Private Equity Partners | market update

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In this installment of our private equity commentary we discuss growing demand for private equity by the institutional investor community.

Renewed Demand

Institutional investors' demand for private equity appears to have grown dramatically compared to 18 months ago. We have noticed a particularly strong increase in interest in the last six months. While it is too early for statistics to show this shift, we are seeing direct evidence of it during our visits with institutional investors and consultants around the country. The increased interest stems from two primary sources, (1) past private equity investors that have been dormant since the recession and (2) new investors to the asset class like many Taft-Hartley plans.

Primary drivers for this increased demand are twofold.

First, many institutional investors have high fixed expenditures, which are not being met by returns from their public market investments. Today, these annual fixed expenditures might equal 5-10% of total assets, but returns expectations for public debt and equity might be just 4-5% and 6-8%, respectively. Because of this conundrum, one well-known endowment recently told us they had been advised by their consultant to nearly triple their private equity allocation because the consultant expected only a 3-4% inflation-adjusted return for public equities over the next 10 years. Pension plans and, and to a slightly lesser extent, foundations are facing similar issues relating to their planned expenditures.

Second, private equity has emerged from one of its worst downturns and the capital overhang that accompanied it has largely dissipated. The recession has passed and the U.S. economy has had 13 successive quarters of real GDP growth. The IPO market has re-opened to provide a fair measure of liquidity to investors. The M&A market is also robust and providing additional liquidity to investors. Banks are lending again to financial buyers. Investment multiples have risen, drawing higher quality companies onto the auction block. Innovative companies that had bootstrapped their finances with loans from founders, government funding and university research grants are poised for growth given the right capital infusion. Such bootstrapping means early stage VC investments are being made at a later stage, in more mature companies, compared to a few years ago. Early stage VC firms like Labrador Ventures confirm that there is a groundswell of fresh entrepreneurs and high quality management teams available today—many of whom had sought shelter at big corporations but are now rejoining the private equity community. A spate of high-quality LBO and VC firms are raising new funds after a 4-5 year hiatus. Returns expectations have normalized, with many predicting returns will outperform public equity by 500 bps or more.

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1993 vintage year LBO and VC funds (i.e., funds launched after the previous U.S. recession), enjoyed a favorable investment environment and generated strong net IRRs of 21.2% and 29.2%, respectively. The private equity industry has evolved since 1993, but there is a certain familiarity in the air. Many institutional investors are now allocating 5-10% of their assets to private equity. We believe they will continue to increase their private equity allocations in the near term to take advantage of current circumstances.

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