

LPs Grit Their Teeth After Big Bets On Mega Funds

By Laura Kreutzer, Private Equity Analyst

3/1/2008 -- Over the past two years, California State Teachers' Retirement System lavished its favorite buyout shops with outsized commitments, including at least two that topped the \$1 billion mark.

The pension system is hardly alone. Plenty of large limited partners recently have poured capital into private equity in general and into a few mega buyout funds in particular, driving both overall fund-raising and their own annual commitment paces to record levels. Many investors committed as much or more over the past two years than they did in the five previous years combined.

But as the credit markets tighten and the economy heads for tougher times, these big bets may come back to haunt limited partners. Many of them find themselves particularly concentrated in mega buyout funds in vintage years that likely won't be particularly strong performers. If these funds underperform, LPs will find themselves under pressure to better balance their portfolios, with few clear avenues to achieve such a goal profitably.

"You could end up with a scenario in which some of the larger investors in private equity could have their [greatest] exposures to vintage years that may turn out to be problematic," said Eric Doppstadt, head of private equity at the Ford Foundation, speaking at The Private Equity Analyst Outlook Conference in January.

Method To The Madness

Both veteran limited partners and newcomers to the asset class poured capital into vintage 2006 and 2007 buyout funds for a number of understandable reasons.

Veteran investors stepped up their commitment pace after a combination of overall asset growth and a steady flow of distributions from their GPs pushed their PE allocations below target. As the private equity market boomed and fund-raising expanded, a number of long-time LPs also found themselves facing the problem of having too many relationships to manage. As a result, they chose to put larger chunks

of capital to work with a smaller number of managers. Because big buyout funds were able to accommodate the size commitments LPs wanted to make, capital naturally flowed to them.

Plenty of large LPs say that given their size, they had little choice but to load up heavily on the biggest funds. They also say they are comfortable with their choices, as they believe the risk of betting heavily on a few firms is less than the risk of becoming an index fund for the private equity industry.

"If you had a \$1 billion private equity portfolio you could overweight venture and load up on the next Google," Calstrs Chief Investment Officer Christopher Ailman wrote in an email. "But due to the hierarchy of size in private equity, when you get to a \$10-plus billion private equity portfolio, you're going to be overweight toward the larger capital areas such as mega buyouts. So we're not saying mega buyouts will be the best-performing sector of private equity, but we are saying that a select group of firms will get us the excess return we're looking for."

At the same time, a number of corporate and public pension systems new to the asset class came online as alternatives investors, including New Jersey State Investment Council and New Mexico Public Employees Retirement Association. Lacking the relationships necessary to get into top firms in certain sub-sectors of private equity like venture capital, these LPs also chose to concentrate a lot of capital in the buyout sector.

Despite the solid reasons behind these choices, some believe that veteran LPs and new LPs alike weren't paying enough attention to diversification, both by year and by sub-asset class.

"In their effort to remain loyal to the GPs that they're backing, LPs can lose control over their vintage year allocations and sub-sector allocations," said Monte Brem, chief executive of adviser Stepstone Group LLC. "So many funds came back to market so quickly. If you were an LP and wanted to maintain an existing relationship, your allocation naturally jumped and that creates potentially sub-optimal vintage-year concentration."

Lay Of The Land

It's too soon to predict exactly what kind of returns buyout funds raised in recent years will generate. But investors and their fund

managers alike agree that it will be a while before the industry sees the 30% to 40% returns of recent years.

Less than half of investors - 44% - expect net returns for North American buyout funds to exceed 16% in the next three to five years, according to the Winter 2007-2008 Global Private Equity Barometer, a survey of limited partners conducted by global secondary firm Collier Capital in October 2007.

Large buyout firms point to the strong cash flow positions of the giant companies they've bought of late, as well as the favorable terms they were able to negotiate on these companies' debt, as factors that will guard them and their LPs against any significant decline in returns by better positioning portfolio companies to weather tough times.

But many of these funds put significant amounts of capital to work as both company valuations and leverage levels were hitting record highs. Now, with the economy hitting a soft patch, some companies will likely have difficulty paying off their debt, and any defaults will hurt buyout firms' returns. And if valuations settle in at lower levels for an extended period, firms will struggle to sell companies for higher cash flow multiples than they paid for them, which could also impact returns.

"I don't think you'll see the spectacular meltdowns that you saw in the wake of the venture bubble, because these are big companies with hard assets," said the head of one Midwestern fund of funds. "But you'll probably see a lot of flat dead money and some mediocre returns."

The problems will be worst for the funds that put their money into the ground the fastest. Funds raised in 2006 and 2007 that showed some restraint as prices soared will still have plenty of capital on hand to find bargains in the current environment. But it is unclear exactly how many of the mega funds can claim such restraint.

Many of the firms that raised massive funds in 2006 and 2007 are already marketing successors, saying they are short of capital. Blackstone Group, for instance, invested around two-thirds of the nearly \$22 billion that it raised for Blackstone Capital Partners V LP, which closed in 2007, during the two years it was marketing the fund, and is already out with a follow-up vehicle. As of Sept. 30, Kohlberg Kravis Roberts & Co. had already drawn down nearly 60% of a \$1.5 billion commitment that the Washington State Investment Board

pledged to KKR 2006 Fund LP, according to the pension fund's Web site. The fund was expected to wrap up at \$18 billion as of last fall. Madison Dearborn Capital Partners V LP, a 2006 fund raised by Madison Dearborn Partners, was already almost three-quarters invested.

"It really depends on how fully invested the fund is," said David de Weese, a New York-based partner at the global secondary firm Paul Capital Partners. "If the firm raised the fund in 2006 and put 80% in the ground [by 2007], you're a lot more worried than if they put 15% in the ground and plan to invest the rest going forward."

The Fall-Out

As limited partners begin to feel the pain of the choices they've made, no one thinks there will be a mass withdrawal from the asset class, as happened after the tech bubble burst in 2000. Investors appear to have learned the lesson that in private equity, it pays to be a consistent investor.

"LPs that left the asset class after the last downturn missed out on some of the best vintage years [for buyouts]," said an investment officer at one West Coast pension fund. "We know that we need to be consistent investors each year. Even if we have some bad vintage years, we're going to stay with our game plan and continue investing."

Experienced LPs in particular are unlikely to panic, as they'll have returns from older partnerships to help buoy the overall performance of their private equity portfolios. But LPs that ramped up new programs in recent years will feel the short-term hit to returns keenly in their portfolios, and thus could face a greater backlash.

"If the consultant did his job and really educated the board about the benefits of a consistent commitment pace through all vintage years, there shouldn't be the kind of knee-jerk reaction that we saw in 2001 and 2002," said a director at one West Coast private equity consultant. "But we won't really know [how they'll react] until they actually start to see some bad news."

Meanwhile, current uncertainty about both the economy and future private equity returns is already having an impact.

Across the board, buyout firms returning to market now are finding investors to be deeply interested in their performance and behavior at

the market peak. "People are focusing more on how much firms simply relied on pure financial engineering to produce their returns," said a partner at one New York-based placement agent. "A fund that is starting to show some cracks in its portfolio, maybe a few big deals that look like they are not doing that well, is probably going to have a tougher time."

It's worth remembering that the last downturn spelled the end of a number of firms that in the late 1990s seemed to be at the very top of their game. Hicks Muse Tate & Furst LLC ranked among the largest buyout shops in 1998, but has ceased to exist as its LPs then knew it. Forstmann Little & Co., also one of the biggest buyout firms back then, continues to wind down its operations.

"Just because you're a mega buyout firm doesn't mean that you will always be successful or even that you will always exist," said Kelly DePonte, partner at placement agent Probitas Partners LLC. "There may be a couple of funds that make a series of really wrong decisions and end up blowing their reputations."

While limited partners figure out which funds those might be, they'll likely be more judicious in how they dole out their commitments, particularly to the largest firms. Some large buyout firms are already having more trouble raising funds than they did over the past couple of years (see story, page 6).

If public stock values continue to decline, fund-raising will only get harder, as LPs find themselves having to make tough short-term choices.

"If you had a 5% allocation to private equity in December, you may have a 7% allocation now and distributions have slowed to a trickle," said DePonte. "Some LPs will have difficulty allocating to funds that they like in '08, because they just don't have the room."

Calstrs, for one, has moved up the timeline for reaching its 9% long-term target, after seeing its actual allocation increase to 8.7% from 7.4% between June and December of last year.

The pension system's allocation still remains well within the upper end of its 7% to 11% target range. However, an investment officer at a Midwest pension fund said that if Calstrs gets pushed too far beyond its range for too long, it would be hard pressed to justify big checks going forward.

"I doubt [that] they'll be writing billion dollar commitments if they're at the upper end [of their range]," he said. "It's fine if you're over for a month or two, but if you're over for a year, you usually have to do something about it."

A Second Chance

Investors that are over-exposed to the asset class could potentially turn to secondary buyers to reduce their exposure to particular vintage years and make room for new commitments. In recent years, the secondary market has gained growing acceptance among institutional investors, including the pension community, as a portfolio management tool. California Public Employees' Retirement System, New Mexico State Investment Council and Colorado Public Employees' Retirement Association are only a few of the pension funds that have sold some interests on the secondary market as a means of tightening up their portfolios.

Secondary players expect such deal flow to materialize, but aren't seeing it yet.

"We're in this period where people are still concerned about what's going to happen in the economy," said Frank Morgan, partner at secondary firm Coller Capital. "The warning signals are on the horizon, but there's still a lot of optimism. In terms of seeing secondary deal flow from people who are disappointed or feel they have a need for liquidity, that's probably a year or so off."

If and when LPs do seek to unload buyout interests from recent vintage years, they may find buyers to be scarce, especially if leverage on the underlying companies is high. That will be the case for many funds that have used dividend recapitalizations in recent years.

"When we look at the equity value on some vintages - and it stretches back earlier than 2006 even to 2005 or 2004 vintage years - a lot of cash has come out of [the investments]," said Paul Capital's DeWeese. "But they weren't exits, they were recaps, but with the current credit conditions, the recaps are all done so that the underlying companies have a lot more debt on them. So, from our perspective, the volatility around the equity value has gone way up. In some cases, we'd rather buy late-stage venture than the equity stake in a buyout fund."