Private Capital Fund Cash Flows

When Private Capital Funds Come Knocking—Guidance on Answering the "Call"

It will come as no surprise to anyone reading an article on Private Capital that this newest darling at the finance dance is, in fact, very popular. As access to this investment class grows, so does interest from institutions and retail investors. And they have money to spend – some $1 trillion for Private Equity (one class of private capital) alone. No wonder, then, that issuers and investors continue coming to the dance in record numbers. According to Preqin, the number of funds and capital raised each year has nearly doubled since 2011 (See Figure 1).

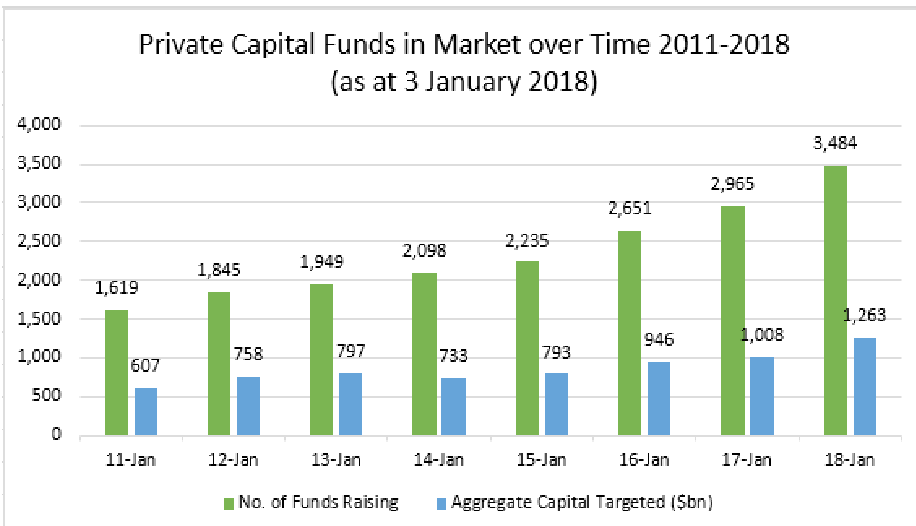

Figure 1 *Source: Preqin*

As the funds increase, and more participants enter the market, private capital investments become a more significant portion of investors' portfolios. To better incorporate these investments into overall portfolio strategies, investors need to better understand the risks and return characteristics.

BACKGROUND

When "Private Capital" is discussed it is usually in terms of Private Equity (PE), Private Debt (PD), or Real Assets. These investments are most commonly achieved via funds, managed by professional management companies. Funds are created with unique investment goals. Investors commit to a specific level of investment in specific funds. Funds build over time as investments that meet the individual funds criteria become available. The investments are facilitated with capital calls from the investors.

Capital calls (commonly referred to simply as "calls") take place over a specified period of time, e.g. five years. As fund investments are made, investors receive calls for additional cash. However, there is no defined time during the five-year period at which the calls may be made by the fund manager; this is determined by the rate at which fund investments are made. If an investor in the fund is unable to meet the call, the failure usually results in a forfeiture of any assets already invested.

Similar to calls, fund "distributions," (i.e. returning cash to investors) take

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place over time. No schedule is set for these distributions. They instead rely on performance and the fund's ability to liquidate the investments.

PROBLEM

Forecasting the timing and amount of capital calls can be tricky. Capital must be available to meet calls when they arise. Yet maintaining adequate liquidity to meet obligations means accepting either a market risk or an opportunity cost.

Market risk, for example, comes from holding domestic large-cap stocks that will have to be sold quickly, whatever the prevailing price, when a capital commitment is unexpectedly called.

Opportunity cost comes from adopting a defensive posture and holding cash or cash equivalents in excess of the amount needed for ongoing operations, especially when short-term interest rates are very low. This problem is compounded when an investor holds a number of different investments in private capital funds and/or has mandated distributions.

Private Capital Funds have moved beyond institutional investors to investors that (accredited or not) have profiles resembling a retail-oriented investor. For funds that are offered through brokerage or other firms to this retail population, the problems associated with unknown cash flows are compounded. Guidelines stressing the need of offering firms to "know your customer" including those requiring an understanding and documentation associated with client time horizons are particularly problematic.

SOLUTION

FRG has undertaken a financial modeling project specifically aimed at the problem of forecasting capital call and distribution probabilities. The overall objective is to help investors with outstanding commitments optimize and control the risks of holding excess cash or volatile liquid securities. The result of this modeling work will guide fund investors as to the probability of capital calls and distributions, quantifying the risks associated with allocation weights, and understanding the probability of future commitments. This enables the manager to keep the total portfolio invested in line with allocation weights through time.

FRG has worked with a private capital data collection firm, applying our proprietary modeling techniques, to assist clients with forecasting the cash flows associated with specific fund investments.

By understanding certain attributes of individual funds and fund offerings, the modeling FRG has conducted allows for the probabilities of capital calls and distributions to be understood at defined confidence intervals, helping to address the uncertainties mentioned previously.

In addition to assisting with cash flow planning are the benefits that this information may have on assessing an investor's liquidity needs at the time the investment is offered.

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