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2011 Leadership in the Distressed Markets (New York)

THOUGHT LEADERSHIP SPOTLIGHT

Donald S. MacKenzie, Senior Managing Director, Conway MacKenzie, Inc.

[Donald S. MacKenzie]: Well, good morning and thank you for the opportunity to speak to you today about a topic that is of interest to us at Conway MacKenzie. It may be prickly for general partners and limited partners in the room but it's a subject that we have interest in and that is the impact of general partner and limited partner relationship conflict on private equity investment portfolios and ways to persevere and maximize the value of assets while being impacted by complex fund level restructuring or external event-driven processes.

The global economic recession has contributed directly and indirectly to instances of potential tension between general partners and limited partners and in certain circumstances has brought about a reexamination of the terms of the relationships between these constituencies. Weakened portfolio performance has been a catalyst for relationship conflict as long established structural provisions of limited partnership agreement including those designed to ensure alignment of interest, transparency and proper governance have been tested.

There is no playbook from which limited partners and general partners can turn for resolving these types of conflicts. In fact a certain elements of the traditional general partner, limited partner relationship create inherent limitations of the resolution of conflict when it arises. The expectation is that conflict between investors and managers will continue as both sides seek to maximize economics in the new realities of our global economy.

As quick background for those of you who don't know me; I am the co-founder of Conway MacKenzie which is a boutique financial and operational restructuring firm, started in 1987 in Detroit which has now grown to include eight offices in the U.S. and affiliation in Europe and Asia. We're primarily a middle market firm but can scale up to large multinational corporations depending upon the industry vertical involved. I have a financial background and have served as a senior financial advisor, interim CEO and chief restructuring officer, a number of situations since the inception of the firm. And Conway MacKenzie is largely a debtor or company oriented firm but often represents various constituencies around the capital structure. We work on transactions in a variety of industries from manufacturing, automotive, trucking, gaming, retail to consumer products and others. Recent noteworthy engagements where Conway MacKenzie was retained as an advisor to the company or to the distressed investors or other constituencies include Delphi Corporation, Visteon, Greektown Casino, Finger Furniture and the Commonwealth of Puerto Rico if you can believe that.

Recent engagement that I'd like to talk about without naming names is, is on point to the subject matter today, briefly. Last summer, our firm was retained as the interim general partner of a middle market private equity fund. We were appointed to this position by the fund's advisory committee following the removal of the prior general partner. The fund's limited partners consisting of multi-billion dollar private institutional investment management firms, insurance companies, pension plans and private individuals exercised their rights under the limited partnership agreement to remove the general partner through a no-fault divorce provision which is an increasingly common provision in limited partnership agreements. I think the statistics shows it's somewhere at or in excess of 95 percent in today's documents. Our mandate in that assignment broadly speaking was to maximize the value to the limited partners and stabilize the fund's portfolio companies the vast majority of which were experiencing some level of distress. Specifically our roles as general partner included running the daily operations of the fund, providing strategic oversight, guidance and restructuring support to the portfolio companies and provide assistance to the management teams acting as stewards to further the interests of the LPs. To get our arms around the situation, shortly after stepping into the role we performed an assessment of the strategic alternatives available to the LPs and evaluation of the fund's investment portfolio. We accomplished this task by engaging directly with the portfolio companies to understand and evaluate the achievable aspects of their respective business plans and identify strategies and risks and opportunities facing each business. This process culminated in our recommendation to the advisory committee that it was in the economic best interest of the limited partners to stabilize the investment portfolio and invest additional capital to support the partnership over a two to three year period to enable traditional exits from the portfolio companies as opposed to immediate liquidation of the fund's holdings. And this is despite our finding that the investment portfolio had actually sustained an approximate 80 percent impairment in value that not previously known to the limited partners. We came to this conclusion based upon our fundamental viewpoint that if managed and properly restructured, the investment portfolio represented significant value creation potential for the LPs. Based on our analysis, the fund's advisory committee adopted that viewpoint. As part of our role, as the fund's interim general partner, we worked actively with all portfolio management teams and drove the execution of various financial restructuring scenarios and other strategic initiatives through the exercise of the board of directors and shareholder rights availed to the general partner. Our actions helped stabilize the portfolio and assisted the portfolio company management teams with the execution of their plans.

We also led a process to structure a capital raise for the partnership and to provide the fund with liquidity to fund necessary operating expenses and to carry out the partnership interests to execute follow on investments in existing portfolio companies. We also amended the LPA to permit the funding and solicited and obtained subscriptions from existing limited partners for the full amount of the purposed funding. During the approximate seven month timeframe of that mandate, the estimated net asset value of the partnership increased by almost 40 percent.

So from that we have drawn and other experiences drawn some key observations that we'd like to share. So our experience as interim general partner in the matter and other similar situations which we've been involved in of like kind, there is poor portfolio performance is typically and

often a catalyst. While there are a multitude of factors that can lead to a relationship conflict between general partners and limited partners, including misalignment of interests, lack of transparency of fund and portfolio reporting, breach of LPAs or even worse, concerns over fraud or misappropriation of assets. Poor portfolio performance tends to exacerbate the tensions and is often the catalyst for action, the impact of the global economic recession and market timing. As a related point, we anticipate continued instances of relationship conflict. In private equity funds that deployed significant amounts of capital in the period leading up to and prior to the global economic recession. As evidence of this, we have witnessed tensions related to requests from general partners for extensions of the contractual lives of private equity funds driven by an inability to achieve acceptable exits from portfolio companies due to weakened performance in recent periods.

We're also seeing an increase in situations where standard management fee and carried interest compensation structures are insufficient to properly provide incentive to general partners and to provide for appropriate alignment of interests in situations where less than 100 percent of invested capital will be returned to the LPs as a result of poor portfolio performance, the need for competent legal and other professional advisers. Given the complexity of legal issues attendant to any general partner removal action, the uncertainty about outcome and the propensity for related litigation, it's imperative that all constituents in these matters retain competent legal counsel to minimize any potential legal exposures. Additionally, given the potential risk of erosion of portfolio value that can result if investment portfolios are not properly managed through that process, it's imperative that the limited partners secure competent portfolio management teams to act as general partner on an interim or permanent basis as early as possible in any transition process. Observe and adhere to ILEA guidelines; as most of you are probably aware of the Institutional Limited Partner's Association or ILPA, established a set of private equity principles, revised recently which were designed to represent best practices for relationships between limited partners and general partners. While the ILPA principles have been criticized by some as favoring the interests of limited partners over general partners, we believe that conflict can be mitigated or avoided entirely by the implementation of standardized provisions in limited partnership and investment advisory agreements which promote proper alignment of interests, governance and transparency which are the fundamental building blocks of the private equity investment model.

Potential investment opportunities, this relationship conflict issue is a source of stress and concern for many funds; however, at the same time, these circumstances also give rise to unique investment opportunities for sophisticated investors to acquire entire portfolios, discrete portfolio assets and/or partnership interests through the secondary market transactions. Given our viewpoints on the potential increased frequency of these situations, we expect to see broader investment opportunities for investment funds that possess the requisite expertise in these matters over the near term. Unfortunately, we believe it's inevitable that instances of relationship conflict between general partners and limited partners will continue and may become more prevalent over the near term.

Drawing from our background in the restructuring industry we see significant parallels between the actions necessary to maximize value in these circumstances and those necessary to resolve conflict and maximize outcome for constituents in a traditional company restructuring scenario. While no established playbook presently exists for constituents to rely upon during the resolution of these types of conflicts, we expect that the increased frequency of these situations will promote efficiency in the implementation of solutions as these circumstances become more commonplace.

So from a distressed investment perspective we similarly see significant parallels between the, the strategies and tactics utilized by investors in distressed private equity portfolio companies and limited partnership interest to those utilized. They warned me about that...utilized by investors in distress companies than in distressed debt. We expect that many of you here today may see increased opportunities to participate in and capitalize on these situations during the next few years.

For those of you who may be involved in a transaction now or in the future involving, resulting from this type of relationship conflict, either as a limited partner or as a general partner, or even as a potential investor in these situations, I hope that we've given you a few points to consider which will be helpful as you navigate through these complex circumstances and we would certainly like the opportunity to call upon you if we become aware of potential investment opportunities related to these situations. Similarly please don't hesitate to contact us if you find yourself in them and require some assistance.

So thank you and would be happy address questions with you during the break later today.

[Applause]

[End of Transcription]

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