MERGERS & ACQUISITIONS

5 Ways to Win Over LPs

In a competitive fundraising landscape, here's how to keep Caspian's Sheryl Schwartz and other limited partners coming back for more

By Danielle Fugazy

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It's no secret that private equity firms have been very busy buying, selling and fundraising over the past few years. In 2014, private equity fundraising exceeded all but the peak totals of 2007. Fundraising in 2015 is on pace to be high once again, proving—as if there were any doubt—that limited partners have had a renewed interest in the asset class. For their part, private equity firms are more than happy to accommodate. This has shifted the balance of power slightly back to the general partners. However, LPs don't want to buy into just any private equity firm. LPs want certain attributes from their private equity partners today—below are five features they are seeking.

1. Alignment of interest

The private equity industry has come a long way since the Institutional Limited Partner Association Private Equity Principles were published in 2011. Since then, limited partners have definitely had the upper hand with GPs. However, as limited partners became overweighted in public equity and private equity became the soup de jour once again, LPs flocked backed to the asset class.

There are certain funds that are oversubscribed where the LPs have less negotiating power, but for the most part GPs have learned from the downturn that relationships with LPs should be lasting. They don't want to be on bad terms with the investors when things get tough.

"Some GPs have improved their terms, but most want to have a long-term relationships with solid LPs so they have remained balanced," says Sheryl Schwartz, a managing director and lead investment professional for primary and secondary funds with New York-based Caspian Private Equity. "We had a stable program during the downturn and GPs appreciated that."

Despite the slight shift in power, LPs still want to be sure the LP-GP relationship remains balanced, because aligning interests is still extremely important. According to Probitas Partners' annual U.S. private equity market survey released in June, 62 percent of respondents want to see a strong level of general partner financial commitment to the fund. LPs are also focused on the level of management fees they are being asked to pay during the downturn and GPs appreciated that."

"Over the last 20 years the power in negotiations between LPs and GPs has swung back and forth like a pendulum depending upon market conditions," says Kelly DePonte, a managing director with Probitas, the San Francisco-based placement agent. "However, the pendulum never swings all the way back, so over time the LP position has made progress. That being said, over the last year I've heard more instances of GPs pushing back and winning. That is of course only for the hot difficult-to-get-into funds."

Star Mountain Capital, a New York-based medium-sized specialized asset management firm investing in private equity, mezzanine and other growth funds, definitely wants to be sure there's alignment on fee personal investment from the general partners," says Brett Hickey, Star Mountain CEO. "We also want transparency so that we can help our managers identify and manage potential threats and structure prior to investing with a fund.

"We like to see a blend on fees paid on committed capital and invested capital as well as a strong opportunities as a value-added partner." Star Mountain makes fund commitments from $5 million to $50 million, and the LP has recently invested in Evolution Partners and Patriot Capital.

Golub Capital figured this out long ago. In 2004, the firm decided to charge LPs only on money it put to work, rather than money that was committed. "When we were raising our fourth fund, we thought about what we could give our LPs. We thought charging them fees on money we put to work was a fair way to show them we were true partners. We have been operating like this ever since," says Lawrence Golub, CEO. Golub Capital has raised over $20 billion of equity and debt for credit investments in about 20 funds.

2. Co-investment opportunities

Over the years LPs have increasingly asked for co-investment opportunities. Investors eager to save on fees and potentially increase returns have in recent years launched co-investment programs or deployed capital to dedicated co-investment funds.

At the end of 2014, Adveq Managing Director Lee Gardella predicted that 20 percent of the capital committed by limited partners to private equity in 2015 would be co-investments.

Some of the larger limited partners, such as the California Public Employees' Retirement System, the Teacher Retirement System of Texas and Alaska Permanent Fund Corp., consider co-investments to critical components of their investment platforms. Texas Teachers is looking to co-invest up to $1 billion and Alaska wants to deploy $900 million in co-investments this year.

Caspian also has an active co-investment program with private equity firms that it is invested with and firms that it has not invested in. The firm looks to make about 10 co-investments a year, and has since 2008. According to Schwartz, the key to Caspian's success as a co-investor is having appropriate staffing to do direct deals and time to assess the opportunities.

"To be successful you need an experienced staff to evaluate opportunities quickly," she says. "If you can't make a decision quickly, GPs will stop showing you deals. Our team is staffed with people who have done direct deals in the past, so they are knowledgeable."

At of the end of 2014, Caspian had $2.2 billion of assets under management, with $1.6 billion invested in private equity funds and about $440 million in co-investments.

While some of the largest LPs are asking for co-investments, they aren't for everyone. "Over time LPs have been saying they want co-investment opportunities, but most LPs are not set up to do co-investments and they simply can't respond in a timely manner," says DePonte. "It's also important to note if GPs are looking for a co-investment they may be going out of their comfort zone and the results could be bad. LPs should be cautious of all co-investment opportunities presented to them. They really need to do due diligence."

3. Sector-focused funds

Investors are becoming more interested in sector-focused private equity funds as they look for alpha returns. According to the Probitas survey, 42 percent of the respondents want to invest in funds focused on single industries. LPs are looking for sector-focused funds because they want to diversify their portfolios. It doesn't hurt that sector focused funds often outperform generalist funds, according to a report from Cambridge Associates called "Declaring a Major: Sector-Focused Private Investment Funds." Sector specialists, defined in the report as historically investing more than 70 percent of capital in one of four sectors — consumer, financial services, health care and technology — returned an aggregate 2.2 times multiple on invested capital (MOIC) and a 23.2 percent gross internal rate of return (IRR) between 2001 and 2010. Those returns beat the 1.9 times MOIC and 17.5 percent gross IRR for generalist funds in the same sectors.

"This outperformance of sector-focused funds comes from intimate knowledge of an industry — in an increasingly competitive private equity environment, a manager's ability to demonstrate deep expertise in a focused field is a key differentiator," says Andrea Auerbach, global head of private investment research at Cambridge Associates. "Investors building private equity portfolios should keep them in mind as one arrow in their quiver of investment return generation."

Consumer-focused funds are more common than they were just five years ago and private equity firms continue to differentiate themselves. VMG just closed on a $500 million fund, VMG Partners III LP, to invest in consumer products, while ParkerGale is targeting $200 million to invest in buyouts of tech-enabled service companies with heavy operational needs.

Other private equity firms such as The Riverside Company have identified multiple industry verticals that they have deep expertise in.

Specialization makes LPs comfortable. "We like sector-focused funds if they are in a sector that we like and we think the management team can be successful in. We tend to follow sectors for a while before we invest," says Schwartz. In the past 12 months, Caspian has made private equity fund commitments to funds focused on health care, financial services, and the manufacturing sector.

4. Operational expertise

It's gotten harder to achieve outsized returns in private equity as the industry has matured. When the industry was new, private equity firms' returns were typically driven by financial engineering. It was a strategy that worked well in a rising economy, but horribly in a falling economy. Over the last 20 years, fund managers and LPs have increasingly focused on making money not solely through the use of leverage or relying heavily on multiple expansions, but by increasing earnings. Today, most private equity firms tout relationships with professionals that offer operational expertise.

Private equity firms far and wide began hiring these people or forming partnerships with them after 2008. This relationship is very important to LPs. In the Probitas survey, 68 percent of respondents say they want to invest in funds focused on operational improvements heavily staffed with professionals with operating backgrounds.

It's important to note that not all firms use the same strategy for working with operational professionals. Some private equity firms, such as Advent International, partner with operating partners around the globe when the timing is right, while other firms such as Riverside, employ operating professionals. Others use operating partners as advisers.

"The ability to drive returns from using leverage is a thing of the past," says Schwartz. "You need to grow a company with revenue and Ebitda. When we are evaluating fund commitments we are always looking at what type of operational expertise a fund has and how those professionals are compensated. We want to make sure there's an alignment of interest. Every situation is different and we don't say one model is best, but we evaluate each situation."

Some believe operating partners are being hyped up more than necessary these days. "Operational expertise is a buzz word, but nonetheless it's something LPs are looking for. It gives a sense of security. If something is wrong they know they are backing someone who can handle the downturns or issues," says Josh Sobeck, a partner with 747 Capital, a New York-based limited partner looking to invest in small buyout funds raising between $50 million and $350 million. 747 has invested in firms such as the Beekman Group LLC, DW Healthcare, Hamilton Robinson Capital Partners, Monomoy Capital Partners and OFS Energy Fund.

5. Exposure to U.S. middle market

According to the Probitas survey, LPs are most interested in investing in U.S. middle market buyout funds and U.S. small-market buyouts funds. The middle and lower middle market have been the darlings of the private equity market for quite some time now. The middle market invested $385 billion in 2014, which is a new record, eclipsing the $362 billion invested in 2007. In fact, the middle market was responsible for 78 percent of overall PE activity in the United States in 2014. Historically, the U.S. middle market is responsible for about 66 percent of overall PE activity by count, according to Pitchbook Data.

"The middle market still allows for business building versus modifying a larger enterprise. There is only so much you can do with a Hertz for instance, but you can really transform a sub-$100 million business," says Sobeck.

Some of the most active private equity firms in the middle market are ABRY Partners, Audax Group and Riverside. Larger funds have moved down market down as well. For example, large-market firms such as the Carlyle Group (NASDAQ:CG), Hellman & Friedman and the Blackstone Group (NYSE: BX) have all been active in the middle market during the past year. In April, Carlyle had a $1 billion first close on its second middle-market private equity fund and TPG Growth closed on $3 billion to invest in small and mid-sized companies. Middle market firms that have recently closed funds includes FFL Capital Partners, Valor Equity Partners, SFW Capital Partners, Catalyst Investors, Argosy Private Equity, Capitala Group, and BV Investment Partners.

According to data from Preqin Performance Analyst, the median internal rate of return from a mid-market buyout firm from 2011 is about 14 percent, versus 10.3 percent for the mega firms.

"There's a lot of interest in the middle market because the returns have been good and LPs tend to have a herd mentality. The larger institutional LPs see strong returns and their peers diving in and they want to participate as well," says Sobeck.

But keeping LPs happy will prove challenging, says RLJ Equity Partners' T. Otey Smith. "The diligence process for new funds is going to be much more intense."

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