The great deleveraging

The turmoil in Russia will bring opportunities for private investment funds

In this investment climate, two months can seem like a very long time. As in the rest of the world, the investment climate in Russia has changed dramatically since July 2008. And yet, in the months leading up to the great deleveraging, plenty of commentators were willing to speak of emerging markets like Russia being, to one degree or another, decoupled from western markets. Rising commodity prices, an emergent middle class and banking system, combined with high growth rates, seemed to make Russia look like a safe haven compared to those developed markets suffering the effects of an emerging banking crisis. As if to confirm this, investment funds investing in Russia and the CIS had been producing consistently high returns corresponding to the economic surge ushered in with the Putin years.

In July 2008 the climate began to change: concerns over Russian government involvement in private businesses, increased political tensions between Russia and the West in the aftermath of the Russia-Georgia conflict, a fall in commodity prices in the face of a global recession, together with the worldwide liquidity crisis emanating out of the US, resulted in dramatic outflows of capital and the collapsing value of Russian equity exchanges. So much for decoupling. Financial commentators no longer sing from the same hymn sheet, as contrasting views now prevail: some take the view that the Russian economy and political course set it up for long-term failure; others observe that Russia's macroeconomic fundamentals remain strong and believe that when the political turmoil subsides the Russian economy will be in position to resume its robust growth rates.

Unsurprisingly, recent events have had severe consequences for managers of investment funds in Russia and the CIS. Hedge funds in particular have been hit hard. With investment funds liquidating positions to meet redemptions and oligarchs selling shares to cover their own financial obligations, the pressure on Russian stock prices forced the index into an abrupt downward spiral. And if the macroeconomic factors were not enough, the particular rules of the Russian Trading System (RTS) and the Moscow Interbank Currency Exchange (Micex) have also contributed to the uncertainty by imposing forced suspensions of trading due to the breaches of various volatility floor and ceiling thresholds (together with wholesale suspensions of trading as ruled by the Russian Federal Service on Financial Markets).

These events have forced many fund managers to suspend withdrawals and net asset valuations or implement withdrawal gates triggered by a high percentage of withdrawal requests from investors. As a response, many investment managers have been forced to offer restructured fund terms or other incentives (lower fees, for example) to encourage investors to stay invested and weather the storm. However, it is a true believer in a manager that has not taken advantage of a hedge fund's periodic redemptions and put in a redemption request in light of the poor performance results.

Hedge funds

With such dramatic declines in equity prices, only a perfectly hedged fund (or net short – something that would have been unlikely in the early summer of 2008) will have fared well. In fact many funds are not likely to survive the collapse in value of the RTS and Micex at all. In the face of catastrophic losses posted by most Russian hedge funds, each fund manager must face the question of whether or not the fund remains a viable economic proposition for its manager.

Notwithstanding redemption pressures from investors, most hedge funds have performance fee mechanisms (the fee generally being structured as 20% of realised and unrealised profits on an annual basis) that include a so-called high water mark that requires the recovery of past losses before any performance compensation is paid to the investment manager in the future. Most Russian funds are now operating with a net asset value per share that is far below the high water mark set at the end of the last performance period (as of October 2008, the Russian market had fallen approximately 70% from its historical high of May 2008).

With holes this deep, few if any hedge fund managers in the equity space are likely to receive a performance fee any time soon. Even assuming that they are able to keep the fund going and to cover expenses from the 2% management fee, many investment managers will find that they are unable to retain individual portfolio managers (without the ability to lure investment professionals with the promise of a share in incentive compensation) or simply that they do not have the wherewithal to make it back above their high water marks.

Private equity funds

Unlike hedge funds, private equity funds are closed-ended and do not face redemption issues. In addition, they draw down investor capital on demand and tend to be rewarded on a realised basis. However, the fact that they draw down capital over time has led to one problem not faced by Russian hedge fund managers. We hear of a number of private equity funds facing a significant investor default threat where investors, presumably faced with a liquidity crisis of their own, are refusing to contribute their capital commitments. Though the constitutional documents of most private equity funds give the general partner wide powers to penalise a defaulter, the net result will still be that the shortfall will have to be met by other investors who also face limited liquidity constraints.

We have also seen issues with liquidity-constrained general partners asking how to proceed in the event the general partner is unable to meet its own commitment requirements to the fund. In some instances, defaulting limited partners have caused some private equity managers to delay or restructure portfolio investments, which could potentially cause a default by the fund on its investment commitments. These issues obviously create problems for the general partner of the fund, not only as to how to deal with the resulting shortfall in funding but also in relation to any damage to its reputation due to a defaulting fund.

However, despite the funding issues that may face private equity funds, there are many who believe now is the right time for investments in Russian private equity. Commentators point to the viability of Russia's macroeconomic fundamentals and to growth rates that, while reduced, are still healthy. Such claims are supported by the fact that Russia has accumulated large gold reserves and is able to serve its domestic and international debt. Also, we have recently seen the Russian government stepping in to advance loans to financial institutions, showing its readiness to purchase equity in certain companies and allowing the Central

Bank to finance unsecured obligations. All of these factors suggest that there may now be an opportunity to invest at the price levels of several years ago before Russia resumes more robust growth rates. Although the Russian market may not have reached bottom, there is no doubt that many Russian company stocks are available at more attractive, or at least more realistic, prices than during the 2007 surge.

It has been observed that some private equity firms in the US have continued to increase fundraising as compared to the same period last year, citing a trend among investors that intend to invest steadily through the economic downturn in order not to miss out on potential returns similar to those achieved following the bursting of the tech bubble in the US. In Russia, it is private investment fund investors with more tolerance for risk and that are willing to be more patient that may be the ones to reap rewards from opportunities arising out of the market downturn.

Aside from attractive prices, Russia has a large number of newly formed businesses that require cash to meet their continuing operations and to fund expansion plans. Such companies are now constrained by the fact that traditional providers of operational capital (whether banks or providers of commercial paper) have almost ceased lending (at least on terms that companies find acceptable). There are also those companies that had counted on a near-term IPO to finance future growth and to reward the founders of the business that now face the fact that public listings are not likely in the near term. This provides an excellent opportunity for investment funds to provide much-needed capital either in the form of a lending or credit fund or through a fund that invests in pre-IPO companies, whether that be a traditional private equity fund or a hybrid or special situation hedge fund.

Private equity terms

In negotiations with investors in emerging market funds, we are often made aware of their concern that such funds offer higher risk and return profile compared to funds in more developed markets. Historically, the potential returns are greater and may come more quickly, as demonstrated by the generally shorter investment term of Russian private equity funds than would normally be the case, but there is more volatility and greater risk of loss.

The difficulty of raising new capital in present market conditions has gone some way to tipping the scales in favour of limited partners in negotiating terms for private equity funds. Although by no means a trend, we have seen general partners being forced to agree to more limited partner-friendly distribution waterfalls, lower fees or rebates for certain investors or offsetting a higher percentage of transactional and other fees against management fees. Given the effect of most favoured nation clauses, which require the general partner to apply the same favourable treatment across limited partners in the fund, this can affect a fund's economics.

Emerging market private equity funds often require that investors be paid their entire invested capital and any preferred return on such capital before the general partner takes any carried interest (often referred to as a back-ended or European model), but before this autumn we have seen some Russian private equity funds implement a modified deal-by-deal waterfall more common in the US.

Part of the rationale for delaying the general partner's carried interest is to avoid a general partner clawback. However, though a back-ended carry reduces the likelihood of there being a clawback, it does not remove the risk altogether. By example, this situation would occur if a fund's early investments are highly profitable, but the later deals are realised for so great a loss as to create an overall loss for the fund. As a consequence, investors have become increasingly concerned about there being an effective means of reclaiming any overpayment to the general partner. A particular trend in emerging market funds is a general mistrust of guarantees of repayment of the carry against entities (usually the investment manager or parent entity) or individuals (usually the individual principals of the investment manager), given that creditworthiness can disappear rapidly under volatile market conditions. Investors are increasingly requesting an escrow account of all or part of the general partner's carried interest.

We are also aware of an interesting twist on the continuing discussion regarding the general partner clawback. Investors are increasingly requesting a back-ended model or even an extreme version of the distribution waterfall where all commitments (funded and unfunded) need to be repaid before a carried interest is paid out. This not only further delays the general partner's receipt of profit but could also lead to the limited partners receiving more profit than they would otherwise be entitled to. In this situation, the general partner would find itself having to enforce a clawback entitlement against limited partners, a situation few general partners would relish.

Hedge fund terms

It is not yet clear what changes investors in emerging market hedge funds might see as a result of the continuing economic downturn and the catastrophic 2008 performance. It is questionable how many equity funds will survive the year at all. A common criticism is that fund managers that may have made handsome performance fees in an earlier period (typically one year but in many volatile emerging markets quarterly measurement periods are not uncommon) have no obligation to return those earned fees when the fund experiences severe losses in a subsequent period (in private equity terms, there is no clawback). With the convergence of private equity and hedge fund models, we may yet see demand for some form of longer measurement periods for performance fees or some form of clawback against earlier incentive fees. For example, a fund might have a yearly performance fee payable, but a portion of the fee may be subject to clawback over the subsequent two-year period.

It is likely that, in order to give an existing investment manager the incentive to stay in the game and allow it to reward employees in times of poor performance (assuming it survives redemption requests), either a resettable high water mark or a rolling high water mark approach will become more common. The resettable high water mark allows for the high water mark to be reset in the event of, say, two years of underperformance. The rolling high water mark allows for reduced performance fees on profits (10%, for example), while under the historic high water mark such reduced performance fee continues to apply until returns to investors have reached some multiple of the losses (150%, for example).

The dance continues

Over the last two months, it has been said that the Russian alternative investment fund industry may drastically shrink or, according to some doom mongers, die altogether. However, though the downturn will result in weeding out the weaker or smaller funds, talented investment managers will continue to find ways to make money and find investors to follow them. Increased government regulation is almost a certainty and it remains to be seen how this may affect investment funds of all stripes. In any event, with the opportunities that arise out of the market turmoil, there will be further investments by investment funds, though the dance between investors and managers has started to change the terms on which those relationships exist.

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