P2P is pretty clear. If your credit is passable but not fantastic you have a shot at negotiating a loan with a real person and not a faceless bank or credit card company that only has profit in mind. For the lenders themselves, there's a little more risk if, for example, the loans made start to go into default or underperform. However, if they perform as negotiated these small loans can be an economical and profitable investment tool. So far, it seems like the benefits outweigh the risks to both sides as P2P loans topped the multi-billions of dollars last year.

The oldest and most popular P2P lending platforms are LendingClub and Prosper Marketplace. They were originally entrepreneurial ventures, but have now gained private and institutional backing. In some ways, P2P is the finance outgrowth of e-commerce, much like crowdfunding or selling your homemade earrings on Etsy. P2P is a step above micro-finance and two steps away from the task based economies, which have also emerged with the advent of the global Internet.

Unlike micro-finance which often targets low income individuals in an effort to help them become more financially secure, the biggest P2P lending platforms have gone out of their way to avoid what could be called the subprime lending market, and focus on people who have passable to good credit but don't or haven't qualified for a more traditional loan. This focus has attracted the interest of yield-starved institutions and private funds that now have access to a new class of credit opportunities.

Blue Elephant Capital Management is one private fund capitalizing on this trend by actively purchasing and managing a highly curated portfolio of these loans. The fund currently has approximately $20 million AUM; its portfolio has a weighted average FICO score of 715, with approximately 60% invested in three-year loans and the remainder in five-year notes. Blue Elephant is one of only a dozen institutions on the Prosper platform, operating in much the same way a bank would when holding a portfolio of loans. Blue Elephant recently decided to secure additional funding from family offices and high net worth individuals by engaging the GrowthCap team to manage its capital raise on the GrowthCap platform.

Right now, lending interest rates across the different platforms hover around 4-7% for creditworthy barrowers and increase slightly for those with less optimal credit scores. That makes the rates for these loans significantly lower than even the best credit card terms, and with approvals that take only a few minutes, the process is more welcoming than an afternoon spent with a bank loan officer.

Other funds are getting into the act, Marshall Wace LLP, one of Europe's biggest hedge fund managers, will launch a portfolio investing in peer-to peer loans through a closed-ended fund that will be offered on the London Stock Exchange. Marshall Wace has more than $17 billion in assets, and started a peer-to-peer lending business in late 2013. Last month it announced plans to buy U.S. firm Eaglewood Capital Management LLC, which will run the new fund. Marshall Wace will also invest in the Eaglewood Income Fund, which invests in the Lending Club platform.

Finance interest in these platforms has gotten so large that both Prosper and Lending Club have increased the hurdles to buying up loans too quickly in an effort to maintain the diversity of lenders. Prosper recently finished a $70 million fundraising round led by Francisco Partners, a private equity firm, with Institutional Venture Partners (IVP) and Phenomen Ventures participating. That company is now worth $145 million, and a portion of the funds raised will go to maintaining the diversity of the platform.

Even with those efforts, P2P is ultimately part of the rapidly growing shadow banking sector and the extent to which private funds and large institutions play in these pools is catching the attention of regulators. Regulators in the US still haven't decided what they think about P2P lending, the responses are somewhat scattershot and formal guidance is lacking. This is the same approach they've taken to crowdfunding in general, coupled with a lot of warnings about widespread fraud. Opalesque has previously spoken with crowdfunding platform owners who make a strong counterpoint – they said the same things about E*TRADE and eBay.

Yet, some signs are troubling, like the growing securitization of P2P loans which are now bundled and offered to a range of investors as seen with mortgages and student loans. History tells us that rarely ends well. However, the sheer fact that (in some cases at least), these loans are made between actual individuals could make the default recourse a little less draconian and a little more honest.

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Quick Hits

Blackstone has sold several office real estate holdings in Boston to a venture led by Oxford Properties Group for approximately $2.1 billion.

SFW Capital Partners, a specialized private equity firm that invests with management in mid-sized companies providing analytical tools and related services, has made an investment in Essen BioScience, Inc. Essen provides analytical instrumentation software in the sciences.

Forstmann Little & Co. has completed the sale of 24 Hour Fitness Worldwide, Inc. to an investment group led by AEA Investors LP and the Ontario Teachers' Pension Plan.

Viking Partners LLC has sold McGalliard Mall Shops to a private investor for $8.78 million. The site's occupancy rate is 95 percent. When Viking bought the site in early 2012, the occupancy rate was nearly 52 percent. Viking Partners Fund I bought the development through Auction.com.

APG Asset Management, a Dutch pension fund, has agreed to invest up to $650 million for a 20% stake in e-Shang, a Chinese warehouse operator backed by Warburg Pincus.

Consonance Capital Partners has acquired KEPRO, a based provider of medical management and cost containment solutions, from The Pennsylvania Medical Society.

KPMG LLP has entered into an agreement by which most of the principals and employees of Rothstein Kass will join KPMG.

Safeguard Properties has formed Safeguard Capital Group, which the company says is "a middle-market private equity fund focused on diversifying and expanding Safeguard Properties' business model into complimentary markets."

Educational security platform Clever has raised $10.3 million (£6.1 million) in investment from investors including Sequoia Capital. The company is based in San Francisco.

New York-based private-equity firm General Atlantic LLC plans to take control of two Chicago-based options trading shops, OptionsHouse LLC and TradeMonster Group Inc., by investing in each of them and then merging the companies.

Events

Private Equity Investing In For-Profit Educaton Companies
July 24, 2014| New York, NY
Hosted By: Capital Roundtable

SuperReturn Boston
June 9-12, 2014 | Boston, MA
Hosted By: SuperReturn

PE Investing in Info Services & Big Data Co.'s
June 12, 2014- New York, NY
Hosted By: Capital Roundtable

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