HANGOVER REDUX: THE IMPACT OF CAPITAL OVERHANG ON PRIVATE EQUITY INVESTING

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Introduction

The hangover from the credit bubble just won't go away. The glut of private equity capital raised from 2005 to 2008 and the pent-up demand from yield-hungry investors is still working its way through the market. Although private equity fundraising has trended higher— hitting a post-crisis record of $431 billion in 2013[i]— the pace of new buyout transactions has slowed. This is despite a significant overhang of dry powder and access to record levels of low-cost leverage. While this overhang was declining in the second half of 2013, the amount of investable private equity capital available actually grew from a year earlier, topping out at over $1 trillion, up from $941 billion in 2012[ii], and initial estimates of $789 billion for 2013[iii].

At NEPC, we have paid close attention to this capital overhang in private equity markets during the current cycle, and have considered several strategies that we believe can benefit our clients. These include investing in managers who are poised to take advantage of pricing anomalies and/or the strong exit environment. To this end, we have focused a great deal of our research efforts on the smaller segments of the market in buyout, including growth equity and secondary strategies.

Buyouts and Growth Equity

Approximately $399 billion of the estimated $1 trillion of investable private equity capital (Exhibit 1) is allocated to buyout and growth equity investments; 80% of these funds were raised after 2011.[iv] The capital overhang dropped to a five-year low in 2012,[v] before trending higher at the end of 2013. As of January 2014, a record 2,084 private equity funds were in the market seeking to raise an aggregate $750 billion.[vi] This number does not take into account the amount of institutional capital or contributions from Limited Partners ("LPs") available for co-investment alongside General Partners ("GPs").

Exhibit 1: Cumulative Overhang– Buyouts and Growth Equity

Note: $ in billions
Source: Bain & Company

i. Preqin
ii. Bain & Company Global Private Equity Report 2014
iii. Financial Times, November 26, 2013
iv. Bain & Company Global Private Equity Report 2014
v. PitchBook, 2H 2013 Private Equity Fundraising and Capital Overhang Report
vi. Preqin

Surging equity markets and cheap debt fueled significant liquidity activity in 2013. Dividend recapitalization transactions totaled a record $66.2 billion last year, up from the previous record of $64.2 billion in 2012.[vii] Private equity fundraising grew 13% during the same period, to $431 billion, the highest level since 2008.[viii] While GPs have enjoyed the tailwind of favorable exit and fundraising environments, competition for quality deals has intensified in recent months. This, combined with the return of high debt multiples spurred by covenant-lite credit structures and fully valued equity markets, has led to a challenging pricing environment for buyers. As a result, 2013 saw a decrease from a year earlier in the number and transaction value of private equity buyout deals (adjusted for the buyouts of Dell and HJ Heinz).

To this end, we recommend proceeding with caution while evaluating opportunities in buyout and growth equity strategies.

Secondary Market

Transaction activity in the secondary market reached a record high in 2013, marking the third consecutive year of record-setting highs. Estimates place 2013 secondary volume between $27.5 billion and $36.0 billion, depending on the source (Cogent and Setter Capital, respectively). Both estimates are in excess of the $25.0 billion of secondary transactions in 2012, and higher than the slow pace of the first half of the year would have suggested. The key takeaway here is that record annual volume has been fueled by factors stimulating both supply and demand.

On the supply side, financial institutions, public pension and superannuation funds still represent the largest segments of deal volume, accounting for nearly 60% of seller volume in 2013. Financial institutions are continuing to sell down their private equity portfolios on the heels of regulations—Dodd-Frank, Basel II/III and Solvency II— calling for higher reserves. These sales come despite extensions to the deadlines for implementing these new rules. That said, 2013 lacked some of the high profile, larger deals witnessed in recent years. With new clarity around implementation guidelines, banks will remain a large source of deal flow. However, given the sophistication of these sellers, the sales process is likely to be strategic and deliberate. Taking advantage of the strong pricing in the market, public pension and superannuation funds are employing more tactical approaches to secondary sales, which are being driven largely by portfolio rebalancing and trimming of non-core relationships. While traditional sales of LP interests remain the largest type of assets being sold, sophisticated managers are spending more time on the growing opportunity involving complicated transactions, such as GP restructurings, investment team spin outs, structured or synthetic contracts, and secondary directs – areas where scale or experience can be differentiating factors.

On the demand side, buyer interest for secondaries was driven by an improving macroeconomic outlook and ample supply of capital to invest. While secondary fundraising declined 47% to $12.4 billion in 2013,[ix] approximately $40 billion of new secondary funds will be fundraising in 2014. At recent transaction volumes, we estimate two-to-three years of dry powder will soon be available for investment in the secondary market. At this level, competition can be fierce for mid-sized deals, which tend to be plain vanilla sales of LP interests brokered by intermediaries. Larger funds will also face pressure as they look to deploy capital.

Secondary pricing has reached the highest levels since 2007 (Exhibit 2), with an average high bid of 89% of net asset value in the second half of 2013.[x] Part of this discount compression is caused by gains in public equities translating into higher expected private equity fund valuations. The heightened competitive environment is also driving higher pricing in intermediated deals. To this end, we aim to avoid managers who are heavily reliant on the auction process as their chief source of deal flow. We remain watchful of how the uptick in pricing and the large available pools of buyer capital could negatively impact underwriting targets and, ultimately, investor returns.

What now?

At NEPC, we believe that we are entering a period of relative stability after a protracted and turbulent recovery process which began in 2009.

Within buyouts, we continue to see the most attractive opportunities in the smaller segment of

vii. Standard & Poor's Leveraged Commentary & Data, October 18, 2013
viii. Preqin
ix. Cogent Capital, January 2014
x. Cogent Capital, January 2014

the market due to the following factors:

- The relative EBITDA valuations make investing in small- and middle-sized transactions more affordable, while providing the potential benefit of multiple expansion from growth and/or economic improvement
- The presence of fewer intermediaries in the middle market creates inefficiencies which, in general, translate into more favorable pricing or true "proprietary deal flow"
- Investors with a solid network and reputation should have an advantage in terms of sourcing attractively-priced assets
- Multiple exit options exist for investors of companies in smaller markets, such as a sale to larger financial sponsors or a strategic dividend re-capitalization

WE ARE TARGETING MANAGERS WHO HAVE CONSISTENTLY DEMOMSTRATED DISCIPLINE IN DEPLOYING THEIR CAPITAL

In terms of secondary managers, we have focused our resources on those who have demonstrated an expertise in executing creatively structured transactions, have strong relationships with banks as repeat buyers, or are focused on niche markets, as we see these as areas where competitive advantages or fewer bidders may exist. Some successful managers exhibiting these traits operate mid-to-large size funds, where they possess flexibility to execute smaller deals and opportunism to execute larger ones.

We continue to spend a significant amount of our time with managers at the opposite end of the spectrum. These are managers focused on smaller transactions— typically ranging from $1 million to $50 million— where we see the following attractive attributes:

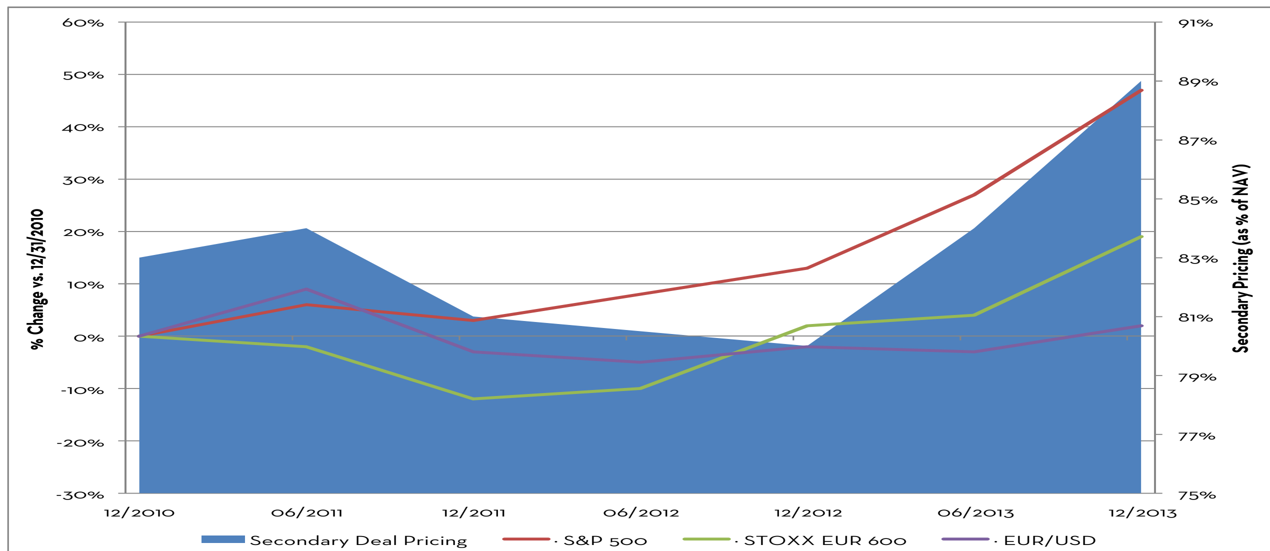
- Transactions in this range generally fall below the size at which auctions involving intermediaries take place
- Sellers may be less price-sensitive on transactions that are relatively small pieces of their portfolios
- The void left behind when secondary firms shift their focus (and fund sizes) to emphasize larger transactions

Conclusion

The decrease in new buyout and growth deal activity, fueled by higher prices of private equity targets and a more positive outlook for fundraising, increased the overhang of private equity assets in 2013. To this end, we are targeting managers who have consistently demonstrated discipline in deploying their capital.

Similarly, in the secondary market, we are focused on disciplined managers able to source

Exhibit 2: Secondary Pricing and Public Equity Performance Comparison



Source: Cogent Partners, Secondary Market Trends & Outlook, January 2014

transactions away from the middle market, which has a heavy concentration of intermediaries. We think managers in the smaller buyout and growth equity space, and those in secondary markets, provide a similar risk-return profile. We believe the growth equity and buyout managers best positioned to outperform in the current environment are those who have been able to generate returns using little or no leverage, relying, instead, on operational improvements and organic growth of the underlying companies. Secondary managers well-positioned in the current environment are those who are able to trade complexity for price, either in sourcing or structuring, and those who are diligent and disciplined in their asset underwriting.

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- Past performance is no guarantee of future results.
- All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.
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