



## Private Equity Review

Trends and insights for private equity funds and their portfolio companies  
Second Quarter 2010

### Private Equity Fundraising: The Current Environment

#### An Interview with Mac Hofeditz

*Mac Hofeditz is a partner with Probitas Partners, a global provider of alternative investment solutions including fund placement, secondary fund advisory, and portfolio management services. The firm specializes in private equity, hedge funds and real assets including debt and equity funds, venture capital, special situations, opportunistic real estate and infrastructure from around the world. Hofeditz spoke at the McGladrey Capital Markets/RSM McGladrey 2010 Private Equity Symposium in Newport Beach, Calif.*

**Private Equity Review:** Private equity fundraising seemed to go on hiatus during 2008 and 2009, but we're seeing indications that it's coming back. How active are PE firms today, and what kind of response are they getting?

**Mac Hofeditz:** There are always funds in the market seeking capital; the variable is how much capital -- if any -- they are able to raise, and how long it takes them to raise it. There are well over 400 firms in the hunt for capital; however the amount of capital raised in 2009 was off 70 percent compared to 2008, and it took them roughly twice as long to close on that capital. Of those, the venture capital and mega-buyout funds are struggling somewhat, while restructuring/turnaround and lower middle-market funds are seeing better results.

**PE Review:** To what do you attribute the VC funds' challenges?

**Hofeditz:** VC funds are struggling for a couple of reasons. First of all, there simply are too many funds competing for capital. And, frankly, their returns have been rather disappointing over the past 10 years or so, with the average fund showing a negative 5 percent or worse. Conversely, buyout fund returns have been stronger over that period, particularly smaller funds, so they seem to be more appealing to investors based on that past performance.

**PE Review:** You mentioned the attractiveness of lower middle-market funds, but indicated that the so-called "mega funds" are seeing less success in their capital-raising efforts.

**Hofeditz:** Money is still being allocated to the larger funds, but investors clearly are less interested in mega funds today than they were in 2005 to 2007. The big funds over-raised somewhat, and people found themselves wildly over-allocated. In addition, the mega-buyout market has been pretty inactive recently, largely due to the lack of available leverage. And finally, the bigger funds have a lot of undeployed capital. Smaller funds have been able to complete deals in 2008 and 2009.

There are exceptions; for example, Blackstone is still trying to raise \$20 billion and may ultimately end up at \$13 billion or so. But the pendulum has definitely swung toward middle-market and lower middle-market funds, largely because people think return opportunities are better there.

**PE Review:** Is it taking longer to close funds than in the past?

**Hofeditz:** It's definitely taking longer. Historically, fund raising was generally a nine to 12-month process. Now it's more like a 12 to 24-month process. Maybe 18 to 24-months, with some funds not able to raise any capital at all. That is a dramatic shift from 2005.

**PE Review:** Have you seen any changes in the make-up of limited partners over the past two or three years?

**Hofeditz:** The investor set has definitely changed. Some of the old private equity stalwarts, including the Ivy League schools and the blue chip foundation endowments, have become less active in private equity, primarily due to liquidity constraints. We're seeing more public funds, smaller foundation endowments and fund-to-funds, as well as European and Australian investors become active. The key is that investors are able to be much more selective and have a wider access to funds that might previously have been hard to access.

**PE Review:** So international investors are playing a bigger role?

**Hofeditz:** Not necessarily, they just didn't get hit as hard as the US investors did. Non-U.S. investors have typically invested at a steady pace, but since North American LPs are being somewhat less active, international investors have become relatively larger participants. They've long been interested in the U.S., though selectively; most tend to have a bit of hometown bias -- with the notable exception of Australia. Australia has a well defined institutional investor base that has a global perspective on investing, so it's pretty much always selectively targeted US funds. Generally speaking, non-U.S. LPs tend to focus on major brand names within the private equity world, so they often concentrate on very well established firm managers such as the Carlyles, Goldmans, Blackstones and Hellman Friedmans of the world.

**PE Review:** Are investors from any particular nations or international regions especially active in North America?

**Hofeditz:** Germany, the UK, France, the Benelux countries, the Nordic regions –

they've all been active for quite some time, and that hasn't changed much over the past couple of years. China and Korea have become more active, but each country is essentially represented by a few large sovereign wealth entities, i.e., the China Investment Corp and the Korean Investment Authority. They literally have billions of undeployed capital looking for opportunities and are struggling to figure out the best ways to deploy it.

**PE Review:** How about India, or Middle Eastern countries?

**Hofeditz:** India has significant capital flow restrictions, so they have not been big players. Most of the M&A business there is strictly inbound. Middle Eastern investors, such as the Gulf State players, invested actively in private equity during the early 2000s, with an emphasis on the larger funds. But their interest seems to have slowed a bit. On the margin, they have shifted their focus to doing direct deals or co-invests.

**PE Review:** Do you see many domestic LPs turning to direct deals and bypassing the PE firms?

**Hofeditz:** Many definitely are considering that alternative, and have begun hiring people with direct deal experience. It's becoming a bigger focus for them, though I should be careful not to overstate the impact. I think most LPs will continue to prefer working with PE firms that have demonstrated their ability to deliver attractive returns.

**PE Review:** So what should PE fund managers be doing to make themselves more attractive to institutional investors and other LPs?

**Hofeditz:** It all basically gets down to showing good returns. In the lower middle market, firms that are on their fourth or fifth fund are getting a lot of favorable attention. PE firms need to stay focused on their strategy and execute brilliantly, while maintaining team continuity and stability. That can be a challenge in an environment where fund sizes are not increasing dramatically and fees are, if anything, declining. There has been some executive turnover as people have left for better opportunities elsewhere. My advice is that GPs should focus their time strengthening their own organizations and keeping their teams together, focused and motivated -- and importantly, doing great deals. That will help them keep their limited partners more committed.

**PE Review:** Any more advice?

**Hofeditz:** Sure: be transparent with your LPs. If you have bad news to share, share it and don't try to hide. When the market indicates it's a good time to do deal, do deals. Generally, firms should be communicating more with their LPs, and they should be doing a better job of it. Investor relations will continue to be critically important for general partners. While management fees seem to be staying pretty steady, there is growing angst about things like transaction fees and portfolio monitoring fees. They're becoming sort of the "third rail" of term

negotiations. Still, you want to maintain strong relationships with your current investors, and open communications can help.

But let's face it: Fund raising is likely to remain somewhat of a challenge until 2012 or so, and as far as I can tell, macroeconomic conditions are unlikely to change that.

**PE Review:** Thank you for speaking with us.

**Hofeditz:** My pleasure.

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