Out of the Ordinary

Investec
Specialist Bank

Investec Fund Finance
GP Trends 2016

High confidence in today's market

Investec's seventh annual GP Trends survey shows a private equity industry confident in near-term dynamics but suggests many firms have yet to prepare for potentially challenging conditions in the coming years.

Respondents from firms worldwide said they were satisfied with the state of the private equity industry in the short term and were less concerned with potential long-term issues, despite the EU referendum and US election.

Ninety-three percent were at least as happy with their career in private equity as they were a year ago while 47% cited new platform investments as the biggest priority over the next 12 months. A further 62% said competition for assets and pricing were the biggest challenges for GPs over the same period while just 9% cited policy risk as a significant concern.

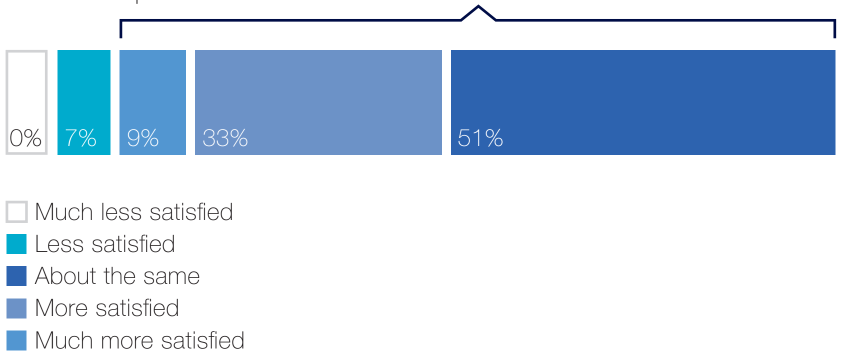
Meanwhile, 59% said the market volatility and uncertainty as a result of Brexit and the US election had yet to affect their businesses.

Career satisfaction

Level of private equity career satisfaction compared to 12 months ago

93%

are at least as happy with their careers in the industry as they were a year ago, up from 90.7%



"The prospect of the UK leaving the European Union, most likely during the first half of 2019, heralds a considerable degree of uncertainty. This is most visible with reference to Britain's future trading arrangements with the other 27 EU countries. Even so, the pound's more than 12% decline against the Euro since the start of 2016 would leave the domestic economy competitive, even if the EU were to impose modest tariffs on UK exporters.

"By its very nature the world economy is an uncertain place, and businesses have become accustomed to adapting to such a lack of clarity. Indeed some events, such as Donald Trump's unexpected victory in the US election, may even provide opportunities, given plans for greater infrastructure spending in the United States." – Philip Shaw, Chief Economist, Investec

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Navigating the future

Steering GPs through the next cycle is an important focus for Investec's fund finance team. A report published by researcher Preqin in the third quarter said that as at March 2016, the total value globally of unrealised capital held by buyout and growth funds aged at least 10 years stood at $196 billion. However, encouragingly, half of our survey respondents said they were taking a proactive approach to managing mature funds.

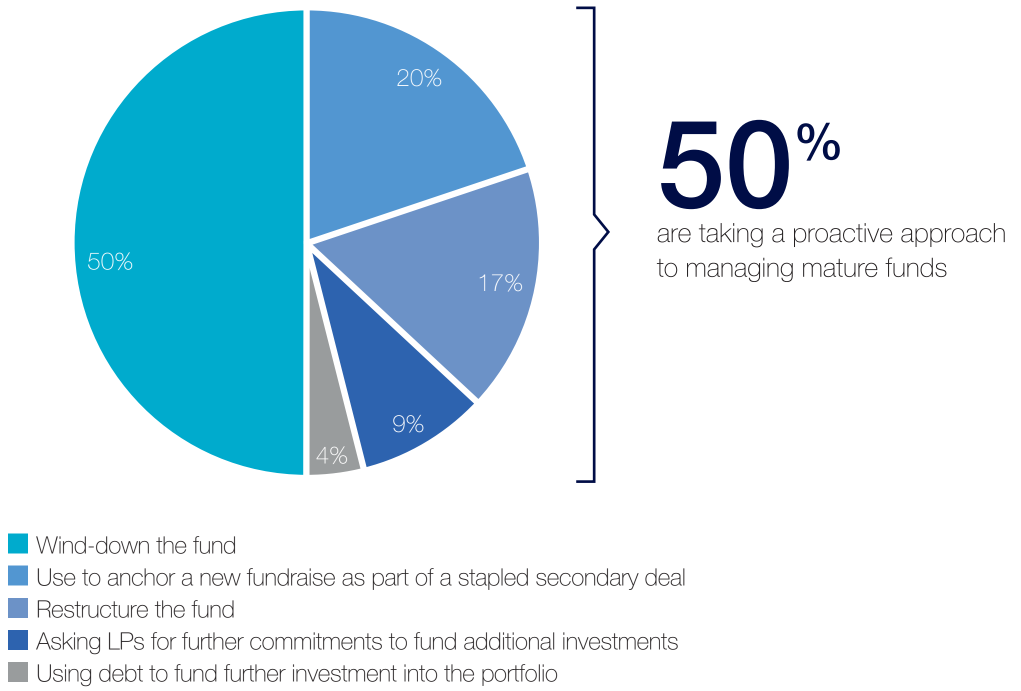
Funds with a 2007-vintage currently have the highest unrealised value with $228 billion, according to Preqin, followed by 2011-vintage funds, which have $215 billion of unrealised assets, and 2008-vintage vehicles with $199 billion.

As GPs grapple with falling consumer confidence and currency fluctuations, exit horizons for older assets become more difficult to gauge. At the same time, it often becomes challenging to satisfy the interests of all a mature fund's LPs.

Winding down a mature fund remains the most popular solution with half of respondents citing the strategy as the most likely course of action in the current market. However, a fifth said they would use the vehicle to anchor a new fundraising as part of a stapled secondaries deal. Existing LPs are likely to welcome the opportunity to back a quality manager with a credible portfolio to ensure its future – these complex and labour-intensive restructurings offer investors the chance to buy a discounted interest in the predecessor fund while returning to the GP as a primary investor in the new vehicle.

Mature Funds

What GPs would be most likely to do with a mature fund in the current market



Preqin said that globally, 143 investors with aggregate assets under management of $2.9 billion were considering buying into a stapled secondaries transaction. Fifty-five percent of the potential buyers are private equity funds of funds while secondaries funds of funds rank as the second-largest proportion of potential buyers at 12%.

Tailored bridging facilities are also a popular consideration for clients in these scenarios. Investec has seen an increase in the requests for hybrid facilities demonstrating their popularity amongst GPs. This can be an attractive option when it no longer makes sense from a returns perspective to put more equity into portfolio companies that require breathing space ahead of exit. Furthermore, such facilities can prove particularly beneficial when GPs struggle to persuade all LPs to agree to invest additional equity.

Often these hybrid facilities come to life in more mature funds as they can enable a platform business to create further value through acquisition when capital calls are impossible.

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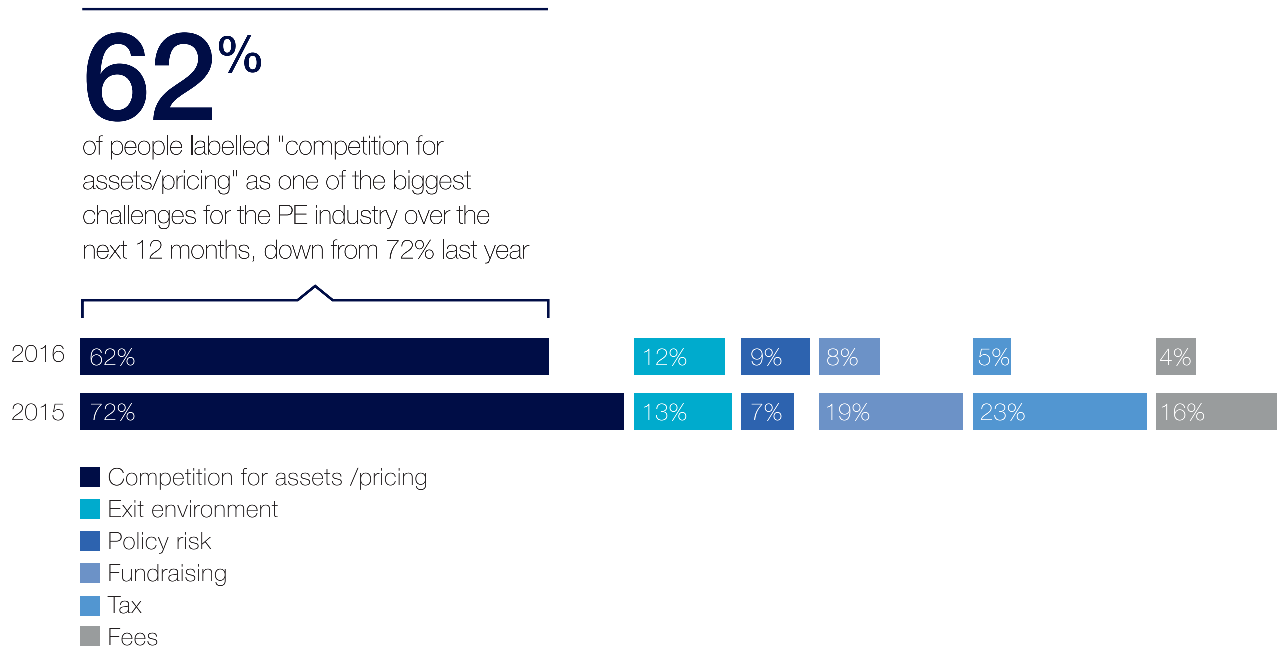
Competition for assets

Elsewhere in the market, the need to invest committed capital following a wave of fundraising led 62% of respondents to cite competition for assets as the biggest challenge that they face in the next 12 months, compared with 72% last year.

Challenges for Private Equity over the next 12 months

Competition for assets/pricing remains the biggest challenge in 2017



With quality deals commanding especially high valuations and a growing number of LPs investing directly, GPs are searching for innovative financing structures to bolster their funds and now recognise fund finance facilities as an essential strategic tool in today's market. With investors concerned about valuations for 2015-, 2016- and 2017-vintage acquisitions, such facilities have the power to boost returns.

Capital call facilities remain the largest financing option for GPs with 78% saying they would consider using them but GP facilities are increasingly popular, with 45% saying they would consider them. Hybrid asset and capital call facilities, and asset recourse facilities are also significant, with 29% and 26% respectively saying they would consider using them.

Event-driven capital call facilities, used strategically as part of an acquisition or to help manage portfolio assets, can create substantial value for GPs and investors. However, GPs should be aware that overuse of such facilities – particularly as a tool to minimise drawdowns – is often viewed as controversial among LPs.

While investors will be pleased to see an emphasis on putting capital to work amid poor returns in other asset classes, high valuations will earn firms impressive returns in the exit market. GPs should arguably devote more resources to selling portfolio companies today and enhancing their returns ahead of the next fundraising cycle, in the event that the market worsens in the next 12 months.

"While we are not claiming that there is widespread overvaluation in the PE space, we would guard against expectations of ever rising prices. Action by central banks has been a major factor in the competition for assets and although the Bank of England and the ECB are both currently conducting quantitative easing programmes, we expect both central banks to curtail or end the schemes in 2017. This would remove a significant factor underpinning asset prices generally. Indeed a correction has been evident in major sovereign bond markets, where yields have risen sharply since the summer." – Philip Shaw

Our survey suggests GPs currently have a lack of concern surrounding political risks that may affect the industry in the near term – only 9% viewed policy risk as the biggest challenge over the next year while 59% said the market volatility resulting from Brexit and the US elections had yet to affect their businesses. Less than a third said the events had somewhat negatively impacted their businesses.

However, GPs, many of which are currently enjoying excellent growth rates among their portfolio companies, should plan today for a myriad of potential attacks on returns. Currency fluctuations fuelled by political events and sterling's weak position over the next year have the potential to wipe out carried interest, shining a light on the importance of securing exits today and hedging against such movements.

Investec is increasingly working with clients to identify FX exposures within the fund, fund management team and even at investor level. Our team is developing appropriate solutions to manage currency volatility and bring these exposures back to the firm's functional currency and protect future value.

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Career progression and succession

Talent retention and the ability to buy into a firm's partnership remain significant issues for GPs, potentially stemming from widespread failure to address succession – 76% described succession planning as critical to the success of their firm, up from 68% last year. However, only 54% said they had such a plan in place, compared with 57% last year.

Succession planning – generational change

Views on the on the need for clear succession planning

Failures to outline clear generational change will leave GPs vulnerable to departures – our survey shows 57% of respondents have considered or would consider setting up their own private equity fund. A string of new fund launches by former executives from big brand firms in recent months highlights the appetite among professionals to take advantage of the buoyant fundraising market.

Seventy-nine percent of respondents said they were confident in long-term career progression opportunities at their current firm. Just a third said they were more satisfied than a year ago while only 9% said they were much more satisfied than a year ago.

Investing in a fund is likely to become increasingly difficult for more junior executives. Pressure on GPs to commit larger sums appears to be growing – a fifth said they planned to commit up to 3% of a fund's overall capital as a team while almost a quarter planned to commit more. Meanwhile, junior to mid-level professionals face much smaller gains than those enjoyed in the boom years, further hindering their ability to commit to funds ever-increasing in size.

Founding partners who recognise their responsibility to facilitate executives' commitments to the fund – and therefore fully align the investment team with LPs – will benefit greatly, ensure smoother generational change and enable them to leave a stronger legacy.

More GPs are expected to use fund finance facilities this cycle to bring the next generation of investment professionals into the fund, and bridge the growing gap between a lack of carry and longer exit horizons. Facilities include loans based on the firm's management fee stream and the fund's unrealised value.

Investec has seen GPs increasingly use fund finance facilities to help their more junior partners buy equity in the management company – a growing challenge for the middle and lower tiers as GPs become steadily more valuable.

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Conclusion

Simon Hamilton, Global Head of Investec Fund Finance

“The seventh edition of the Investec Fund Finance GP Trends survey shows members of the private equity community are satisfied with conditions in their industry and focused on immediate concerns such as putting capital in the ground for investors. However, our research raises questions about how prepared GPs are for a change in fortunes for private equity firms and their portfolio companies.

“Executives are clearly competing hotly for deals, exacerbated by a smaller pipeline of new transactions post-buyout boom. GPs acknowledge rising valuations are set to lower returns in the coming years and are increasingly looking to fund finance to strengthen bids and better protect their future gains.

“While firms are focused on finding attractive investment opportunities for LPs, there appears to be more room for future planning. The challenge for GPs in the coming months will be to balance new investments with exit activity and preparations for difficult market conditions ahead.

“Approximately half of our respondents have no succession plan in place and concerns surrounding the ability to bring junior to mid-level professionals into the carry scheme continue.

“At Investec, our fund finance professionals, with deep private equity expertise, will work closely with the industry to continuously steward firms through their next cycle, and help them find and protect value amid volatility. For mature vehicles, a fund finance specialist is an invaluable resource for facilitating change – a lender welcomed by GPs and LPs searching for certainty. For deal doers, Investec is a creative adviser in a fast-moving market where flexibility and deliverability are crucial.”

About Investec Fund Finance

Investec Fund Finance is a specialist finance provider focused on lending to funds and fund management teams.

We aim to build lifelong relationships with our clients. We offer flexible finance solutions at each stage of the fund cycle, which can enhance returns, maximise the efficiency of the fund’s equity and increase competitiveness in an aggressive market environment.

Innovation is at the heart of our thinking and our global team has the vision and the resources to create unique financing structures for unique financing requirements.

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About the research

A sample of 76 senior private equity professionals in the UK, Europe, Australia, and United States of America with approximately $60.7bn USD billion in total commitments under management, were surveyed between September and October 2016.

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