THE LEAD
https://theleadpc.com/private-equity-now-impact-on-fundraising-lp-perspective/

Private Equity Now – Impact on Fundraising (LP Perspective)

THE LEAD | December 2, 2024

We resume our discussion of the private equity liquidity crunch and its impact on fundraising, this time from the LP's perspective. The supply/demand imbalance in the fundraising environment has shifted to favor LPs. This gives them greater GP access, longer diligence windows, and more negotiating power with LPA terms.

But many LPs, their investment programs tied to distributions, are hamstrung: no cash in means no cash out. For those with ample dry powder and who deploy from independent pools of capital, now can be a great time to invest. That said, there are pitfalls to avoid.

Lower distributions dominate headlines, but less publicized is a slowdown in capital deployed. GP grapple with fewer exits, which means fewer businesses bought. Compounding the issue is the number of GPs raising capital and the amount of dry powder chasing assets. For LPs looking to deploy capital, choosing managers who can't find enough opportunities or settle for lower quality assets that introduce unnecessary risk into the portfolio is problematic.

The first line of defense, then, is to find the best GPs with the mechanisms and strategies to source the right deals. A flight to quality is a good place to start. Over time we have found low correlation between purchase multiple and investment return (within reasonable parameters), confirming the notion "you get what you pay for." The deal flow to sponsors who seek the highest quality assets is less impacted by the market slowdown, since the flow of "A" assets hitting the market has been resilient.

Next is a demonstrated track record of proprietary origination outside of banker-led auctions. A middle market focus is helpful because it insulates investors from capital markets-derived changes in deal flow. Unlike large cap strategies that largely buy assets from other sponsors, middle market GPs source much of their deal flow from family and founder-owned businesses. Companies without institutional involvement are more likely to time a sale on the owner's life circumstances rather than macro or fundraising issues. Availability of assets for purchase is accordingly more durable for middle market acquirors, granting GPs enhanced deployment stability.

Finally, we suggest there are benefits to investing consistently across vintages. An excellent way to decouple a portfolio from challenging economic and market periods is to diversify away from them, constructing programs to invest through all business cycles. As we've argued in previous commentaries, trying to time the market for private capital investing rarely works. We argue that consistent capital deployment is a best practice. The best path is to always be buying.

We covered last week the question of DPI as a meaningful metric from the GP's perspective. And while a strong track record returning capital in all environments is a positive KPI, equally important is the ability to demonstrate portfolio company growth. There's no question that exit timing has been slowed across the board. But sponsors can focus on the controllable: growing EBITDA in the underlying assets and positioning portfolio companies for a successful realization at the right time. The "when" may be uncertain, but the "if" is not.

LPs looking to deploy capital are sitting pretty. Given the amount of fund capital seeking investors, LPs enjoy the luxury of choice, even with top managers. Continued focus on the fundamentals of underwriting those managers is prudent, but by keeping a few key principles in mind LPs can find the GPs who are better positioned to deploy successfully in today’s market.