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ASIAVIEW: The oversubscription problem

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While a late stampede by investors into a fund may be considered a good problem to have, issues can arise if it isn't handled correctly. PERE Magazine February 2014 issue.

What do the latest fundraises by Secured Capital, Gaw Capital Partners and Phoenix Property Investors have in common? Besides these three opportunity funds closing within the space of a few months, each presented their sponsor with one of those rare 'good problems' to have: what to do with an oversubscription. Interestingly, the three firms responded in different ways.

Phoenix was the most recent to hold its closing. The Hong Kong-based investment firm soared past the original $600 million target for its fifth fund, Phoenix Asia Real Estate Investments V, hitting its hard cap of $750 million. PERE understands that the firm, founded by Samuel Chu and Benjamin Lee, was approached by certain investors about reducing its own 2 percent ($15 million) GP commitment to make room for late-coming investors. It rejected the proposition out of hand and has stuck with its lot.

Phoenix's neighbor, Gaw Capital, took a different and arguably more complicated approach. Its Gateway Real Estate IV Fund also hit its hard cap, a firm-record $1 billion back in October. Unlike Phoenix, however, its capital-raising team moved heaven and earth to accommodate latecomers. It had an official request to extend the hard cap rejected by two large early investors, but it scoured the remaining investor pool for folks willing to pare down their commitments by as little as $5 million to accommodate others and keep within the hard cap. The firm even managed to convince enough of its investors to permit it to not count its own $25 million GP commitment towards the hard cap. Consequently, it ended up with $1.025 billion.

In Japan, Secured Capital had more joy with its request for a hard cap extension. Originally targeting $1 billion for its fifth opportunity fund, Secured Capital Real Estate Partners V, the firm sensed it would blast through its original hard cap of $1.3 billion. It managed to convince existing investors that extending the cap would not have a detrimental effect for those that came aboard earlier and ended up raising 50 percent more than its target, closing out in November at $1.5 billion.

The actions by these three firms each produced a positive result on this occasion. Still, make no mistake: while it undoubtedly is a positive for a GP to have abundant demand for its products, accommodating tardy investors in the event of an oversubscription can be a tough and politically sensitive juggling act to pull off.

After all, why should an institutional investor convinced enough to back a fund in the first instance have to scale back its commitment? It completed its due diligence in a timely manner, so why should it be asked to share a promising fund with those investors that would rather watch others test the water to see if the fund is likely to perform first? While there are fee penalties that come with being a final closer, those expenses are paltry when compared to the rewards on offer from a fund that already is proving its mettle with early investments. All GPs should be sensitive to that part of the fundraising equation in the name of fair client management.

In no way is this column supposed to be a critique (or endorsement for that matter) of how Phoenix, Gaw and Secured have dealt with their respective predicaments. Moreover, the commonality between what happened with their latest fund offerings gives us an opportunity to prescribe how we think GPs facing oversubscriptions should handle such good fortune.

In the event of an oversubscription, GPs should first ask their existing LP pool for permission to extend the hard cap. As they do, they should have the intellectual honesty to verify whether an enlarged capital pool still matches the scale of the opportunity underpinning the fundraising in the first place. GPs should accept that LPs would then have the right to reassess the proposition on a newly defined basis and be prepared for a knockback.

Should LPs reject the request, the next fair thing to do is request that those trying to force a place in the fund accept a pro rata commitment based on how many units are left. Sure their commitments would be lower and some even might be prohibited from committing owing to their minimum commitment requirements, but that way the commitments of existing LPs are safely ring fenced, with newcomers divvying up the leftovers.

On no account should a GP contemplate removing its own commitment without recommitting its resources in an equally impactful way. Skin in the game is the most tangible way for an investment manager to demonstrate alignment with investors. Skin out of it does the reverse.

If neither measure works, the GP should politely decline the commitments of the final investors while reminding them to be quicker about getting onboard next time. That is all part of being a fiduciary. One or two LPs might be disappointed, but the GP’s reputation is preserved, which surely is more important.