The PE landscape

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Bruce Fenton and Daniel McDonough of Pepper Hamilton examine the challenge of lengthening PE lifecycles and what sponsors can do to overcome it.

Over the last five years we have witnessed a shift in the PE landscape. In advising our clients on everything from fund formation to transactions, we sensed that the private equity lifecycle has extended. In an attempt to quantify this trend, we surveyed 50 PE firms across the United States.

To give a sense of the sample, the majority (80%) of PE firms surveyed cover buyouts and growth equity, with the total value of the assets under their management ranging from US$250m-US$2bn for 92% of respondents. For most (76%), their latest closed fund (i.e. one no longer raising capital) was worth between US$100m and US$500m. We felt that this group would allow us to check the pulse of the country's middle-market, the heart of the PE industry.

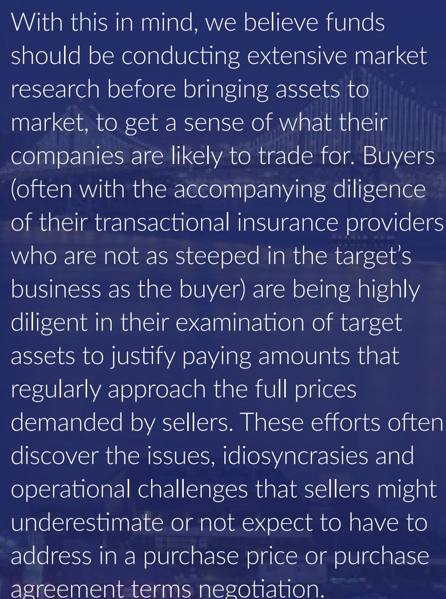
The findings support our observations. For more than half of managers, lifecycles are longer than they were five years ago, and on three fronts: fundraising, investment holding periods, and overall fund life spans. So what do we see driving this trend?

The PE market today is hyper-competitive. Investors have enjoyed net liquidity in recent years and are re-funneling their capital back into the asset class to achieve outsized returns.

On the face of it, this would suggest that the time spent raising funds should be decreasing. Yet there are many mouths to feed. We have never before seen more managers out there marketing such a broad selection of products.

At the same time, LPs are more diligent than ever. They are going over new offerings with a fine-tooth comb, assessing whether managers have the capability to sustain their track records, weighing the credibility of emerging talent and negotiating more aggressively on terms and conditions of their limited partner rights and obligations. An increasing emphasis on shadow capital – money committed outside of traditional fund structures for co-investments and directs – means that, while the industry is not short of funding, for many managers it is taking longer to raise the desired amount of committed capital for their funds.

On the deal side, GPs continue to face significant challenges as they grapple with a market that can be both overheated and cautious. There is a notable flight to quality, resulting in a small slice of assets commanding substantial premiums. When looking at market comps, sellers have high expectations that often cannot be met, prompting them to pull deals and adding further pressure to pricing.



With this in mind, we believe funds should be conducting extensive market research before bringing assets to market, to get a sense of what their companies are likely to trade for. Buyers (often with the accompanying diligence of their transactional insurance providers who are not as steeped in the target's business as the buyer) are being highly diligent in their examination of target assets to justify paying amounts that regularly approach the full prices demanded by sellers. These efforts often discover the issues, idiosyncrasies and operational challenges that sellers might underestimate or not expect to have to address in a purchase price or purchase agreement terms negotiation.

Sellers should also be prepared to make concessions on deal terms. While today's high multiples and representation and warranty insurance are often the status quo for premium target assets, buyers have had success in negotiating claw backs, higher indemnification caps (or limited exclusions from caps) and lower "tipping" baskets to protect them from certain potential downsides and those issues which are excluded from coverage under the transaction's representation and warranty insurance policy.

Credit markets present their own challenges. The leverage caps imposed by regulators mean that lenders, at least mainstream banking institutions, are being more prudent with the leverage multiples they are willing to advance on buyouts. Sponsors are being pulled in opposite directions, pushing for high valuations and in many cases having to do so with more of their equity in lieu of ample leverage.

Looking ahead, we expect GPs to use every tool at their disposal to give them an edge over the competition and deliver the returns that their investors have come to expect of them. Specialization is only going to continue. For middle-market houses, which typically manage consecutive funds rather than a stable of products, the focus of successive funds will not necessarily reside within the same sector lines.

To distinguish themselves from their rivals, GPs will have to identify what has contributed most to their track records and hone their strategies accordingly, whether that be pursuing a small handful of industries, incentivizing their best talent, exploiting proprietary origination and management team networks, seeking assets that are under stress, expanding the size of the portfolio's assets by means of add-on transactions, or by more clearly identifying the identity of a portfolio company by the use of spin-off transactions to separate distinct business lines.

The PE industry needs committed capital to exist, but is struggling to deal with the inefficiency caused by a crowded marketplace of competitors for capital, for deals and for high multiple exits. Those who accept the market's current challenges and are willing to adapt and focus on what they do best, will, in time, more easily stand out from the pack.