PRIVATE EQUITY ONLINE

Default concerns to lead LPs to secondaries

As private equity firms await a decline in valuations to deploy dry powder, GPs and LPs alike are looking at whether there is ample liquidity to meet capital calls.

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Concern over cash on hand is expected to drive increased private equity secondary activity going forward as limited partners reexamine their cash flow models in order to avoid the potential for defaulting on capital calls.

The rush to the secondary market hasn't fully begun yet, according to Richard Lichter, managing director at private equity secondaries firm Newbury Partners.

"I haven't seen many instances where there's actual defaults on capital calls," said Lichter. "The fact is there aren't that many capital calls out there because there aren't many deals going on."

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Dennis Chookaszian

Lichter believes we are in the first stage of a predictable secondary cycle in which most sellers are motivated sellers. Some LPs are distressed and facing liquidity issues at present but most are driven by wanting to sell as opposed to needing to sell.

The LPs under the most pressure at present are banks. The banking community is generating 60 percent of current deal flow for private equity secondaries firm Paul Capital Partners, general partner Bryon Sheets told *PEO*.

Banks are looking at "every corner of their balance sheet" for illiquid assets that can be turned into cash in order to preserve their capital bases, said Sheets.

Concern over defaults will become a more widespread issue as private equity firms once again become more active.

"Private equity firms have raised very large new funds and are sitting on a lot of undrawn available cash, but a question that you must ask is: Given the market crisis will their LPs be able to provide the cash when they need to draw on it for acquisitions?" said Dennis Chookaszian, chairman of the Financial Accounting Standards Advisory Council.

General partners and LPs alike are doing analysis to assess the answer to this question.

GPs have begun paying attention to the solvency of their LPs and are conducting "sensitivity analyses" on their entire capital base, according to a one placement agent. Banks and insurance companies are the most concerning, but GPs are reviewing everyone.

LPs have told Lichter they believe their cash flow models are wrong in the current market environment. LPs rely on models to determine how much liquidity is needed to meet capital demands, taking into account predicted inflows and outflows of capital. The expectation is now that capital is going to be called down as the pricing of investment targets becomes increasing attractive but there will be little in the way of distributions.

Lichter said: "General partners have investment periods, they have money. When they can do deals they will start doing deals at these lower prices but that doesn't mean that there'll be an opportunity to sell other deals and that doesn't mean they'll want to sell at those prices."

Reexamining their financial models as well as shock resulting from the impact of fair value accounting standard FAS 157 on year-end statements will create a second wave of LPs going to the secondary market that Lichter predicts will occur early on in the second quarter of 2009.

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