This article sponsored by MVision originally appeared in the PEI Perspectives 2019 published by PEI in December 2018/January 2019

FUNDRAISING

Why mega-funds are on a roll

MVision's CEO Mounir Guen talks huge fundraises, new pools of capital and the value opportunities from Brexit

Q Looking big picture, what has been the key theme of 2018?

This year was really all about mega-funds and that trend will continue. Investors have been highly focused on the US market and still are. If they are investing in 10 GPs, they are easily investing in eight in the US, as the returns have been very prominent. And that is why US GPs are able to get bigger and bigger. Many are doubling their fund size and they are still having allocation stress.

There's rising demand for European GPs because investors are significantly underweight in Europe and can't ignore a market of half a billion people with the rule of law, bankruptcy laws, financial and capital markets infrastructure and a lot of noise. There's a lot of inefficiency and opportunity to capture value partly caused by Brexit, and other government changes.

Q Can funds continue to grow?

Yes. Managers will grow in terms of business structure, the number of alternative vehicles they manage and assets under management. Individual fund sizes are capped by a strategy, so GPs will keep raising different types of funds and maximise their businesses.

Q Bigger funds means increasing competition for assets. How are LPs responding to rising prices?

Are investors a little nervous about investing at higher multiples? Of course they are. Do they want to dig in a bit more into the operational and risk profiles of private equity firms? Yes they do. Are the regulators doing that also? Yes they are. Investors manage their portfolios very carefully. Right now, with the equity markets so high and when we're approaching the end of the cycle, the question is: should an investor be more cautious or continue to invest a regular amount of capital consistently? I believe they should do the latter and the reason is that private equity firms, particularly at the larger end, are buying great companies. If they are expensive that's fine. At the end of the day, these companies are well positioned with strong operational infrastructure and excellent management and are likely to continue to perform. They are not commodity orientated or cyclical.

Guen: *LPs are nervous about rising prices*

Q Are LPs concerned about a turn in the cycle?

Let's have a reality check. The industry is structured to work through a cyclical transition. What would damage the industry is a dramatic event, a war, or the unexpected financial collapse of a major country or financial institution. Unless there is a large unexpected drop, people are going into their investment exposures with their eyes open. The industry has enough seasoned professionals who have been through a shock and there's a huge amount of disclosure to investors and dialogue.

The private equity community has learned from the recent financial crisis. On one side of the equation, they are buying great companies and continue to generate outstanding returns. And on the other, interest rates are still low, and many GPs are finding alternative sources of financing that are covenant-light or free. Creative financing with a lot of covenants is not part of the equation today and the portfolio risk profile is quite different. It doesn't mean there won't be a problem somewhere or a portfolio company won't go wrong. But these are outliers.

Q With the US and European markets so bullish, are LPs still looking at other geographies?

The interest in new markets like Latin America or Africa and even parts of Asia is extremely limited. Not because of lack of opportunity or experience, but due to local currency volatility relative to the US dollar and the net dollar returns. For local LPs it is fine to invest and currency returns are attractive. A lot of local investors are now becoming more international which is reducing the potential volume of capital available domestically for GPs. Over the next few years, GP headcount in those markets will be inhibited because it's very difficult to finance them.

One of the few markets breaking that mould is China: the local headcount of private equity firms financed exclusively by Chinese capital is really high. It is also seen in the South Korean and Japanese midmarkets but not at the same scale as China.

But the volume of domestic capital invested locally is particularly pronounced in China.

As a GP, you have to be very focused on making investments that will generate cash and put you within a range of your global peers, as well as demonstrate your strategy, internal governance and discipline. The benchmark is a challenge for the emerging managers right now.

Q Can international GPs also access these pools of capital?

Absolutely. GPs are targeting these markets. In the next five years we are going to see a lot of new capital specifically from northern Asia, Japan in particular – Japanese pension funds are all between $1 trillion-$3 trillion in size and they are allocating 2-3 percent to alternatives, which is going to move to 5-6 percent – and also markets such as Taiwan and South Korea will be more prominent. There's a good volume of capital coming from these countries and a lot more to come. When the Chinese pension and insurance companies become more international, there will be a huge amount of capital moving into the global market place from pension funds and insurance companies.

One of the things you need to decide as a GP is whether you're going to open an office for investor relations in the region or not. Also, LPs have opened up offices in London and New York to address access. The GPs can reach them in these offices, but they still need to be very conscious of local regulations.

In a market where there is a significant local investor community, as a local GP my decision is how much non-local money to accept if any. A domestic GP in Japan, for example, might as well get financed 100 percent by Japanese investors. They are dealing in local currency, with investors that understand the local market.

Q If I'm a new LP, from Asia say, how do I compete for allocations?

For GPs in demand it is complicated. Imagine 80 percent of LPs want to re-up with an incredibly popular manager and increase their allocation by 1.5 times in aggregate. The space for new capital becomes very limited. Even more so with European funds that only scale up by 30-50 percent. You have to introduce an LP early – one or two years before a fundraising. US public pensions have a short list of firms they will review in two years' time. Also, most investors have decided to have fewer GP relationships: 40-60. When I first started it was more than double that. All these dynamics can create huge access issues for investors.

Q What do you do if you can't get in?

The appetite for co- and direct investing is increasing substantially. It's become part of portfolio construction. The largest Asian investors are very sensitive to the construction of their J-curve, so they will use secondaries and a combination of primaries and directs to manage it. This new capital has a significantly steeper J-curve than I've ever seen in my career. They are in the money in very short times. When I first started in the business, it would take 12-15 years for people to work through the J-curve and arrive at a good place. As a result, historically, US capital is so prominent because those LPs have been through multiple J-curves. The Japanese investors in particular have caught up super-fast. They can see what everyone else has done. Investors are all hiring the same consultants and lawyers and they face similar regulatory conditions. That's why a lot of the investment programmes convert to a mean.

Q Are direct and co-investors at risk come a downturn?

Mega-investors can't put enough money to work in third-party vehicles and they have to find solutions.

Over the past few years there has been a discussion about investors not having the infrastructure to match a GP. But they are now hiring people from GPs all the time. Remember, direct investments from investors are quite conservative – reputational risk is a very big focus for them. Also they are becoming more specialist. They have huge amounts of capital with a lot of discipline and experience, governance and infrastructure and are able to weather a turn in the cycle with their long-term horizons.

Q Does the focus on going direct dampen LP interest in first time funds?

In the US, LPs have been very good at creating "emerging manager" programmes and allocating funds to first time funds. Their favourites are spin-out teams. If they can access a team from one of the big firms who are launching a fund and going down the investment ladder to go up again, investors love that, especially from popular funds. But outside of the US there is limited support for first time funds or infrastructure for it. At the other end of the spectrum, the more remote your market is, the more likely it is the government will kick in or development finance institutions. In between, it's quite difficult. For European first-time funds, for instance, it's more challenging and most support comes from the US investors. ■