

Getting to Yes - Successful PE Fundraising in Challenging Environment

PE fundraising development

In the past decade, fundraising in PE has undergone dynamic developments. Fundraising describes the process of capital raising by PE funds (also referred to as “General Partners” or “GP’s”) from a diverse set of investors (also referred to as “Limited Partners” or “LP’s”). Historically, the fundraising developed very well until a steep decline in 2008 due to the financial crisis. This trend was followed by a recovery phase in 2010. A low interest environment, paired with a transformation of a number of firms, such as KKR and Blackstone, into core private markets players favored a strong historical fundraising growth and boosted fundraising activities in Europe until the early 2020’s (Lynn, 2022).

The overall fundraising in Europe has averaged at around EUR 50bn, with buyout accounting for over 80% of total allocated assets. Caused by the global financial crisis, fundraising records of EUR 112bn in 2006 plummeted to EUR 16bn in 2009 (Kelly, 2012). Since then, PE fundraising has experienced continuous growth until 2021, amounting to over EUR 134.1bn (McKinsey & Company, 2022). Since early 2022, the PE fundraising environment has been cloudy, with predictions of even darker future fundraising developments (Falconer, 2024). As a result of the global pandemic outbreak in 2019, rising operating costs and resulting inflation jumps have increasingly put pressure on PE funds’ financial performance. The below average returns of the asset class, among others, fueled LP’s continued loss of confidence and is reflected in European fundraising slumps to EUR 93bn in 2022, being the lowest since 2017 (McKinsey & Company, 2023).

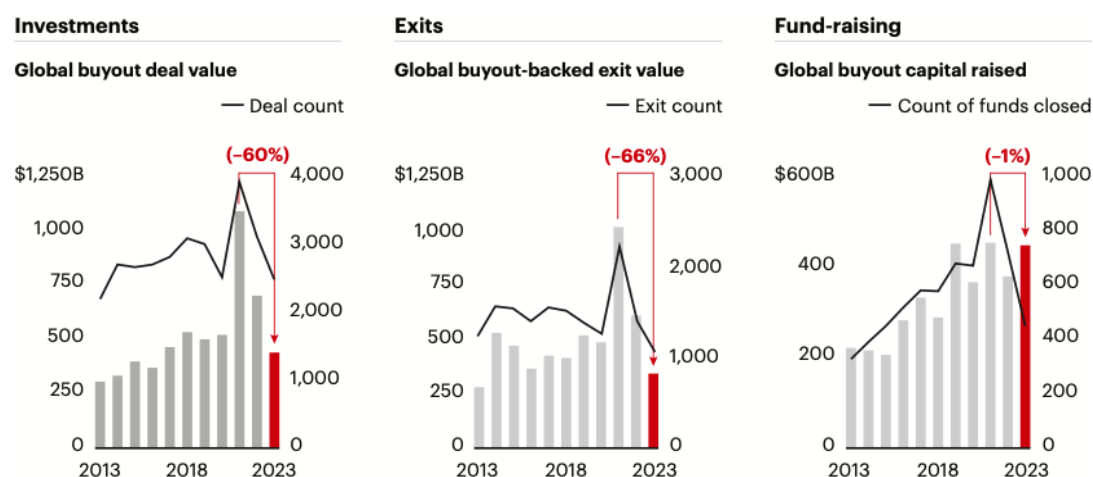
Since 2022, the PE industry is not only facing the aftermath of the global pandemic, GP’s are now also confronted with challenges of higher cost of debt, and the denominator effect, namely the rapidly decreasing public market valuations and resulting overallocation of assets in the private market sector (McKinsey & Company, 2023).

In 2023 and beginning of 2024, macroeconomic challenges prevailed, affecting overall fundraising efforts. Despite an overall European fundraising growth of 57%, amounting to EUR 157bn, the observed development is somewhat misleading as LP’s shifted assets predominantly towards big, established investors, while a decrease of fundraising in small and midsize vehicles was strongly evident. Further, last year’s fundraising growth in Europe is a result of underfunding in prior years (McKinsey, 2024).

The economic downturn, higher costs of capital as well as increased market competition create a necessity to adapt to current fundraising strategies in order to secure long-term fund success. In the following, the article aims to shed light on GP’s new fundraising strategies and measures to navigate the funds through uncertain waters.

Recent challenges and implications on fundraising strategies

To better understand GPs room for maneuver in regards to fundraising, one first needs to further examine its drivers. Macroeconomic trends such as a low interest environment and economic growth historically favored fundraising activities. In the context of a maturing industry and economic uncertainty, PE fund managers are now required to scale the investor relations function accordingly (Skolnik et al., 2023a). Paired with rising interest rates and inflation, the macroeconomic conditions took a toll on PE returns as well as deal activity. According to Bain’s Global PE Report (2024), “deal value and deal count have fallen 60% and 35% respectively, from their peaks in 2021. Exit value is down 66%...” (p.3). This negative trajectory is also reflected in the industry’s record high dry powder levels, exceeding USD 3.9bn in 2023. The resulting negative cash flows for LPs have further limited their ability to deploy capital in the asset class.



Source: Bain Global PE Report 2024

Introduction of changing fundraising strategies

As the golden era of PE has come to an end, fund managers are obliged to enforce a set of actions in order to regain LPs confidence and to usher in a new era of PE. To gain an upper hand in fundraising activities, GPs consequently must take action 1) on the fund level, as well as 2) on their LP base/fundraising structure.

First of, as LPs are losing confidence in the asset class and are awaiting distributions, fund managers should double down on value creation and higher returns.

As traditional value creation through leverage is now limited, GPs should focus on operational excellence. Optimizing pricing, net working capital improvements, but also the sale of crown jewels, ultimately provide liquidity solutions and a superior return profile. Another option is to deploy more

equity through add-on acquisitions, which both decrease dry powder levels and offer arbitrage as well as synergy opportunities.

This action should be accompanied by a professionalization of the IR function, tackling the increasing industry maturity (Bain & Company, 2024). With almost a quarter of total capital raised by the top 10 PE funds, smallcap and midcap funds are now facing fierce competition for the remaining capital (Wang, 2024). Hence, close and long lasting LP relationships are now a prerequisite for a successful fundraising.

On an LP level, GPs can apply a set of levers for a smoother fundraising process, comprising the investor base structure and different fund structures.

In terms of the investor base, GP's can approach the untapped market of retail investors. This investor base comprises ultra high net worth individuals and family offices, holding approximately 50% of global assets under management. Yet, only 16% has been allocated to alternative asset funds (Skolnik et. al, 2023b). Prerequisite for the investor base restructuring however is again, a highly professional and dedicated IR team as investor management increases in complexity.

Introduction of changing fundraising and exit strategies

The main strategy being recently adopted by most PE funds to address this fundraising issue is deal-by-deal fundraising. The latter is a fundraising strategy PE has as an alternative to traditional fundraising. After identifying a potential investment opportunity, firms reach out to individual investors who might be interested in the opportunity on a deal-by-deal basis, ultimately securing capital for that specific investment.

Although already existing, deal-by-deal fundraising has recently seen an exponential increase in popularity. According to data provided by PE advisory firm *Triago*, a record \$31bn dollars were deployed through deal-by-deal fundraising by PE firms last year. As an indication, the amount of capital allocated through deal-by-deal fundraising in 2019 was around \$6bn dollars. Moreover, the amount of companies bought through deal-by-deal fundraising increased by 50% in the past 5 years.

Deal-by-deal fundraising increased in popularity given its effectiveness in addressing the changes in interests of both investors and partners in a struggling PE market.

As mentioned priorly, an important dynamic of this trend is 'dry powder'. Although PE firms have raised trillions of dollars in the past years, much of it is 'stuck' in LPs capital commitment contracts as GPs are reluctant to invest today. Eventually, investor capital commitment contracts might expire, leaving PE funds without capital. Partners rely on commissions from capital raised, and are aware that proposing new traditional rounds of fundraising to investors will not be viable, as investors are reluctant to blindly commit as their past commitments still have not been invested.

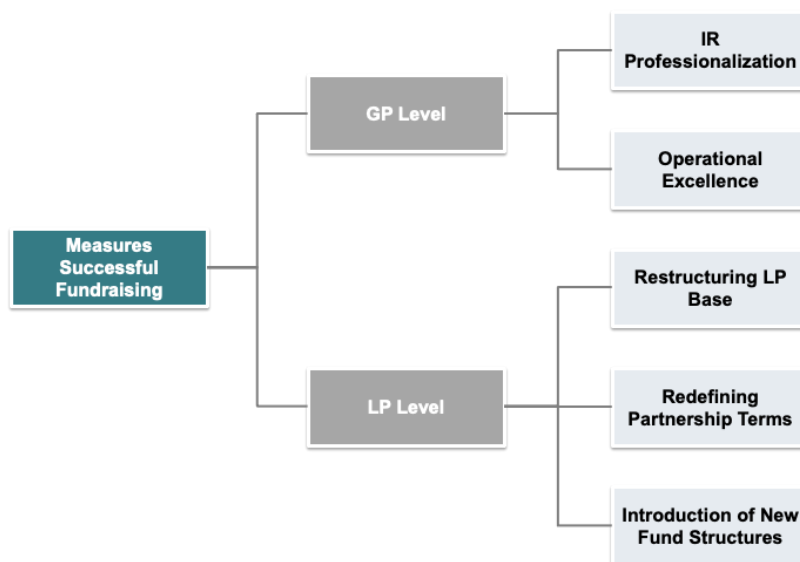
Given this deadlock situation, what partners can do is to propose deal-by-deal fundraising. The latter “are favored by institutional investors because they have the opportunity to cherry pick their preferred companies”, as stated by Sunaina Sinha Haldea, head of Private Capital at Raymond James, and obviously allow partners to receive a certain level of commissions.

Similarly to fundraising strategies, PE’s traditional exit strategies have also become challenging, giving way to alternative exit strategies such as continuation funds.

Continuation funds allow sponsors to keep investments they are reluctant to sell or go public with given current unfavorable market conditions. They do so by transferring existing investments from the original fund into a new vehicle, ultimately prolonging the lifetime of portfolios by five to seven years.

According to PitchBook, the PE market saw 71 exits into continuation funds totaling a value of \$6bn, meaning around a 70% increase in both the amount of exits and their value compared to 2022. PitchBook also estimates the figures to increase in 2024.

In the past decade, continuation funds have been considered as a method to deal with underperforming assets in need of recovery. However, given the recent market conditions, continuations funds have significantly increased in attractiveness as they provide a safe stay option for both GPs and investors. As noted by senior VP of Sequoia Financial Group, Nick Zamparelli, “the structure of continuation funds, used responsibly, can benefit both the fund and the investors by allowing the fund to take later exits and the investor to receive liquidity earlier.”



Source: Bain Global PE Report 2024, own analysis

Explore possible short/long term effects and implication of new strategies on PE performance as well as attractiveness

On the whole, the future PE landscape will undoubtedly be affected by the rise of new fundraising strategies. By resorting to deal-by-deal fundraising, PE firms will benefit from more flexibility in their portfolio management and greater recognition of their efforts and track record, ultimately enhancing additional funding availability as well as investor relations. However, deal-by-deal fundraising as well as any other kind of fundraising activity will also imply stronger competition among firms when it comes to selecting the best target company. Another aspect to be considered is the impact on management fees: as many fund investors and LPs are increasingly questioning the 2% management fee on committed capital, the deal-by-deal fundraising allows to bypass the traditional management fee and carry structure, leading to a fee negotiation on a deal-by-deal basis, with fees being paid once the capital has been deployed.

Continuation funds, in turn, may potentially redefine the constraints of the traditional PE model by enabling fund sponsors to retain assets beyond the customary 10-year fund term. With a continuation fund, instead of liquidating an asset that has not yet realized its full potential and selling it to third parties, the same fund sponsor can sell the asset to the newly established fund. LPs that invested in the legacy fund can either roll their interests into the continuation fund or exit; new investors, on the other hand, may enjoy the opportunity to invest in more “mature” and visible assets. Despite the surging popularity of continuation funds among PE investors, some investor resistance still persists. Some asset managers criticize their circular structure, tossing assets back and forth like in a Ponzi scheme. Additionally, in August 2023 the SEC approved new rules that aim to provide a check against a sponsor’s conflicts of interest in structuring continuation funds, in order to provide the right price of the asset transferred into the new fund so that LPs will not profit from this new establishment of funds.

Taking everything into consideration, such strategies have the potential to enhance alignment of interests between investors and fund managers over time, fostering better performance and returns for all the stakeholders involved. Successfully managing these new fundraising strategies can position firms for long-term success and potentially higher returns in the ever-evolving PE landscapes.

Conclusion

The PE business must continue to develop and adapt its methods to address the difficulties of an ever-changing economic context. By concentrating on professionalizing investor interactions, increasing value generation, and adopting innovative fundraising and exit methods, PE firms may better match investor objectives with their own, resulting in more stable returns and investor trust. As corporations strive to manage the intricacies of global financial markets and regulatory environments, the future of private equity will most certainly place a larger focus on these adaptable tactics.

This strategy development is critical for PE companies' long-term performance in a competitive and continuously changing market, where the goal is to earn significant returns while effectively managing investor expectations and regulatory constraints.

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