Pepper Hamilton LLP
Attorneys at Law

Going the distance

The Expanding Lifecycles of Private Equity Funds

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Methodology

In H2 2016, Mergermarket interviewed 50 private equity partners, directors and principals from across the US. The fund sizes managed by the interviewees range from US$250m to US$5bn. For the purposes of this report, private equity includes closed-end funds for buyouts, growth equity, private debt, real estate, and infrastructure. The results are anonymized and presented in aggregate.

Foreword

This year has seen private equity (PE) fundraising continue to rise to new heights. According to Preqin data, funds that closed in Q1-Q3 2016 secured in excess of US$414bn in total investor commitments, a 17% increase over the same period of 2015. Limited partners are especially interested in capitalizing on the downturn in certain sectors and are demonstrating an eagerness to invest in buyout funds.

Overall, limited partners (LPs), excluding those in certain hard-hit sectors, have enjoyed positive net cash flows for the past two years. This has been driven, in part, by a buoyant exit environment propped up by robust economic growth and relative stability in capital markets. Certain commodities aside, PE fund managers are capitalizing on these favorable conditions and seeking to monetize and realize strong returns on their investments.

Low interest rates and potentially strong distributions, coupled with longer due diligence periods and increased deal competition, brought the global stockpile of dry powder to a record US$1.55tn at the start of Q4 2016, according to Preqin. Nevertheless, there are currently more than 3,074 funds on the road targeting an aggregate of US$1.05tn, more than has ever been sought before. While it is taking longer for managers to deploy capital, the entire lifecycle of PE funds also appears to be lengthening. Managers are seeing longer fundraising periods, partially because of increased diligence and a complex regulatory framework; sourcing periods for creating and generating viable deals; and holding periods for investments. This longer lifecycle can also be attributed, in part, to the very competitive market for investors' dollars and, in turn, deals.

In order to gain a better understanding of both the drivers and impact of the longer lifecycle on fundraising, deployment and return, Pepper Hamilton commissioned Mergermarket to interview PE partners, directors and principals from across the United States. Key findings from the survey include:

Longer on the road. More than half (58%) of respondents say the PE fundraising period for the current fund was longer than the preceding one, with 16% describing it as having increased significantly.

Patience is a virtue. More than half (56%) of respondents say that the timeframe from investment to disposition has increased over the past five years, with 12% saying it has increased significantly. This means that LPs' called capital is illiquid for longer, making it unavailable for other general partners (GPs) who are in fundraising mode.

Stiff competition. Dry powder is at an all-time high, and yet PE firms are also setting records for additional fundraising. Two-thirds of respondents believe that the proliferation of PE firms and funds is behind this trend, meaning that managers will have to compete hard to raise new capital.

Investors remain committed to PE, and the best GPs should be able to raise their new funds with similar effort to that of prior funds. But on average, fund managers are spending more time both marketing and investing their funds. To ensure their best chances of minimizing these timeframes, buyout houses require clearly defined and articulated strategies that investors can understand and, crucially, can execute. We hope you find this report valuable.

The PE landscape

Bruce K. Fenton
fentonb@pepperlaw.com

Daniel W. McDonough
mcdonoughd
@pepperlaw.com

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.

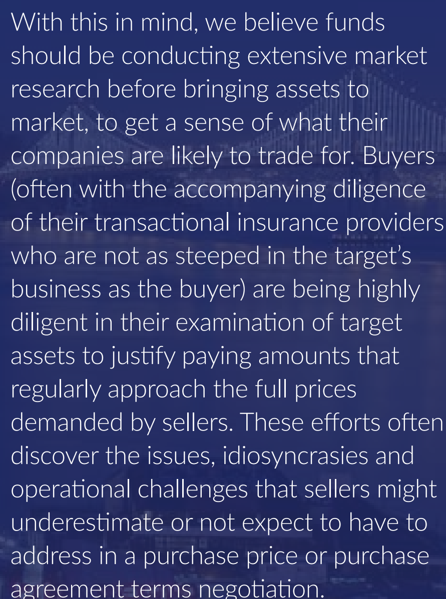
The findings support our observations. For more than half of managers, lifecycles are longer than they were five years ago, and on three fronts: fundraising, investment holding periods, and overall fund life spans. So what do we see driving this trend?

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.

State of play: PE lifecycles in 2016

58%

said fundraising time had increased compared to their preceeding fund.

24%

fewer funds were raised over the past year.

It is taking longer for GPs to raise and invest their funds. How much longer, what is behind this trend and what are fund managers expecting for the future?

For the majority of US GPs, the time spent raising money from investors for their most recent fund has increased. Specifically, for 58% it was a longer timeframe than the fundraising period for the preceding fund, with 16% describing it as having "increased significantly." For 36% of respondents, the timeframe was either the same or shorter.

While fund lifecycles are extending, the amount of capital being raised has largely remained stable, increasing only slightly year over year. This appears contradictory. How is it taking longer for GPs to raise funds if fundraising levels remain high?

We believe the answer comes from a shift in industry trends. Investors are streamlining their PE assets by selling into the secondary market, which continues to grow, and concentrating their capital with fewer managers for primary commitments. By writing larger checks for fewer GPs, they are able to leverage economies of scale and negotiate more favorable fund terms, averaging down costly fees.

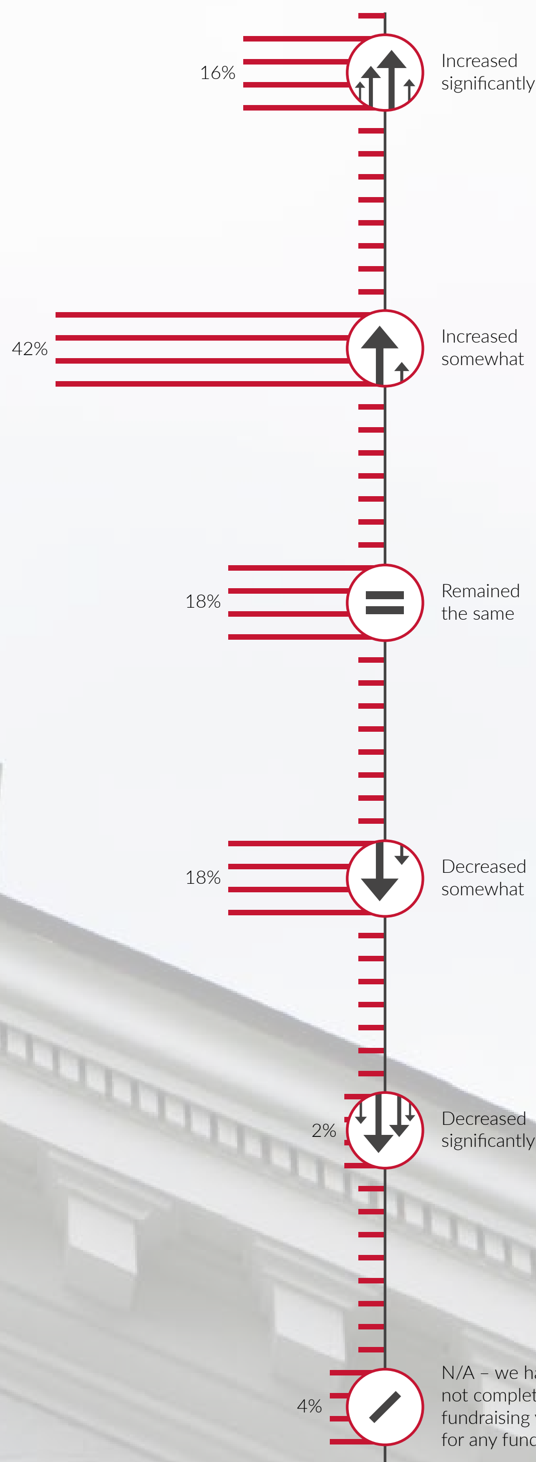
An example of this push to streamline portfolios was demonstrated last year by CalPERS, the largest US pension fund, which aimed to cut the number of GPs it is invested with by more than two-thirds, to no more than 120. Speaking to the Financial Times, Ted Eliopoulos, CalPERS' chief investment officer, said the pension fund would use "every possible lever" to pare back fee-based costs, an issue that LPs have focused on in recent years.

Preqin data bears this trend out. The more than US$550bn raised last year was shared

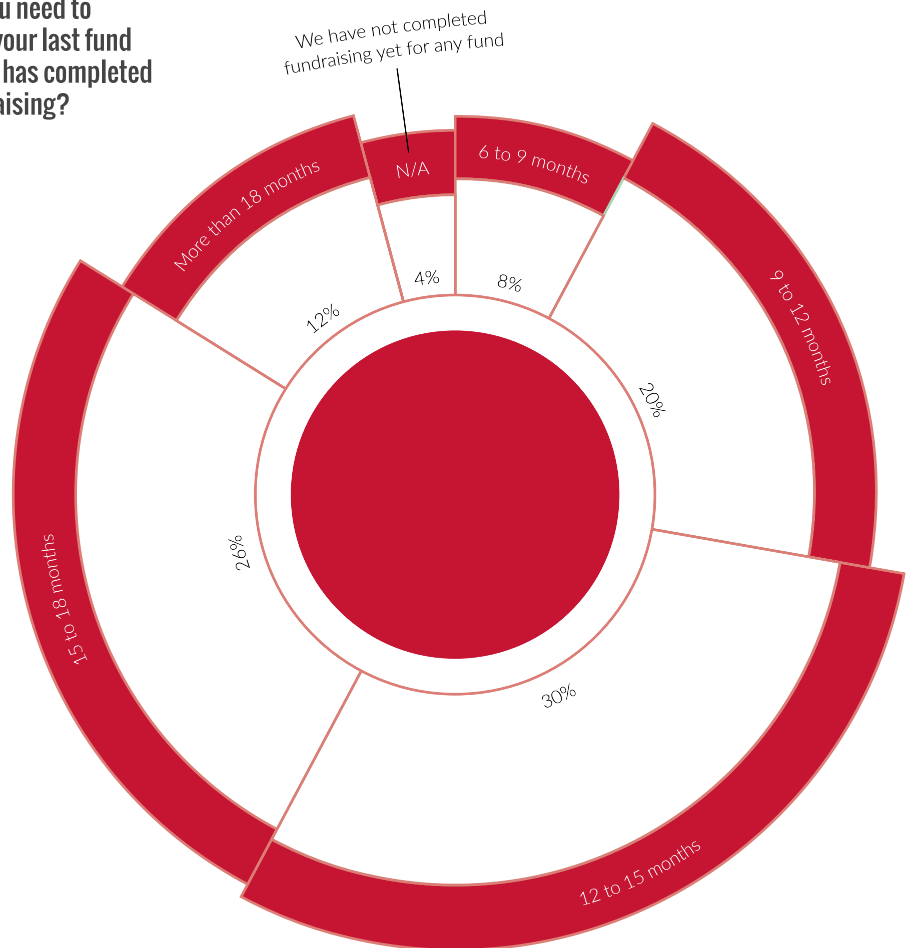
between 1,061 funds, an annual drop of 24% by fund count. In short, fewer funds are raising more money. Capital is concentrating into the hands of the upper quartile managers with the most convincing track records; interestingly, despite the desire of LPs to achieve more favorable investment terms, this appears to be the case, even when the upper quartile managers do not offer the most attractive terms.

A case in point, Advent International closed its seventh fund in March 2016 of US$13bn, its largest haul to date and above the US$12bn target the firm set for itself — despite the fact that the fund dropped the preferred hurdle rate it needs to reach before it collects performance-related carried interest. Although such top performers are seeing their funds oversubscribed, there does seem to be a resulting spillover effect in which lower quartile managers are able to absorb commitments from LPs who are unable to access the best funds. This suggests that, while the overabundance of capital is being directed to lower

Q1: How does the time spent raising your most recent fund compare to the fundraising period for the previous fund?



Q2: How much time did you need to raise your last fund which has completed fundraising?



performers, these investors may be more hesitant to commit, which lengthens average fundraising timeframes.

According to our survey, PE firms needed anywhere from six months to more than 18 months to complete their latest fundraising, with 76% needing between 9-18 months. One PE partner, whose firm specializes in buyouts and for whom the latest fundraising period had "increased significantly," said: "Previously, finding opportunities with aligned interests was possible. But over the years, changes in the marketplace, demand from investors and regulatory pressures have changed, which has resulted in a longer fundraising period."

The trend of LPs concentrating on fewer relationships also favors the very biggest PE managers, as their funds have the capacity for larger LP checks without pushing out existing investors. The blue chip managers have been reaching their targets with relative ease.

For example, Blackstone Group raised US$18bn last year for Blackstone Capital Partners VII, the second-largest buyout fund raised since 2008, and in 13 months.

Behind them, Warburg Pincus Private Equity XII reached its US$12bn target in just six months. Indeed, the five largest buyout funds to close last year all matched or superseded their goals, and each was larger than the fund that preceded it. Three of these achieved their final close within eight months of launching.

GPs at the top of the food chain are mopping up investors' capital. However, with an abundance of capital being redeployed back into PE, there is enough to go around for the less attractive funds, even if it is taking them longer to complete fundraising.

Thus, with the exception of these blue chip funds, in general, the funds surveyed said their most recent fund is taking longer to raise than predecessor funds. The majority of managers surveyed don't expect this to change any time soon. Our results show that, looking to their next fund, 68% of respondents expect fundraising to take roughly the same amount of time or more. Almost a third of respondents (32%) believe it will take somewhat or significantly longer.

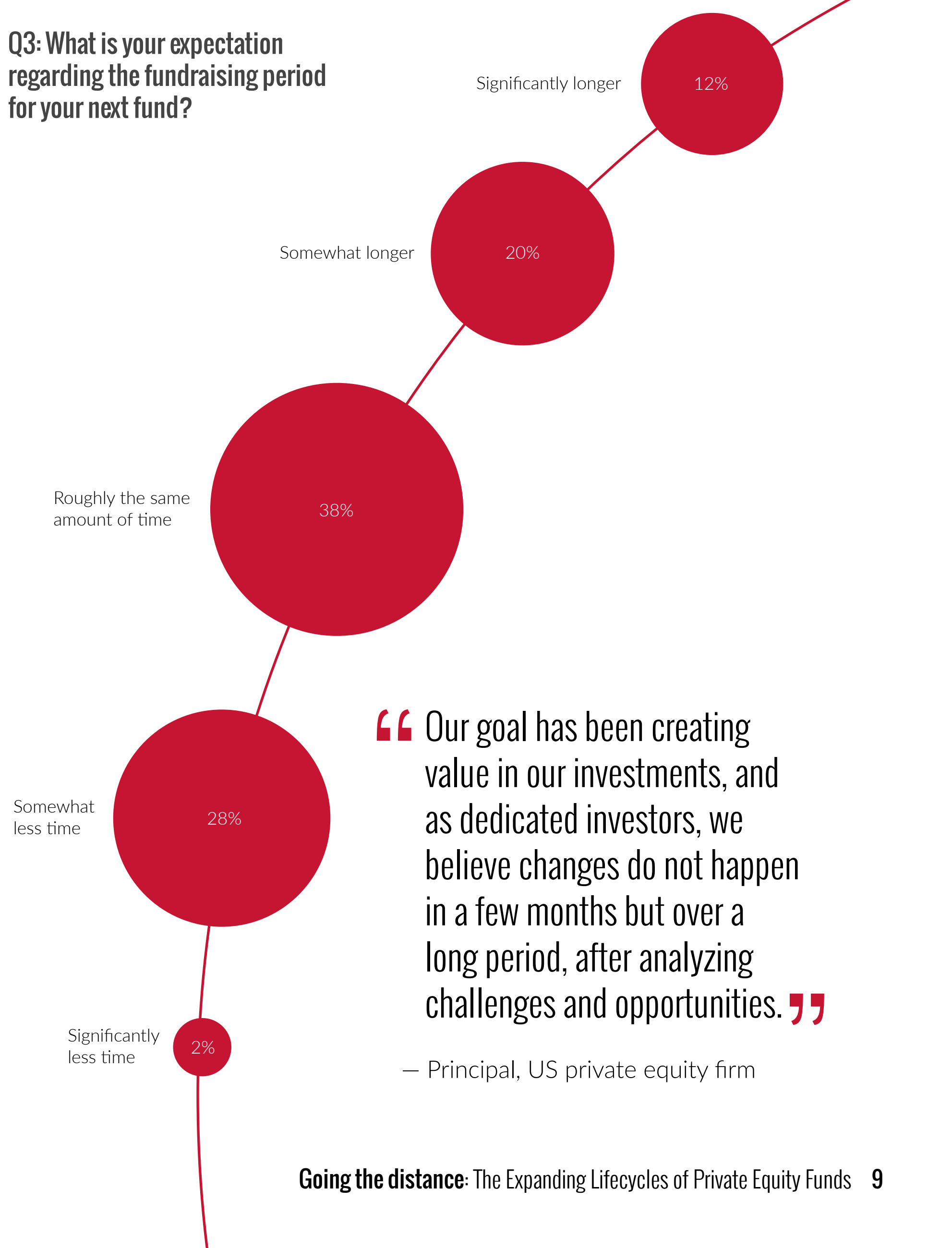
Buying time

It's not only fundraising that is taking longer. More than half (56%) of the partners we surveyed say that the length of time between their fund's initial investment in and complete disposition of a portfolio company has increased over the past five years, with 12% saying it has increased significantly.

Ideally, PE firms seek to invest in and exit portfolio companies in as short a timeframe as possible, as this boosts time-weighted internal rates of return. This is not always possible. In some cases, GPs may wish to hold businesses for longer periods of time if they feel that there is more value to be realized or simply to reach their agreed hurdle rate so they earn carried interest on the deal.

There has also been a notable shift away from leverage as a key value driver in recent years. Indeed, in the US, regulatory

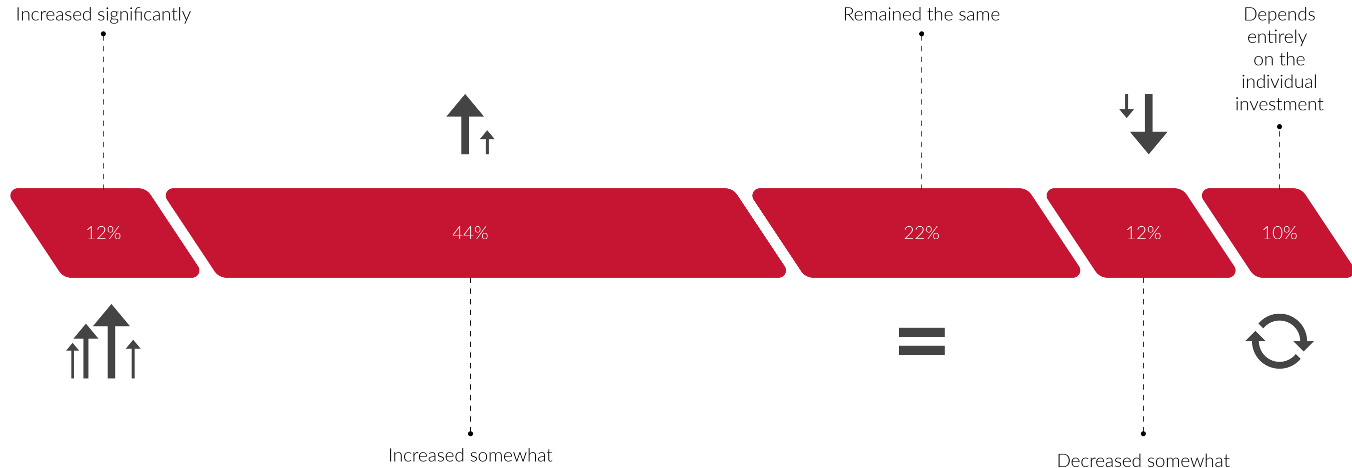
Q3: What is your expectation regarding the fundraising period for your next fund?



> Our goal has been creating value in our investments, and as dedicated investors, we believe changes do not happen in a few months but over a long period, after analyzing challenges and opportunities.
>
> — Principal, US private equity firm

guidance has caused many banks to cap the leverage they are willing to advance on buyouts. This has put pressure on funds to apply transformational improvements to their portfolio companies' operations, merge them with competitors and genuinely reposition their place in the market in order to drive higher returns. This emphasis on operations as opposed to financial engineering can require GPs to hold their investments for longer to get the job done.

Q4: How has the period between investment and disposition changed for your fund's investments over the past five years?



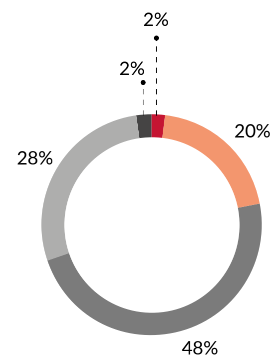
One principal at a US PE firm specializing in growth equity who cites "10 years or less" as his fund's term lifecycle said: "Our goal has been creating value in our investments and, as dedicated investors, we believe changes do not happen in a few months but over a long period, after analyzing challenges and opportunities. I would say about seven to 10 years would be a justified timeframe."

Almost half of survey respondents (48%) say that, on average, taking a fund from initial investment in, to complete disposition of, a portfolio company takes six to seven years. For 20%, that turnaround is faster (three to five years), while 28% say the process can run for eight to nine years.

Of course, no two investments are the same, and each investment will have its own unique holding period to achieve the required value. A partner at a US PE firm specializing in growth equity said: "It keeps on changing — we usually hold on to a company for seven years, but depending on the market conditions, the company value and the returns we could generate, we can extend that timeframe. We have held on to companies for more than seven years when we were not finding buyers or if we were certain of getting better returns later."

Looking to the next three years, 52% of those surveyed expect the timeframe from investment to disposition to remain the same, with equal proportions (16%) saying that it will increase and decrease somewhat. This suggests that, for the most part, US PE executives believe the time needed to invest in and divest an asset has plateaued.

Q5: What was the average time between initial investment and disposition of a portfolio company?



- 3 years or less
- 3-5 years
- 6-7 years
- 8-9 years
- 10 years or more

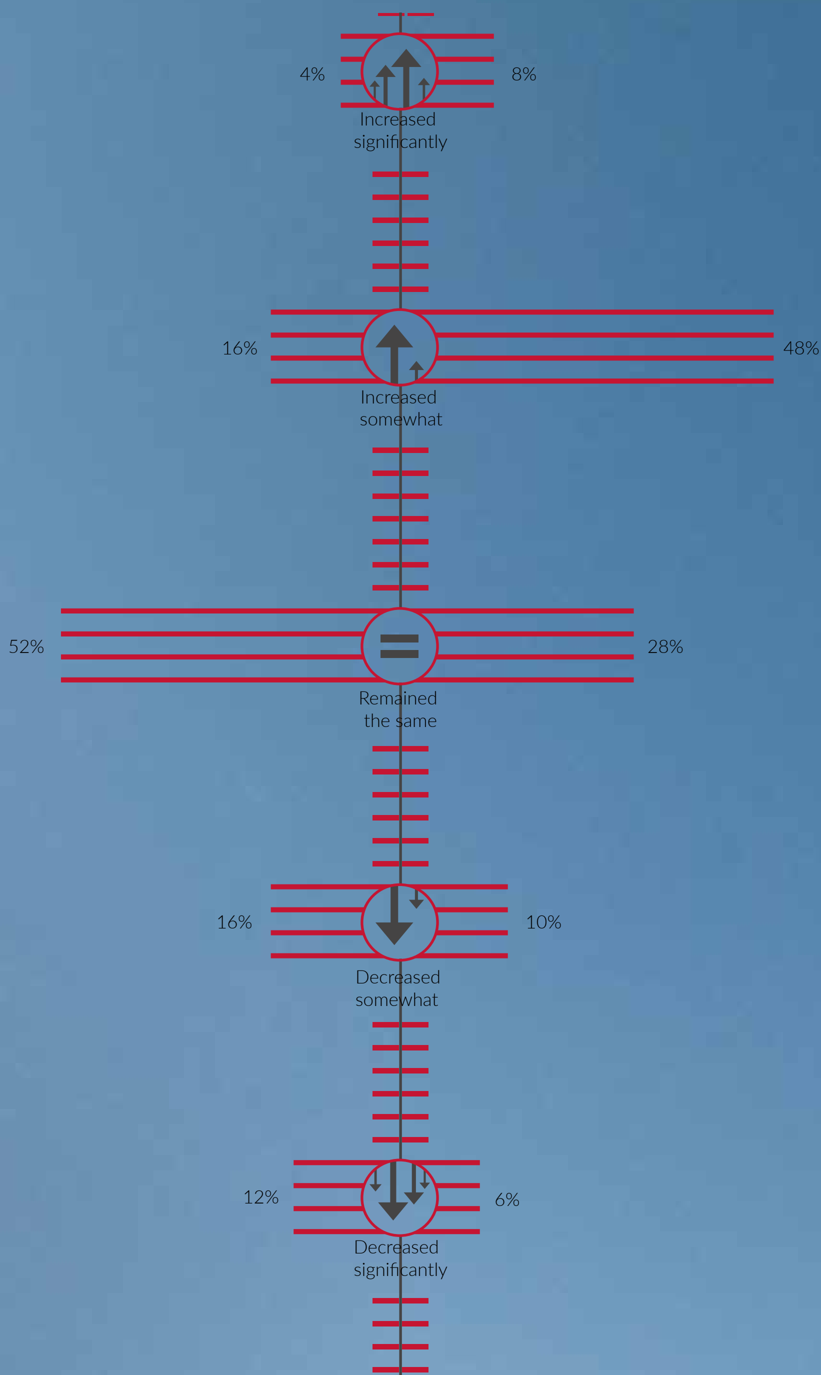
From start to finish

It should come as no surprise that overall fund terms have grown longer. Just as the time between a fund's initial investment in and disposition of a portfolio company has increased, so too has the average investment/divestment lifecycle of funds as a whole. More than half (56%) of survey respondents said that the lifecycle of their most recently wound up or liquidated fund (inclusive of any extension periods) was somewhat or significantly longer than the lifecycle of their prior fund.

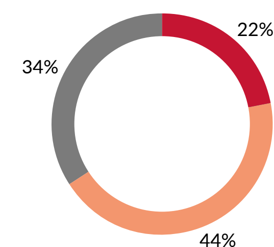
To get a sense of the current lifecycle length of PE funds, we asked partners how long it took for them to put their fund to work and then realize those investments; 66% said that their most recent fund took between 11 and 14 years from initial investment to being completely wound up.

As a rule of thumb, PE funds aim to return all of their investors' capital within 10 years — using approximately five years to invest and five years to harvest those deals, with two or more years of extensions written into the Limited Partner Agreement in order to realize value in underlying portfolio companies if necessary. Our findings show that fund life spans have increased beyond 10 years for the majority of GPs.

One of the reasons for this is the drop in asset valuations following the global financial crisis. Ultimately, loose monetary policy and widely available debt precipitated the perfect exit climate for PEs to sell down their companies in recent years. But it took at least five years for the S&P 500 to recover the losses resulting from the crisis, meaning GPs had to wait for the market to recover before they could sell pre-crash investments in earnest.



Q8: Which period best describes the term of the fund which you most recently wound up or liquidated (inclusive of any extension periods)?



Compounding this is the fact that purchase price multiples have reached an all-time high. US buyout firms paid an average of 10.3x EBITDA for their deals in 2015, according to S&P Capital IQ's LCD. With private companies selling for more than ever before, GPs must work harder to close the bid-ask spread to win new deals and then generate value from assets for which they paid full price.

One principal at a US PE firm said: "The term of our funds will increase significantly as market volatility, competition and valuation mismatches seem to be on the rise in the current investment environment, and our priority will continue to be creating value, which is surely going to take time."

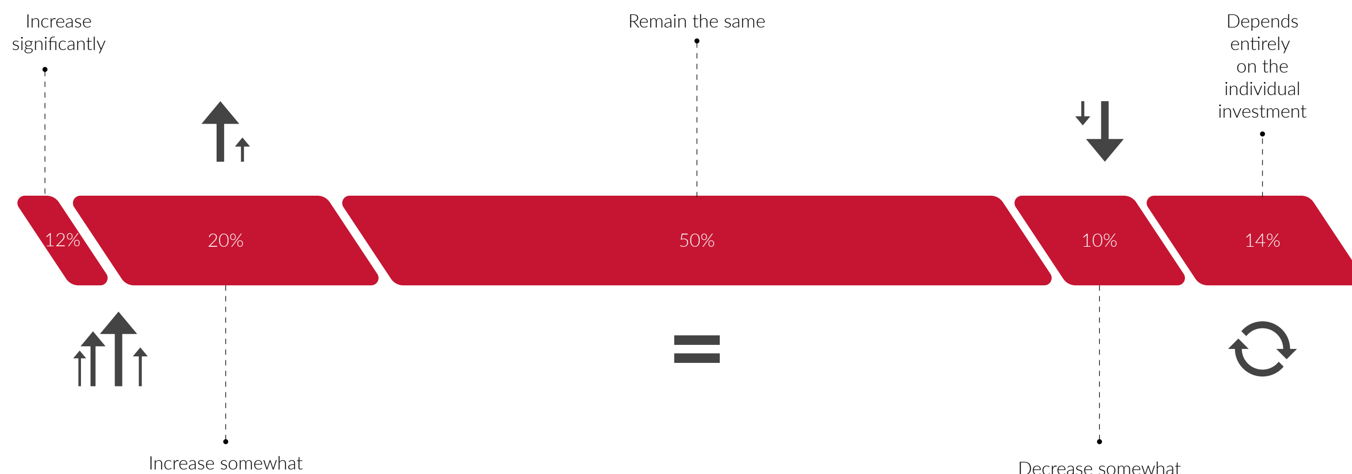
Our findings suggest that the increase in fund life spans that has already been experienced will stabilize for 50% of GPs, who said they expect the terms of their funds to remain the same over the next three years. However, 26% say they believe it will increase, with 14% reporting that it will depend entirely on the individual fund.

Sector by sector

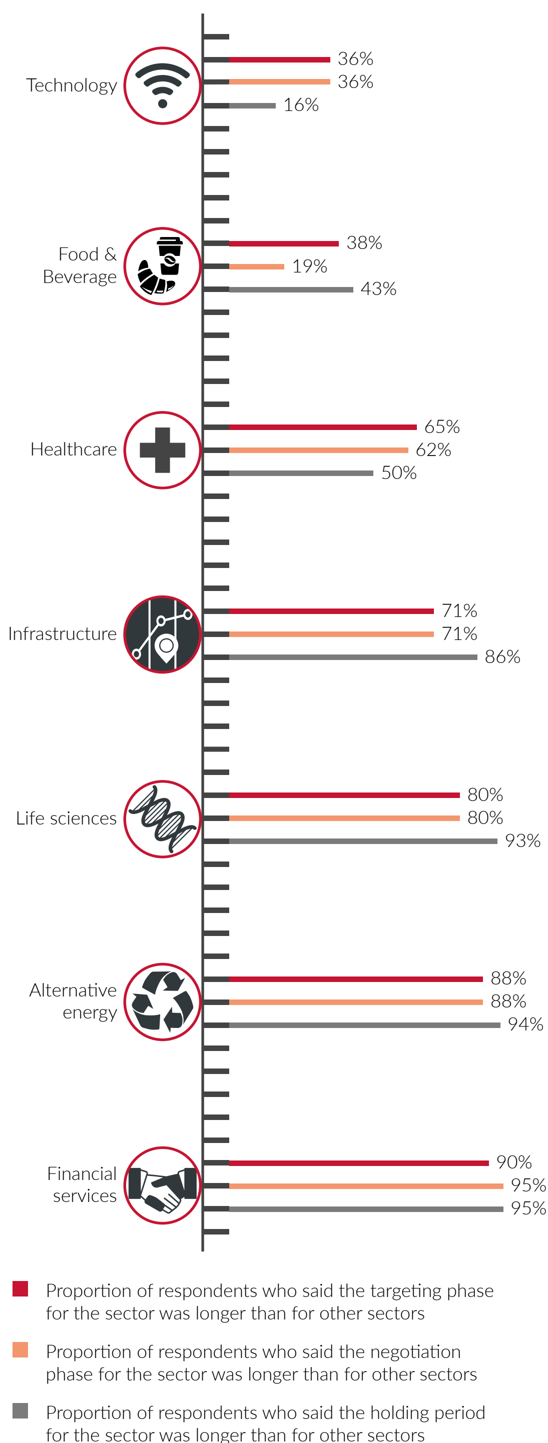
When it comes to deal lifecycles, from deployment to realization, all sectors are not created equal. Our survey found that financial services and alternative energy — two of the five most popular sectors among respondents — were more time-consuming in deal targeting, negotiation and length of investment holding periods.

In financial services, 90% said that targeting took longer than for other sectors, with 95% saying that negotiation and holding periods are also longer than average. In alternative energy, 88% said that targeting and negotiation took longer, while 94% said that holds were longer.

Q9: How do you expect the terms of your funds to change over the next three years?



Q10: Proportion of respondents who said the lifecycle for the sector was longer than for other sectors.



For technology — the second most popular sector after healthcare — the reverse is true. For 64% of respondents, both deal targeting and negotiation were either the same or shorter than for other sectors, with 84% saying that holding periods are shorter than for other industries.

Tech remains one of the most in-demand sectors, both from a PE and a broader M&A standpoint. According to Dealogic data, 46% of all US buyout deals in the first half of 2016 were in the tech space, the highest level since the data provider began tracking deals in 1995. While buyout shops typically leave high-risk/high-return venture capital (VC) funds to seek out the next Uber or Airbnb, they have become comfortable with subscription-based software companies, whose recurring revenues are able to pay down the debt incurred in typical leveraged PE deal structures.

Corporates are also hungry for deals, with Microsoft's US$26bn acquisition of LinkedIn being a notable example. With tech demand running high, GPs are under pressure to rapidly negotiate to seal the deal and, once invested, are able to sell into a willing buyer pool at strong multiples after shorter holding periods. Therefore, managers with tech companies in their portfolios should find this helps to keep their fund lifecycles from drifting out.

A partner at a US PE firm specializing in buyouts, who cites 10 years or less as its PE fund term lifecycle, said: "As our investments are in the hottest sectors, there has been no change in the PE term fund lifecycle. A few investments were retained for longer, but overall the strategy of investment and disposition has been quite constant."

Future investments

Andrew Hulsh
hulsha@pepperlaw.com

James B. Jumper
jumperj@pepperlaw.com

Andrew Hulsh and James Jumper of Pepper Hamilton explain why it's taking longer for GPs to source and negotiate new transactions, and what they can do to mitigate this challenge.

One of the more notable findings in our survey is that more than half (56%) of PE houses report that the length of time spent tracking and investigating potential investment targets has increased over the past five years, with more than a quarter (28%) saying it has increased "significantly."

The simple fact is that the US PE industry is fiercely competitive. The supply/demand imbalance between capital chasing a home and available transactions is such that we are in the highest multiple environment in the industry's history.

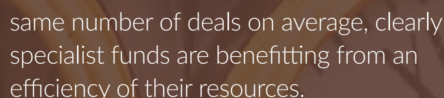
This is forcing GPs to change their dealmaking considerations and behavior. Due diligence has never delved deeper. Funds must drill down on assets to ensure high prices can be justified, whether it be through operational improvements to the business, creating synergies, mapping potential roll-out strategies or reengineering capital structures.

They are also having to use their smarts to avoid paying hefty multiples. One strategy is to look beyond typical investment bank-led auctions to source proprietary buyouts. We are seeing our clients taking the efficacy of contact management systems more seriously than ever before and being proactive with service provider relationships — whether it be investment banks, accounting firms, law firms or deal executives — to bring more deals through the pipeline.

Another solution to overcoming saturated market conditions has been to reach into niches and pockets where others aren't looking. Some are forming strategic alliances with industrial partners to tap expertise and access assets that would otherwise fall under the radar.

Expertise is more than just a buzzword. Those funds with highly developed networks and who can bring industry mavens into portfolio company board seats are at a significant advantage in today's pricing environment. Capital is capital. Management teams will be won over by those funds who have the credentials to truly transform companies and bring added value by leveraging their sector expertise.

Specialization is a theme we expect to see continue. It is estimated that generalist funds consider as many as 80 potential transactions before deciding on a deal. By contrast, specialist funds typically see approximately 20 investment and acquisition opportunities before settling on one. If both are concluding the



same number of deals on average, clearly specialist funds are benefitting from an efficiency of their resources.

Such strategies also present a value-creation play. GPs that own a number of companies within a given sector, or verticals within the same industry, are able to eke out extra margins by synergizing operating costs. For example, one of our GP clients investing in a sector that is heavily dependent on manufacturing has outsourced all of its portfolio companies' production to another business in the fund with ample capacity to service their demands. Typically, strategic buyers are able to outbid PE houses on deals by paying a synergistic premium. However, managers who are able to daisy-chain their portfolio companies can justify meeting today's high multiples by implementing significant cost savings post-transaction.

While the leveraged buyout will always remain PE's deal structure of choice, we are also seeing the rise of minority investments as a means to create portfolio diversity and balance upside while limiting capital risk exposure. This requires a slightly different approach.

Since funds forego control in minority investments, it is necessary to conduct additional due diligence on the management teams in such situations. Any issues must be identified early and addressed prior to closing the transaction.

We have been helping our PE clients resolve the concerns they have over buying non-controlling stakes, by building economic rights into deal documentation. Redemptions, put-right mechanisms and drag-along rights enable GPs to control their exits—a critical aspect of every PE sponsor-backed transaction—if a liquidity event does not occur within their desired investment horizon. This may involve time-based provisions, milestones based on earnings or other metrics, or default protections. In the case of a "put"-type option, if the portfolio company does not meet the agreed conditions, the fund would have the right to sell its shares back to the company for a pre-negotiated price.

Some of our clients have expressed concern that these rights are academic. If the company doesn't have the capital to repurchase the shares, our clients fear being locked in and unable to liquidate their investment. In some instances, we have included springing board rights into transactions that allow the GP to take additional board seats if milestones are not met or covenants are breached, allowing them to force a sale and realize a return for their investors. While this may be an extreme measure, it underscores how private equity dealmaking is evolving to keep up with the times.

We are in one of the most challenging deal environments of any business cycle and, short of a major sustained macroeconomic shock, substantial multiples are likely here to stay. This, in turn, is lengthening the time GPs spend seeking out deals that match their risk-return profiles. It is the most creative managers who can think outside the buyout box that will surpass their peers in these conditions.

FUTURE PE
Cause and effect

Market volatility and limited growth at portfolio companies create a longer, more difficult path for PE fundraising.

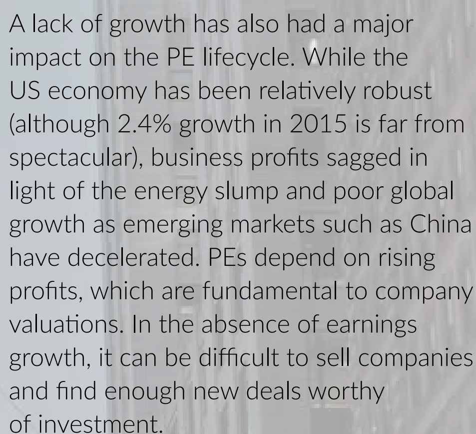
44%
said market volatility had lengthened lifecycles.

30%
blamed under achievement of target growth for longer lifecycles.

30%
claim difficulty in finding suitable targets caused longer lifecycles.

Our research shows that the primary reason for longer PE fund lifecycles is market volatility creating a poor exit environment (cited by 44% of respondents). Broadly speaking, between 2012 and summer 2015, we witnessed a stock market boom, which has thrown a lifeline to the PE industry. Companies bought before the financial crisis could finally be sold for a profit as the S&P 500 surpassed its pre-crunch peak. However, markets have been less stable in the last year, giving investors reason to exercise caution in buying new companies and forcing GPs to hold for longer in order to reach their return hurdles.

A partner at a US PE firm specializing in growth equity said: "Our return strategies have been affected by the market conditions; the volatility in the market has grown and this has affected our ability to make returns. Even managers have requested us to extend the time we hold on to companies to sell at a future date as the returns expected then will be much higher. It has also become challenging finding companies to invest in, and pulling out of our current investments without having any other asset or business to invest will not be good for our capital."



A lack of growth has also had a major impact on the PE lifecycle. While the US economy has been relatively robust (although 2.4% growth in 2015 is far from spectacular), business profits sagged in light of the energy slump and poor global growth as emerging markets such as China have decelerated. PEs depend on rising profits, which are fundamental to company valuations. In the absence of earnings growth, it can be difficult to sell companies and find enough new deals worthy of investment.

Indeed, 30% of respondents said that portfolio companies not achieving target growth was the main reason for lengthy PE lifecycles, with 30% blaming the trend on the difficulty of finding targets with suitable growth prospects.

A principal at a US PE firm specializing in buyouts said: "Achieving target growth at portfolio companies is the main driver of longer life spans. Getting management to follow the lead has been challenging due to internal conflicts and discrepancies realized in the later stage of deals, causing value creation to take its own time. Also finding targets with growth prospects is another driver as big firms seem to capture the best, leaving middle market firms to choose between good and bad."

> "Achieving target growth at portfolio companies is the main driver of longer life spans. Getting management to follow the lead has been challenging ... also finding targets with growth prospects is another driver."

Regulation is also pushing out the PE lifecycle. Post-crisis, the industry has come under stricter scrutiny, particularly on the fundraising side of activities where banks face restrictions on investing as LPs in funds and firms have to register with the SEC and comply with various conduct rules. Additionally, deal making has been stymied by closer scrutiny of banks, which are vital to leveraged buyouts. Under the tougher regulatory regime created by the Dodd-Frank banking law, US banks are under pressure to avoid carrying unsold high-yield debt on their balance sheets, which incurs heavy capital charges. A dislocation in the credit markets early in 2016 meant that some of the biggest firms struggled to find debt packages to finance their deals as banks retracted, anxious that they would not be able to sell down underwritten debt. Some 28% of survey respondents blamed regulatory barriers for a lengthening of the PE lifecycle. This reining in of leveraged financiers has put pressure on GPs to write bigger equity checks and accept higher rates on leverage, ultimately making their investments less profitable.

Q11: Overall, the average life span of PE funds has increased in recent years. In your experience, what have been the main drivers of these longer life spans? (Select top two)

The managing director at one US PE firm said: “In the US, the government and the regulatory bodies have increased the level at which they scrutinize deals, making it tough for PE companies to carry out deals, and have made changes in the laws, which has made it more expensive to carry out acquisitions or divestments.”

Having moved from a perfect seller’s market into a period of volatility also appears to have pushed out the PE lifecycle, as funds struggle to bridge the gap between what they are willing to pay and what sellers expect to receive for their portfolio companies. Indeed, the fifth major reason for the PE lifecycle extending is a lack of time to find targets with acceptable valuations, cited by 26% of respondents.

The increase in the average life span of PE funds has had a number of effects. With LPs having to wait longer before they see their money returned, there may be an expectation that their eventual returns will be higher to compensate for the wait. We found this to be the consequence cited by most respondents (84%) in our survey, with LPs not re-upping in the next fund (70%) and putting pressure on managers to lower their fees (70%) tying as the second most widely cited consequences.

Market volatility leading to poor exit environment
44%

30%
Difficulty in finding targets with suitable growth prospects

Challenges in achieving target growth at portfolio companies
30%

28%
Regulatory issues creating barriers to completing deals

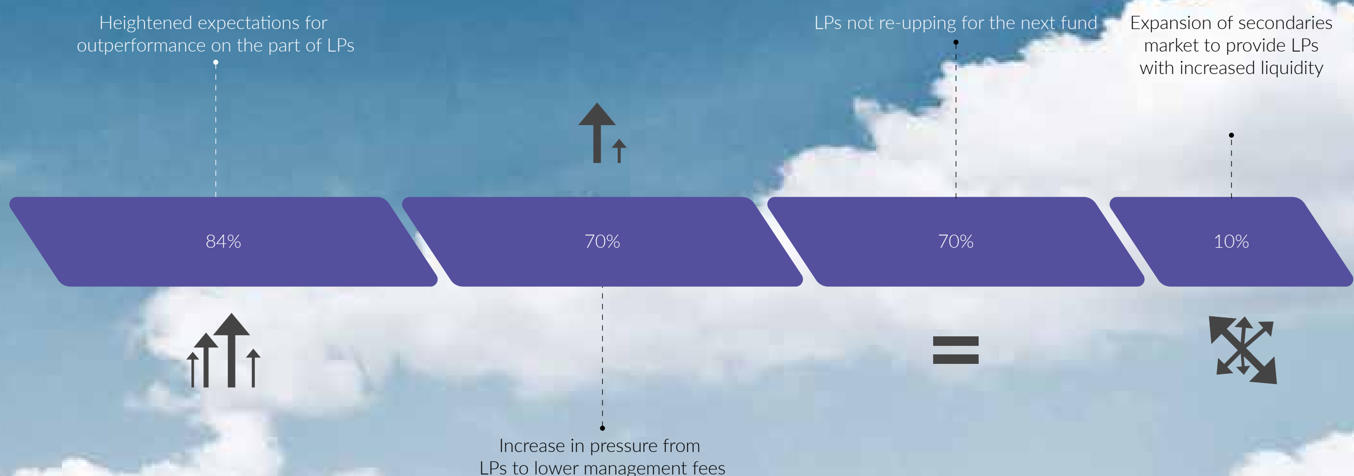
More time needed to source targets at acceptable valuations
26%

18%
Managers requesting fund extensions to increase potential returns

Additional time needed to add companies to platform firms
14%

10%
Tighter financing for LBOs, leading to difficulty closing deals

Q12: Which of the following have been consequences of PE fund life spans becoming longer in recent years? (Select all that apply)



Limited partners: In it for the long haul?

Julia D. Corelli
corellij@pepperlaw.com

Stephanie Pindyck Costantino
costantinos
@pepperlaw.com

Julia Corelli and Stephanie Pindyck Costantino of Pepper Hamilton explain the changing dynamic of the LP/GP relationship and its impact on the fundraising process.

It should come as no surprise that for many GPs the time spent fundraising is longer today than it was five years ago. The relationship with their LPs has become more demanding, as investors capitalize on their bargaining power and exercise greater diligence.

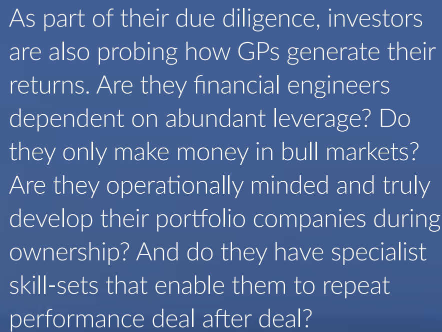
This is in no small part the result of tighter regulation. Under revisions made to the Advisers Act in the wake of the financial crisis, any PE house with more than US$150m in assets under management must register with the Securities and Exchange Commission (SEC). The threshold is so low that virtually all houses must comply with the rules. Not only that, state regulations usually require that any manager with more than five clients in a given state must register at the local level unless they are already registered federally.

This trend favors large-scale managers, who are able to leverage economies of scale. With bigger and more various funds generating higher fee income, these GPs can cover the cost of compliance by sharing their resources across multiple vehicles. Smaller managers are not so fortunate and must levy proportionally larger costs on their smaller funds, raising legitimate concerns about the pipeline of emerging talent in the industry.

Additional regulatory requirements have added another layer to the due diligence process. LPs are scrutinizing compliance procedures, checking whether managers have, for example, been issued disciplinary notices from the SEC, and whether what the GP is reporting reflects reality. Any managers whose story doesn't match the regulator's records will be given short shrift.

Enforcement is also on the rise. In the last two years the SEC has made efforts to clamp down on fees and expenses where it feels investors have been misled. In 2014 the regulator said it was putting the industry "on notice," and has since fined major players such as KKR and Blackstone as much as US$39m in connection with monitoring fees and other costs passed on to LPs.

This attention has prompted LPs to put more weight on transparency. They are questioning hidden fees and charges that would have previously gone unchallenged. In this scenario, investors will seek out managers who are open, collaborative, relationship-driven and – perhaps most importantly – have developed stellar track records. It is easier for those GPs who can demonstrate consistent outperformance to be honest with their clients.



As part of their due diligence, investors are also probing how GPs generate their returns. Are they financial engineers dependent on abundant leverage? Do they only make money in bull markets? Are they operationally minded and truly develop their portfolio companies during ownership? And do they have specialist skill-sets that enable them to repeat performance deal after deal?

Only when they are satisfied with the answers to these questions will LPs commit to a fund, and even then only after considerable negotiation on terms and conditions in the LPA. In recent years investors have been more aggressive, demanding rights on everything from fund extensions, fee offsets, indemnification carve-outs, recycling provisions and review rights. Side letters have become more common and more onerous, giving LPs more control over the contracts that define their relationship with their PE managers. The intensified negotiations of LPAs and side letters have driven up costs of fund formation dramatically.

So the question is not whether LPs are in PE for the long haul. On the whole, private equity continues to deliver the returns investors have come to expect of the asset class. The industry will continue to raise funds. The question is — are LPs devoted to their incumbent managers for the long term? With more regulation and negotiation than ever before driving up operating costs, that will depend entirely on a GP's transparency and ability to meet heightened due diligence requirements while delivering just-as-good performance.

Keeping powder dry

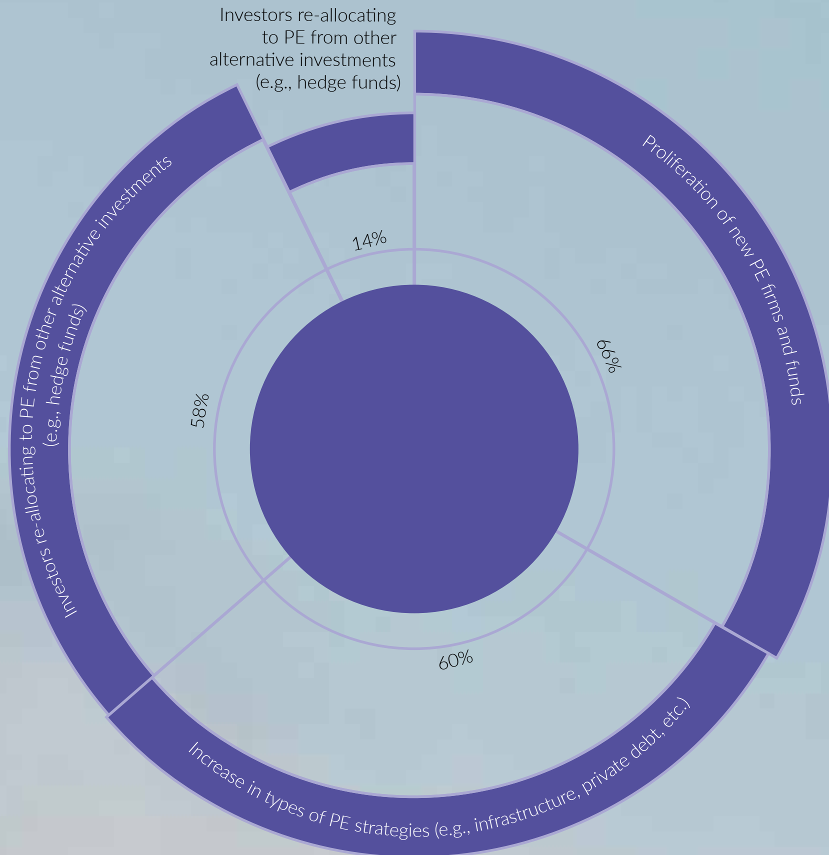
Dry powder in the PE industry is piling up. Estimates put the global reserves of uncalled capital under GPs' management at US$1.31tn, with data provider Pitchbook pegging the US' share at around US$525bn.

Simultaneously, PE firms are setting records for additional fundraising. These two trends seem to be at odds. However, the majority (66%) of US PEs surveyed believe that the capacity of the industry has grown, owing to a proliferation of PE firms and the funds they manage. Furthermore, 60% say that rising fundraising and dry powder figures can be explained by an increase in the number of strategies being employed, such as private debt and infrastructure, which allow more money to be put to work in a wider spread of assets by exploiting niches.

Placement agent Triago, for example, has noted that while Advent International, which closed its seventh fund on US$13bn in March this year, is widely seen as a blue chip buyout shop, many of its investments are predicated on a growth or turnaround angle.

Another reason PE managers are continuing to receive more money, while at the same time accumulating unspent reserves, is that investors are reallocating from other alternative investments into PE. More than half (58%) of respondents believe this to be the case. This comes as the performance of hedge funds has come under close scrutiny and redemptions have led to net outflows from the sector. In the period of September 2015 to year-end, Preqin estimates that the average hedge fund made returns of just 0.18%. Meanwhile, according to data from eVestment, the end of June 2016 marked the third consecutive quarter in which money has left the sector as investors bolt for the door.

Q13: PE dry powder is at an all-time high, and yet PE firms are also setting records for additional fundraising. What do you think the main drivers are of this trend? (Select top two)



It's not just competing alternative asset managers that are losing out to PE. For a minority (14%) of our respondents, PE houses' fundraising has benefitted from investors redeploying their money from more mainstream asset classes such as stocks and bonds.

Calling capital

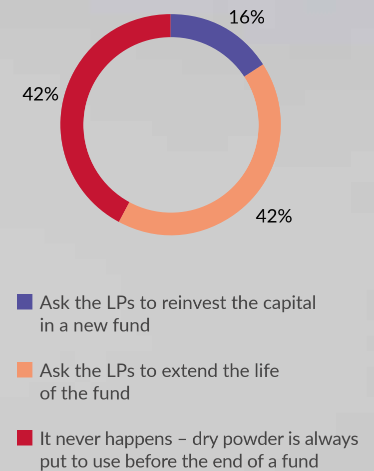
As GPs sit on their investors' committed capital for longer, there is greater pressure to put that money to work towards the end of the fund's life. Returning uncalled capital is typically a last resort — LPs pay management fees of around 2% a year on their commitments, so if cash goes unspent, overall fund returns slip.

There are other options. Fund managers may ask their investors for permission to trigger extension clauses written into Limited Partner Agreements, giving them more time to invest uncalled capital. We found that the preferred method for 42% of PEs in dealing with dry powder that hasn't been invested within the lifecycle of a fund is to ask their investors for extra time.

A principal at a US PE firm specializing in buyouts said: "We extend the life of a fund to deal with the excess capital we have under us to create a larger capital pool for our LP companies to use. We prefer keeping it aside and using it later rather than investing all of it in deals. We want to have capital to invest in sectors and opportunities that may arise in the future."

Alternatively, a minority of GPs (16%) may request that their investors roll the commitments over into a successor vehicle, which can help kick start the GP's next fundraising while ensuring that the fee-bearing capital gets put to use.

Q14: What is your preferred method for dealing with dry powder that you haven't invested within the lifecycle of a fund? (Select one)



- Ask the LPs to reinvest the capital in a new fund
- Ask the LPs to extend the life of the fund
- It never happens – dry powder is always put to use before the end of a fund

A US PE firm principal with a diversified platform said: “It depends on the amount we have invested and the extra capital that we have. We hold on to capital and look for ways to invest it in order to use our capital efficiently. Sometimes we return the capital to the LP so that they can use the extra capital, or we ask them to invest in one of our other funds.”

For nearly half (42%) of GPs, however, this is not a problem as they say all dry powder is put to use before the end of a fund’s life.

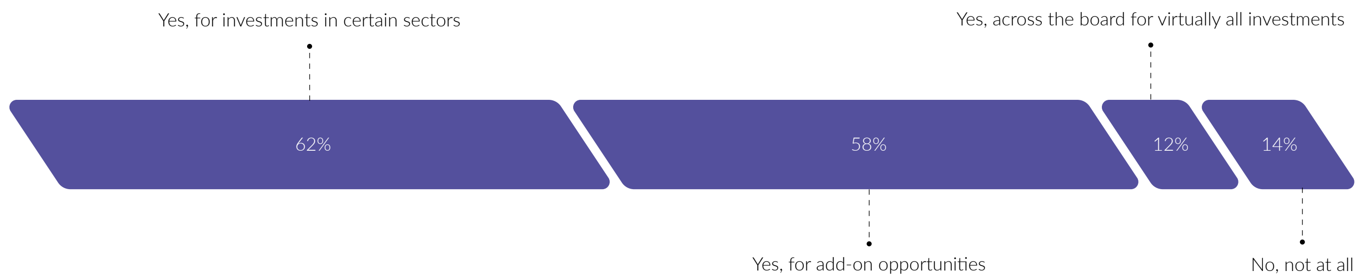
Risk and return

One worrying outcome of the extended PE lifecycle and subsequent rise in dry powder is that, in some cases, managers are adjusting the price they are willing to pay on deals, at least in certain sectors. Our findings show that, over the last five years, a clear majority of firms have relaxed their buying criteria in terms of valuation in order to put their dry powder to work, whether for investments in specific sectors (62%) or add-on opportunities (58%).

A managing director at a US PE firm specializing in growth equity said: “In the past five years, we have relaxed our buying criteria in terms of valuation in order to put investor capital to work. However, we have only done this in certain sectors, such as healthcare and technology, where we could see a number of opportunities.”

Of course, accepting higher prices has risk implications. For example, for 86% of respondents, allowing dry powder to accumulate within the industry could produce lower returns due to less rigorous investments. The difficulty of investing all of this capital could also make any future fundraising more challenging, as cited by 90% of respondents, while 40% believe this phenomenon may cause PE to lose credibility among investors. If the industry is to overcome its dry powder dilemma, each individual manager must develop a clear strategy for investing their funds in a timely manner.

Q15: Over the last five years, have you relaxed your buying criteria in terms of valuation in order to put investor capital to work? (Select all that apply)



Q16: What do you view as the biggest risks associated with the rising volume of dry powder across the PE industry? (Select all that apply)

Conclusion

The extended lifecycle and rise in dry powder is changing the profile of the PE asset class and how funds invest their LPs' capital.

Although it is not hampering the industry's ability to raise new money for investments, the time taken to raise that capital has increased for the majority of managers. This is because there are now more firms and funds than ever before working across a broad spectrum of strategies. This is by necessity. The wide mix of firms means the industry has the capacity to absorb investor demand while at the same time putting its money to work in assets.

A number of challenges remain, however. Never before has the fundraising landscape been more competitive. While the very best GPs will raise new funds with relative ease, on the whole, GPs must work harder than ever before to win commitments. And with dry powder at an all-time high, there has never been more pressure to deploy that capital prudently

in order to achieve the kind of returns that will keep LPs re-upping in future funds.

With this in mind, consider these four takeaways to help you navigate today's market:

Differentiated strategy. With so many GPs competing for capital, it has never been more necessary to ensure that your strategy is differentiated and clearly articulated. Understand exactly how you create value and know how to explain this to potential and existing investors. LPs today are spoilt for choice. If they don't buy your story, they won't invest.

Beyond buyouts. The leveraged buyout is PE's bread and butter. However, such deals are dependent on debt and are more closely correlated with public market performance than other PE strategies. Amid volatility, it will pay to look at other strategies that play to your team's strengths, whether growth equity, turnarounds, private debt or some other relevant niche.

Know what LPs want. Some investors have specific reporting requirements, others prefer low management fees in favor of lower carry hurdles. All LPs are different, and their demands vary. Therefore, understanding exactly what they are looking for will not only expedite the fundraising process, it will also help you determine whether they are the right partner for your fund when it comes to issues like deployment rates in the longer PE-lifecycle environment.

Spend it. But spend it wisely. One of the biggest challenges for the PE industry over the coming years will be putting its vast stores of dry powder to use. To that end, it may be wise to build longer fund extension periods into agreements or agree upfront that uncalled capital will be rolled over into future funds. Whatever the solution, investors will want to see their fee-bearing commitments put to use, but put to good use. Resist the urge to overpay for assets for the sake of deploying your fund in time.

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IFIG's bench of more than 60 lawyers across our offices assists clients in the following areas:

- Funds services, including fund formation and operation
- Fund transactions, including acquisitions, investments and financings
- Fund regulation and regulatory compliance

Our clients receive the most current thinking on market conditions and cutting-edge trends as our IFIG lawyers work seamlessly with other practitioners to address the entire liquidity spectrum, as well as the varying degrees of fund regulatory oversight. We fully understand the interrelationships among these functions, and we work to optimize our clients' performance across all of them.

For more information contact:

Bruce K. Fenton
Partner and Chair of the
firm's Private Equity Practice
Group and Investment Funds
Industry Group
Tel: (215) 981-4646
Email: fentonb@pepperlaw.com

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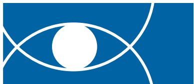

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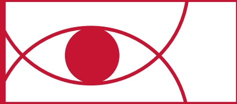

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Part of The Mergermarket Group

www.mergermarketgroup.com

330 Hudson St. FL 4
New York, NY 10013

t: +1 646.412.5368
f: +1 212.686.2664
sales.us@mergermarket.com

10 Queen Street Place,
London,
EC4R 1BE
United Kingdom

t: +44 (0)20 3741 1060
f: +44 (0)20 3741 1001
sales@mergermarket.com

Suite 1602-06
Grand Millennium Plaza
181 Queen's Road, Central
Hong Kong

t: +852 2158 9700
f: +852 2158 9701
sales.asia@mergermarket.com

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