Private Equity Fans Prepare for Leaner Times

By ARLEEN JACOBIUS | July 29, 2014

Jacques P. Chappuis says general partners are using more debt in deals, reminiscent of the days before the big recession.

Private equity investors and managers are attempting to position their portfolios for a period of lower returns in some sectors and of global economic uncertainty without quantitative easing, if the lively discussions at The Pension Bridge's The Private Equity Exclusive conference in Chicago on July 21-22 are any indication.

Some investors are looking to get in on the ground floor with new emerging private equity managers, many of which have spun out of larger firms. Other investors are looking for returns in emerging and frontier markets, while still others are reconsidering venture capital, mezzanine and other debt strategies. At the same time, some larger asset owners are continuing their push to invest more money with fewer firms. Meanwhile, private equity managers are keeping an eye on pending regulations and the mountain of unspent capital commitments, the so-called “dry powder” needed to invest or return by the end of their funds' investment periods.

Some investors are looking at smaller firms. Among them is the State of Wisconsin Investment Board, which oversees $104.1 billion in assets including $94.6 billion of the Wisconsin Retirement System, said John A. Drake, senior investment officer, private equity, speaking on the panel “Pension Plan LP Perspectives.”

“I believe in being very selective,” Mr. Drake said. “Our peers have done large strategic accounts. We have been going down market.” SWIB is shifting from the megafunds, and now is considering funds of $500 million to $1 billion, he said.

“We like the alignment of interests down there,” Mr. Drake said. SWIB has also been active investing on the private equity secondary market, he added.

'Build a relationship hook'

Dale Martin, director of illiquid alternatives at the $4 billion Fire and Police Pension Association of Colorado, Greenwood Village, speaking on the same panel said the Colorado fund is investing its relatively new 26% alternatives target in smaller funds, including those with $200 million in total capital.

As a smaller pension fund, the Colorado fund would be a very small relationship to a larger private equity firm, which means it would not get the same attention or deals as larger limited partners, he said.

Instead, the pension fund aims to make bigger commitments to smaller funds to “build a relationship hook,” Mr. Martin said.

Many at the conference noted signs that the private equity markets are getting back to the prerecession go-go days. General partners are using more debt on deals, almost as much as they did in 2006 and 2007, said Jacques P. Chappuis, managing director, head of Carlyle Solutions, the Washington-based fund-of-funds business of alternative investment firm Carlyle Group. There is also a move to remove covenants, he noted.

“It's a sign of frothy markets,” Mr. Chappuis said, adding that private equity managers are being more careful.

And as the economy picks up, general partners can justify what they are paying, said David Fann, president and CEO of San Diego-based private equity consulting firm TorreyCove Capital Partners, who spoke on the panel “Current State of the Private Equity Market.”

“Private equity should get (returns in the) low- to midteens in this environment,” Mr. Fann said.

Meanwhile, the moderator of another panel on emerging managers, John M. Barger, chairman of the board of investments of the $47 billion Los Angeles County Employees Retirement Association, Pasadena, Calif., said the county fund might consider investing more capital with emerging managers and less with larger private equity firms.

“We think about seeding talented people ... and forgoing some of the larger managers,” Mr. Barger said.

Mr. Barger moderated the panel on emerging managers that also featured Paul Denning, CEO of San Francisco-based private placement firm Denning and Co LLC; Sharmila Chatterjee Kassam, chief of staff, investment division at the $26 billion Employees Retirement System of Texas, Austin; and Kelly M. Williams, president of GCM Customized Fund Investment Group LP, the private markets business of Chicago money manager Grosvenor Capital Management.

The Texas fund might consider investing in funds of funds for its emerging managers portfolio, said Ms. Kassam. While pension fund executives prefer direct investment in private equity funds, they consider funds-of-funds managers more as partners that would help bolster internal expertise in specialized areas.

Different route

Taking a different route, Shawn M. Winnie, senior portfolio manager, alternative investments at the State of Michigan Department of Treasury, Bureau of Investments, said the bureau is making larger commitments, which pushes it into larger and larger funds. The bureau manages the $54.8 billion State of Michigan Retirement Systems, Lansing.

Mr. Winnie noted one reason the fund is making fewer large commitments is because it is harder to manage general partner relationships than it was five years ago. “There are more things to do in the funds ... more LP vs. GP conflict,” said Mr. Winnie who spoke on the panel on pension plan LP perspectives. “This means staff attention is a real problem.” Mr. Winnie has a seven-person unit.

Those attending the conference acknowledged that they are not investing in a bubble. World political and economic affairs have an impact on their portfolios.

Charles Dallara, executive vice chairman of the board of and partner, chairman of the Americas of money management firm Partners Group, kicked off the conference by reminding the group that outside factors beyond their control could have huge impact on portfolios. Two big influences are the impact of the Federal Reserve and other central banking systems around the world removing the quantitative easing that has “levitated” the global economy, he said. “It's a more uncertain world for investors than the market has priced today,” Mr. Dallara said. “Sovereign debt is not the safest investment around. ... It's inevitable that pension funds have substantial investment in fixed income.”

If interest rates rise as a result of the removal of the quantitative easing, “it could be damaging to fixed-income portfolios,” he said. The Ukraine crisis could affect asset allocations, especially fixed income, equity and private equity. Mr. Dallara was the keynote speaker on July 20.

The crisis surrounding the downing of Malaysia Airlines Flight MH17 could not only disrupt Russia's deteriorating economy but also its oil and gas market, affecting global energy markets and the fragile economic recoveries of a number of countries around the world including of Western Europe, the U.S. and Japan, he said during the speech and in a later interview.

Russia supplies around 30% of the gas and close to another 30% of the oil for Europe, which is through Ukraine, noted Mr. Dallara, who was managing director and chief executive officer of the Institute of International Finance before joining Partners Group about 18 month ago. He was also the lead negotiator for private creditors in the Greece sovereign debt crisis in 2011.

This could negatively impact the debt markets and equity markets, he said. It also impacts private equity managers who cannot rely on market dynamics to make returns but have to be prepared for a world where it is up to private equity managers to increase the value of their portfolio companies, he added in the interview.

“We look at the markets today and ask where can an investor hide?” Mr. Dallara queried. “There's not enough mattresses out there.”