Patience is a Virtue

- Tripp Brower, Partner, Capstone Partners

How did the fundraising market in 2012 compare with that of 2011?

LPs continue to be active in their commitment programs, but the competition among GPs for fund capital is fierce, and fundraising timelines are extended for all but the most sought after funds. The underlying themes of oversupply and re-up management that were prevalent in 2011 continued through 2012. Fund due diligence is often deeper and lengthier due to the decisions LPs have to make regarding re-ups and new relationships. Investors are more willing to walk away from a fund late in diligence than in prior years. With an abundance of options for LPs to choose from, fund managers are increasingly looking at co-investment opportunities as a point of differentiation and to serve as a catalyst for the LP to diligence their fund.

In 2012, the willingness of investors to commit to a new relationship in a first close was at an all-time low. Those LPs that were willing to come into a first close were generally looking for some form of benefit ranging from preferred co-investment opportunities (usually not documented but certainly understood) to preferential economics. The best performing funds continue to get raised quickly (4-12 months), while those with good but less than perfect stories were generally supported by their existing LPs but struggled to garner interest from new LPs. Fundraises that take from 18-24 months are no longer considered failures as they have become more common even for solid managers.

How are investors viewing the asset class at present and what impact is this likely to have on fundraising going forward?

LPs continue to have a positive view of the asset class. While 2012 was again dominated by re-ups, LPs are exercising caution in determining which of their legacy relationships to support, even applying a fresh underwriting approach in many cases. Private equity investors in general have very mature portfolios and will be targeting investments to fill the gaps in their portfolio. Managers with specialized fund strategies are more likely to appeal to investors with mature portfolios. LPs are also very focused on alignment of interests. With the financing markets continuing to improve, exit and recap activity increased in 2012. Hopefully this additional liquidity, along with steady public markets, will allow LPs to continue and potentially increase their level of commitments in 2013.

Which are the major areas of focus for LPs?

We are seeing LP commitments across all fund types, but there are certainly some sectors that have generated stronger interest. In the buyout space, middle market and lower middle market continues to be of greater interest than large cap. Although solid generalist funds will always attract capital, sector specific funds seem to be more appealing to most LPs as they fill in the gaps in their portfolios. In 2012, there was less emphasis on distressed managers, although we find LPs reconsidering this position as the uncertainty in Washington has created renewed concern about the strength of the recovery.

Traditional venture, with the exception of the top tier managers, continues to be out of favour, but innovative strategies like direct secondaries have found traction in the market. Funds of funds continue to struggle to raise money and seem more willing to take on separate account mandates for larger LPs, as well as offer reduced fees. Energy, power and infrastructure funds gained considerable attention from the LP community in 2012, and we suspect this will continue in 2013. Our expectation/optimistic hope for 2013 is that LPs will have largely worked through their backlog of re-ups and will have a more normalized year with incremental allocation for new relationships.

With a record number of funds on the road, what advice would you give fund managers that are competing for commitments?

GPs need to be patient when preparing to come to market and during the fundraising process. Many areas need to be lined up correctly before going to market to best position the firm for fundraising success:

- Existing portfolio – LPs are most interested in seeing the performance results of your prior funds; realizations serve as a catalyst to build momentum for your fundraise.
- Existing LPs – Make sure you have a clear handle on re-up levels and timing from existing LPs and close relationships before starting to approach the broad market.
- Documentation – All of your marketing documents and due diligence documents should be finalized before approaching both existing and new investors.

Some other suggestions we give to GPs include:

- When looking at deals, be mindful of co-investment opportunities early on.
- If you can get a first close done and then complete a deal or two into the new fund, it will help new investors see your ability to execute on your investment strategy.
- Regarding fund terms, don't try to be too aggressive and push the edge of the envelope. With the market still tight, LPs will walk away if they feel GPs are pushing the terms.
- Make sure the fund is appropriately sized. LPs may take a quick pass on a group that might otherwise be of interest if they feel the GP is attempting to raise too much capital. Should the fund become a high demand fund, LPs will generally be willing to allow the fund size to increase within reason.

Remember, you only have one chance to make a first impression with a potential investor, so it's important to be fully prepared before reaching out to new relationships. You need to be focused

in your marketing efforts – you or your agent should have a pre-qualifying conversation with an LP, send marketing materials in advance of a meeting, sell into a meeting, and then be patiently persistent in follow-up. More than ever, momentum is key, which is dependent on fundraise timing, existing LP support and appropriate LP targeting.

What impact do you think incoming regulations will have on sources of capital to the private equity industry?

Dodd Frank has clearly had an impact on groups previously supported by anchor investments from financial institutions as they have big holes to fill in their LP base. Registration requirements have also had an impact on GPs' administrative burdens, but are unlikely to impact fundraising. The other notable change has been the JOBS Act, which is designed to allow smaller investors access to private equity. We don't expect this to have a significant impact on the investor universe, as the reporting requirements to make the broad offerings are more onerous than the expected benefit. Informally, we are seeing the continuing impact of some public pension funds or separate account managers for public pension funds who are unable to talk to agents or pay success fees. In these cases, it would be best for the GP to contact the investors directly, provided they are a good fit for the fund strategy.

Have you witnessed any concessions in fees being offered to investors by GPs in the past year?

When thinking through any fee concessions, there is clearly a difference between the mega funds and the sub $1bn funds. On the larger side, LPs and GPs are being innovative in establishing longer term partnerships with very large commitments at preferred economics. On the smaller side, as I mentioned previously, we see LPs asking for preferred economics or preferential treatment on co-investments as an enticement to enter into a first close. We see fewer funds in market with the old-style sponsorship model where the LP becomes an anchor investor for a piece of the GP, although some firms still find that model beneficial. In general, we don't expect pressure on fees for middle market funds, especially if their performance is strong.

What predictions do you have for the private equity market in 2013?

Fund capital is in tight supply and the degree of difficulty in fundraising will continue to be high. Track record performance will continue to be a key metric and driver of fundraising success. The 2006-2008 vintage funds that are coming back to market might struggle in this area as the average returns are sub-optimal. 2012 was dominated by re-ups, a trend that will continue in 2013. These factors will most likely force more managers to search for innovative ways to recap older funds in an effort to obtain incremental dry powder for investment. Several of these transactions were completed in 2012 and more are expected in 2013. Anecdotally, we are seeing more distributions from private equity portfolios which would provide liquidity that could lead to an increase in fund investments in 2013 and beyond.

Thank you for your time.

Capstone Partners

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