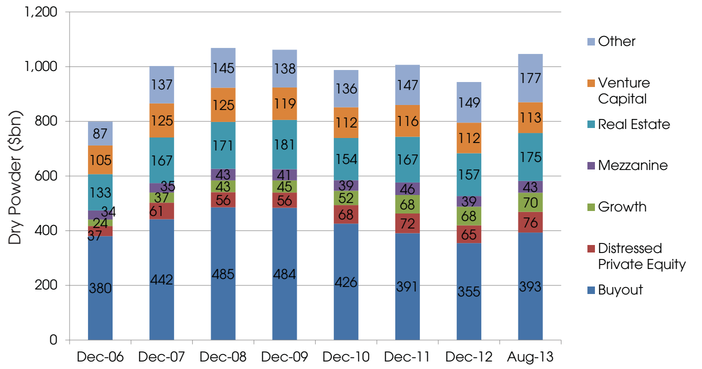
Too Much Dry Powder, Too Few Deals?

Jessica Duong considers whether the recent increase in private equity dry powder is linked with low availability of investment opportunities, or if there is still sufficient deal activity in the market.

The improvement in private equity fundraising recently was demonstrated in the impressive figures for Q2 2013, when $139.1bn was raised by the 209 funds reaching final close in the quarter, the highest level of capital commitments in a quarter since the end of 2008. This shows positive signs of growth within the industry that has recently been impacted by the wider financial instability in the markets. However, could this positive achievement contribute to problems further down the line?

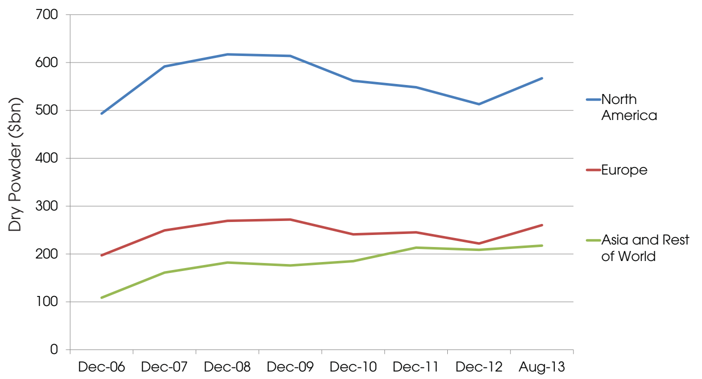
The case of too much dry powder (capital available to fund managers for investment) and not enough investment opportunities is a notable concern to many fund managers and investors today. Preqin's Investor Outlook: Alternative Assets, H2 2013, which includes the results of interviews with 100 private equity investors around the world, reveals the key issues and challenges investors currently face when seeking to invest in the asset class. A number of investors specifically cited fund managers' difficulty in finding investments, a lack of availability of deals and too much dry powder as key issues and challenges at present. One US-based public pension fund told us: "There is a large inflow of institutional capital, but not as many deals".

Fig 1: Estimated Private Equity Dry Powder by Fund Type



Source: Preqin Fund Manager Profiles and Performance Analyst

Fig. 2: Estimated Private Equity Dry Powder by Primary Geographic Focus, 2006 - August 2013



Source: Preqin Fund Manager Profiles and Performance Analyst

Dry Powder

As private equity fundraising levels improved during Q2 2013, the amount of dry powder available globally also increased. Preqin estimates that as of August 2013, private equity managers of all fund types had a total of over $1.0tn of dry powder available, as shown in Fig. 1. When broken down by fund type, buyout funds have the most estimated available dry powder, with a total of $393bn, which is to be expected given the fact buyout funds typically secure the highest amount of capital within global fundraising. Fig. 2 shows that geographically, North America-focused vehicles have the greatest amount of estimated dry powder by far, which again is unsurprising given the dominance of US vehicles in the fundraising market.

Fig. 3 shows the top five private equity firms by the amount of estimated dry powder they have available to invest. The top five firms collectively have an estimated $80bn in dry powder, with four based in North America and one in Europe. CVC Capital Partners, headquartered in the UK, has an estimated $19.6bn at its disposal. The firm has closed several multi-billion buyout funds since its establishment, including CVC European Equity Partners VI on €10.5bn in July 2013, and is currently in market targeting $3bn for CVC Capital Partners Asia Pacific IV.

Deal Activity

With an abundance of dry powder now available for investment, many investors are concerned this may mean too many fund managers are chasing too few investment opportunities and that GPs may in fact find it difficult to invest all the capital they have available. When looking at private equity-backed buyout deals in Q2 2013, there was a decrease in both the number of deals and aggregate deal value compared to the previous quarter. A total of 643 private equity-backed buyout deals were announced globally in Q2 2013, with an aggregate value of $62bn, a substantial decrease from the $86bn witnessed during Q1 2013, as shown in Fig. 4. Since Q4 2012 there has been an overall decline in the number of deals and Q2 2013 saw the first drop in both the number and aggregate value of deals since Q1 2012. However, it is important to note that the aggregate deal value in Q1 2013 was the highest level seen since Q3 2007, before the onset of the global financial crisis; this is largely attributable to the $52.6bn combined value of the H.J. Heinz Co. deal, which was completed in June 2013, and the Dell Inc. deal, which is yet to reach completion.

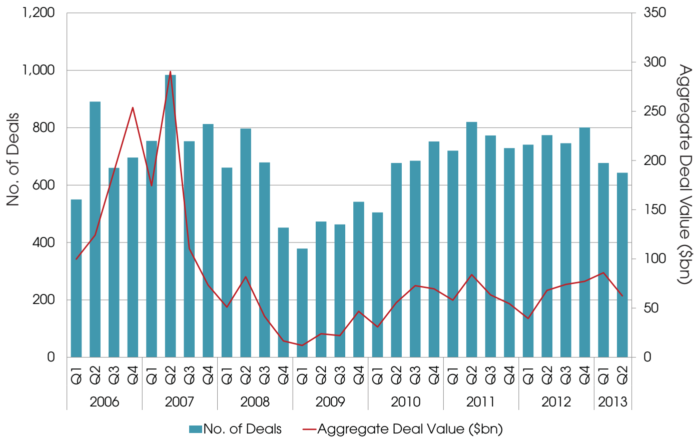
The largest deals in 2013 so far are listed in Fig. 5, and include the $24.6bn Silver Lake-backed privatization of Dell Inc. and the proposed $28bn Berkshire Hathaway Inc- and 3G Capital-backed buyout of H.J. Heinz Co. The announcements of these two mega-sized public-to-private transactions contributed to the strongest

Fig. 3: Top Five Private Equity Firms by Estimated Dry Powder Available (As at 28 August)

Firm	Estimated Dry Powder ($bn)	GP Location
CVC Capital Partners	19.6	UK
Kohlberg Kravis Roberts	17.5	US
Apollo Global Management	15.7	US
Blackstone Group	14.8	US
Goldman Sachs Merchant Banking Division	12.4	US

Source: Preqin Fund Manager Profiles

Fig. 4: Number and Aggregate Value of Private Equity-Backed Deals Globally, Q1 2006 - Q2 2013



Source: Preqin Buyout Deals Analyst

period for buyout deals in over five years, which was welcomed after the tight credit conditions the industry had seen since the boom era, and subsequent lack of mega-sized deals (over $10bn).

Although buyout deal activity dropped in Q2 2013 when compared to Q1 2013, before this, the aggregate value of private equity-backed buyout deals had increased every quarter since Q1 2012, from $40bn to the $86bn in Q1 2013. This demonstrates that over the past year, even though the economic environment remains difficult, there has by no means been a lack of suitable investment opportunities found by fund managers.

Exit Activity

Q2 2013 witnessed one of the highest quarterly aggregate exit values in the period since 2006, with 342 private equity-backed buyout exits announced during Q2 2013 valued at $92bn, second only to Q2 2011 when 364 exits were valued at $128bn, as shown in Fig. 6. This shows that recently, certain fund managers have had some success in exiting investments. A breakdown of the different exit types provides further interesting analysis. In particular, the statistics show that this year the number of sales to GPs has slightly declined as a proportion of all private equity-backed exits from 2012. Last year, sales to GPs accounted for 29% of all exits, whereas in 2013 so far, the figure has fallen by five percentage points to 24%.

IPOs and follow-on offerings accounted for 19% of exits so far this year compared with 13% in 2012, suggesting a growing confidence in the wider financial market.

Company Stakes

There is evidence suggesting that appetite for certain private equity strategies moves in correlation with the rise and falls of the financial market. Shifts in market confidence can be linked to some strategies becoming more common as others fall out of favour and therefore fund managers are considering alternative ways of deploying capital. A regional disparity is evident in the respective growth and decline of minority deals within North America and Europe in particular.

In North America, a significantly increased proportion of all private equity-backed buyout deals involve acquisition of minority stakes in portfolio companies, rising from 30% in 2012 to 41% in 2013. This peak comes after lows of 22-23% in the buyout boom era of 2006-7, and suggests a transition in strategy by GPs in response to the worsening credit availability, and perhaps a decreased level of confidence in North America. The benefit of minority share holdings is that they involve lesser financial constraints, as they require a smaller amount of leverage to support these investments.

On the other hand, Europe has seen a proportional surge in deals whereby firms take full ownership or a majority/controlling stake. During 2012, 60% of private equity-backed buyout deals in Europe-based companies were for a majority or full ownership stake in the company. This proportion of acquisition of majority or full ownership stakes in Europe-based companies has risen to 72% in 2013 YTD. This upward trend could be a result of renewed confidence in the region, which in turn motivates private equity firms to pursue majority or full ownership stakes in portfolio companies in order to possess more voting power and influence over company strategy, as well as hopefully benefiting from financial upside.

Fig. 5: Five Largest Private Equity-Backed Buyout Deals, 2013 YTD (As at 28 August 2013)

Firm Name	Investment Type	Investment Date	Deal Size ($bn)	Status
H.J. Heinz Company	Public To Private	Feb 2013	28.0	Completed
Dell Inc.	Public To Private	Feb 2013	24.6	Announced
BMC Software	Public To Private	May 2013	6.9	Announced
Hub International Limited	Buyout	Aug 2013	4.4	Announced
Springer SBM	Buyout	Jun 2013	4.4	Completed

Source: Preqin Buyout Deals Analyst

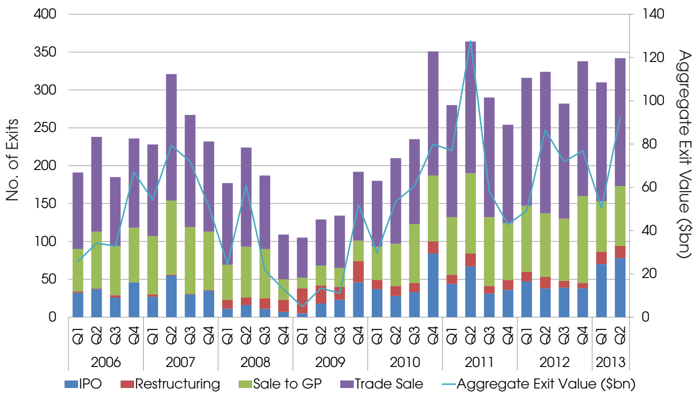
Outlook

The substantial increase in current dry powder available to GPs as a result of the buoyant fundraising market in H1 2013 has caused many investors to be concerned as to whether there will be too many fund managers searching for limited investment opportunities in the near future. Indeed, the decrease in the number and aggregate value of private equity-backed buyout deals in Q2 2013 goes some way to contribute to these concerns. Given the steady quarterly increases evident prior to this in terms of aggregate value of buyout deals, it appears there has been some halt in momentum in the market. Preqin's latest data for Q3 2013 so far as we move into September offers some insight into future outlook, with only 463 deals announced in the quarter to date, and a relatively low aggregate deal value of $37bn. This demonstrates a continued decline in both the number of private equity-backed deals and their aggregate value.

It is important to bear in mind when contemplating a GP's chase to deploy dry powder that terms are set in a fund operating agreement outlining a limited investment period. A private equity fund is permitted to enter into new investments only during this set time, typically of around four to six years from the closing of its first investment or final close of the vehicle. After this defined window, the firms lose access to the funding. These built-in deadlines to invest the money raised place some pressure on fund managers to find ways to deploy their capital before their time limit is reached. It is possible for the firms to request extensions from their investors, though this could be perceived as unfavorable to the GP's reputation and can even negatively affect fundraising efforts in the future.

Perhaps this pressure is linked to the upward trend seen in proportion of the value of all buyout transactions that is accounted for by secondary buyout deals. A long term trend of growth in secondary buyouts as a proportion of all buyout deals has come in spite of the recent decrease in sales to GP as a proportion of all private equity-backed exits observed during 2013 and mentioned previously. In 2012, the total value of secondary buyouts accounted for 31% of the aggregate value of all buyout deals globally. This compares to corresponding figures of 10% in 2006 and 15% in 2007. While some GPs do believe that this deal type presents an attractive opportunity to invest, there is some negative sentiment towards it in the industry. Secondary buyouts, where both the buyer and the seller are private equity firms, can sometimes be deemed as 'pass-the-parcel' deals; some LPs worry that these and may be more of a deal type pursued by those GPs under increased pressure to invest dry powder.

Fig. 6: Number and Aggregate Value of Partial Private Equity-Backed Exits Globally, Q1 2006 - Q2 2013



Source: Preqin Buyout Deals Analyst

As we continue through H2 2013 and approach 2014, it will become more apparent as time passes whether this decline in deal activity is a momentary blip or an indicator of a more sustained struggle felt across the industry, and how this falls in line with the increasing levels of dry powder available to GPs. Data so far suggests that the types of deals and exits change as credit conditions alter and fund managers face pressure to invest LP capital, but we will have to wait and see if the momentum of private-equity backed deals seen in early 2013 will pick up again.

Data Source:

Subscribers to Preqin's Fund Manager Profiles can click here to use the Dry Powder feature to analyze the amount of capital available to fund managers by fund type and primary fund focus.

Subscribers to Preqin's Buyout Deals Analyst can click here to view detailed information on over 30,700 private equity-backed buyout deals. Premium subscribers can download all this data into Excel for detailed analysis by size, industry, location and more.

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