PRIVATE EQUITY ONLINE

Tempest in a teacup

Liquidity concerns have pushed LPs to the secondary market amid default anxiety, but the likelihood of major defaults looks slim, writes Suzanne Weinstock.

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Fear of capital call defaults has swept the private equity community, leading to a surge in secondary activity that is only expected to increase. However, it is ultimately unlikely that LPs fail to meet their obligations.

For some, the move into the secondary market is an indicator of immediate distress. However, many limited partners are simply taking appropriate action in light of current market impact on liquidity expectations.

Few, if any, defaults have occurred to date. Certainly no high-profile ones, even as major financial institutions crumble.

We are at the beginning of a predictable secondary cycle, according to Richard Lichter, managing director at private equity secondaries firm Newbury Partners. The causes of this particular cycle are unique in terms of the credit squeeze, Lichter admits. But the increased deal flow is exactly where he and other secondary specialists expected it to be.

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Distress is of course a major factor for a handful of LPs, particularly among 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 under pressure, scrambling to preserve their capital bases by unloading illiquid assets for which private equity stakes are prime targets.

GP concerns regarding the majority of LPs is likely overblown though. GPs 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 including pensions and endowments.

The issue for most LPs at present is that the cash flow models they use to determine how much cash to have on hand have been thrown out of whack by the public market swoon and by a halt in exits. Models are being tweaked to reflect a rise in capital calls as valuations for investment targets drop with little in the way of distributions.

Running the adjusted models means a further increase in secondary activity, which will bring LP liquidity to appropriate levels, thereby negating any default risks.

Even if a smattering of defaults occur, the impact should be minor. "You have in some cases well over 100 LPs in a fund where if any one, or even two or three, defaults its not going to materially impact that GP's ability to continue to support their portfolio," said Sheets.

Generally, anxiety regarding defaults should mean that few defaults come to fruition.

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