Recovery beckons for Jersey's private equity sector

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The past 12 months have represented a difficult period for the private equity sector in Jersey as everywhere, but industry professionals are confident that the first green shoots of recovery are clearly visible, even if the rebound has not yet seen the launch of many new funds. Some go further and speak of a wall of pent-up investor demand that is poised to produce a surge of new business in the months to come.

The credit crunch has exacted a double toll on the industry. The drying-up of bank credit has brought to a grinding halt the market for heavily leveraged buyouts and severely constrained other categories of transaction, while at the other end of the business a dearth of initial public offerings and a relative shortage of trade buyers has severely limited the options of private equity firms for realising their investments in portfolio companies.

The contraction in deal flow has meant that a significant number of existing private equity funds still have significant quantities of commitments to draw upon, although some are looking to shore up portfolio companies left squeezed by the combination of economic downturn and high levels of debt service.

Jersey has also seen its share of funds where the level of limited partner commitments has been negotiated downward because liquidity-strapped investors might have faced difficulties in meeting cash calls. Often general partners have recognised these problems rather than risking getting into legal conflicts with their LPs, a situation unlikely to benefit either party; in some cases they may have faced problems in deploying the money anyway.

This has left fundraising at a low ebb, at least temporarily. Law firms and administrators report that behind the scenes activity has picked up, with work being carried out to enable new funds to be launched perhaps around the turn of the year, if investor confidence is back. Once it is, they say, institutions in particular are likely to return to private equity and other alternative asset classes in force, especially at a time when fixed-income investment is yielding generally paltry returns.

"There is still not a huge volume of funds being raised in the industry, but that seems to be because there's a fair amount of uninvested capital still available," says Jersey Finance technical director Rob Kirkby. "We've been hearing that message now for nearly 12 months." However, he points out that ongoing work on existing funds continues to provide a steady stream of revenue to the island's service providers.

"The private equity services industry seems to be bearing up quite well. A lot of our work is about audit reports, quarterly reporting, net asset value calculations, day-to-day administration and corporate governance, and that goes on despite asset values dropping. Jersey has survived relatively well because of that annuity income, but we haven't got away scot-free.

"The lawyers have felt the impact of the lack of new funds being set up, as have the advisory accountants. On the flip side there has been quite a bit of restructuring work for a number of vehicles and maintenance-type tasks. It's not all doom by any means, but not all roses either – flat is probably the best description."

Tom Amy, head of the funds and SPV group at Volaw Trust & Corporate Services, believes that the largely positive publicity the island has enjoyed since the publication of the OECD's white list in April has contributed to the upturn in potential new business. "People making enquiries at the moment are fully aware of Jersey's position," he says. "After the downturn in the industry in late 2008 and early this year, the volume of enquiries picked up considerably from around April onward after the white list designation was made."

Amy's colleague Kate Anderson, head of the funds legal team at the Voisin law firm, adds that the perception among clients that Jersey is a well-regulated jurisdiction has helped to keep the level of activity high during the summer period when new enquiries normally see a seasonal dip. "The summer has been a lot busier in terms of enquiries," she says.

They acknowledge, however, that it is taking longer for enquiries to turn into concrete new business, and that for the time being expectations of capital commitments have been scaled back. "The tide is starting to turn in certain areas," Amy says. "People are attempting to launch new funds but with much-reduced fundraising targets.

"In addition, the due diligence carried out before making investment decisions is much greater than two or three years ago, when it was largely based on a manager's track record." One result, he adds, is that the flexibility offered by the Unregulated Funds introduced by Jersey two years ago, which for instance do not require the fund's investment manager to be regulated, is no longer in great demand. Says Amy: "Now investors are saying they want these people to be regulated. That may represent an extra burden in the establishment process for the promoter, but it's what investors are demanding and they have to respond to it."

Ben Robins, head of the funds team at Mourant du Feu & Jeune, notes that the much-heralded shake-up in fee structures for alternative funds has largely failed to materialise. "We haven't seen any signs of lowering of fees, possibly because new funds have been few and far between and those that have been launched are from larger players that are surer of their ground," he says.

"By contrast, where commitments are reduced or returns from exited investments are being recycled, one often sees a pro rata reduction, as you'd expect, where fees are calculated in relation to commitment sizes. But in general managers feel quite justified in their current level of fees because they are working harder and are under much greater stress. In the meetings I've attended investors have been reasonably sympathetic, recognising that no individual manager caused this and that they're just dealing with a difficult situation."

Robins points out that many investors have long-term relationships with the general partners of their funds. "At the moment their fourth fund may be struggling, but funds I to III performed brilliantly," he says. "If fund V is launched in a couple of years' time, when there are attractive deals to be done, the rate of return may be very good. They're just constrained by the current market with one particular fund. Longstanding promoters and general partners often have a historic track record that speaks for itself."

The mood is sanguine among fund administrators, which believe that Jersey's overall competitiveness as a jurisdiction remain intact or even enhanced, and that the resumption in earnest of new business flows is only a matter of time. "Post-Madoff, people will be looking for well-regulated jurisdictions," says Nigel Strachan, head of business development for corporate clients in Jersey with Kleinwort Benson. "On the deal side, the private equity industry is largely dependent upon credit, and even if it comes back at lower multiples, everyone can start doing deals again, and as a by-product we will see new funds raised and launched."

Over the past few years Kleinwort Benson has carved out a significant niche in services to mezzanine funds, where it has become Jersey's dominant provider. "About seven years ago we were able to demonstrate the capability and capacity to service a very big UK mezzanine provider that structured funds through Jersey," Strachan says. "We developed our private equity IT system to be able to track mezzanine loans and allocate interest, which can be different for each loan.

"Mezzanine is an even smaller world than private equity as a whole, and once we started to get traction with that client and they started talking to other managers in the City, we started to win other clients, including Mizuho, Rothschild, Indigo Capital and more recently Mezzanine Management. The problem with the mezzanine market is that it is dependent on banks providing that top tier of leverage for buyouts, which right now is now right down at the bottom of their lists of priorities.

"So the mezzanine market is largely dependent upon the recovery of the senior market. But mezzanine managers now are looking to the senior secondary market, where there are some good credits trading at a discount. As banks are unable to provide refinancing, funds are stepping in."

Anna Carrington, of specialist private equity fund administrator Ipes' Jersey based office, says the firm and other well-established providers "are gearing up for an upsurge in business. There is a sense of more optimism and preparation within the industry for the wall of work that will hit next year.

"During the downturn, funds have taken longer to attract enough cash to launch, but enquiries are picking up now, at least for the larger administrators. The very small players that drew up plans to enter the industry just before the bubble burst were unlucky in their timing when they set up operations on the island. People are looking for more established players at a time when confidence has really suffered."

Ian Moore, chief executive of administrator Moore Management, says his firm may have come through the downturn relatively unscathed because of its "strong and steady" business from Japanese managers, particularly for structured products, although he also notes that the firm also recently closed a life sciences private equity fund for a high net worth family office with some hand-picked co-investors. Moore already administers five private equity funds of funds for the client.

Ian Moore believes that the downturn has had a silver lining for the island. "As the dust settles people will get back to business, but it won't be the same as two years ago," he says. "If you look back, it wasn't sustainable. It was ridiculous to think that all those ambitious growth plans would actually come to fruition, and from that point of view it's been a good thing. Jersey would not have been able to sustain that level of growth, and most other places would have struggled as well."

Some industry professionals expect to see some consolidation in Jersey's administration market, as some of the newer entrants struggle to win business, while big global banks look for opportunities to develop their market share. "A number of the large financial institutions have been constrained over the past 12 to 24 months by the credit crunch because their haven't had war chests available for expansion by acquiring smaller local businesses, but for many of them the handcuffs are coming off," Robins says.

"There have also been recent examples of management buy-outs of administration teams. Notwithstanding a degree of downturn in new mandates, their strong and steady historic cash flows present interesting opportunities for private equity investment."

Kirkby says there is continuing interest among specialist administrators and custodians in moving to Jersey. "We've seen some looking at moving in from Guernsey as well as Luxembourg and Irish firms, although decisions about that seem to have been put on ice because of the uncertainties over the AIFM Directive," he says. "We are keen to encourage new business and the government is committed to making it easier for them to come in. Hopefully once issues around the directive are resolved, we will see a number of new service providers come to the island."

Another area of business that could be set for a strong rebound is the listing of funds on the Channel Islands Stock Exchange. "Listing enquiries are picking up," Amy says. "The exchange has been very active in marketing itself and is highly regarded among offshore exchanges. We've had an enquiry about moving one fund from the BVI exchange and another from Luxembourg, and I expect that area of business to continue to pick up in the next 12 months."

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