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3 Types Of PE Funds Attys Can Expect To See More Of In 2020

By **Benjamin Horney**

Law360 (January 1, 2020, 12:04 PM EST) -- A historic pile of dry powder and the looming threat of an economic downturn won't deter private equity clients from raising funds in 2020, but the industry's fundraising habits are changing to match the marketplace, meaning the new year should see an uptick in areas like private credit and secondaries.

The private equity industry's penchant for raising leveraged buyout vehicles with a standard PE holding period of between five and seven years is not going away, but PE players are always trying to stay one step ahead of their peers. Today, finding an advantage or niche is especially important because the global mountain of unspent capital earmarked for deals sits at roughly $1.4 trillion, according to research firm Preqin.

Clients are seeking to differentiate themselves in numerous ways, including by offering longer investment horizons or providing additional liquidity options for limited partners, and as clients chase the returns they and their investors desire, attorneys should expect an increasing focus on areas they may not have explored in the past.

Here, Law360 explores three types of funds attorneys should be prepared to provide counsel on in the new year.

The Secondaries Market Is Sizzling

The demand for private equity secondaries deals, which involve the purchase or sale of investors' existing interests in an investment vehicle, has been on the rise for a few years now, and increasing interest in the space has led to more funds. The proof is in the data: Two of the 10 largest funds that closed in the third quarter of 2019 were secondaries vehicles.

Limited partners love the idea of the secondaries market because it allows them the opportunity to get out of investment commitments early for any number of reasons, including regulatory issues, changes in their investment strategy or a general need for liquidity.

"The secondaries market has become an arena that now provides a variety of liquidity solutions," said Morri Weinberg, a partner in the asset management group of Ropes & Gray LLP and co-head of the firm's private funds practice. "Not just for individual investors in a fund, but potentially for fund managers themselves that are looking to restructure their portfolios while offering whole fund liquidity

opportunities to existing investors. There was a lot of secondaries activity [in 2019] and we continue to believe there's going to be a lot of activity in 2020 as well."

Attorneys should be aware, however, that the legal work associated with secondaries funds demands expertise in both mergers and acquisitions and fund formation.

"It can almost be like just doing a transaction for your M&A practice," noted Todd Boudreau, a partner in Morrison & Foerster LLP's global private equity investments and buyouts practice.

"It is very similar to doing a transaction for an M&A partner but you need to understand fund economics," Boudreau said.

Thus, lawyers must be comfortable calling upon colleagues for help drafting any number of secondaries-specific clauses, whether it's a provision stipulating the general partner will assume the responsibility to find someone to buy out a limited partner's investment or that the LP has the ability to go and sell its interest on the secondaries market.

"We have seen an increasingly active secondaries market for both limited partner and general partner interests," said Neill Jakobe, co-head of Ropes & Gray's private equity group. "That's something that was less common historically, but clients are seeking interim liquidity options, which has led to a more robust market for these transactions."

Impact Investing Is Becoming Mainstream

The practice of impact investing is no longer novel, and limited partners have warmed up to the idea that considering environmental, social and governance issues in their investments does not necessarily mean less than stellar returns.

According to the Global Impact Investing Network's 2019 Annual Impact Investor Survey, 82% of the 229 respondents said their investments have met expectations for impact, and 76% said their investments have met expectations for financial performance. Roughly 15% said their investments had outperformed expectations for both of those categories.

Fund managers may look to raise vehicles that are specifically focused on impact investments, but that's not the only time attorneys will have to take into account that their PE clients are considering impact.

"You might have funds with an impact twist," Boudreau said.

Specifically, he detailed that you could start to see more individuals branch off from larger firms and funds in order to launch vehicles with a specific impact focus, whether that's related to the environment, health care, employment, or any number of issues.

"It could be 'single' impact focused, where it's designed to solve one particular issue," he said. "Maybe it's someone who was a fund manager at a bigger fund and now wants to branch-out or do something specifically in an area they're passionate about."

Expect More Special Situations Funds

The PE industry has shown interest in special situations, which typically refers to investments in

distressed companies or those that might be nearing bankruptcy, since before the last economic downturn in 2008. But the popularity of funds focused on special situations spiked in the direct aftermath of that recession: In 2008 there were 24 distressed debt funds that closed with a record total of $44.7 billion in capital raised, according to Preqin.

Though the asset class stayed strong even as the economy strengthened after the economic crisis 10 years ago — with the private equity industry typically raising upward of $20 billion total across 20 or more funds annually, according to Preqin — don't be surprised if there's another boom in the popularity of special situations funds in the event that the economy does falter at some point in the near future.

"There's always going to be opportunities for certain types of investors," Weinberg said. "So in the event of a recession, for example, you might find that special situations funds suddenly become much more en vogue than traditional buyout vehicles."

Everyone is wondering when the U.S. economy is going to take a hit, as it has been steadily expanding since the end of the last recession a decade ago, the longest time between downturns for at least the past 10 recessions, according to the National Bureau of Economic Research.

With that in mind, many private equity clients are gearing up for the opportunities that would arise in the event that there is a recession in the somewhat near future, and funds focused on private credit or special situations would likely be among the more popular investment vehicles. Although it's not entirely clear when the economy might falter, private equity players are not going to play the wait and react game. Instead, many are likely to be proactive and seek to set up such funds before anything major happens to the economy.

"There are more funds in the market that have some kind of recession focus, because people are anticipating a downturn," Boudreau said. "Special situations funds have been around forever, but we're seeing a lot more talk about people trying to get into the market."

--Editing by Alanna Weissman.