



# Cautious Optimism: Outlook for Private Equity in the Year Ahead

With the encouraging fundraising statistics, exit levels and investor appetite at the end of 2013, there are promising indications that the private equity industry will see another successful year in 2014. [Jessica Duong](#) explores what the current wave of optimism in the industry is riding on and considers how smooth the path ahead will really be.

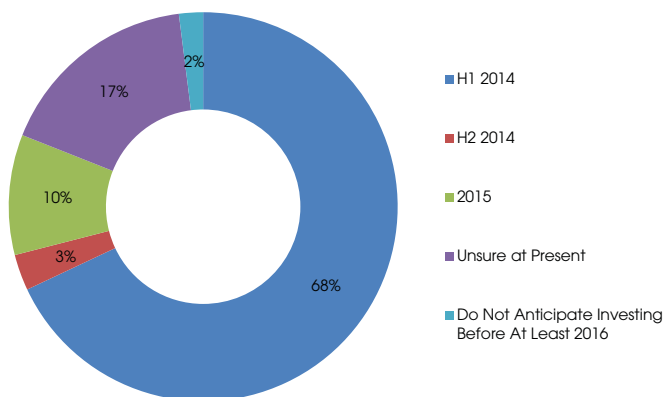
With both fundraising and exit levels reaching their highest figures in years, a consistent flow of capital is powering the steady stabilization of the private equity industry after the financial crisis that rocked global economies. As we move into the new year of 2014, the outlook is hopeful for the continued success of the asset class, and there is optimism stemming from both fund managers and investors alike. However, when closer consideration is given to the influencing macro and micro factors within the private equity landscape, there is some apprehension over the challenges GPs and LPs face on their path ahead.

Fig. 1 shows the expected flurry of investor activity for private equity in 2014, based on Preqin's interviews with over 100 investors in December 2013. The vast majority (71%) of investors intend to make their next commitment to the asset class this year. While this is indicative of healthy LP appetite and anticipated flow of capital toward private equity fund managers, 17% of investors stated that they were uncertain as to when they will make their next commitment to a private equity fund. This could be linked to a flexible LP investment strategy, or hesitation in selecting precise cycles of commitment if faced with cash flow issues or limited choice of managers.

## Swings and Roundabouts

Looking at the amount of capital that has been secured by fund managers over recent years reinforces the substantial appetite that exists for private equity, with improvements seen every year since 2010, as shown in Fig. 2. The statistics reflect the gradual stabilization of the industry since the financial crisis in 2008, and 2013 in fact saw the highest level of capital commitments since the onset of the global crisis, with \$467bn raised by 932 private equity vehicles that closed in the year. Though the year ranks

Fig. 1: LPs' Timeframe for Next Intended Commitments to Private Equity Funds



Source: Preqin Investor Outlook: Alternative Assets, H1 2014

as the highest amount of capital raised since 2008, the number of funds that reached a final close in order to raise this sizeable aggregate total is actually a decrease from previous years' figures. This signals a surge in the average size of private equity funds and suggests increased activity from larger fund managers raising substantial funds.

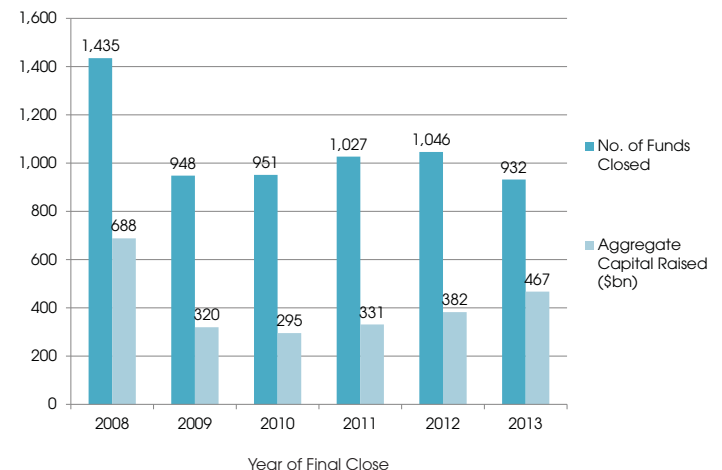
Further analysis reflects the dominance of the larger, more established fund managers in the fundraising arena, as they make up the majority (93%) of all capital garnered by private equity funds. First-time fund managers contributed only 7% of all private equity capital in 2013, which is a decrease from the 11% they accounted for in the previous year of 2012, and is the lowest proportion ever recorded. The importance of track record is implied when it comes to successfully securing LP commitments, as well as the value investors are placing on selecting a team with proven experience to manage their investments.

Moreover, there are a record number of private equity funds on the road, with over 2,100 as of February 2014, all vying for investor capital. The fierce competition between GPs, coupled with the increasingly stringent LP due diligence process, presents real challenges to any fund manager looking to operate a successful private equity program.

## The Draw of Private Equity

Investors worldwide are attracted to investing in private equity funds and are aware of the illiquid and long-term nature of the industry. Over the long term, private equity can offer superior risk-adjusted returns compared to other asset classes. Fig. 3 illustrates the horizon IRRs for private equity compared to a number of public indices as of 30 June 2013. With investors locked in for 10 years

Fig. 2: Historical Private Equity Fundraising, 2008 - 2013



Source: Preqin Funds in Market

or longer, it is vital to look at the performance of the industry over a longer time period. For the 10 years to June 2013, the annualized returns for all private equity stand at 21.7%, high above the public indices of MSCI Europe (7.5%), MSCI Emerging Markets (13.7%) and S&P 500 (7.3%) over the same time period.

### Performance of Buyout Funds

The horizon IRR for the buyout fund type clearly shows the outstanding performance for the three, five and 10 years to June 2013, with this particular strategy performing even better than the private equity asset class as a whole over these periods, recording an annualized IRR of 25.5% for the 10 years to June 2013.

Buyout has traditionally been the most prominent private equity strategy in recent years, generally securing the most aggregate capital of all fund types and receiving much attention in the press for its successes. In January 2014, the final closing of Apollo Investment Fund VIII on \$18.4bn was widely reported, noted for its ranking as the largest private equity fund to close since the onset of the financial crisis in 2008. The mega buyout fund surpassed its original target of \$12bn quite significantly, collecting \$17.5bn of commitments from third-party investors.

While the success of such mega buyout vehicles can be celebrated by the fund manager and the wider industry as it serves as a testament to the improvements in the markets, at the same time, it raises questions of the difficulties investors face in gaining access to these large vehicles. The oversubscription to the multi-billion Apollo fund exemplifies just how sought after a buyout vehicle can be, especially one managed by a richly experienced manager. Mega buyout funds in particular have relatively high barriers to entry, limiting several LPs from accessing them. Consequently, these investors may turn to the secondary market, or fund of funds vehicles, or may even whet their appetite for the smaller scale mid-market funds instead.

### Shrinking Appetite for Emerging Markets

Similarly, with the varying appetite for different investment strategies, different geographies have also witnessed shifts in LP preferences. Emerging markets such as Asia, Africa and Latin America have enjoyed steady rates of growth in their relative

private equity industries, but have recently been coping with much lower interest from investors. In Asia specifically, where there are concerns of slowing economic growth in conjunction with an absence of exit avenues, fundraising levels and deal activity have seen marked declines. This parallels the recent bounce back of the traditional markets of North America and Europe, as investor confidence in these geographies is strengthened, following the knocks felt in the aftermath of the global financial crisis.

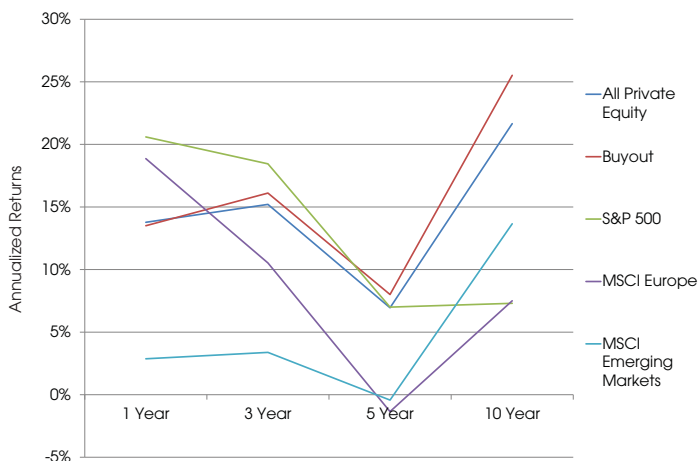
This is further evidenced when looking at private equity-backed exits. Fig. 4 shows the steady recovery seen in North America, with the aggregate value of exits increasing from a low of \$30bn in 2009 to \$172bn in 2013. The European market has also shown evidence of stabilization, though it hit a dip again following the 2011 sovereign debt crisis. As of the end of 2013, however, the aggregate value of private-equity backed exits in the continent for the year stood at more than three times the amount recorded in 2009.

### Cautious Optimism

The outlook for private equity over the coming year is positive; indications of healthy LP appetite for private equity commitments and predictions for the continued trend of the year-on-year increases of overall fundraising figures are not unfounded. Given the additional success of funds closing in recent years, deal and exit activity is set to reach high levels in line with this, as GPs put the capital raised to work. But as micro and macro factors come in to play, there are several potential challenges that investors, fund managers and service providers alike will face.

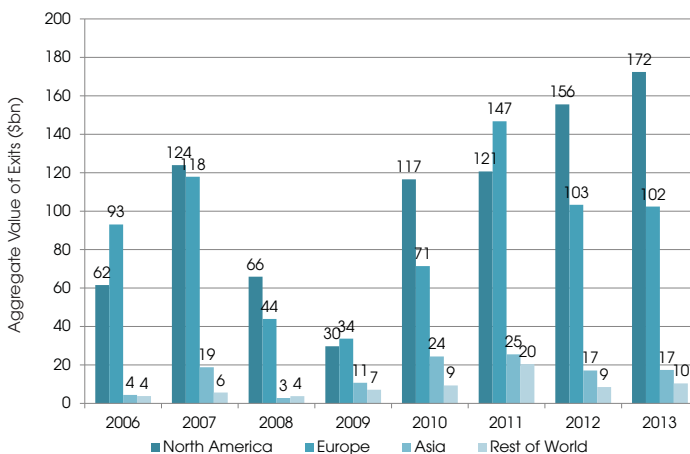
In 2013, private equity deal and exit activity was abundant, with private equity-backed buyout exits in particular recording the highest annual number and second highest aggregate value since 2006. High levels of deals that are successfully exited bolsters the confidence of LPs that may in turn re-invest capital and a flow of capital can feed back into the industry. Thus a productive cycle is created, from investors committing to funds, funds successfully closing and making investments, and eventually exiting deals to give investors satisfactory or high returns. But should there be any breaks in the cycle, such as difficulties felt by the GP when trying to secure investor capital (as first-time fund managers in particular may experience or as a result of volatile economic conditions), or LPs struggling to make commitments (unable to access the top

Fig. 3: Private Equity Horizon IRRs vs. Public Indices as of 30 June 2013



Source: Preqin Performance Analyst

Fig. 4: Aggregate Value of Private Equity-Backed Buyout Exits by Region, 2006 - 2013



Source: Preqin Buyout Deals Analyst

managers they desire or perhaps as a result of concerns over implementation of new regulatory laws), the flow of private equity capital is interrupted.

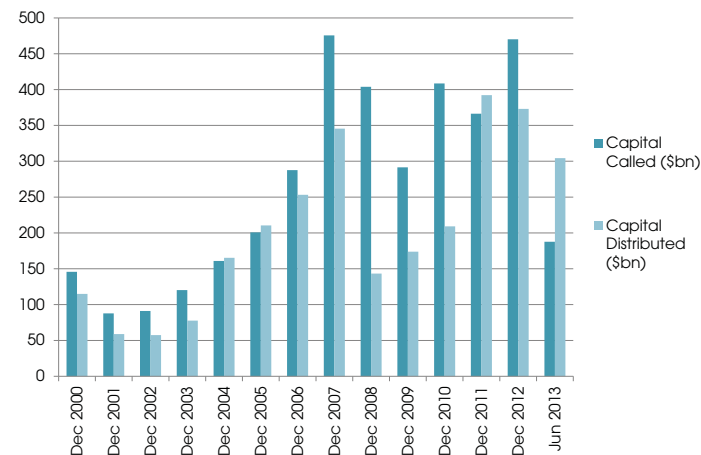
The possibilities of these threats arising are real, given the catalyst factors such as a bubbling market; clear dominance of the more established fund managers, and those focused on the traditional geographic markets; and regulatory pressures that will impact portfolio allocations, which were apparent in 2013, and are likely to hold in 2014. In particular, with fund managers competing more intensely than ever before as the market is flooded with funds trying to raise investor capital, the road to the final close is littered with challenges to stand out from the crowd.

However, it is true that the foundations for a more positive picture for private equity exist too, with all nodes of the aforementioned cycle generally showing promising progress in recent years, with a consistent flow of fundraising and exit activity. Fig. 5 depicts the time series of the annual amount of private equity capital called up and distributed, with post-crisis figures climbing steadily over recent years. With the increase in liquidity available to investors and the continued drawdowns for investment, industry AUM has remained above \$3tn since December 2011, increasing year on year since, and stands at just under \$3.5tn as of 30 June 2013.

In summary, players in the private equity industry indeed have reason to be optimistic in their outlook for the coming year, though this is tinted with some anticipation of a potential bumpy ride. A superficial glance at the figures for 2013 demonstrates the real strength of the private equity industry, but deeper analysis and consideration of interrelated factors highlight some chinks in the armour and show that the story is far from perfect. As 2014 unfolds, we will see if the collective private equity universe will carry the momentum of the successful year just passed, and if within that, certain winners and losers will emerge.

The rise in dry powder available for investment in the private equity industry is in line with the upticks seen in fundraising particularly in the last year. As of December 2013, there was an estimated \$1,077bn of capital for fund managers to deploy, which is the greatest aggregate total on record. But do the excessive amounts of dry powder raise concerns about fund managers' ability to

Fig. 5: All Private Equity Annual Amount Called-up and Distributed, 2000 - 2013



Source: Preqin Performance Analyst

actually invest, especially given the challenging and overheated investment landscape? A private equity fund is permitted to enter into new investments only during a set investment period, terms of which are outlined in a fund operating agreement in advance. This is typically of around four to six years from the closing of its first investment or final close of the vehicle. After this defined window, the firms lose access to the funding. These built-in deadlines to invest the money raised place some pressure on fund managers to find ways to deploy their capital before their time limit is reached. It is possible for the firms to request extensions from their investors, but unfavourable knock-on effects such as damage to the GP's reputation and even hampering of future fundraising efforts in the future are potential consequences. When deploying capital fund managers also face challenges, with concerns in the industry that deal entry EBITDA multiples are growing too high, and that private equity firms are overpaying for investments.

Data Source:

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