PRIVATE EQUITY FUNDRAISING: TOO FAST, TOO FURIOUS?

NEPC Private Markets Research

Introduction

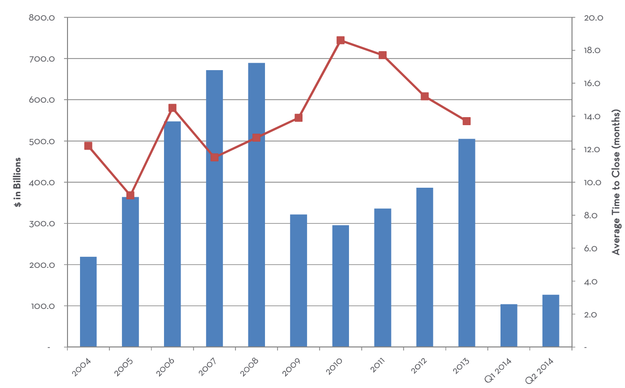
As the pace of private equity fundraising continues unabated, investors are getting increasingly selective in allocating capital, fueling a sharp distinction in the industry between the haves and have-nots.

Limited partners are displaying a preference for established private equity fund managers in more mature economies while paring down the overall number of managers in their private equity portfolios. As a result, investors are finding themselves shut out of oversubscribed deals in high demand or receiving less than their allocations. On the other hand, investor demand is discouraging for less established fund managers or first-time funds.

In 2013, nearly 3,000 private equity funds were targeting to raise approximately $1.2 trillion.[i] That year, 873 funds reached final closings totaling approximately $505 billion.[ii] The first six months of 2014 have benefitted from this momentum with investors emboldened by a strong exit environment (generating cash distributions and strong returns), capital appreciation of private equity funds, and a reverse denominator effect. Last year saw a record number of private equity-backed buyouts exiting with 1,348 exits valued at $303 billion.[iii] In addition, limited partners have been cash flow positive for the past three years, that is, distributions have outpaced contributions or capital calls.[iv] By most accounts, fundraising time lines have shortened considerably. Last year 85% of US-based PE funds reached their target and the average time to close a fund fell to a five-year low of 13.7 months.[v] However, this good fortune has not held constant for all private equity fund managers. Over the past 12-18 months we have observed managers with long track records of success enjoying an accelerated closing schedule while median-return fund managers and first-time funds have languished and, in some cases, abandoned their fundraise.

At NEPC, we expect competition for high-quality deals across the board to remain fierce given the existing dry powder in the market and the furious pace of fundraising so far this year. The takeaway for limited partners: If possible, seek good opportunities ahead of the fund raise; run your due diligence in an efficient, effective manner; and quickly and clearly convey interest, if any, to managers. To this end, we continue to remain vigilant in managing our pipeline of managers and fundraising calendar, proactively sourcing managers that are difficult to access.

Exhibit 1: Global Private Equity Funds Raised



Source: Preqin, PitchBook

i. Global Private Equity Report 2014, Bain & Company, Inc.
ii. 2014 Preqin Global Private Equity
iii. 2014 Preqin Global Private Equity
iv. Global Private Equity Report 2014, Bain & Company, Inc.
v. PitchBook 1H 2014 U.S. PE & VC FUNDRAISING CAPITAL OVERHANG

The Haves: Established Managers in Attractive Segments of the Market

In an environment where limited partners are paring back the number of managers in their private equity portfolios, consistency in strategy and returns has been rewarded by increased capital commitments to fewer managers. Over the past 12-18 months we have observed what can only be referred to as a feeding frenzy for allocations in funds of established managers with consistent returns. Aside from top-tier venture capital managers, we have, in general, seen the most competition for allocations to managers in the growth equity and small-to-lower middle-market buyout strategies. The term "oversubscribed" has become less of a buzz word and more of a harsh reality for many investors.

This has caused managers to handle allocations very tightly and, in some cases, turn down investors or allocate less than their asking amounts. Although the data tell us that the average time to close is currently between 13-to-14 months, there have been several highly publicized examples of funds with significantly shorter time frames from launch to final close. Most of these are what we refer to as "one-and-done" closes. For example, Thoma Bravo XI launched in January and held a first and final close in May, and GTCR XI launched June of 2013 and closed in January, according to press releases from the respective firms. Both managers exceeded their fundraising targets having hit their respective hard caps, and publicly stated that their funds were heavily oversubscribed. These are two instances of managers who have demonstrated staying power in the industry, maintained relative consistency in their investment strategy, and provided strong returns to investors. Investors rewarded these managers with a relatively short fundraise for substantial fund sizes. However, we have observed managers using compressed or controlled fundraising processes as a way to contain investor demand, which leads us to believe this trend will continue in the near-term. As such, we could add many anecdotes to these examples of shorter than average fundraising times.

The Have-nots: First-time Managers and Those with Lackluster Returns

The trend is much less encouraging for less established fund managers or first-time funds. In 2013, 64 private equity funds aiming to raise $34 billion were abandoned. Of these funds, 57% were being raised by first-time fund managers.[vi] This underscores investors' preference for quality brand names and for investing capital with fewer but established managers. This makes them reluctant to commit capital to new managers. The data seem to support this: In 2013, both the average and median institutional commitment by limited partners hit a decade high of $81 million and $40 million, respectively.[vii] Further fanning the flames for these managers, the supply of private equity funds in the market continues to outweigh demand from investors. As of April 2014, 2,116 private equity funds were currently in market raising capital globally for hundreds of billions of dollars.[viii] The number of funds raising capital in 2013 was 3.3 times greater than the number that held final closes during the year, and the total amount private equity managers were targeting to raise was 2.6 times more than investors committed.[ix]

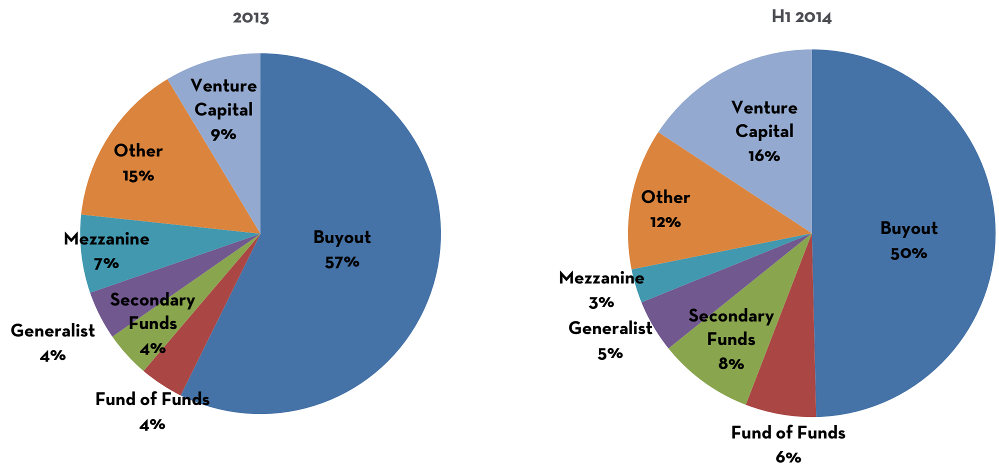
In addition, we have observed managers with lackluster returns struggle to raise successor funds. As investors pare back the number of managers in their private equity portfolio and concentrate capital on better performers in more mature economies, we expect headwinds to continue for first-time and median-return profile managers, as it is questionable if the industry can attract sufficient capital for the number of funds currently raising money.

Types of Managers Raising Capital

The bulk of investors' capital continued to support managers in ***buyout***-oriented strategies in 2013, with buyouts representing 57.3% of the funds raised globally, at $183 billion.[x] This was a four-year high fueled by 12 funds that raised $5 billion or more, totaling approximately $100 billion. Apollo Investment Fund VIII raised $18.4 billion while the Carlyle Group, Warburg Pincus, CVC, and Silver Lake Partners also closed funds north of $10 billion. The momentum for buyouts has continued into the first half of 2014 as almost

vi. Preqin Press Release, April 10, 2014
vii. PitchBook 1H 2014 U.S. PE & VC FUNDRAISING CAPITAL OVERHANG
viii. Preqin Press Release, April 10, 2014
ix. Global Private Equity Report 2014, Bain & Company, Inc.
x. Thomson Reuters

Exhibit 2: Percentage of Total Capital Raised by Strategy Globally



Source: Thomson Reuters

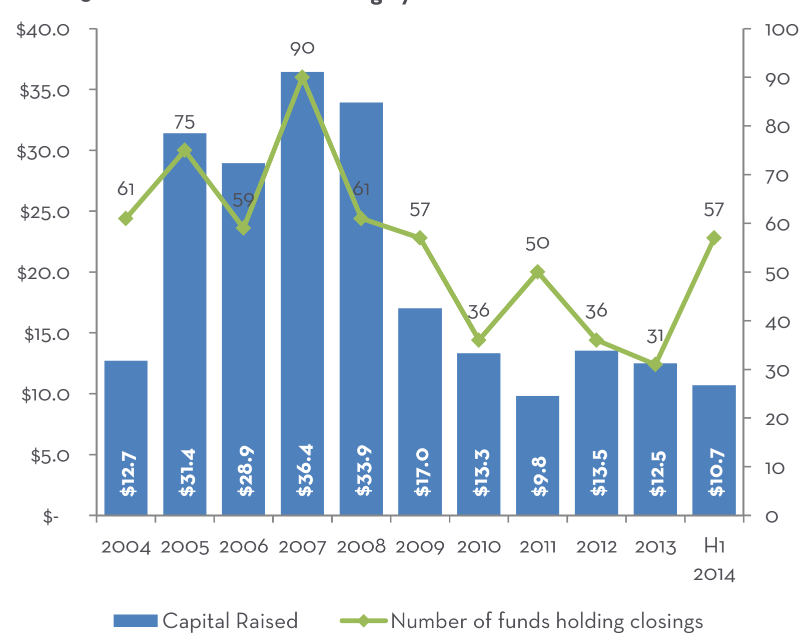
50% of the capital raised was allocated to the strategy by investors.[xi] The appearance of an allocation away from buyouts (Exhibit 2) is misleading given the absence of mega funds holding closings through the first half of 2014. As such, the second half of 2014 is on pace to set a new record on the heels of the financial crisis for buyout fundraising as Bain Europe, KKR Europe, Carlyle Europe and Thomas H. Lee Partners are in the market with their latest buyout funds.

Funds of funds have been out of favor with many limited partners, or LPs, in the years since the financial crisis. While PE fundraising, in general, has been trending higher, activity in funds of funds and their market share remain at some of the lowest levels in the last decade (Exhibit 3). A few well-known firms have continued to have success, but overall there seems to be a shift away from diversified funds of funds managers. We observed a trend toward specialist fund of funds, separate accounts or "fund of one" vehicles for targeted exposure.

With a wave of large ***secondary fund*** managers starting to return to market in 2014, capital allocations to secondaries in the first half of 2014 were $14.5 billion, surpassing the $13.2 billion[xii] added to secondary funds in 2013. There are currently 27 vehicles for private equity secondaries in market seeking to raise an aggregate $24 billion.[xiii] While financial institutions continue to methodically sell-down their mature private equity portfolios, we are closely watching the secondary market for negative implications of a potential oversupply of capital.

Last year saw a reversal of the trend towards

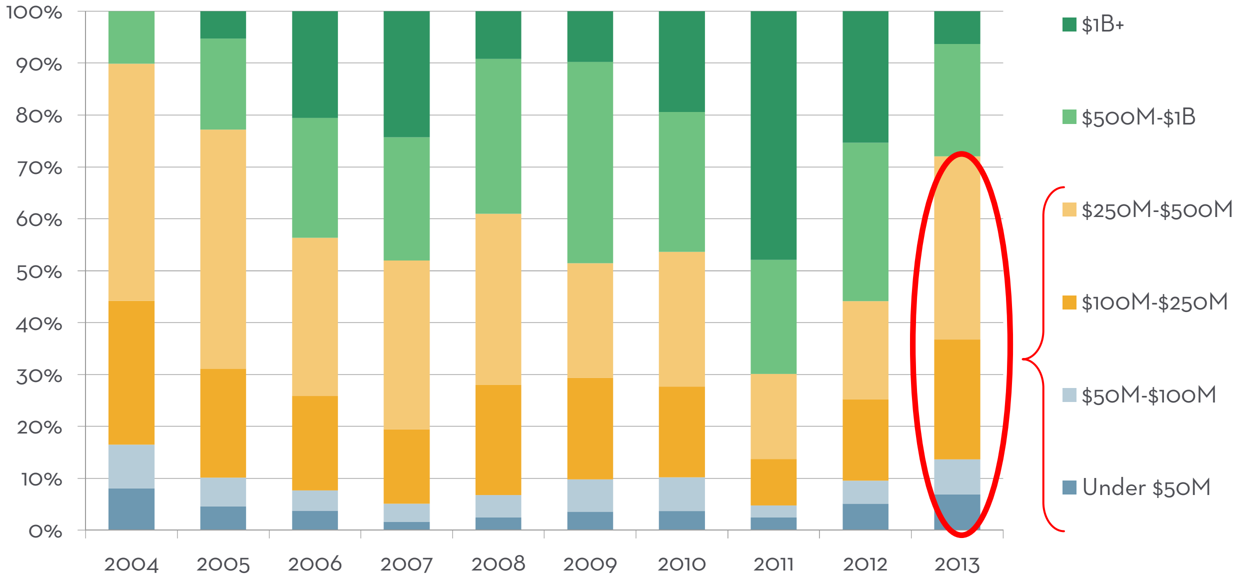
Exhibit 3: Funds of Funds Fundraising by Year



Source: Thomson Reuters, Preqin, PitchBook
Note: Does not include secondary funds
Note: In billions of $

xi. Thomson Reuters
xii. Thomson Reuters
xiii. Preqin

Exhibit 4: Venture Capital Fundraising by Fund Size



Source: PitchBook

large funds in ***venture capital***, as over 70% of venture funds raised in 2013 were less than $500 million (Exhibit 4). No funds in portfolios that have raised more than $500 million have returned more than two times capital after fees, according to a 2012 Kaufman Foundation study of 100 venture funds over 20 years. This is primarily driven by the impact that a "home run"—for instance, Facebook, Twitter and FireEye—has on a larger pool of capital versus a smaller-sized fund.

Many of the better small funds are inaccessible to new investors and institutional investors who make large commitments (due to capacity and concentration). Often, these managers hold one-and-done closes or commitment by appointment only. We have observed this dynamic repeatedly over time and, in some cases, seen highly sought after venture managers close in weeks versus months. For those investors desiring venture capital exposure, this creates pressure to invest in larger-sized funds with capacity for new investors. Despite 2013's trend towards smaller funds, firms such as, Accel, Greylock, NEA and Oak have each raised $1 billion in funds over the past few years and at least some of these managers, or general partners, will return to market during the calendar year. NEA is the most notable, raising the largest venture fund in history in 2012 while closing on more than $2.5 billion. In addition, venture funds raised $27.2 billion[xiv] in the first half of 2014, an amount that was heavily influenced by TCV VIII, Andreessen Horowitz Fund IV and Accel Growth Fund III, each raising funds north of $1 billion. Although these funds have a growth equity bias, they get rolled into the venture capital number by most industry sources.

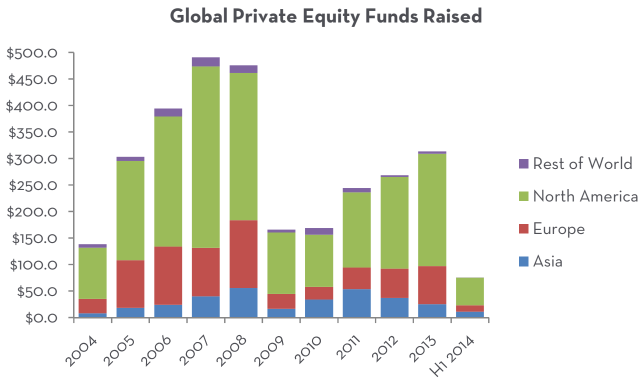
Mezzanine funds continue to face strong headwinds of a robust high-yield market and an expanding supply of private debt and uni-tranche lenders competing away investment opportunities. In the first half of 2014, new mezzanine commitments represented only 3%[xv] of all new private equity commitments.

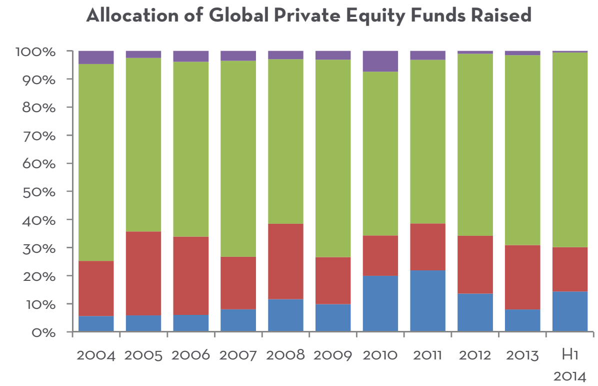
On a ***geographic*** basis, competition for capital was fierce in emerging markets where the target amount managers were attempting to raise was nearly four times greater than capital raised in 2013. By comparison, it was 2.9 times greater in Europe and just 2.2 times greater in North America;[xvi] year-over-year fundraising in North America increased by 22% in 2013 (Exhibit 5). European commitments increased 30%, bolstering our views on investors focusing on managers in more mature economies.

By contrast, Asia-focused funds experienced a 31% decline in new commitments as investors are signaling concerns on slowing growth in China.[xvii] That said, current investor sentiment appears in line with what we view to be the potential for out-

xiv. Thomson Reuters
xv. Thomson Reuters
xvi. Global Private Equity Report 2014, Bain & Company, Inc.
xvii. Thomson Reuters

Exhibit 5: Venture Capital Fundraising by Fund Size





Source: Thomson Reuters
Note: In billions of $

performance given the decrease in competition for new deals and a pullback in investable capital relative to recent years. While the overall trend was up, commitments to North American private equity funds fell by 3% in the first half of the year. For a growing number of investors, the relative value of European and Asian private equity may be outweighing the risks of investing overseas with US equity markets at record levels and US debt capital readily available with few covenants.

What Now?

With lower deal activity in 2013, capital remaining to be invested stayed at post-crisis highs. Dry powder in several of the larger funds raised in 2007 and 2008 continues to roll off and be replenished by newly raised funds, creating a potential oversupply of capital. Fundraising for 2014 is also on pace to reach another post-crisis high and we continue to observe high-valuations. In our research piece in May, titled "Hangover Redux: The Impact of Capital Overhang on Private Equity Investing," we identified small market private equity funds as presenting attractive opportunities for investors due to relatively lower EBITDA valuations, multiple expansion potential, and lesser intermediation. We continue to evaluate managers with similar attributes across all strategies. We are also paying close attention to types of exits/mechanisms for liquidity. Cheap leverage and "covenant-lite" debt is still contributing a fair amount to private equity liquidity as dividend recapitalization transactions totaled a record $66.2 billion last year.[xviii] We believe it is important to analyze not only how much liquidity managers are generating, but also by what means they are generating liquidity, as dividend recapitalizations could leave the remaining equity investments exposed to unexpected downturns in the economy. In general, we look to support managers who have multiple means of exit for their portfolio companies.

To alleviate some of the timing pressure of fundraising, we continue to remain vigilant in managing our pipeline of managers and are proactively sourcing difficult to access managers. At the same time, it has helped to have frank and open conversations with managers about fundraising expectations, research processes and timelines. Despite the pressures to commit quickly, the accuracy and thoroughness of our diligence remain paramount. The message here is: Find good opportunities ahead of the fund raise if possible, conduct your due diligence in an efficient, effective manner, and quickly and clearly communicate your intentions to general partners when there is interest in moving forward.

Conclusion

From the general partners' perspective, we expect competition for high-quality deals across the board to continue to be fierce. As such, firms will need to be more creative in how they structure deals in order to put capital to work, be more disciplined in what prices they pay for companies, and be better prepared to facilitate operational improvements within their newly acquired portfolio companies.

From the limited partners' perspective, in some cases, it is clear that investors with drawn out processes (i.e., those driven by requests for proposals and/or quarterly meetings) might miss some of the more highly sought after opportunities due to timing and the inability to move quickly. The current fundraising environment should underscore the importance of communicating

xviii. S&P Capital IQ LCD

with fund managers off cycle to stay ahead of the fund raise. In addition, we have observed investors increasing the frequency of their investment committee meetings or implementing an "e-vote" or shared data rooms for opportunities that need attention outside of normal meeting cycles. In short, some investors have chosen to augment their approval process. We would recommend investors consider revamping their approval process to mitigate compressed or shortened fund-raising cycles so as to avoid missing out on the more highly sought after opportunities.

Disclaimers and Disclosures

- Past performance is no guarantee of future results.

- The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.

- Information on market indices was provided by sources external to NEPC, and other data used to prepare this report was obtained directly from the investment manager(s). While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.

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In addition, it is important that investors understand the following characteristics of non-traditional investment strategies including hedge funds, real estate and private equity:

1. Performance can be volatile and investors could lose all or a substantial portion of their investment

2. Leverage and other speculative practices may increase the risk of loss

3. Past performance may be revised due to the revaluation of investments

4. These investments can be illiquid, and investors may be subject to lock-ups or lengthy redemption terms

5. A secondary market may not be available for all funds, and any sales that occur may take place at a discount to value

6. These funds are not subject to the same regulatory requirements as registered investment vehicles

7. Managers may not be required to provide periodic pricing or valuation information to investors

8. These funds may have complex tax structures and delays in distributing important tax information

9. These funds often charge high fees

10. Investment agreements often give the manager authority to trade in securities, markets or currencies that are not within the manager's realm of expertise or contemplated investment strategy