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Private Equity: Part III—Changes in a Maturing Industry

The future of private equity is changing, which is good news for middle market companies.

by Jay Schembs

We conclude our three-part investigation into the private equity industry with a discussion of the future. Part I examined the structure of a typical fund, concluding that short-term horizons often result in a number of incentives and constraints to investments. Part II introduced unintended consequences often encountered in traditional private equity fund structures, including asymmetric payoff structures and excessive costs. Part III of this discussion examines the current and future competitive environment and the evolution of the industry as it matures.

SUPPLY IN EXCESS OF DEMAND

Since the early 2000s, financial liquidity has increased, and is projected to continue increasing for the foreseeable future. For better or worse, capital abundance is here to stay.

Commensurate with this liquidity growth is an unprecedented amount of investor dry powder – amounting to nearly $500 billion of undrawn equity committed to private buyout funds. Further, the number of funds in North America trying to deploy this capital has grown to nearly 2,000 today from less than 1,000 in the year 2000. During the same time, the number and dollar value of investments have remained relatively steady. The differential, accommodated by a lenient credit market, has driven up prices. As current private equity portfolios were liquidated into an attractive market for sellers, investor returns were buoyed, further encouraging the supply side.

The very forces that rescued recent private equity investments – record low interest rates and plentiful capital – now magnify the two issues that make it more challenging for private equity funds to profit from investments made today. Tepid GDP growth and limited further downside in interest rates suggest that longer holding periods and lower investment returns will be the norm.

THE EMERGENCE OF SHADOW CAPITAL

Institutional investors have spread their wings in recent years, investigating new ways to participate in private equity with the objectives of deploying more capital and enhancing returns. Their methods:

- *Co-investments alongside funds to which they have committed capital.* An example of this practice is when an institutional investor makes an equity commitment to a fund and gains an opportunity (but not requirement) to invest side-by-side for a certain percentage of each deal. Two objectives of this movement are to reduce the fees associated with investment management, by paying fees only on funds employed (rather than commitments), and to gain more direct control into which investments their money is deployed. A variant on this theme has fueled the growth of the fundless sponsor and pledge fund organizations. These entities are similar to traditional private equity funds except they do not have committed capital from limited partners. Fundless sponsors (or pledge funds, as they're also known) maintain handshake agreements with potential equity investors that are formalized for each investment.

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- *Co-sponsorships with private equity funds.* In this case, a specific "partnership" is created for an individual deal in which the institutional investor and the private equity fund are partners in the investment. The objective behind this is to allow the institutional investor to have input on the management of the investment, thereby evolving the traditional relative roles of general partner (GP) and limited partner (LP).
- *Separate accounts exclusive to the investor.* In this arrangement, the fund manager takes on a role more similar to a wealth manager or asset manager, with discounts on prices for services, reducing fees and carry from the traditional "two and twenty" formula. The fund manager accepts these lower prices in exchange for a larger, steadier volume of assets.
- *Direct investing.* In a growing number of cases, investors are recreating the capabilities and processes private equity firms possess by building their own experienced teams, thereby creating direct competition to traditional private equity fund managers.

THE COMPETITIVE RESPONSE

Private equity funds have responded in several ways to address current trends. With the objective of slowing fund turnover ratios, thereby allowing more time allocated to investing rather than fund raising activities, private equity fund managers have undertaken the following changes:

- Strategic relationships with certain investors to secure longer-term commitments outside of the normal fund raising cycle, in exchange for lower fees and carry.
- Extended fund term to 15-25 years, thereby allowing investment in cyclical industries and avoiding liquidation of an investment in a growing company simply because of fund structure.
- Smaller funds with rollover features that allow returns from investments to be reinvested rather than returned to investors.

It is reasonable to expect that further industry responses will emerge to address the unexpected consequences of the traditional fund structure.

A BETTER WAY FORWARD?

Private equity as a general model is a wonderful source of liquidity for business owners, and an important source of capital to support middle market business growth. However, every mature industry morphs as competition drives down prices and returns, and private equity is not immune. The changes and competitive dynamics, in our view, are mostly positive, especially for middle market business owners pursuing a sale or a capital partner.

Higher purchase multiples are a general result of increased competition (more money chasing fewer deals). In addition, sellers have gained sophistication and realized that in most cases a one-off transaction, negotiated directly

(continued p.2)

between a private equity buyer and seller, is not in their best interest. Instead, most private equity groups, whether willingly or not, end up spending more time in competitive auctions that tend to drive higher prices. This condition is unlikely to be reversed.

A movement towards longer holding periods could have enormous positive benefits.

- Long-term ownership aligns with many selling families / business owners.
- Investors with a long-term orientation can focus more on acquiring and building great businesses, and less on preparing the business for a near-term exit.
- Investors are able to think more like strategic buyers, with less reliance on transaction leverage to generate returns and greater focus on investments anticipated to produce significant long-term payoffs.

A refocus on long-term ownership should help businesses and investors make decisions in the company's long-term best interest, which ultimately is in their best interest as well. ZS

Zachary Scott
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1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Mike Dannenberg
206.838.5531
mdannenberg@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Derrik Larsen
206.838.5527
dlarsen@zacharyscott.com

David Petrisor
206.838.5529
dpetrisor@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com