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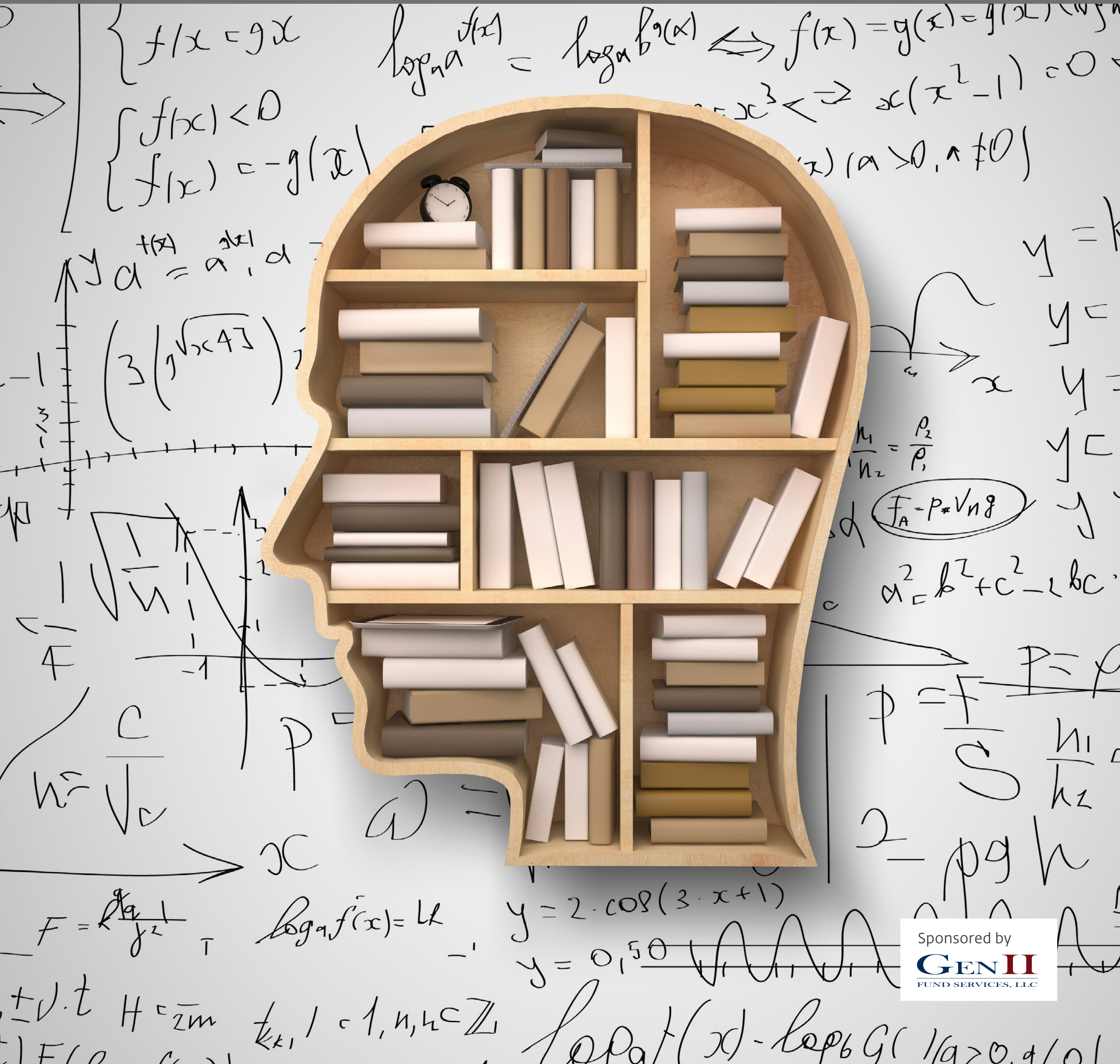
Four Facts About the State of PE

Three experts discuss facts that could change the way PE is viewed



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Four Facts About the State of PE

FOUR FACTS

1. **PE Deals Outnumber Exits** — *In the past five years, there have been three times as many private equity deals as exits.*
2. **Fundraising Isn't Easy** — *Only 26 percent of fundraisings reach their targeted amount and do so within a year. The vast majority are disappointments.*
3. **New Firms Are Starting Up Everywhere** — *Since the recession, more than 700 new PE firms have launched around the world. That's a lot—but maybe it's a good thing.*
4. **GPs Are Holding LPs' Investments Longer** — *In today's market, it's taking much longer for limited partners to receive returns from GPs.*

The Panelists

Steven Millner
Managing Principal
Gen II Fund Services

Millner has more than 20 years in the PE administration business and is a founding partner of Gen II Fund Services, LLC. He previously served as managing director and co-president of BISYS Private Equity Fund Services, Inc., co-founded DML, and was an audit manager at BDO Seidman. He is co-founder of DMLT, Inc., and a CPA. Millner received a degree in accounting from Bentley College.

Russell Steenberg
Managing Director
BlackRock Private Equity Partners

Steenberg is the founder and head of BlackRock Private Equity Partners, and member of the firm's leadership committee. He was previously co-founder and managing director of Fenway Partners and co-head of AT&T Investment Management Co. pension fund's PE investment portfolio. He also serves on several advisory boards. Steenberg received degrees from the Amos Tuck School of Business at Dartmouth College, American University, and St. Lawrence University.

David Wachter
Managing Director
W Capital Partners

Wachter is a managing director and founding partner of W Capital. Previously he had senior roles at Lehman Brothers, Jefferies, and Unterberg. Wachter received degrees from New York University and Tufts University.

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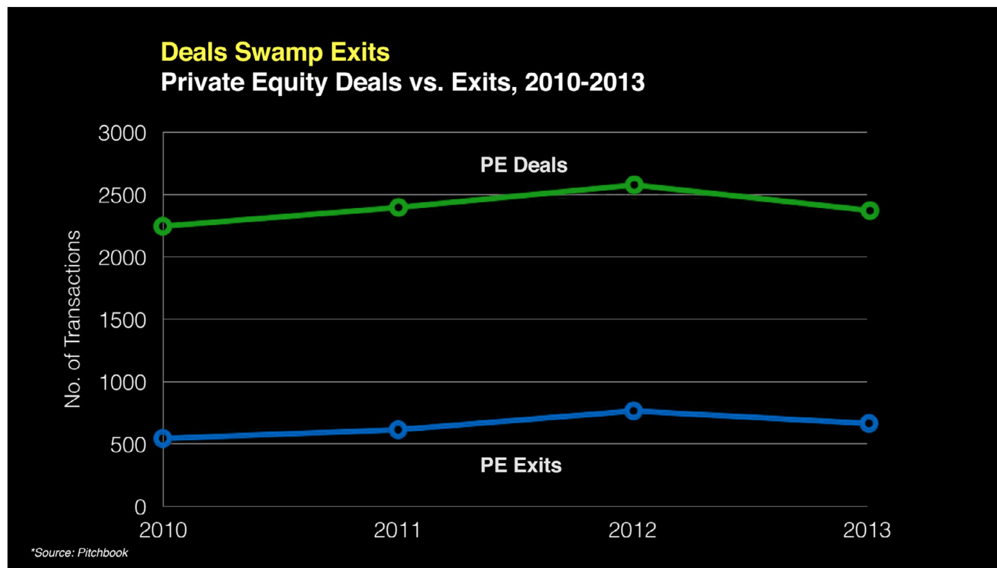

Fact 1: PE Deals Outnumber Exits

Exits are the lifeblood of the private equity industry, but lately they've been in short supply. Throughout the past five years, exits have come at a rate of 200 to 240 per quarter, while PE deals have been happening at a much quicker pace of 600 to 800 per quarter. Takeaway: Only one out of three deals is delivering a liquidity event.

The implications of this ratio are numerous and ominous. First, obviously, is that more companies are staying private for longer, says David Wachter, founding partner of W Capital Partners. And as the private equity business expands—which it is—that trend will accelerate.

"Ultimately, the industry is growing, and that means many more companies are going to stay private for longer periods of time—perhaps indefinitely," Wachter notes. "It also means that trade from sponsor to sponsor will continue to grow."

Fewer exits and longer holding periods also mean more companies accumulating in the PE portfolio, which raises serious operational questions for many firms.

"First of all, how are you staffed to cover a greater number of portfolio companies, monitoring them, helping them grow, and, hopefully, monetizing them?" asks Steven Millner, managing principal of Gen II Fund Services.

Another point of impact is fundraising. "You may have a plan to raise a new fund, but if you're still sitting on a whole bunch of capital, you may be delayed in doing that," Millner says. "It also affects how you're going to promote people on your team. So there's a tension between managing the business but also thinking about your human capital and how to manage that."

With longer holding periods, private equity firms now own more companies than ever. Currently, 5 percent of all companies in the U.S. with revenue in excess of $10M are PE-owned. By comparison, in 2004 only 2.2 percent of companies of that size had PE owners.

That number does not concern Russell Steenberg, managing director at BlackRock Private Equity Partners. "If the penetration rate is 5 percent, that means there is still 95 percent opportunity out there," he says. "This business has just scratched the surface."

Steenberg emphasizes that private equity today is an industry that has left the cottage far behind. "The biggest change in 30 years is that PE is not just two guys and a secretary," he says. "You're not just running a fund anymore, you're managing a business. I spend as much time on the noninvestment side as I do on the investment side."

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—Russell Steenberg, BlackRock

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David Wachter, W Capital Partners

Fact 2: Fundraising Isn't Easy

Only 26 percent of fundraisings are both reaching their targets, and happening within a year, meaning the vast majority are protracted and disappointing Is this the new normal? Fundraising will take longer and be more painful? That depends, says Steenberg. The primary determining factor is the strength and success of your brand in the marketplace.

"If you have a fund that's been able to survive through the downturn, that's been able to provide very good distributions to its limited partners, that has a very good strategy, and that's proven time in, time out, that it can create value for limited partners, then you will raise money, whether it takes a year or 16 months or 18 months," he says. "But those folks who haven't met the kind of criteria I've laid out, they will struggle."

Still, there's no denying that the fundraising process has gotten a lot more stressful and time-consuming for everyone. Funds must now do more legwork on the front end, well before they engage with LPs, if they want to woo investors.

"What's really happened over the last couple of years, especially post-Madoff, is you've got a much bigger focus on operational due diligence, as well as investor due diligence," Millner says. "That's a big change. Historically, as a fund administrator, we wouldn't get hired until the GP was pretty close to raising the money."

These days, PE firms are engaging with advisory firms like Gen II Fund Services long before they take their first meeting with LPs. "The GPs want to have all their ducks in a row and be prepared to check the box when the LP comes in," Millner says. "That's a new phenomenon. The other thing that's happened is there's more uncertainty as to what the size of the business is going to be, what the management fee is going to look like, and how to staff the firm. So an administrator like Gen II does a good job at giving GPs optionality in terms of how they think about structuring the business."

At the end of the day, what LPs care most about is return on investment. And with PE firms carrying more portfolio companies for longer periods of time, GPs need to find convincing methodologies to value their unrealized holdings if they want to successfully raise a new fund.

"Clearly, harvesting a portfolio is taking longer for everyone," Wachter says. "The tricky part is fair valuation of portfolio companies. Both GPs and LPs understand that's a challenge—and there is a lot of art in it and very little science. Assessing unrealized portfolios for an LP is really challenging, so getting the ball of realizations far enough down the road so an LP can feel more comfortable with your track record and performance is vitally important."

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Steven Millner, Gen II

Fact 3: New Firms Are Starting Up Everywhere

The financial crisis and ensuing recession threw a wrench in many industries. But not, apparently, private equity. In the years since the economy went flat, more than 700 new PE firms have sprung up. That's not a glitch in the matrix. It's simply the market behaving as markets should.

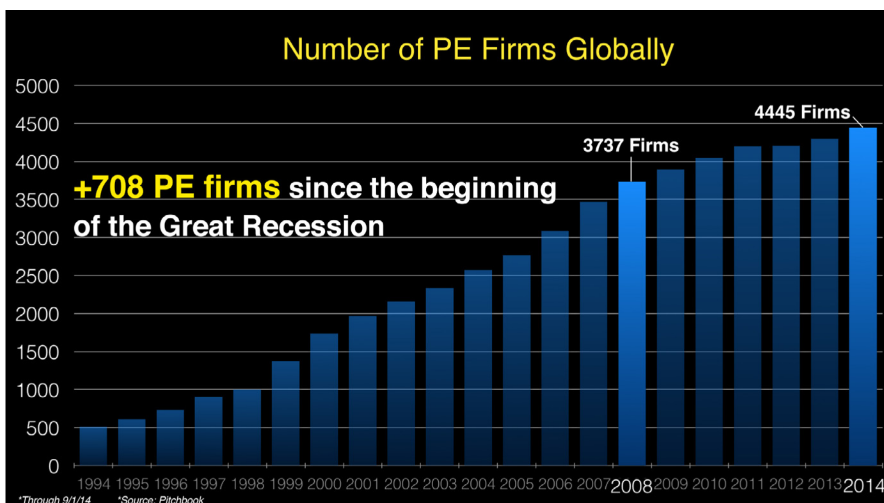
"The asset class grows because there's demand for the product," Millner says. "In a yield-depressed environment, private equity, frankly, is the one asset class that can really help a portfolio manager meet their investment objectives. It's supply and demand, ultimately. It's Econ 101. There are 700 fund sponsors because there needs to be 700."

Diversification in the asset class is as important as it's always been. That's why investors don't simply hand their money to Blackstone or KKR and call it a day. They need to spread their money around. Another reason there are 700 new private equity firms is that the PE universe has expanded in the past 10 years.

"It's called globalization," Steenberg says. "There are more firms outside the U.S. and Europe today than there have ever been before. Firms are growing faster in the nondeveloped world than they are in the developed world, and that will continue."

The grandfathers of private equity might not appreciate the current baby boom and the competition it brings. But it's a healthy sign that the PE industry is reinvigorating itself as talented people leave long-established firms and start their own shops.

"Spinout firms and teams that have left larger institutions because they have a passion for a particular niche or an expertise, it's a great thing," Wachter says. "The industry has to continue to reinvent itself in terms of strategies and geographies and stages of investment. And as more and more of the economy continues to move into private equity hands, it's logical that new firms and new generations of partners and new strategies are developing."



But it's survival of the fittest, because anyone who wants to launch a PE firm now must be in great shape indeed. The barriers to entry are more imposing than they've ever been. Regulations are stricter, expenses are higher, fundraising is tougher. The days when three investment bankers could decide PE is easy and go out to raise a fund—those days are long gone.

And yet new managers keep coming, Millner says. "Our pipeline has never been more fulsome with emerging managers, i.e., first-time funds, than it is right now. So there's something going on. There's a change of the landscape. We see many individual private equity people wanting to become entrepreneurs, leaving the bigger firms and seeking to put their shingle up."

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Russell Steenberg, BlackRock

Fact 4: GPs Are Holding LPs' Investments Longer

Today's average five-year-old fund has distributed back about 40 percent of an investor's money. Rewind to 2007 and an average fund had given back investors about 85 percent of their money. Translation: it's taking about twice as long for an LP to get their money back from a GP as it did in the past.

"Now take it to seven years," Wachter says. "A seven-year-old fund back in '07 had given investors 100 percent of their capital back. Today a seven-year-old fund, on average, has given back investors about 70 percent of their money."

Although the money multiples are not changing significantly, the duration is.

Of course, a major factor in this return deceleration is the economic downturn. Most firms lost about two years' worth of cash flow relative to their underwriting plan—their long-term, five-year plan—and that's still working its way through the pipeline.

"Are we going to revert back to a more normal distribution pattern, which in the buyout world typically means getting your money back between four and six years?" Steenberg asks. "Whether this is a permanent shift or part of the cycle, it's something that time will tell us."

Investors seem willing to wait. Otherwise the PE industry would not be growing as it is. But the longer marriages between LPs and GPs are not without consequence on the home front.

"If the GPs haven't gotten into carry by a certain point…their business economics have changed," Millner says. "You may have a bunch of junior partners who had a piece of the carry, and they haven't seen that—and that's not what they signed up for. Oftentimes the senior folks need to help the junior folks recalibrate, so there's a big internal dialogue going on regarding that."

Another place where longer durations are leaving a mark is incentives at the firm. When a fund is in its 10th, 11th, or 14th year, incentives alter.

"When funds are below their hurdle rate—and about a quarter of all funds are below the 8 percent target threshold for net IRR—incentives change and motivations change," Wachter points out. "The only way to clear it, particularly late in the life of a fund, is by taking more significant risk. Funds that are underwater and funds that are in clawback have a completely different set of motivations and incentives than any fund that's in the middle of the well-performing category."

But even though PE firms didn't expect to be looking after assets that are 12 or 13 years old, experienced GPs should be able to vint the longer durations into palatable liquidity events.

"If you asked most investors, they'd probably say they're a little surprised it took as long as it did to get liquidity and that the portfolios probably have more names in them than they would've thought," Millner says. "But I don't think that's really negatively affected anybody. I think most good firms are prepared to deal with this." ■

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ABOUT GEN II

with **Steven Millner**, Managing Principal, Gen II Fund Services

Gen II offers private equity firms the best-in-class combination of people, process and technology, enabling GPs to most effectively manage their operational infrastructure, financial reporting and investor communications.

Gen II administers more than $75B of private capital covering more than 600 fund entities and reports to more than 6000 LPs on behalf of our clients. The Gen II team is the most experienced and longest tenured team in the private equity fund administration industry, and has received the highest levels of customer satisfaction of any fund administrator.

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