EDITORIAL

Too much of a good thing

Fundraising is no longer the slog it once was. This is creating problems of its own.

17 June 2014 by Nicholas Neveling. Permalink.

It was with some interest that I recently looked through some private equity fundraising and distribution figures for the first quarter of 2014.

Fund managers pulled in $99bn (€73.1bn) in the first three months of 2014 – the highest amount raised in the first quarter for six years, according to the quarterly newsletter of placement agent Triago. As a result, the total amount of committed but uninvested capital has climbed three per cent. The amount of dry powder available to buyout firms is now sitting at a record $1.1trn.

At the same time as uninvested war chests have been piling up, general partners have been returning capital to their investors at a rate of knots. By the end of April private equity houses had returned some $22bn in cash to their backers. This followed a record year of distributions in 2013 ($120bn). While investors have been receiving cash from buyout firms, the stock market bull run has left 40 per cent of investors underweight in private equity, Triago estimates.

What can be concluded from all of this is that the great fundraising crisis of just three or four years ago appears to be over. Who would have thought?

Funds are closing faster and there are fewer fundraising failures. GPs promoting "early bird" discounts have suddenly become a lot less prominent. Understandably, dealmakers have welcomed the fundraising recovery. I have yet to encounter anyone in the industry who will miss the endless roadshows and mind-numbing due diligence that characterised fundraising post-crash.

But even though money is flowing into the asset class once again, private equity would do well to remain grounded. Accessing capital is one thing. Finding a way to deploy it profitably is quite another.

"People assume that when extra capital comes into the industry there will be a new pool of deals to absorb it. There aren't. You just end up with more money chasing the same number of companies," a UK mid-market GP explains.

As industry cash piles swell, so does competition for assets. Buyout houses are taking longer to deploy capital, and when they do they are finding themselves scrapping amongst themselves to win auctions. Valuations are sky high and firms are having to pay some very chunky multiples when adding to their portfolios. This is not just a feature of the mega market, where high-yield bond issuance and cov-lite loans have inflated prices. One corporate finance adviser told *Real Deals* that he had recently seen a bog standard mid-market deal valued at an eye-watering 17 times earnings. The companies that are fetching these prices are not tech start-ups or social media companies with huge growth potential either. Losing an auction these days can seem like a blessing in disguise.

The challenges of deployment have not gone unnoticed by LPs, who are becoming more cautious. Two of the most experienced investors in private equity – CalPERS and Yale – are trimming their allocations to the industry. Other investors are said to be concerned that they will either have to follow suit or lower their fund selection criteria in order to meet target allocations. Some LPs have been so frustrated with slow deployment rates that they have sought to mitigate the J-curve by putting money into secondaries funds instead, despite the fact that discounts to net asset value are thin.

Our industry has, on the whole, come through the downturn much better than many anticipated, but as any turnaround investor will tell you, the riskiest time for an industry or business is not necessarily when an economic cycle is at its worst, but when things start looking up. If this applies to private equity, the industry's biggest challenge could lie ahead.

Investing large sums of money in good businesses at a time when competition is at its fiercest presents a massive challenge. GPs who found the latest fundraising cycle tough might find the upcoming deployment cycle even tougher.

Make no mistake, a strengthening fundraising market and record levels of dry powder are not bad news per se. There is little doubt that the industry is in a much stronger position now than it was four years ago, when even firms of the highest calibre were struggling to get new funds across the line. Having too much money is a much better problem to have than having none at all.

As capital flows into private equity once again, however, it is worth remembering that every rose has its thorn.

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