

LP Perspective: Cautious Optimism in a Challenging Market

- Tripp Brower, Capstone Partners

Preqin: How are LPs viewing the market in January 2010? Have their views changed compared to this time last year?

TB: The market has certainly improved from where we were at this time last year, but it is not yet back to normal. In January 2009, many LPs were worried about the effects of the financial crisis: the denominator effect, the implementation of FAS 157 and its impact on valuations, the lack of distributions and an uncertain future capital call calendar. For these reasons, many LPs went into hibernation.

LPs now have more stability, but there is no sign of a return to 2007/08 commitment levels; many have an interest in rationalizing their GP relationships, and 2010 presents them with an opportunity to do so. The general theme is one of cautious optimism. This year will be better than last, but will remain a grind. Liquidity concerns are much lower now – it will be interesting to see if increased capital calls and deal activity trigger LP defaults.

Preqin: How do LPs view the long-term future of the asset class?

TB: In spite of poor recent performance, private equity continues to provide a larger return opportunity relative to traditional asset classes. Performance data for recession and post-recession vintage year investing is compelling; the LP community recognizes this and wants to have capital exposed in 2010/11.

Most LPs remain committed to the asset class, and the term “broken model” is an overstatement. Bargaining power has shifted in favor of LPs, which we routinely see driving greater alignment of interests compared to prior down cycles. This is the first time that LPs are coming out of a down cycle with a unified voice about driving terms towards a more market neutral or LP-friendly result.

Preqin: What are the key issues for LPs?

TB: There has been a focus on operating capabilities versus financial engineering. This has been a recurring theme over

the years but has now become of greater importance to LPs.

With regards to terms and conditions, the pressure has been on logical areas such as management fees, transaction fee splits and the elimination of deal-by-deal carry structures. Certainly the European waterfall concept is a frequent ask from most LPs. Key-man clauses are also going to be important; clauses with teeth, not the structurally open ones we have seen in the past. We are likely to see turnover in the GP ranks; many firms will not see carry and many will not survive. Smart people will decide to move on when this happens, which could cause a real problem in the industry. LPs are looking to ensure they have protection in these situations.

Larger than normal GP capital commitment can be a true differentiator. A number of GPs will not see carry in their most recent 2005-07 vintage funds, and will therefore find an increase in GP capital commitment difficult to achieve.

The private equity model is not necessarily broken but is certainly undergoing refinement. By way of example, in early 2009, a forward-looking GP recognized a compelling market investment opportunity contrasted with constrained LPs largely sitting on the sidelines. The firm was quite flexible regarding structure and challenged us to create a new model. We strongly advised them to let the “market speak” and entered into discussions with 15 active, sophisticated LPs with allocation. We discussed the team, market opportunity, performance and shared the openness around structure. All 15 LPs concluded that the standard 2/20 private equity structure with well-aligned terms was better than doing something overly creative. That GP was one of the successful first-time funds last year and had a very meaningful institutional closing.

Preqin: What will be the key trends in 2010 and what are the big areas of interest for LPs this year?

TB: We expect that 2010/11 will be a crowded market – many GPs competing

for finite dollars. As a general rule, GPs will face larger than normal gaps created by LPs who do not re-up, or re-up but at a lower level. The fundraising time frames will be

extended for all but the top decile GPs. LPs will continue to put pressure on lower fund sizes. We expect to see GP turnover and spinouts because of poor performance and no view to carry, resulting in the inability to raise successor funds.

Realizations will continue to be critical. Average performance will be a very tough sell to existing investors, and a non-starter for new investors. First-time funds without a realized track record will be more difficult (i.e. nearly impossible) to raise.

We routinely hear interest in “smaller funds”. It is difficult to define what size this is exactly – different LPs have different definitions – but many LPs will gravitate to funds focused on small- to mid-cap deals in their search for compelling returns. There is increasing appetite for small-cap buyout, turnaround and control distressed funds and we also see interest in distressed/opportunistic real estate, certain industry/sector strategies (e.g. clean energy) and specific emerging markets (mostly China and Brazil). We have seen less interest in mega buyout funds (except for certain brand-name firms), venture capital and core real estate funds.

Although actual commitments in 2009 did not line up with the indicated interest from LPs, we expect to see interest in credit funds (e.g. mezzanine) and more secondary activity in 2010. In the secondary market, there was a large bid-ask spread last year, so not many deals got done. We sense, and many LPs share our view, that the tide will turn this year. More secondary market deals will close; a significant amount will happen through dedicated secondary funds. Sophisticated LPs will also utilize the secondary market as a tool to gain additional exposure to their “buy list” GPs.

In short, look for 2010 to be directionally better than 2009, but not a return to normal fundraising in terms of magnitude, pace or degree of difficulty.



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