

Shine Is Off Mega-Firms, LPs Say In Survey

Mega-firms have officially lost their luster. Limited partners both in North America and Europe predict that 2008-vintage funds bigger than \$5 billion will generate distinctly un-mega returns, according to annual investor survey conducted by **Probitas Partners**, a San Francisco-based placement agent.

In 2008, mid-market funds are shaping up to be the belles of the ball, with LPs reporting that they plan to spend most of their time looking at mid-market vehicles and that they expect the best returns from those funds. Distressed-debt funds aimed at taking control stakes in companies also proved popular among investors. But backing mega-funds and buying stakes in management companies of LBO firms proved less desirable, according to the survey, which is slated to be released in mid-March.

Among North American investors, 57.0 percent felt the best returns from 2008 vintage funds would come from U.S. middle-market vehicles. European middle-market funds came in second, with 41.7 percent of respondents saying they would produce the highest returns. Coming in third, with 31.8 percent of the vote, was U.S. venture capital vehicles. Mezzanine and current income funds ranked fourth, garnering 9.9 percent. Mega-buyout funds, defined as those larger than \$5 billion, came in fifth with only 7.9 percent of respondents predicting those funds would be top performers. And European and Israeli venture capital funds came in last, with 6.6 percent of the vote. Respondents were allowed to pick two categories from a group of six, so the percentages add up to greater than 100, said **Kelly DePonte**, a partner with Probitas Partners.

When the same question was put to European investors, they favored the home team. European LPs—a whopping 73.3 percent of them—predicted that European middle-market funds will provide the best returns this year. In second place were U.S. mid-market funds, with 36.0 percent. The Europeans ranked the remaining four categories in the same order as their North American counterparts, though the percentages varied a bit. U.S. venture capital vehicles took 19.8

percent of the vote, putting them in third place. European investors indicated slightly more interest in mezzanine and current income funds, with 14.0 percent. Mega-buyout funds earned 9.3 percent of the vote, and bringing up the rear again are European and Israeli venture capital funds, with 8.1 percent.

“Across the board, there’s not much interest in mega-buyout funds,” DePonte said, pointing out that the survey comes at a time when there’s virtually no financing available for mega-deals, while middle-market deals can still get done. He added that some LPs cited a drop in projected mega-fund returns as a reason their interest in those pools has waned.

Still, DePonte was quick to point out that the degree of interest LPs profess to have in certain fund strategies doesn’t always correlate with the amount of capital they commit. For example, an LP may talk a big game about mid-market funds and even make a conscious effort to invest in more mid-market funds by making \$25 million commitments to four different vehicles. But those small slugs can get dwarfed by a single commitment to a mega-fund. “And, oh by the way, I’ve got a good relationship with Blackstone and I want to put \$500 million into that fund,” DePonte quoted a hypothetical LP as saying.

For larger investors, such as public pension funds who commit capital in chunks of \$50 million or \$100 million, it’s harder for them to actually invest in the middle market. Some of them, such as the **New Jersey Division of Investment** and the **New York State Common Retirement Fund**, have formed separate accounts targeted to that area.

The survey also asked LPs to identify the sectors they plan to focus most of their attention on in 2008. The responses for this question pooled answers from U.S., European and some Asian investors. The top area was U.S. middle-market buyouts, with 50.8 percent of investors planning to focus on that space. European middle-market buyouts and distressed-debt funds were tied for second place.

“There’s a very strong interest in distressed-debt-for-control funds and a reduced amount of interest in distressed-debt trading funds,” DePonte said. In discussions with LPs, he learned that while a fair amount of private equity money flows into the distressed-debt arena, hedge funds commit much more capital to the space, reducing the chance for buyout shops to realize significant returns. Distressed-debt-for-control funds, however, tend to have a much longer hold period for

portfolio companies and are more suited to private equity investment than hedge fund backing. "There's a strong interest in funds that follow a loan-to-own strategy. You have to be able to control a company through the Chapter 11 bankruptcy process," DePonte said.

Sounding a different note of caution, LPs were dubious about general partners selling stakes in their firms' management companies. According to 65.2 percent of respondents, such financial arrangements raise the possibility of conflicts of interest between LPs in funds and management company investors.

Only 28.3 percent of respondents think the trend is likely to expand significantly beyond the large funds that currently have such relationships. Another 27.9 percent said selling pieces of management companies is better handled through private stake sales rather than public offerings. Some 21.1 percent of respondents think selling a piece of a buyout shop's management company is a natural solution to succession dilemmas. And just 14.6 percent of investors responded that it presents an interesting investment opportunity.

Some LPs didn't want to confine their sentiments on this subject to one of the pre-written responses provided by Probitas Partners. This is where the fun begins. One LP wrote that the sale of a stake in a buyout firm's management company "suggests that general partners believe the gig is up on fees, carried interest and current market valuation. Managers don't sell shares unless they're significantly overvalued." Another investor put it more succinctly, describing the purchase of a stake in a management company as "a sucker's game."

Probitas Partners sent its survey to 4,000 institutional investors and received responses from 359. The placement agent has offices in London, New York and San Francisco.—J.P.