ALTERNATIVES RESEARCH

Navigating Larger and More Frequent Funds

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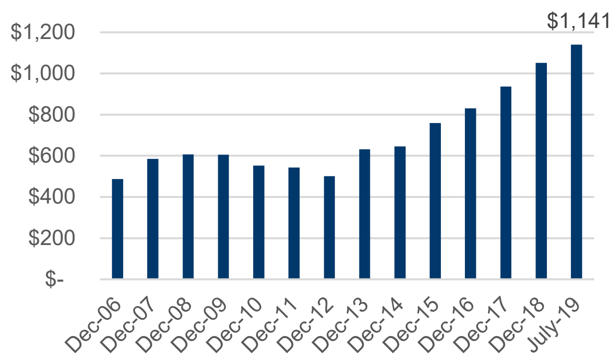
Limited Partners (LPs) investing in private equity funds have always been faced with inherent issues relating to investment strategy scalability. Specifically, as General Partners (GPs) become more successful, they typically raise larger and larger funds, which often translates into lower returns for LPs. In today's competitive US private equity market, this issue has been exacerbated for LPs. A situation that LPs are commonly faced with is the following: a GP they've invested with in the past is raising a fund that is double the size of their previous fund and the GP is back in the market much sooner than anticipated. In addition, the GP's most recent fund was deployed over a short amount of time so it is still "early" in showing meaningful progress. So how do LPs deal with these types of situations? What type of due diligence can potential investors perform to quantify and fully understand the strategy scalability risk associated with these opportunities? This brief article will shed light on the market dynamics surrounding larger fund sizes and shorter fundraising periods, while also providing due diligence insight on how Wilshire Private Markets assesses scalability risk.

MARKET DYNAMICS

The U.S. private equity industry remains a mature and competitive market. The last several years have been generally strong from an investor perspective; however, a significant amount of capital has entered the ecosystem and created a capital supply and demand imbalance. As shown in Exhibit 1 below, North American private equity dry powder1 has steadily increased since 2012 and currently sits at $1.1 trillion, which is nearly double the amount of capital prior to the Global Financial Crisis in 2008. Unsurprisingly, the increase in capital supply has amplified the competitive dynamics in the market. In particular, U.S. LBO purchase price multiples have eclipsed the 10x enterprise value-to-EBITDA threshold for the past couple of years while the average amount of total debt for these transactions has consistently hovered around 6x EBITDA.

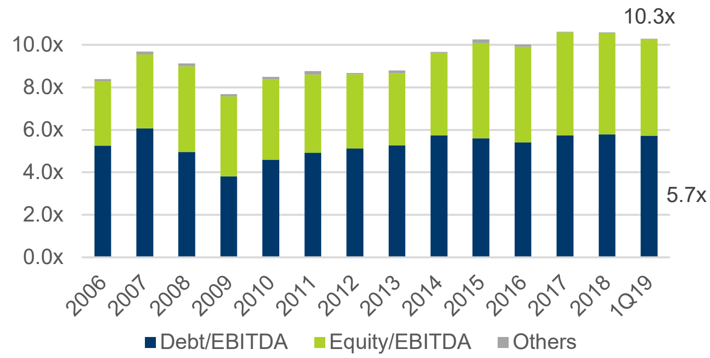
[1] The amount of capital that has been committed to a private equity fund minus the amount that has been called by the GP for investment. Source: Preqin.

Exhibit 1 – North American Private Equity Dry Powder ($B)



Source: Preqin.

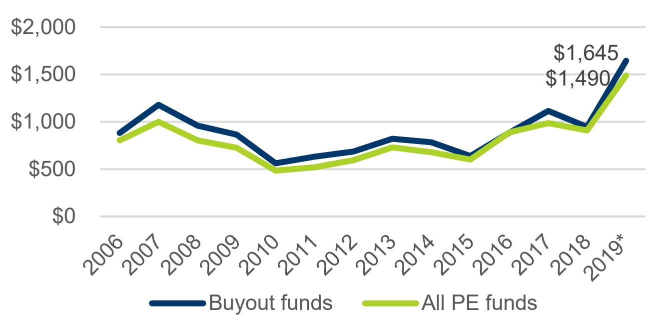
Exhibit 2 – U.S. LBO Purchase Price & Debt Multiples



Source: S&P LCD.

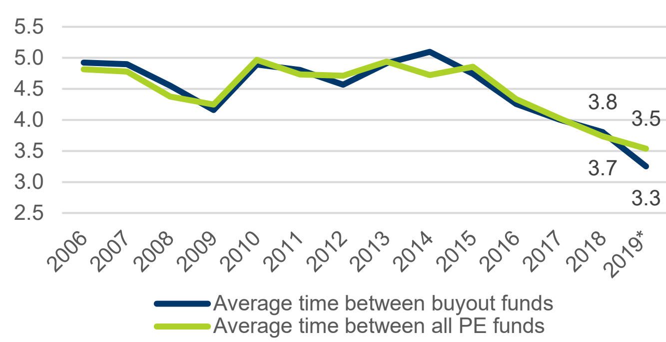
Furthermore, GPs are highly aware of the cyclical factors of the private equity market, especially as it relates to fundraising efforts. In recent years, private equity returns have been strong, the public markets have produced attractive returns and the broader U.S. economy has continued to modestly move forward. Nonetheless, history suggests that economic expansionary periods are bound to end and many private markets investors continue to believe a market correction or downturn is likely in the near-term. The fear of a broader market correction, in addition to the aforementioned competitive forces in the private equity market, have resulted in GPs raising larger and more frequent funds. As highlighted in Exhibit 3, the average size of U.S. buyout funds and all private equity funds have increased by 58% and 47%, respectively, since 2015. Concurrently, the average time between funds has significantly decreased from nearly five years across 2013-2015 to between 3.3-3.5 years in 2019.

Exhibit 3 – Average U.S. Private Equity Fund Size ($M)



*Source: PitchBook. *As of June 30, 2019.*

Exhibit 4 – Average Time (Years) Between U.S. Private Equity Funds



*Source: PitchBook. *As of June 30, 2019.*

AREAS OF DUE DILIGENCE

The key consequence of these market trends is that it is becoming increasingly difficult for LPs to assess fund opportunities. In light of these trends, we've continued to emphasize and innovate within our due diligence process to ensure that we fully understand the scalability risk involved in these types of GP situations. The section below highlights five areas of due diligence that we believe are critical when analyzing scalability risk.

1. Investment Pacing – To a certain extent, the GP must be able to justify their ability to execute on a larger fund based on historical capital deployment. There are several ways to analyze investment pacing. A simple analysis focused on deployment per vintage year is always helpful for a baseline. However, analyzing run-rate pacing is most insightful for understanding the current capabilities of the GP. Varying the time period for the run-rate calculation will result in a comprehensive view of recent deployment trends. We'll often incorporate co-investment capital into these analyses as well with the rationale being that the GP may have been able to invest additional capital into each deal (without the need for co-investment capital) if they had a larger fund. Once the annual run-rate figures are calculated, we calculate the amount of theoretical capital deployed across a multi-year investment period and then layer in management fees to arrive at an implied fund size, which we'd compare to the actual size of the GP's fund.

Exhibit 5 – Implied Fund Size Analysis

Time Period	Implied Capital Deployed*	Implied Capital Deployed + Fees = Implied Fund Size
2014 - Current	$372	$423
2015 - Current	$424	$482
2016 - Current	$579	$657
2017 - Current	$729	$828
2018 - Current	$1,215	$1,380
Average Implied Fund Size		**$754**

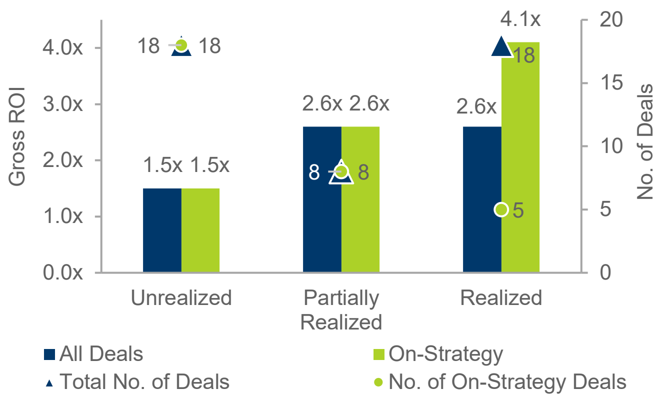
2. Portfolio Company Metrics – Another consequence of GPs coming back to market earlier is that their prior fund's portfolio remains relatively young. At a fund-level, the returns may be modest and GPs will often state the immaturity of the portfolio as the main reason for those modest returns. While this is partially true, potential investors can still analyze company-level metrics to get a better sense of the portfolio's progress. Typically, we compare the financial metrics (e.g., revenue, EBITDA, net debt) of portfolio companies at the point the GP invested into the company compared to the current quarter's metrics or at the point of exit. In most cases, financial progress can be seen even across a shorter hold period. If not, there should be a clear reason why that's not the case (e.g. turnaround scenario, company is investing in growth). In these types of situations, you should be able to see similar patterns of financial progress in their prior deals assuming the broader strategy has been consistent.
3. Fund Projections – Furthermore, it's important to understand the trajectory and future potential value of the GP's current portfolios. For each private equity fund we analyze, we build bottom-up, company-level financial projections for each deal within an active portfolio. The objective of the exercise is project the gross returns for each deal and roll them up to estimate fund-level, net returns to LPs. Equally as important, this exercise allows us to understand the GP's approach at a granular level including how specific deals were sourced, various exposures across the portfolio, post-investment role of the GP, company-level value creation plans and exit expectations. For each projection analysis, we leverage all the data we've gathered in our due diligence process including data from GPs, reference calls with portfolio company CEOs and co-investors, and other sources to form our own independent view of the portfolio's potential value.

Exhibit 6 – Fund Projection Analysis

		IRR			ROI		
		Low Case	Base Case	High Case	Low Case	Base Case	High Case
Fund II	Gross	11%	26%	38%	1.7x	3.2x	4.4x
	Net	5%	19%	29%	1.3x	2.3x	3.1x

4. "On-strategy" Deals – Another analysis we perform to understand strategy scalability is assessing the "on-strategy" deals in a GP's portfolios, which are commonly defined as the larger-sized companies that are consistent with the anticipated larger fund. With each new fund, GPs often state the expected range of enterprise value for the targeted companies and LPs can utilize this company range to identify which historical deals would theoretically qualify for the new fund. In essence, you can build a more relevant track record for their larger fund and analyze metrics such as total capital invested, deployment pace, returns, etc. Similar to the pacing analyses, this type of analysis can also include co-investment capital. If there are zero on-strategy deals within the GP's track record, this data point may suggest the increase in fund size is quite aggressive.

Exhibit 7 – Performance: All Deals vs. On-Strategy Deals



Source: Wilshire Private Markets. Exhibit is for illustrative purposes only.

5. Seed Assets & Pipeline – Although less common, the most tangible mitigant for scalability concerns is a seeded portfolio. This is a scenario where the GP is still in the fundraising period for their fund, but has already invested in one or two deals using capital from an initial fund close. Now, instead of potential LPs committing to a blind pool of capital, there is some visibility into the portfolio and investors can form a view on the assets in the fund. If the seed assets are consistent with the GP's stated strategy and attractive on the surface, this de-risks the portfolio from both a sourcing and execution perspective. Similarly, understanding a GP's pipeline can provide some comfort around their ability to execute on larger companies and/or a larger fund. However, pipelines can be easily manipulated by sponsors so it's crucial to drill down on the deals and understand the likelihood of the pipeline assets ending up in the fund.

CONCLUSION

In today's private equity environment, it's relatively easy for LPs to criticize GPs for not being disciplined enough with regards to deploying capital, especially given the high valuation environment. But LPs must also be introspective and similarly disciplined with regards to the continued support of aggressive GPs who seek to raise substantially larger funds within a short amount of time from their prior fund. If the underwriting analyses described in the above section clearly does not support the scalability of the GP's strategy, it may be prudent to "step off the bus" and find an alternative manager who can provide stronger risk-adjusted return potential.

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