PREQIN QUARTERLY UPDATE: PRIVATE EQUITY & VENTURE CAPITAL Q2 2019

Insight on the quarter from the leading provider of alternative assets data

Fundraising
Funds in Market
Deals
Institutional Investors
Fund Performance

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Foreword

What to make of the private equity industry in Q2 2019? By most markers, it seems to have been a worrying period of decline – fundraising has well and truly withdrawn from the heights reached in 2017 and much of 2018, while both the buyout and venture capital deals markets have recorded fewer transactions and lower values in the first half of the year.

But investor appetite remains strong, and fund managers are upbeat about the prospects for the asset class. What, then, can explain the slowdown in activity? It is likely a combination of factors: China has moved past its recent flurry of record-setting funding rounds, which drove the high venture capital deal values of the past 18 months. North America and Europe have both seen a slowdown in buyout deal activity, possibly because of concerns over central bank policy and the continued pressure of high pricing. Finally, the unprecedented period of fundraising has pushed dry powder to a new high of $1.54tn as of the end of June, meaning that many investors have significant commitments yet to be deployed.

There are no simple solutions to any of these, meaning all these factors will likely continue to impact the asset class in the second half of the year. Private equity is certainly more difficult to navigate than ever, and with almost 4,000 funds seeking capital, the challenges are greater than ever for both for allocators and operators.

Long-term performance is strong, investor appetite is substantial and deal opportunities are certainly out there. But for investors and fund managers alike, it will require more intensive analysis, more granular insights and more sophisticated strategies to succeed in private equity than ever before.

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It's Not You...It's Me: The Reasons Why LPs Won't Commit

Fundraising is a maddening process for all but a few firms. Let's call that latter group the 'one-percenters': the elite who announce their fundraising plans at their annual meetings, send out an email the following day with a PPM and an LPA, and tell their LPs they have 60 days (or less) to complete their work. The world comes to them – no schlepping briefcases full of pitchbooks across the country and globe.

For everyone else, it is scores of meetings, delayed flights and late arrivals at Marriotts and Hiltons when you're lucky, or $600/night 1950s-era motor inns in Menlo Park with plastic-encased mattresses when you're not so lucky. You have early-morning breakfast buffets with powdered eggs and grease-coagulated bacon. You tell the same story over and over in one-hour segments, until you feel like you're caught in a time loop, much like Bill Murray was in the movie Groundhog Day.

Sure, most meetings feel like they went well. The LP was engaged, took copious notes, asked penetrating questions and closed with asking about the timeline for the fundraise. You send a thoughtful thank-you note – the LP responds, saying how nice it was to meet you, and that she will discuss internally and get back to you. All good. And then, the trail goes cold. Emails and voicemails go unreturned. Maybe a note back saying "we would like to see you develop the portfolio so let's stay in touch for the next fund." Placement agents typically can elicit more candid feedback from LPs, or at least can divine the meaning behind the canned turndown rationales.

For example, recently we were doing a fundraising post-mortem for a client – i.e. how many meetings held, how many LPs converted from meetings to accessing the data room, how many came for on-site

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diligence, how many committed and, also, how many declined and for what reason. A small percentage of LPs declined because of issues with performance. Another small percentage declined because of team transition issues. However, over 70% of LPs that declined cited "internal reasons," such as allocation issues, a full re-up pipeline or, my favourite, "not a portfolio fit." In other words, it was the classic "it's not you...it's me."

What is a GP to make of all this? Certainly, no firm nor fund is perfect. All have some form of hair – I guess it's a matter of whether the LP community sees it as just as an acceptable amount of five o'clock shadow, or do you strongly resemble Billy Gibbons of ZZ Top? Let's try to parse through the noise and get to the real reasons behind the declines.

Allocation Issues – The LP has been making private equity commitments for many years with middling success. Some top-quartile funds, some not-so-top-quartile funds, a bunch of capital called, limited distributions. The private equity portfolio manager's bonus last year was below plan. The CIO is recommending a shift to secondaries. She's not convinced your offering is any better than what she has and is thinking about updating her LinkedIn profile.

Team Dynamics and Succession – The founders have a decent track record, but a lot of time has passed and the LP isn't convinced that they're still as motivated and engaged. A quick Google search turns up the founders' private planes, houses in Aspen and Jackson Hole, and a constant feed of vacation pictures, and the LP starts to think that maybe they've achieved pretty much everything they set out to do – and questions their drive. The next generation is unproven, even if they do seem to work hard.

Track Record Issues – Sure, you've got a few winners, but also a donut, and a lot of wobbly deals held at questionable valuations that seem to increase quarter to quarter with the sole purpose of assuring your returns remain in the top quartile of your vintage. Even with that, a PME calculation shows your returns lagging 500 basis points below most index funds.

Cannot Make Fundraise Timeline – The LP has a full re-up pipeline that can easily absorb their annual allocation. He also has some funds he's been following where he hopes to get allocation - and he'd rather hang around the hoop on those than spend time working on your fund. Even if you're in market for two years, he just can't make that timing work.

First-Time Fund Issues – Though research shows that Funds I and II tend to outperform, that same research also shows those same funds fail more frequently. The LP is not rewarded for taking risk but could be fired for it, so why should she take it? Plus, they take a lot of work to underwrite.

Sector Focus Not a Fit – If you're a generalist fund, this means the LP wants to invest in a sector fund. If you're a sector fund, this means the LP wants to invest in a generalist fund. This feedback often comes from the same LP at the same time, depending on your strategy.

Unresponsive – LPs are busy and, like most people, they do not like to convey bad news. Easier to stay radio silent than communicate a turndown because your fund strategy/returns/team do not rise to the level of moving into diligence.

With such structural headwinds in place, GPs (in many cases with the help of their agent) must carefully consider the fundraising strategy, pre-launch. Where are the existing investors? Who are my potential first-movers among new LPs? What support from my best relationships do I need locked down before approaching new names? What are the potential holes in the story I need to plug before evangelizing it? Every fundraise needs a plan, then careful monitoring on the pulse of the fundraise, and course correction when required. The fundraising world is built to reject you. Planning for that rejection is the first step towards joining the one-percenters.

My recommendation to GPs is not to take any of this rejection personally. After all, it's not you...it's me.

Capstone Partners

Founded in 2001, Capstone Partners is a leading independent placement agent focused on raising capital for private equity, credit, real assets and infrastructure firms from around the world.

Alex is responsible for distribution and client origination in the Western United States and Canada.

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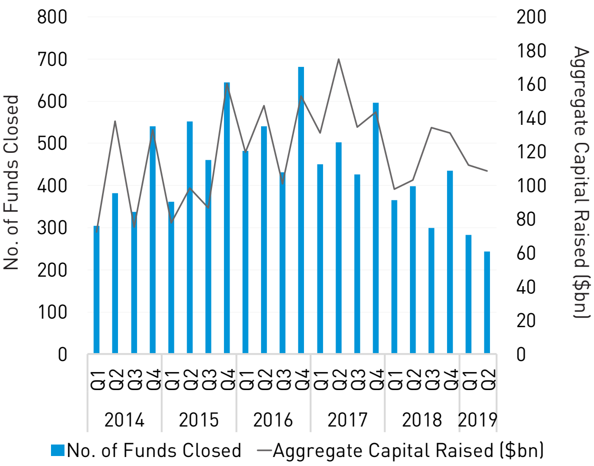
Fundraising

Once again, the private equity industry raised significant amounts of capital through relatively few fund closures in Q2 2019. Total fundraising for the quarter was $109bn, on par with Q1, but only 244 funds globally reached a final close (Fig. 1). This is significantly fewer than the 399 that closed in Q2 2018, which itself was a decline from 503 a year prior.

Fundraising activity was focused on North America, as 139 funds secured $68bn (Fig. 2). Europe and Asia were level in terms of fund closures – 43 and 45 respectively – but Europe-focused funds raised $21bn compared with just $15bn in Asia.

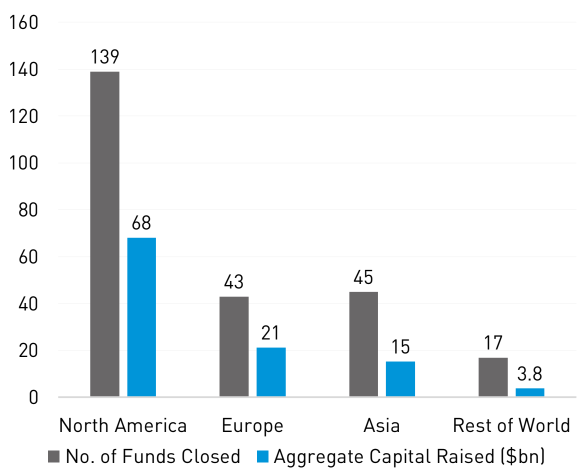
Just 19% of funds closed so far in 2019 have failed to meet their targets, continuing a long-term trend of increasing fundraising success for private equity firms. At the same time, high demand from investors is allowing fund managers to speed up the fundraising process. Forty-one percent of funds closed in H1 2019 were in market for six months or less, and more than six in 10 were on the road for less than a year (Fig. 3). This is encouraging for managers launching new vehicles, but does suggest that those that have been in market for a significant period face an uphill challenge to secure funding.

Fig. 1: Global Quarterly Private Equity Fundraising, Q1 2014 - Q2 2019



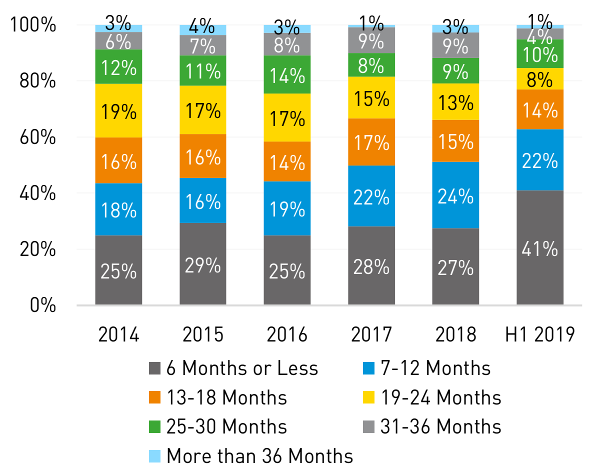
Source: Preqin Pro

Fig. 2: Private Equity Fundraising in Q2 2019 by Primary Geographic Focus



Source: Preqin Pro

Fig. 3: Average Time Spent in Market by Private Equity Funds Closed, 2014 - H1 2019



Source: Preqin Pro

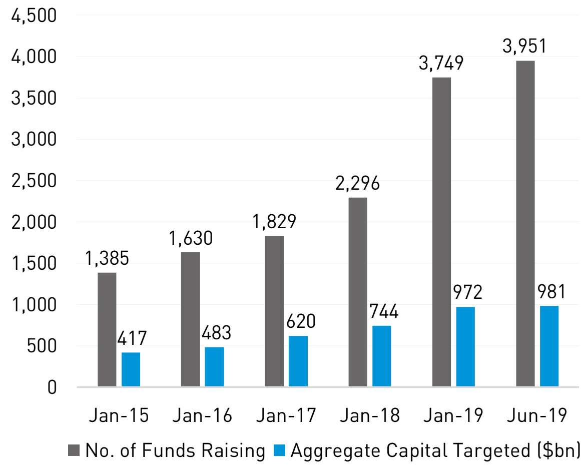
Funds in Market

The number of private equity funds coming to market continues to rise, reaching almost 4,000 at the start of Q3 (Fig. 4). The level of capital being sought has stayed level in recent quarters, and in total funds are seeking $981bn from investors. This represents two years' supply at 2018 fundraising levels, showing how crowded the fundraising market is.

North America and Asia are vying to be the most active fundraising market, with more than 1,500 funds on the road targeting each region. By contrast, there are fewer than 500 Europe-focused funds in market, and only 300 funds targeting other regions. Venture capital funds account for by far the largest number of funds (2,388), while buyout funds are seeking the most capital ($352bn, Fig. 5).

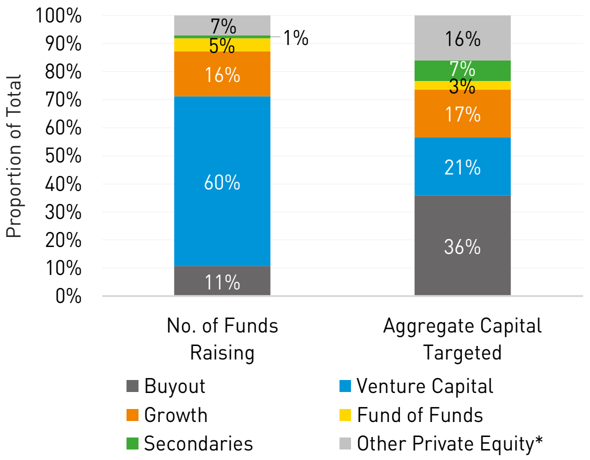
The field is dominated by the largest firms and funds, making the lower end of the fundraising market intensely competitive. Just 5% of funds in market are targeting $1bn or more, but collectively they account for almost two-thirds of all capital sought. The five largest alone are seeking $175bn – 18% of the total capital targeted (Fig. 6). Almost half (46%) of funds are seeking less than $100mn, and are competing to secure just 4% of all capital targeted.

Fig. 4: Private Equity Funds in Market over Time, 2015 - 2019



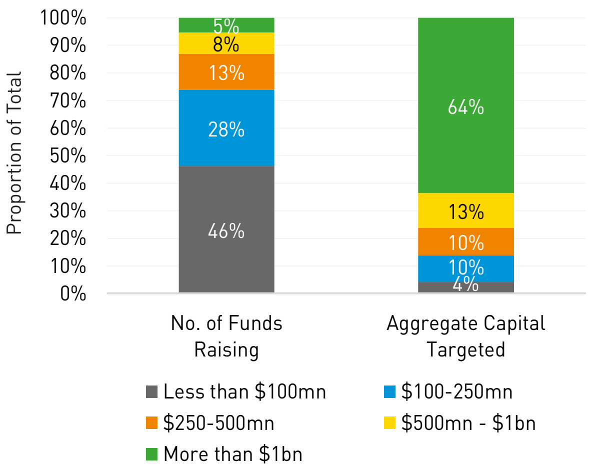
Source: Preqin Pro

Fig. 5: Private Equity Funds in Market by Fund Type



Source: Preqin Pro. Data as of July 2019

Fig. 6: Private Equity Funds in Market by Target Size



Source: Preqin Pro. Data as of July 2019

**'Other Private Equity' includes balanced, co-investment, co-invest multi-manager, direct secondaries and turnaround funds.*

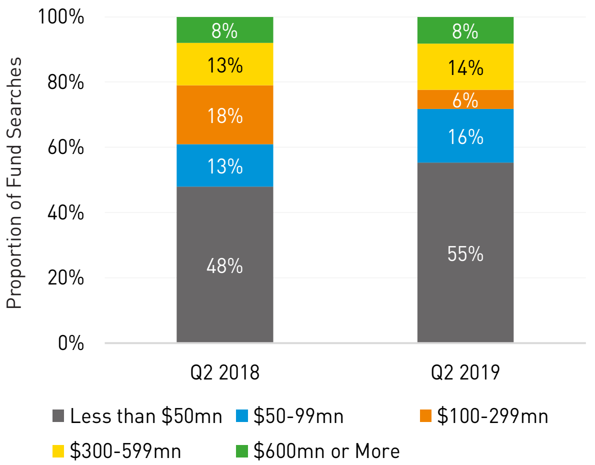
Investors

Over the course of the next 12 months, private equity investors will mostly be looking to make fewer commitments than at the same point one year ago, with almost half targeting a single commitment. This may be a result of investors taking a more cautious approach to new investment in anticipation of a market correction. This is also reflected in the amount of capital investors plan to commit: almost three-quarters expect to commit less than $100mn in the year ahead (Fig. 7).

Buyout remains the preferred strategy among private equity investors, with 69% planning to commit to such funds in the next 12 months, although this is a slight decrease from 74% in Q2 2018 (Fig. 8). Venture capital and growth vehicles have both witnessed an increase in investor appetite over the past 12 months.

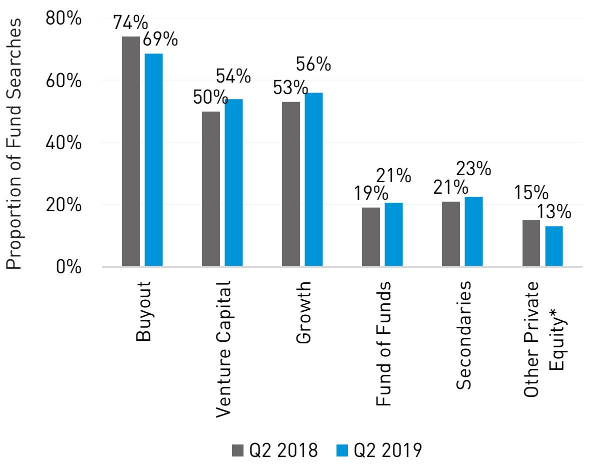
Europe appears to have fallen somewhat out of favour with investors over the past year: 49% are targeting commitments to funds focused on the region in the next 12 months, compared with 61% in Q2 2018 (Fig. 9), with delays and uncertainty surrounding Brexit potentially deterring investors.

Fig. 7: Amount of Fresh Capital Investors Plan to Commit to Private Equity Funds over the Next 12 Months, Q2 2018 vs. Q2 2019



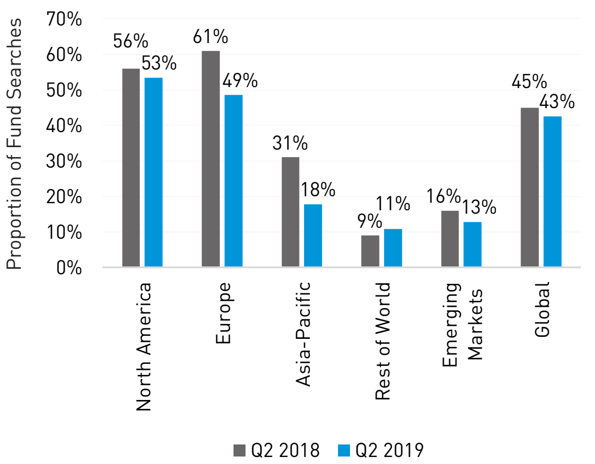
Source: Preqin Pro

Fig. 8: Strategies Targeted by Private Equity Investors over the Next 12 Months, Q2 2018 vs. Q2 2019



Source: Preqin Pro

Fig. 9: Regions Targeted by Private Equity Investors over the Next 12 Months, Q2 2018 vs. Q2 2019



Source: Preqin Pro

**'Other Private Equity' includes balanced, co-investment, co-invest multi-manager, direct secondaries and turnaround funds.*

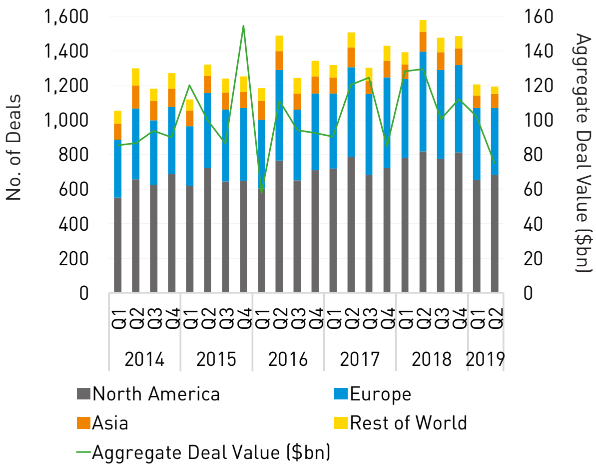
Buyout Deals

The private equity-backed buyout deals market has been active in recent quarters, but Q2 represented something of a decline in deal-making. Globally, 1,193 deals were announced in the quarter, worth a total of $75bn (Fig. 10). This is on par with the 1,206 deals announced in Q1, but is some way off the $102bn that those deals were worth.

While total deal values in Asia and Europe ticked up from Q1, in North America the aggregate deal value fell from $68bn to just $38bn – the lowest quarterly total since Q1 2017 (Fig. 11). Despite this, the number of deals in the region was up from 655 in Q1 to 683 in Q2.

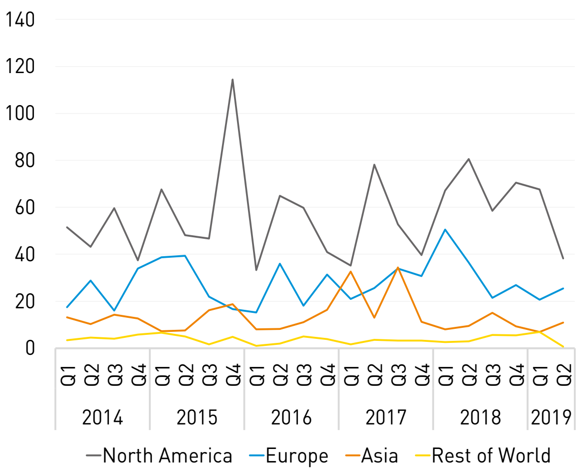
The exit market also slowed, as 326 buyout-backed exits were made in Q2 for a total of $133bn (Fig. 12). This is the third consecutive quarterly decline in the number of exits, but represents a significant uptick in exit value compared to Q1 ($44bn). This puts Q2 2019 in line with Q3 2018 and the peak exit market in 2014-15, suggesting Q1 was a dip rather than a trend. The decline in the number of exits has been largely due to a fall in trade sales, with the number of IPOs and sales to GPs (secondary buyouts) remaining stable.

Fig. 10: Quarterly Private Equity-Backed Buyout Deals by Region, Q1 2014 - Q2 2019



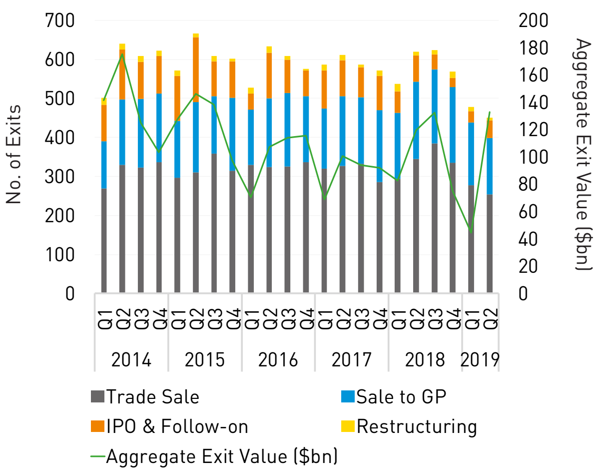
Source: Preqin Pro

Fig. 11: Aggregate Value ($bn) of Private Equity-Backed Buyout Deals by Region, Q1 2014 - Q2 2019



Source: Preqin Pro

Fig. 12: Quarterly Private Equity-Backed Buyout Exits by Type, Q1 2014 - Q2 2019



Source: Preqin Pro

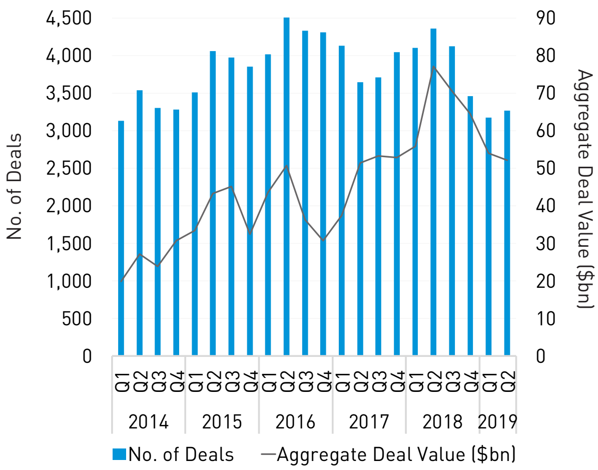
Venture Capital Deals

By the end of Q3 2018, the venture capital industry had already broken full-year totals to record the most active deal-making period of all time. Since then, though, both the number and value of deals have subsided. In Q2 2019, 3,263 deals were announced globally, worth a total of $52bn (Fig. 13). This total is significantly lower than the 4,356 deals announced in Q2 2018 worth $77bn – a record high.

A slowdown in investment in Greater China is primarily responsible for this decline. Q2 2019 saw just 684 deals announced in the region, down from 1,366 in Q2 2018 (Fig. 14). Activity also waned somewhat in other regions: 1,155 deals were announced in North America in Q2 2019 compared with 1,536 in Q2 2018, and deals in Europe fell from 822 to 695 in the same period.

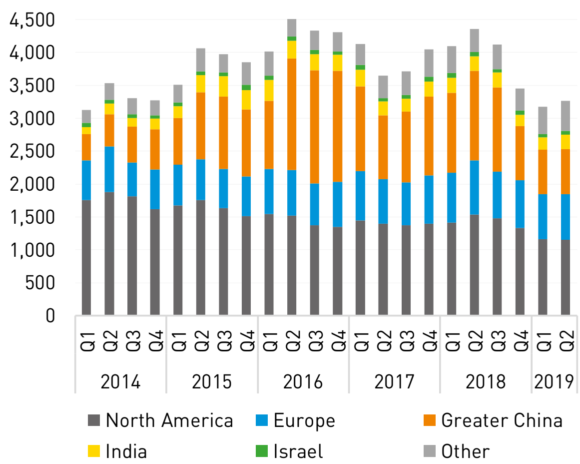
Despite these declines, deal-making remains substantial compared to historical levels, and activity has been stable in the first half of the year. Exit activity, meanwhile, has been building momentum, and Q2 saw the greatest number of exits announced since Q3 2017 (305, Fig. 15). The value of those exits reached $56bn, the second highest quarterly total ever, driven by a number of high-profile mega exits.

Fig. 13: Quarterly Venture Capital Deals*, Q1 2014 - Q2 2019



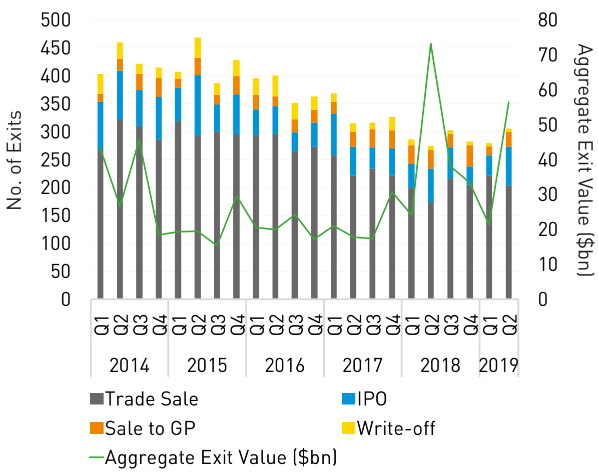
Source: Preqin Pro

Fig. 14: Number of Venture Capital Deals* by Region, Q1 2014 - Q2 2019



Source: Preqin Pro

Fig. 15: Quarterly Venture Capital-Backed Exits by Type, Q1 2014 - Q2 2019



Source: Preqin Pro

**Figures exclude add-ons, mergers, grants, secondary stock purchases and venture debt.*

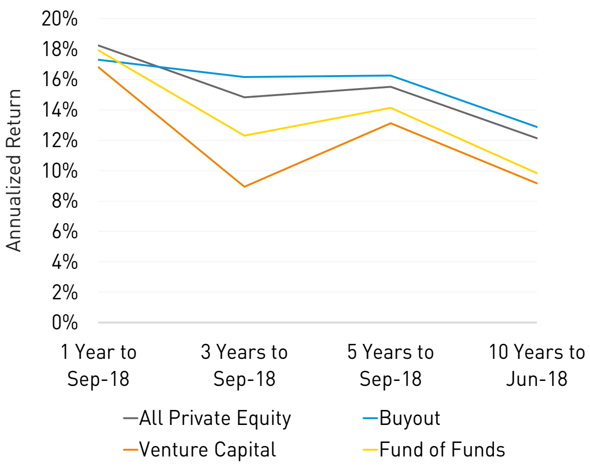
Performance

Private equity funds collectively have posted strong, double-digit annual returns across all horizon periods examined in Fig. 16. Venture capital funds performed the worst of the strategies over all time periods, whereas buyout outperformed the private equity asset class over the three-, five- and 10-year horizons, exhibiting its highest return of 18.2% over the one-year period.

The implications of launching a fund in the GFC years are apparent, with post-GFC vintages outperforming those that began investing during the crisis (Fig. 17). Quartile figures for funds of more recent vintages are subject to change, however, as they are still relatively early in their respective fund cycles.

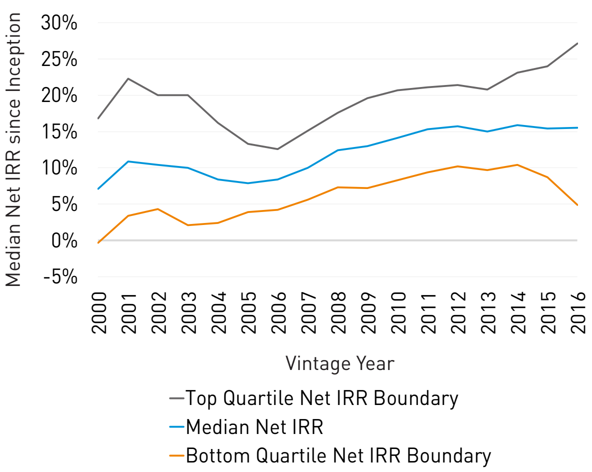
Following six consecutive years of positive annual net cash flow, capital calls in 2017 edged higher than distributions by $2.5bn (Fig. 18). This negative net cash flow can be partly attributed to record levels of capital called up over 2017 ($497bn).

Fig. 16: Private Equity: Horizon IRRs by Fund Type



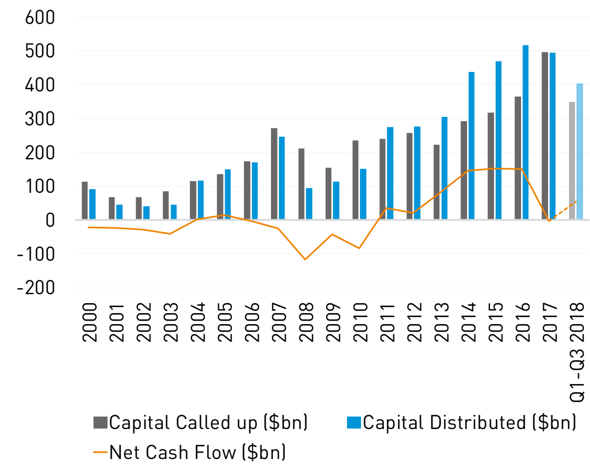
Source: Preqin Pro

Fig. 17: Private Equity: Median Net IRRs and Quartile Boundaries by Vintage Year



Source: Preqin Pro

Fig. 18: Private Equity: Annual Capital Called up, Distributed and Net Cash Flow, 2000 - Q3 2018



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