The Changing Private Equity Landscape

- Mounir Guen, CEO, MVision

We have recently seen high levels of capital distributions from private equity funds. What impact does this have on LPs?

An investor in a particular calendar year has to commit a certain amount to meet their allocation. In years when they have very high distributions, they have to put out more allocations to be able to stay at that number.

If you have a 10% allocation, and in a particular year, you get back about 35% of it, you have to get back to 10%. That creates a re-investment cycle that they need to adjust for. So on one side it is absolutely terrific that all this cash is coming back and it is a real testament to the industry, to the asset class and to the general partners that are returning it. On the other side of the equation, it does create more work for the investor because they have to then, in that particular calendar year, put more money back to be able to maintain their allocation. There is a cash flow that has to be worked around.

So LPs have to put more and more money back to work to meet these allocations. Are you seeing LPs take different routes to put this money work?

The thing is, they are very sensitive about the criteria with which they are going to invest. In the early 2000s it was very common for the fund manager to double or triple their fund size. There are examples of this in the market. So a $500mn fund became $1bn or $1.5bn, and then the next time they were $3bn. You don't see that any more. Investors are very conscious of the general partners working in a disciplined manner and within the comfort zone of their strategy. This means that fund sizes generally are capped and investors will have an inability to put that capital to work through funds alone. The larger funds can absorb some of the capital, but they cannot absorb all of the capital. It is more complicated, especially at the larger end of the investor scale, because they have a deployment need and a return objective. The only alternative that they have is to do more directs, either in the form of co-invests, co-underwritings, or just direct deals.

When you talk about LPs being very particular about their strategy, have you seen any significant changes in LP appetite for specific fund strategies or geographies in the last 12 months?

Investors have a need to attain a return and to diversify their risk to be able to obtain that return. Within that context, they are looking at deployment: the velocity of deployment and the preservation of their capital. So they need to be able to understand that and they need to feel comfortable with the net returns they are receiving from the general partner and also that the net/gross spread should be close. As a result, they need to assess where they can find the general partners that can meet their criteria.

There is a benefit to global diversification, especially across the US, Europe and Asia, with some other new markets that could be considered in addition. They then select, across those regions, general partners that can meet the criteria that I was referring to in terms of performance, deployment, preservation of capital and solid net numbers. From that perspective, they are not necessarily looking to make sector bets or to have views on whether one part of the market might do better than the other. They need to see who can give them that target return. The larger investors need a lot of capital deployed and the smaller investors have a bit more versatility in their choice. Saying that, a geographic filter is a straightforward filter. In terms of fund sizes, the historical data shows that larger funds can perform, and mid-market sizes can outperform larger funds, but may have a bit more volatility to them; maybe that is because there are more of them, so the statistics will look different in terms of volume.

There are nuances that investors think about and they are always trying to attain the performance on a net basis, to move their capital, and to preserve their capital. So they need to look at this grid and understand where they want to have exposure and, within that grid, with private equity, they need to understand the formation of their J-curve and to understand how curved or how steep it is or whether they are achieving a tighter portfolio dynamic between capital put out and capital returned. This then leads them to consider strategies in the private equity space that might have a bit more of a credit inclination or a real asset inclination. So again, there is a very sophisticated view and filtering system that goes on. That is dealing with a more typical investor. Larger investors have more needs in terms of capital deployment. Smaller investors may actually have the luxury of going after much higher performance and being a little bit more comfortable with the volatility or risk aspect of their portfolios.

Have you seen any changes this year in the way that GPs are trying to secure this LP capital?

I think they are learning to be much more open. They are learning to understand how to prepare themselves in different market conditions. What is absolutely crucial is that the general partner is ready to fundraise: they have deployed enough capital, they have returned enough cash, and their business model is comfortable.

What you do not want to do is launch a fundraise where there might be restructuring or repositioning of your business taking place, where you have not reached the deployment numbers yet, or alternatively, where you have not returned enough cash to the investors.

It is extremely important that the general partners align the fundraising with the portfolio investment and exit dynamic. Communication with the investor must be very open and they need to be prepared for the type of questions the investor will ask. I think the GPs understand this concept of alignment, and that transparency is extremely important. They know that they need to be prepared, and that their business and the positioning of their portfolio have to be correct. They really need to avoid coming to market prematurely, otherwise it will be a big problem.

Do you see the role of a placement agent changing at all based on what we have talked about?

Well, we call ourselves a fundraising advisor. That probably says everything! So of course it has changed. We have to be able to advise our clients. In some cases, we advise them on diversifying their funding relationships and their investor contacts. In others, we advise them on strategy and the positioning of their strategy. We may also manage the material preparation. It is really the essence of understanding how to target, how to convert and how to be least obtrusive to both the investor and to the general partner, where we are not creating extra work for them. They know that when we are involved, things go along very smoothly and we have done a lot of work selecting them.

What are your predictions for the private equity industry as we move into 2016?

Alpha in private equity is not really driven as much by economic and external factors as it is by skill and the ability to run good GP businesses. I believe that the private equity community on the general partner side has a very strong mindset and the right understanding of the skillsets that are needed in today's environment and going forward. I also think that the investor community and the regulators are working hard to institutionalize and further strengthen the industry. So, it is all going in the right direction and I am very positive about it.

Within that, the US will continue to be very strong. I think Europe will also benefit, especially at the larger end of the market. Asia is here to transform everything, so we have to live it and be a part of it. And the newer markets will follow. What is most important is that there is a convergence of skill, a convergence of transparency, a convergence of top-quality business done by both the general partners and the investors.

In 2016, I also think we are going to see more innovation come into the industry. We are going to see investors looking at different and more creative ways that they can access the alternative market.

Private equity in, and of itself, is still a minuscule part of the whole picture of finance and so there is a lot still to be done and a lot still to contribute, and more GPs and LPs will need to enter the market.

MVISION

Founded in 2001, MVision is widely recognized as one of the world's leading independent international advisory firms, focusing on raising capital for Private Equity, Real Estate, Real Assets, Credit and Direct transactions in both the developed and emerging markets.

MVision has a long-standing reputation for working with winners – the firm's clients are current and future market leaders across the globe. MVision firmly believes that fundraising is far more than a one-time event; it continues to assist clients with the on-going task of funding and growing their businesses effectively, managing issues such as positioning, growth and performance.

Our team of over 50 professionals provides a global service to clients, covering institutional investors worldwide. Together the team represent 22 nationalities, speak 22 languages and operate out of offices in London, New York, San Francisco, Hong Kong and Sydney. The depth of our expertise across all areas of the market allows our clients privileged access to the strategic industry insights vital to achieving success.

www.mvision.com