FrontLine Research Paper

Interpreting Drawdowns: The Data Lens

Investors in private market funds face the operational challenge of managing their cash efficiently while still being able to answer capital calls. Funds call a proportion of the committed capital ten to thirty days ahead of the payment date. These calls can be planned by fund investors when they are the payment of management fees (usually quarterly in advance) and some recurring operational costs (such as custody, fund administration or audit fees). Other calls are rather unpredictable if related to the actual execution of investments.

Capital deployment in Year 1 does not seem to be correlated with macro-economic conditions.

Fund investors are under pressure to use available cash. In a context of low or negative interest rates, it is difficult to park this cash in short-term liquid and low-risk financial instruments while generating meaningful performance. Thus, fund investors exercise a certain pressure on fund managers to quickly deploy the capital committed to funds. The rationale is that if they do, the performance drag from idle cash will be reduced.

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This reasoning assumes that all else remains equal. This is not necessarily the case for at least two reasons. First, the increasing use of equity bridge financing (also called credit lines) means that even if fund managers actually invest, this does not necessarily translate into immediate capital calls. Instead, they draw on credit lines to magnify their internal rates of returns. Fund investors might face the situation that the capital reserved for actual investments sitting on their account as capital calls are delayed by the use of credit lines. As this practice has gained momentum rather recently, it is difficult to assess the actual impact for investors.

Second, under pressure, fund managers might have less freedom to select the best opportunities over time. Even though fund managers usually have a pipeline of potential investment opportunities when they raise new funds, there is no certainty about when these opportunities will materialise. Putting pressure on fund managers to deploy capital could thus lead them to execute investments they would have normally decided to pass on. This also means that unless a major macro event materializes, the use of investment period extensions should be an exception. Thanks to the high-quality data provided by eFront Insight, it possible to check these assertions with factual elements.

There seems to be an inverse correlation between the amount of capital deployed in Year 1 and the performance of funds.

Exploring the first year of investment periods

Looking at Figure 1, it seems that managers of US LBO funds of vintage years (VY) 2000 to 2010 have been deploying more capital in the first year (29%) than during each of the following ones. Years 2 and 3 are roughly at par (20%) and amounts decline after that rather regularly and rapidly.

At first glance, the recent increase in pressure from fund investors to deploy capital would not imply a radical change of behaviour from fund managers.

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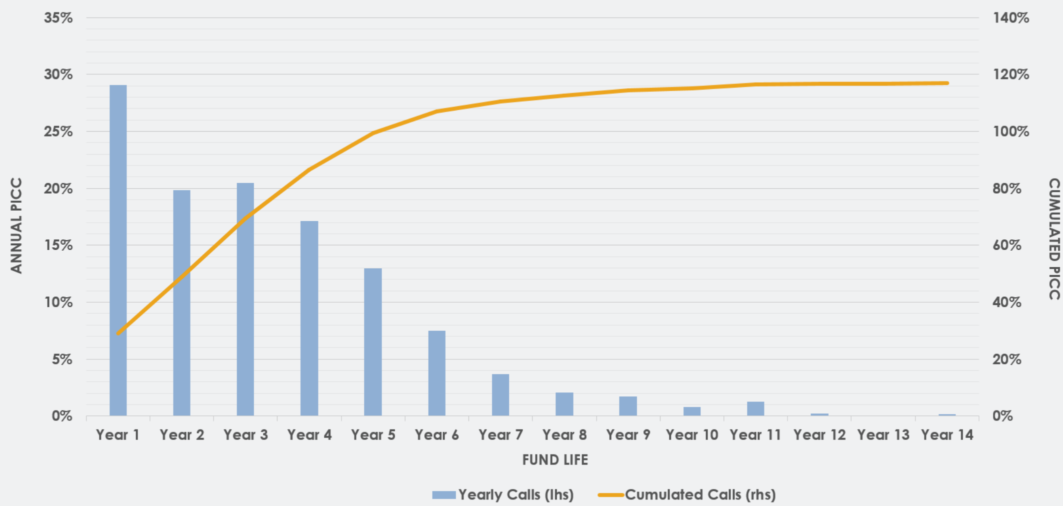
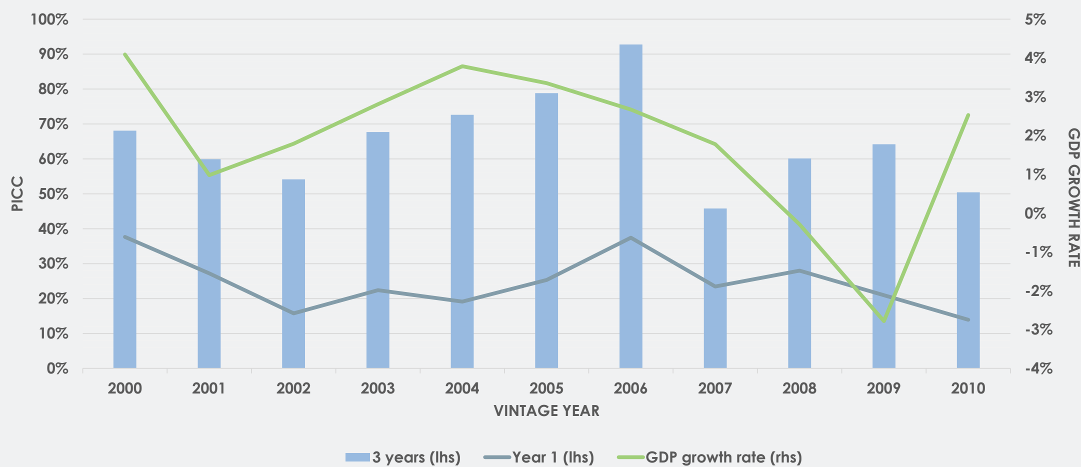
Figure 1 – Yearly and cumulated capital calls of US LBO funds (vintage years 2000-2010)



Source: eFront Insight, as of Q2, 2018.

However, a deeper look (Fig. 2) shows that the amount deployed in Year 1 fluctuates, from 14% (VY 2010) to 38% (VY 2000). Surprisingly, the capital deployment in Year 1 does not seem to be connected with macroeconomic conditions: the coefficient of correlation with US GDP growth is only 0.19. Therefore, the freedom of deployment is not a token in the toolbox of fund managers but a real instrument to optimize investments.

Figure 2 – US GDP growth rate and PICC of US LBO funds (vintage years 2000-2010)



Source: eFront Insight, as of Q2, 2018.

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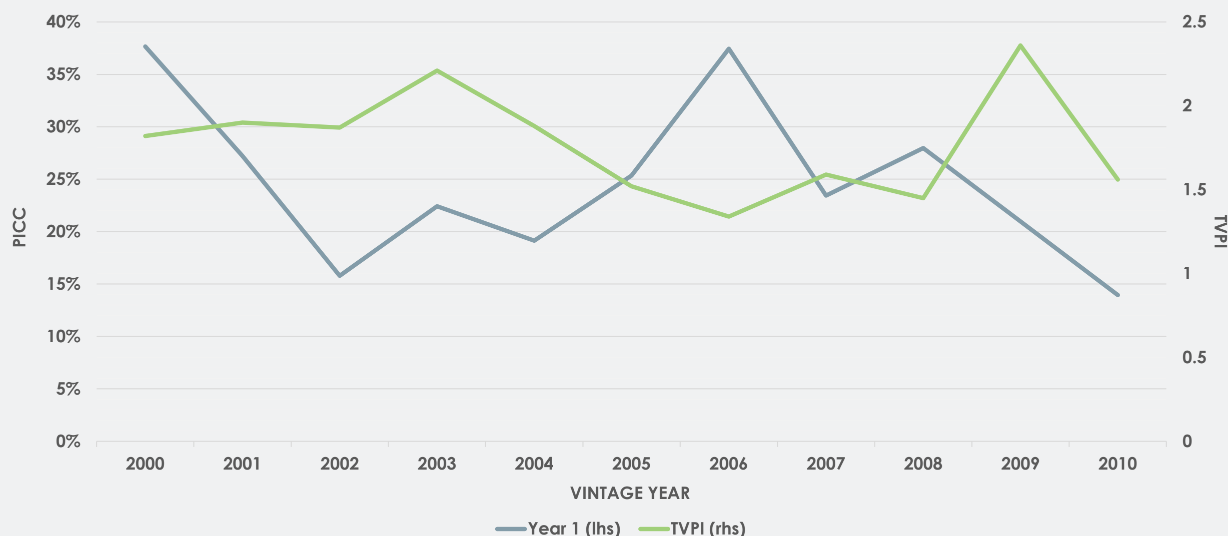
There is a direct connection between the pace of deployment in Year 1 and over the first three years (the coefficient of correlation is 0.59), with exceptions. VY 2007 is, not surprisingly, one of them: after a rather good start, capital calls in Year 3 amount to 8.1%, to be compared with an average of 20.5%.

Nevertheless, some patterns appear. For example, the profile of VY 2001-2002 and VY 2009-2010 is similar, whether for capital called in Year 1, or capital called over the first three years. This would indicate that recessions tend to shape current and immediately following vintage years. In that respect, there seems to be an inverse correlation between the amount of capital deployed in Year 1 and the overall performance of funds (-0.32), as shown by Figure 3. This correlation increases as funds mature, but would require a larger sample to be confirmed.

Figure 3 – TVPI and 1-year PICC of US LBO funds (vintage years 2000-2010)



Source: eFront Insight, as of Q2, 2018. Note: VY 2006 to 2010 still account for a significant residual value. Their performance is still in the making, thus warranting caution in drawing conclusions.

Interestingly, Figure 1 shows that a significant amount of capital is called after the usual end of the investment period of LBO funds. In Year 6, 7% of the committed capital is called, more than half of the capital called in Year 5 and more than the double of what is called in Year 7. This triggers interesting questions, such as for example: how often do fund managers use investment period extensions? Which factors trigger the use of this extension?

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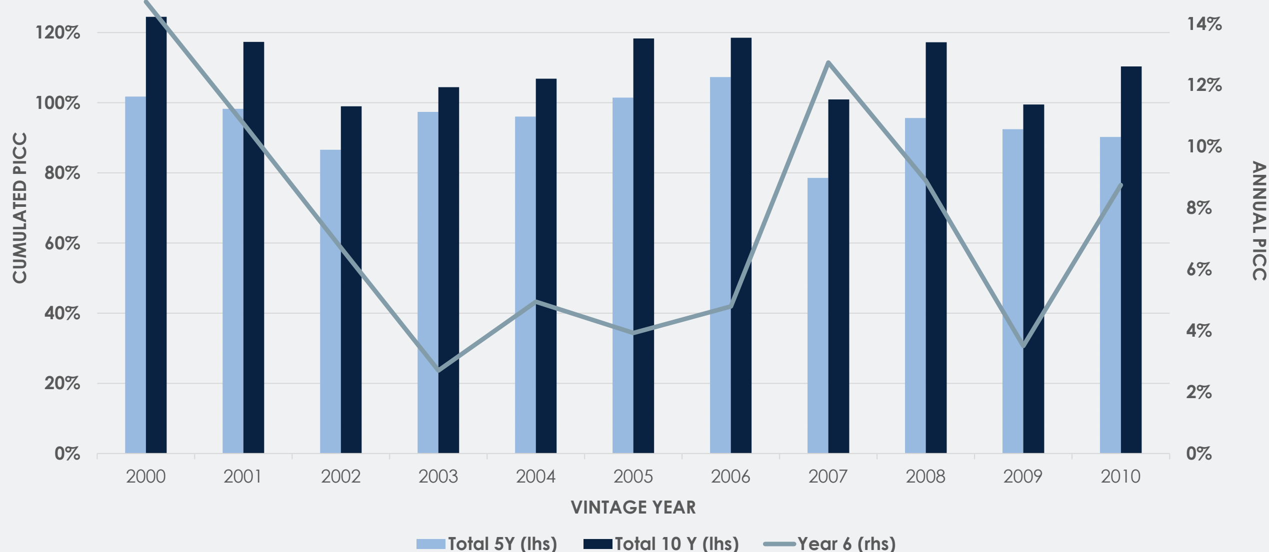
Looking into investment period extensions

Drawing significant capital in Year 6, during the extension of the investment period seems to be routine practice (Fig. 4). Discounting a proxy for management fees of 1.5 to 2% calculated on committed capital[1], only VY 2003, 2004, 2005, 2006 and 2009 draw less than 3 to 4% of the committed capital (probably to pay for additional costs, including divestment costs). That leaves half of the considered vintage years drawing net[2] capital calls of 7.3% to 13.2%.

Figure 4 – Multiples on invested capital of European and North American secondary funds



Source: eFront Insight, as of Q2, 2018.

1 Though in general it is computed on the NAV of funds, so it should be lower than the amount calculated.

2 Assuming a 1.5% management fee on committed capital.

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The most obvious reason associated with an extension of an investment period is that fund managers struggled to deploy capital during the usual five years and needed an extra year. This seems to be true at least for certain vintage years. Funds created in 2002 and 2007 deployed respectively only 87% and 79% of their capital during their first five years (Fig. 4). Not surprisingly, funds of VY 2007 deployed 13% more in Year 6. But funds of VY 2002 deployed only 7%, in line with the average of the period (7.5%).

More surprisingly, funds of VY 2000, 2001 and 2010, which deployed respectively 102%, 98%, and 90% after five years still called 15%, 11% and 9% of the committed capital in Year 6. In theory, at this point, the remaining capital to be drawn to pay the management fees during the divestment years would be insufficient. The logical conclusion is that fund managers decided to use the provision of their fund regulations (limited partnership agreement) usually allowing them to recycle early distributions operated during the investment period to effectively invest up to 100% of the committed capital. This is clearly the case for VY 2000, 2001, 2008 and 2010.

Drawing significant capital in Year 6 seems to be routine practice.

Another explanation, which could explain the 7% called in Year 6 and 4% of capital drawn in Year 7, is that some fund managers might execute buy-and-build strategies. Fund regulations in effect prevent new investments after the investment period, but usually, allow reinvestments in existing portfolio companies (including to support acquisitions). This could be another possible explanation.

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Conclusion

This analysis debunks some common assumptions about drawdowns. One of them is that fund investors have put an increased pressure on fund managers to deploy more capital faster. Given the fact that most of the fund regulations cap the capital deployed in any given year at 25 to 30% of the committed capital, it is difficult to see how much further fund managers can go in that respect. What is also clear from the analysis is that having the freedom to deploy or not is an important tool to invest for fund managers. It also seems that there is an inverse correlation, to be confirmed, between a fast deployment in Year 1 and the performance of funds.

The second conclusion is that extensions of investment periods are not unusual. They might be formally triggered, as in 2007, to allow fund managers to deploy significant capital. Or they might be informal if fund managers reinvest in existing portfolio companies in build-up operations.

Beyond the most obvious reason, compensating for a difficult time during the investment period, fund managers seem eager to recycle early distributions including in Year 6.

It could be tempting to draw definitive conclusions from a limited analysis of cash flows of US LBO funds. Dynamics can differ depending on the type of LBO operated, the size of operations, the relative performance of funds in their peer group and various other factors. However, analysing data provides interesting and undeniable finds, in this case about the dynamics of investment in Year 1 and after the end of the investment period. This is useful food for thought – and for a deeper assessment of criteria when selecting funds.

Note

The aim of this newsletter is to provide readers with elements of analysis and understanding of the private finance universe, based only on data collected by eFront Insight. It does not intend to draw any definitive conclusion, nor judge the performance of fund managers. By providing a guided reasoning, FrontLine hopes to contribute to the overall progress of understanding of the asset class in a short monthly format, with all the limits that this entails.

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