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Viewpoint: “Zombie” funds: An ounce of prevention is worth a pound of cure

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As investors track the economic recovery, discussions regarding private equity portfolios and the return prospects of individual funds following the recession are common. A frequent element in these discussions is the topic of the “zombie” fund. According to *The Wall Street Journal*, a zombie fund is “a near-dead private-equity fund that lingers on beyond its set life span, usually 10 to 12 years".[1] By definition, a zombie fund’s remaining assets will generally offer little hope of returning significant, if any, profit, yet the fund may continue to charge investors unnecessary fees.

A zombie fund often results from a manager with no clear ability to raise a successor fund and a decreased incentive to maximize profit for investors. These funds are perceived to be more prevalent now due to a combination of factors. Funds raised in the 1999-2000 timeframe, i.e. funds that are now generally at the end of their set life span, raised a high volume of capital, much of which was put to work during the tech bubble. Compounding the impact of the 1999-2000 bubble, the post-2008 recession limited refinancing and exit options near the end of their terms. As a separate data point, Preqin estimates that over $100 billion in private equity assets was trapped in zombie funds as of June 2013.[2]

It is important to note that not every fund that has exceeded its set life span [results in] a “zombie”. Given the long-term nature of private equity, many examples exist of funds that seek necessary term extensions, and, as a result, are in a position to deliver what the funds’ management teams believe will be better returns for investors through better-timed exits. Further, many private equity fund managers who seek and receive fund extensions discontinue charging full management fees during the extension, either reducing their management fees for the period of the extension or forgoing their management fees altogether, in an effort to maximize investor returns. However, once a fund manager loses its incentive to create further profit for investors, the potential for a fund to become a zombie greatly increases.

Private equity investments are illiquid and therefore an investor’s options to exit a zombie fund are generally limited. Investors often wonder: Can I diagnose the potential for a fund to become a zombie prior to investing? Is there a post-investment cure, once I have invested? While no formula exists to detect a zombie fund in advance, several critical stages of the investment process – pre-investment due diligence, ongoing monitoring, and proactive risk management – can help minimize the potential for development of a zombie fund and possibly mitigate the impact on the investor in such a fund.

[1] “Trying to Squeeze Life out of ‘Zombie’ Funds”, *The Wall Street Journal*, June 2012
[2] “Private Equity Zombie Funds,” Preqin Private Equity Spotlight, June 2013

Phase I – Pre-Investment Due Diligence

Pre-investment due diligence is the initial and most critical step in determining whether or not a fund manager has the tools necessary to meet expected performance objectives. Prior to investing, a private equity investor should seek to determine whether the fund manager has the experience, skills, strategy, and discipline not only to deliver the expected returns in a variety of market conditions but also to manage the fund through completion. A rigorous pre-investment due diligence process will allow an investor to form a more complete profile of a fund, the fund's management team and their track record, and ultimately the fund manager's culture, which combined can provide insight into the potential for both future performance and the long-term health of the fund manager. Investors should: assess the culture of the firm and its contributions to the investment process; evaluate special skills or industry expertise of the fund manager; determine whether the manager follows strong pricing disciplines; and require the manager to adhere to a well-defined and realistic strategy. In addition, an investor should also devote significant time and effort to analyzing the fund manager's track record.

While there are several steps in an effective due diligence process, from the initial screening of investment opportunities to analyzing partner performance attribution, one of the important steps when making a commitment is the evaluation and negotiation of the relevant terms designed to address certain risks associated with "end-of-life" management. All private equity funds must come to an end, and the organizational documents for every investment should provide well-defined investment limitations and investor oversight to ensure incentives remain aligned throughout the fund's life and into the fund's liquidation phase. Properly aligned incentives can allow the manager to focus on maximizing profits, instead of managing conflicts. Terms regarding end-of-life management include: provisions requiring approval for fund extensions; realistic limitations for follow-on investments; clearly defined processes for recycling of investment proceeds; provisions regarding the identification and resolution of potential conflicts of interest; and provisions ensuring the proper sharing of profit.

Perhaps one of the most important factors to evaluate in the due diligence process is one of the most challenging to assess – a fund manager's culture. Culture can have as much impact on a manager's behavior as any legal provisions. A healthy culture, reinforced by aligned incentives between the fund manager and investors can help to ensure that a fund manager behaves appropriately in a variety of future situations. A stable team with a high-performing culture is more likely to have an interest in raising future funds and therefore has an incentive to avoid zombie-like behaviors at the end of its prior fund's life.

Phase II – On-going Monitoring

Active monitoring throughout the entire term of a private equity fund is essential to minimizing the development of zombie funds. In order to gain the information needed for effective monitoring, an investor should analyze quarterly and annual reports, participate in annual and other investor meetings, review and negotiate amendment proposals and conduct meetings and calls with fund management teams throughout the term of the fund. Investors who hold advisory board seats may have useful insight on factors affecting the valuation of fund investments, as well as increased dialogue with the fund management team during the fund's life. Through active monitoring, developments that could negatively affect investment returns and/or the ability of the fund manager to realize profit on investments within a reasonable timeframe may be identified. Once identified, these developments can be proactively discussed with the fund manager, and risk-mitigating actions may be put in place. We have observed that proactive limited partners and advisory board members can have a direct, positive impact on reducing potential for zombie fund outcomes.

Phase III – Managing End-of-Life

Intensive pre-investment due diligence and active, ongoing monitoring may decrease the potential for the development of a zombie fund. However, by definition, a zombie's characteristics become evident later in the fund's life. For this reason, particular care should be taken to ensure proper management of this last phase, where proactive risk management is the priority.

An important action is the careful evaluation of extension requests and end-of-life expectations of the fund manager. In instances where a fund manager seeks to extend the term of the fund beyond the original term, investors should consider:

1. reasons for the extension;
2. actions the fund manager is taking to achieve timely exits of the remaining investments;
3. incentives in place for the manager to maximize investor returns;
4. reductions or elimination of fees to the fund and investors during the extension; and
5. outstanding clawback and profit-sharing concerns.

Investors who have negotiated approval and oversight rights at the time of commitment and who make informed decisions regarding a fund's extension requests have taken significant steps to avoid zombie funds in their portfolios. Similar to our observations regarding the need for proactive steps in the ongoing monitoring phase of the due diligence process, we have found that often the best outcomes can be achieved through very active investor involvement in final phase. Although this last step can be time-consuming, it is critical for minimizing exposure to zombie funds and preserving returns in private equity portfolios.

Once a fund is a zombie, few options are generally available to investors. One option is exiting a fund via a sale of the interest on the secondary market. The proliferation of secondary buyers in recent years may make this a more attractive option than relying on the fund manager to exit investments at a profit. The key consideration in selling a partnership interest is whether the price on the secondary market, often a discount to net asset value, is worth the benefit of exiting the fund early. An alternative option is invoking a "no fault divorce" provision, in which limited partners remove the general partner and appoint a new fund manager. This option generally requires that investors act together, which can be difficult to coordinate.

Conclusion

As outlined in the sections above, rigorous pre-investment due diligence, active ongoing monitoring and proactive risk management are effective tools that can reduce the potential development of a zombie fund and can mitigate the impact should such a situation develop. The long-term and illiquid nature of private equity investing means that investors need to remain actively engaged throughout the entire life of a fund. Through the development of a carefully due diligenced and actively managed portfolio, an investor may achieve long-term exposure to the private equity asset class while also minimizing exposure to zombie funds.

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