Privcap/Report

Includes a bonus interview with

Steve Pagliuca

Managing Director, Bain Capital

Q3 2016 Fundraising Roundup

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Co-investment Grows, But Should It?

About This Report

This publication is a companion to Privcap's Fundraising Roundup, a quarterly video program on the latest trends in private equity dealmaking.
You can watch the full program here.

About the Experts

Alan Pardee is a managing partner and co-founder of Mercury Capital Advisors, among the world's elite institutional capital-raising and investment-advisory enterprises. Pardee was previously a managing director and chief operating officer of Merrill Lynch Private Equity Funds Group.
Learn more about **Mercury here.**

Click to watch the companion video

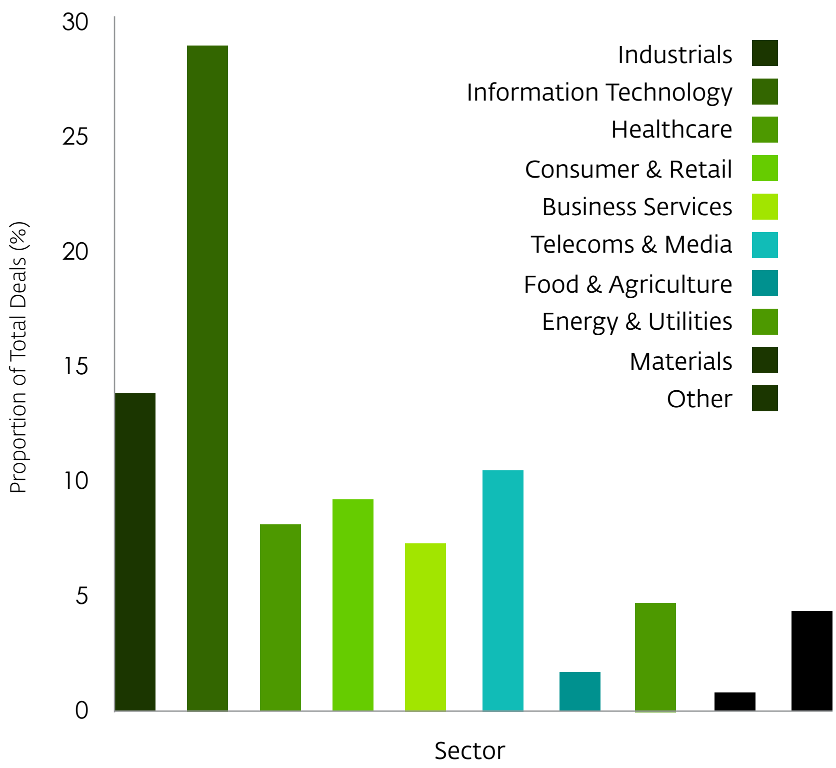
Mark O'Hare was one of the founders of Preqin in 2003 and is responsible for the company's strategic development. O'Hare was previously a manager with Boston Consulting Group and founded Citywatch, the equity shareholdings information service that is now part of Thomson Reuters.
Learn more about **Preqin here.**

David Snow is CEO and co-founder of Privcap Media, the leading channel for thought leadership in private capital investment.
www.privcap.com

The Q3 Numbers: Software Goes Big

PE-Backed IT Deals Far Outpace Other Sectors

Source: Preqin



Privcap: Let's start with data. It looks like Q3 was strong and may make 2016 a banner year for fundraising.

Mark O'Hare, Preqin: Absolutely. We've got an environment where LPs are happy with the returns they're getting. They want more private equity, and guess what? They're getting very strong returns and distributions back from their GPs. So all the stars are aligned.

Alan Pardee, Mercury: Fundraising has been robust this year. And every year, there is a bulge of fundraising that takes place in the fourth quarter, simply because people need to use the allocation of that calendar year. It also speaks to why, in the first quarter, one ends up with another bulge as people are reaching into the following year to access that capital and commit to the fund.

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In the third quarter, Thoma Bravo, which is largely a software-focused private equity firm, had the biggest fundraise. How important is that subsector?

O'Hare: More and more GPs are focusing their activities around industry verticals, and software clearly is a very important one that's been important in M&A globally recently, and hence in private equity deals.

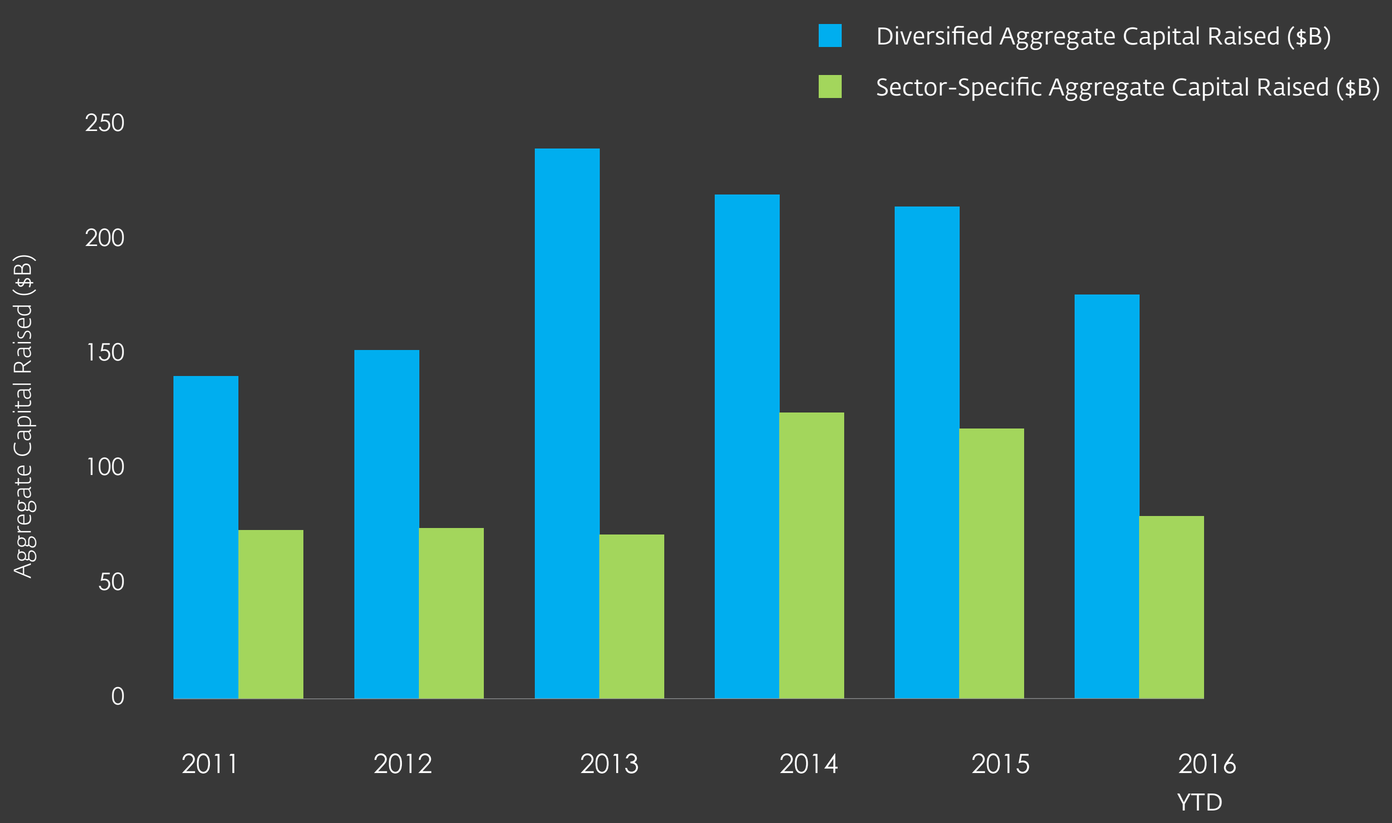
Pardee: What we've definitely seen over the last dozen years—even going back to the late 1990s—has been the rise of the sector fund. Software is obviously a key driver of value in many companies. In fact, in some cases, it's hard to define what is a software company versus what is a business-services company; it's a part of everybody's operations, at this point. So you see it, in part, in the rise of groups like Vista and Thoma Bravo. You also see it in some generalist funds that have it as one of several verticals. So it's an important piece of fundraising, and an important piece of the economy in the U.S. and globally.

Is the interest in software similar to the boom in energy funds before oil prices collapsed? In other words, its recent outperformance, as much as the sector itself, is driving capital flows?

Pardee: You'll find that software and all things that one might fit into IT have done very well. There's not a commodity cycle to worry about, of course. If you were to break up those funds—the focus and the sector—and see their track records laid out, you'd find that in most years, people do well with software.

Diversified Fundraising Drops Globally as Sector-Specific Funds Gain Traction

Source: Preqin



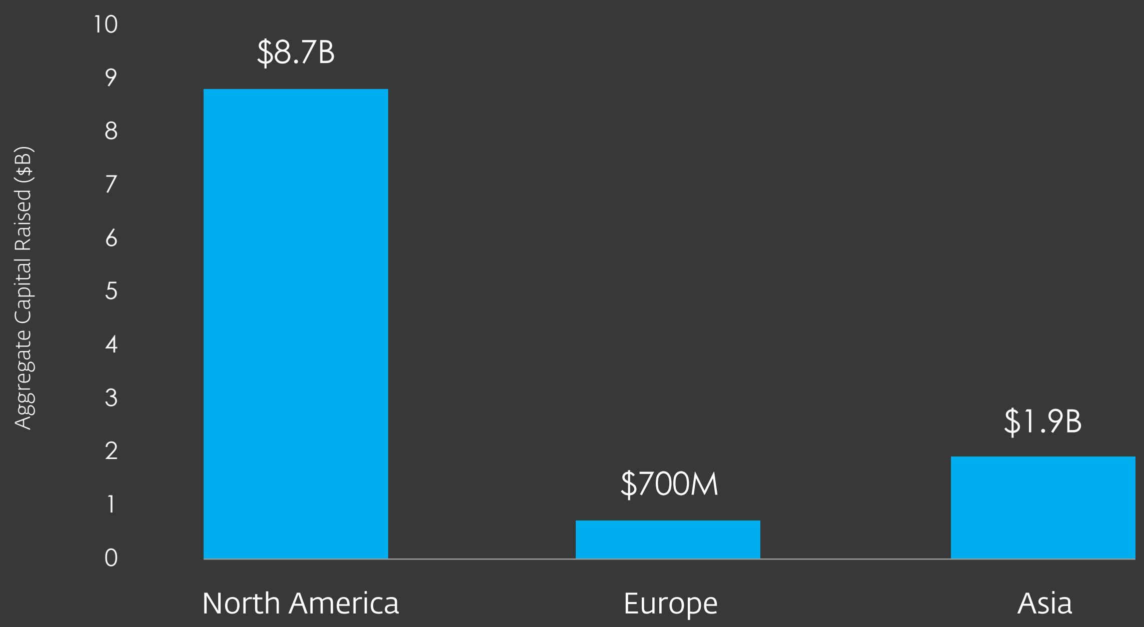
The VC Market: Asia Outpaces Europe

The vast majority of venture capital funds have been U.S.-focused. And yet the data shows that Asia-focused VC funds have done very well, even outpacing Europe. Mark, what's behind that?

O'Hare: I think a good leading indicator of fundraising is the deals that are being done. And if you look at Asian venture capital deals, whether in number or in value, the numbers turn out to be quite similar. And Asia was 10 percent, 15 percent of the global total even five or six years ago. It's now 30 percent or 40 percent. So it's still behind the U.S., but it's growing incredibly quickly.

Pardee: We've been involved with an Asian venture capital fundraising recently. Asia is a place of dynamism, a place of innovation. And that tends to track how the capital gets formed. Distinct from how things work in the United States, you do have a fair number of corporate actors that substitute the need for VC funds. That's whether they are large tech companies that do their own corporate venturing, or it's some of the sovereign wealth funds that participate in backing some of these organizations. And of course, the public markets, with all of the many unicorns, have been doing some of what VC had traditionally done. If you look at the United States, what we're really talking about is the 38 square miles of Silicon Valley being the focal point of most of the venture fundraising.

Asia Gains on North American VC Fundraising



Source: Preqin

Co-investment Grows, But Should It?

Co-investment vehicles have done very well over the past five years. Is increased LP demand changing fundraising discussions?

Pardee: If you look at the numerous co-investment vehicles that have been raised since about 2013 onward, there's a mirror image to that that you can look at in, say, 2005, '06, or '07. So it's not new, but we're at a time when co-investment is important, where LPs are asking, and the deal volume is such that there's actually something to negotiate about. There have been times where people have asked for one-to-one co-investment to investment right. That's usually done when there's nothing to invest in at the bottoms of markets.

O'Hare: I absolutely agree. But I put in a note of caution. I confess to being quite concerned about the trend to more co-investment. Done correctly, they're a great idea.

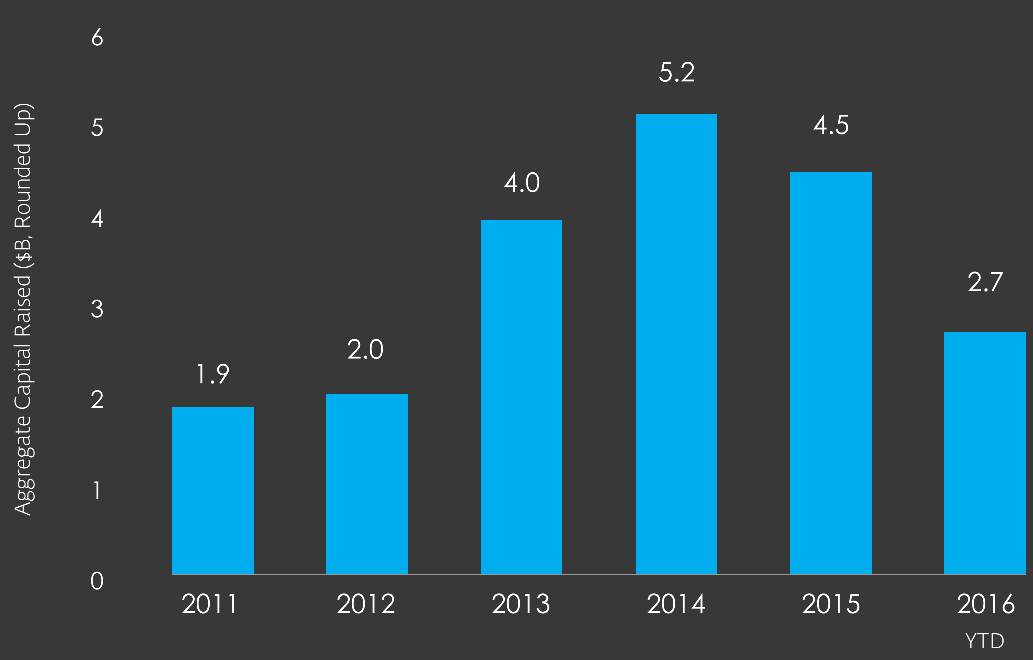
A lot of funds are being raised at the moment where, frankly, a material factor in getting the fund over the line is the promise and commitment to provide co-investment opportunities to the LP. And there you've got to step back. Take two GPs, one with five top-quartile funds and an unimpeachable track record, and the other with a slightly more "iffy" track record. Who is going to be more likely to fill the impetus to make that kind of offer during the fundraise? We all know the answer.

If you're an LP finding yourself negotiating with a GP who can't say anything but yes to your co-investment request, you need to ask yourself if you're getting into the best club you can get into.

O'Hare: As with any negotiation, absolutely. I fundamentally believe that certain types of deals are more appropriate for LP co-investment than others. It's very easy to focus, for example, on the actual deal itself and getting the deal done and what the LP needs to do. And yes, they need to respond quickly and so on. But just as a dog is for life, not for Christmas, so a co-investment is for 10 years, not for the deal. And for LPs to get involved directly in co-investing in an early-stage or a later-stage venture investment—is that truly appropriate? I question that. ■

Co-Invest Fundraising Drops from 2014 High

Source: Preqin



POWER BROKERS:
Steve Pagliuca

Insights from the world's leading investors and dealmakers

Click to watch this video at privcap.com

Michael Ricciardi of Mercury Capital sat down with Bain Capital managing director Steve Pagliuca to talk about how to find value amid shifting market conditions.

Steve Pagliuca
Managing Director,
Bain Capital

Michael Ricciardi
CEO & Managing Partner,
Mercury Capital Advisors

Michael Ricciardi, Mercury Capital Partners: How do you still manage to ferret out value, given all these changes that have taken place in the market?

Steve Pagliuca, Bain Capital: Because of the quantitative easing and because of the search for yield, asset prices have gone very high. So the business is very tough. Many deals we look at, they're not going to generate the returns at the prices you have to pay.

So we've now built specialized expertise and done many, many deals in each of those areas, and that's paid off in terms of our understanding of the industry—what are good companies, what companies need to be improved—and then specifically going in and looking for transformational situations.

Multiples are at the high end of the range; I don't see them going much higher. So you've got to plan for reduced multiples—or the same multiples—and you've got to grow the companies and grow the earnings, so you can make a good return for investors. ■