FrontLine Research Paper

Peering into the future: capital distributions

In three decades, private equity has developed from a cottage industry managing an estimated hundred billion of dollars to a fully-fledged asset class with close to three trillion of assets under management. This fast growth has been relatively immune to macroeconomic booms and busts, but it is unclear how long this rapid development can continue.

Five years on, significant net distributions from private equity continue and even accelerated in 2017, possibly leading to significant fund commitments in 2018.

Fund managers compete with each other to raise capital regularly. If the pace of capital inflows in private equity abates or stabilises, this competition will increase. Fund managers will have to work harder to attract capital. This would also reduce some of the pressure on pricing, potentially leading to better long-term returns.

Fund investors track capital inflows to deploy their own capital effectively. Although sophisticated investors avoid market timing, they build their asset allocation dynamically. Their task is to deploy capital while avoiding overheated markets. Part of their challenge is to track capital raised, raised but undeployed ("dry powder") and capital already deployed.

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However, these indicators are only known with a certain time lag and are far from being reliable. While most direct private equity investments will be followed by a press release, most co-investments, mandates, and segregated accounts will stay private. Investors may declare their asset allocation intentions in surveys, but this lacks precision. The pace of deployment, the strategies chosen to deploy capital and the actual capital invested are not consistently and systematically reported.

Private equity portfolios are actually counter-intuitively contracting, due to large distributions and low capital calls, but this fact is hidden by ever increasing residual values.

Capital inflows in private equity are driven by the dynamics of asset allocation, but also by capital distributions that are reinvested in the sector.

Net capital distributions could in effect be an early indicator of the future dynamics of fund raising, assuming that fund investors do not divert them to direct investments, secondaries or other asset classes.

Thanks to eFront Insight, it is possible to track the latter consistently and reliably, and thus to get a perspective on future fund raising.

Capital calls and distributions

Cash flows are of particular importance in private equity, as they provide an unbiased perspective on the dynamics of the sector. Figure 1 provides an interesting perspective on the evolution of the global private equity sector. From 2000 to 2004, the sector called more capital than it distributed.

The balance shifted in favour of net distributions from 2004 to 2006. Then, from 2007 to 2011, funds called again more capital than they distributed. Interestingly, distributions dropped from mid-2007 whereas calls dropped from mid-2008. Both bottomed in the first half of 2009. From 2011 to 2013, they were more or less in line, and it is from 2013 on that the distributions significantly and durably exceeded capital calls.

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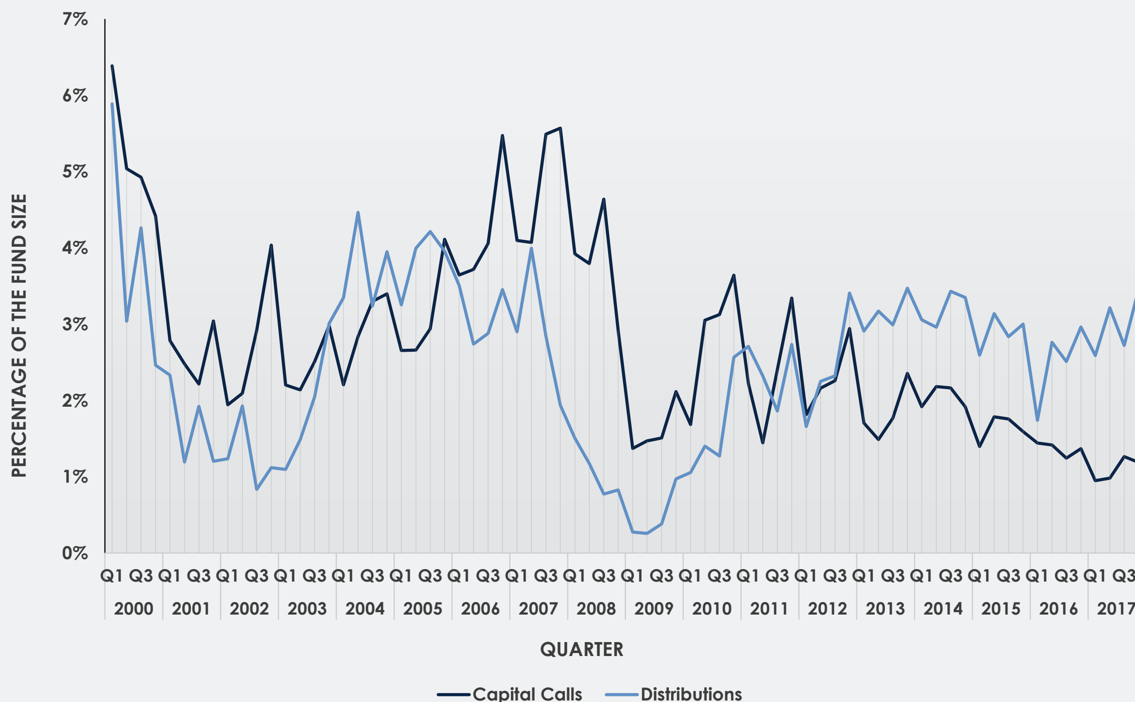
Figure 1 – Global private equity capital calls and distributions by quarter



Source: eFront Insight, as of Q4, 2017.

The current phase is exceptional in its duration and the size of the gap: five years of significant net distributions. This has three consequences. First, there is a significant amount of capital distributed that can be reinvested in funds. Distributions even accelerated in 2017, thus possibly leading to significant fund commitments in 2018.

Second, and even more strikingly, the pace of capital deployment is even slower than during the worst of the 2007-2009 crisis. This is clear evidence of discipline in capital deployment by fund managers, and of a build-up of dry powder. This could translate into a further extension of investment periods of active funds, or fund size reductions.

Third, private equity portfolios are actually contracting, a fact that is counter-intuitive and seems to contradict our introductory description of a fast and continuous increase of assets managed by private equity funds. The reason revolves around 'residual value'.

Assets under management are the sum of the dry powder and the residual value of portfolios. These portfolios are largely marked-to-market to reflect their fair market value. Portfolio companies are quarterly assessed in comparison with their listed peers. As listed stocks have seen a continuous increase in value over the course of the last nine years, the value of assets in portfolio also increased. This phenomenon masked a more muted contribution of new assets to the increase of portfolio valuation.

In addition, calls and distributions do not track exactly the same cash flows. Capital calls include management fees, for example. At times, capital calls might give the impression that investments are higher than they are. Distributions embed performance. Therefore, the gap between capital calls and distributions cannot immediately be used to assess the actual shrinkage of private equity portfolios, but the fact that the gap is significant and lasting leads to this conclusion.

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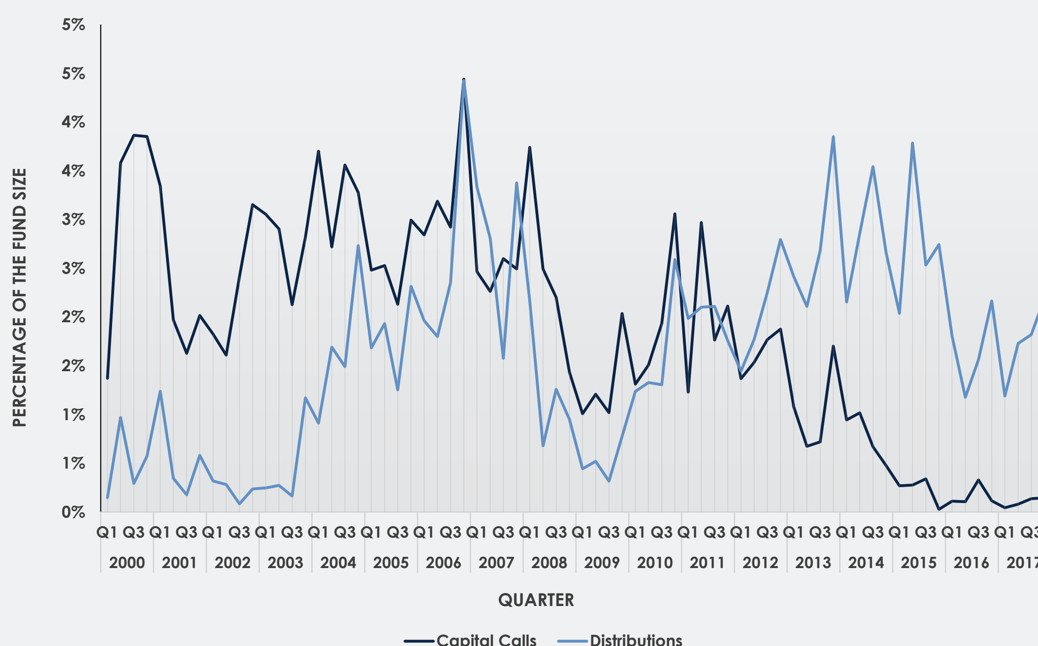
Proof by funds of funds

A confirmation comes from primary funds of funds (Fig. 2.). Funds of funds deliver a perspective on cash flows as seen by a fund investor deploying capital methodically over three years every year in a professional program. They add a layer of fees and smoothen calls and distributions. The image that they provide is even more contrasted than in Fig. 1: capital calls exceeded largely distributions until 2005, in a phase of portfolio build-up. Then, from 2005 to 2012, contributions and distributions were closer, though investors still overall contributed on a net basis. Since 2012, distributions have been significant and capital calls have been below the level of 2009 in 2013 and then since 2014 on to be minimal since 2015. It is as if the 2012-2017 period was the inversed mirror image of 2000-2007.

Funds of funds provide an ever more contrasted image: 2012-2017 is the inversed mirror image of 2000-2007.

Figure 2 – Capital calls and distributions of primary funds of funds by quarter



Source: eFront Insight, as of Q4, 2017.

Further analysis

US venture capital (VC) is the source of the massive distributions of 2000 (Fig. 3). After the end of the IT boom, capital contributions and distributions have followed the three phases mentioned above, although the gaps are more moderate than those exhibited in Fig. 1 and 2. This is also visible for Western European VC (Fig. 4), without the massive distributions of 2000. Thus, it is US (Fig. 5) and Western European LBO (Fig. 6) that are driving the evolutions described along with Fig. 1.

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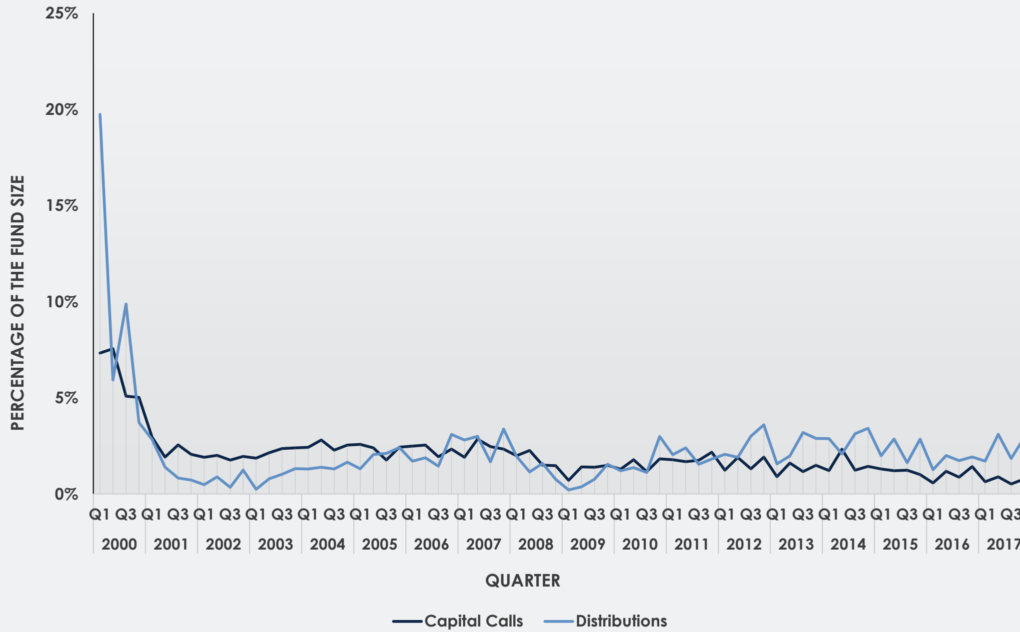
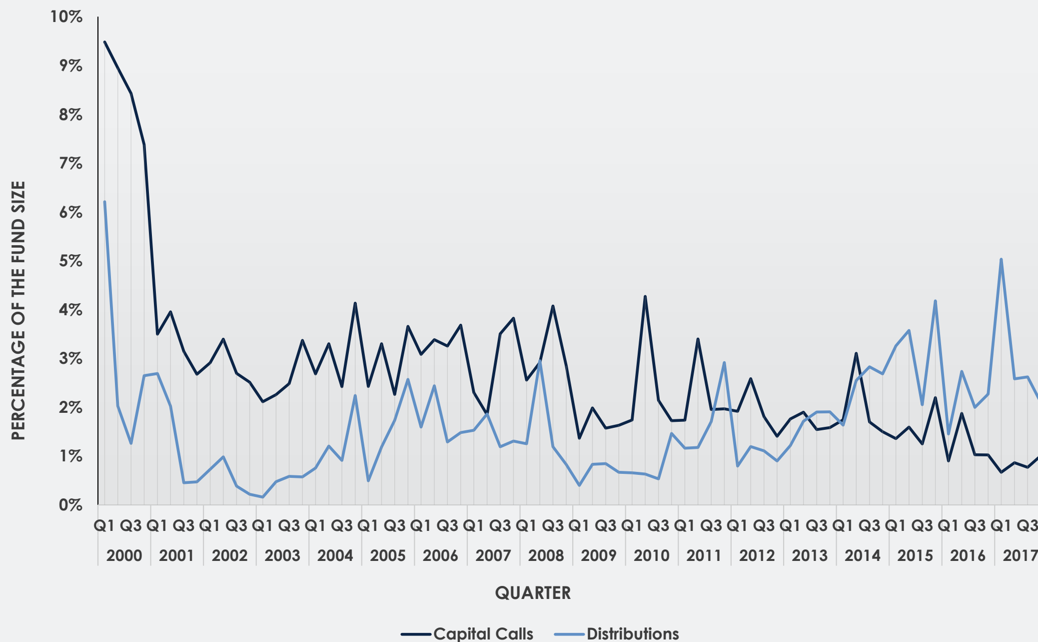
Figure 3 – Capital calls and distributions of US venture capital funds by quarter



Source: eFront Insight, as of Q4, 2017.

Figure 4 – Capital calls and distributions of Western European venture capital funds by quarter



Source: eFront INSIGHT, as of Q4, 2017.

Indeed, US LBO is the major contributor to the 2004-2006 episode of net distributions, while European LBO funds did not experience it. That makes the large net distributions post-2013 even more striking.

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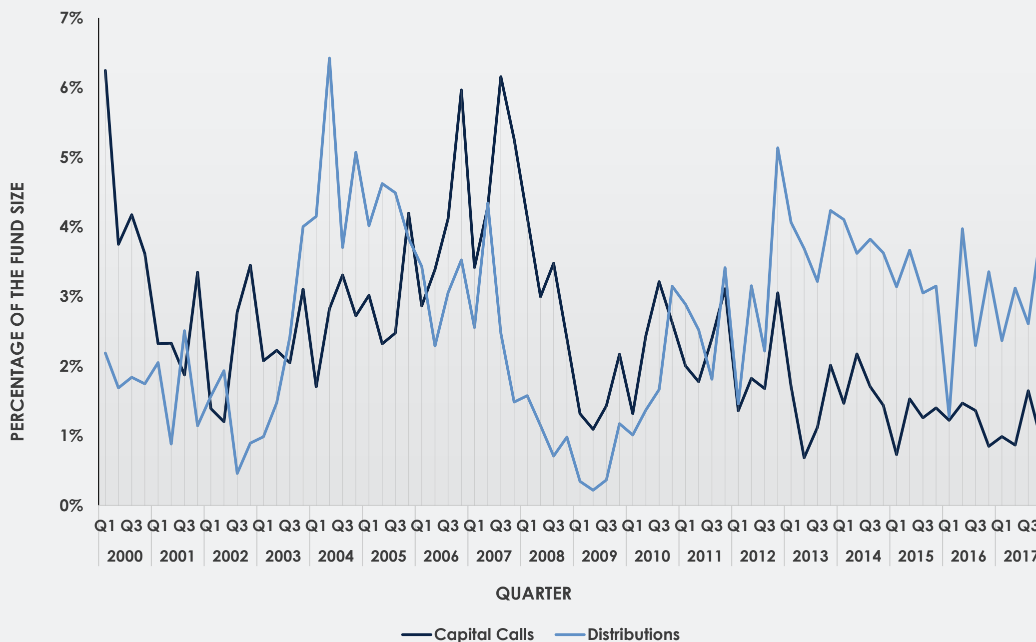
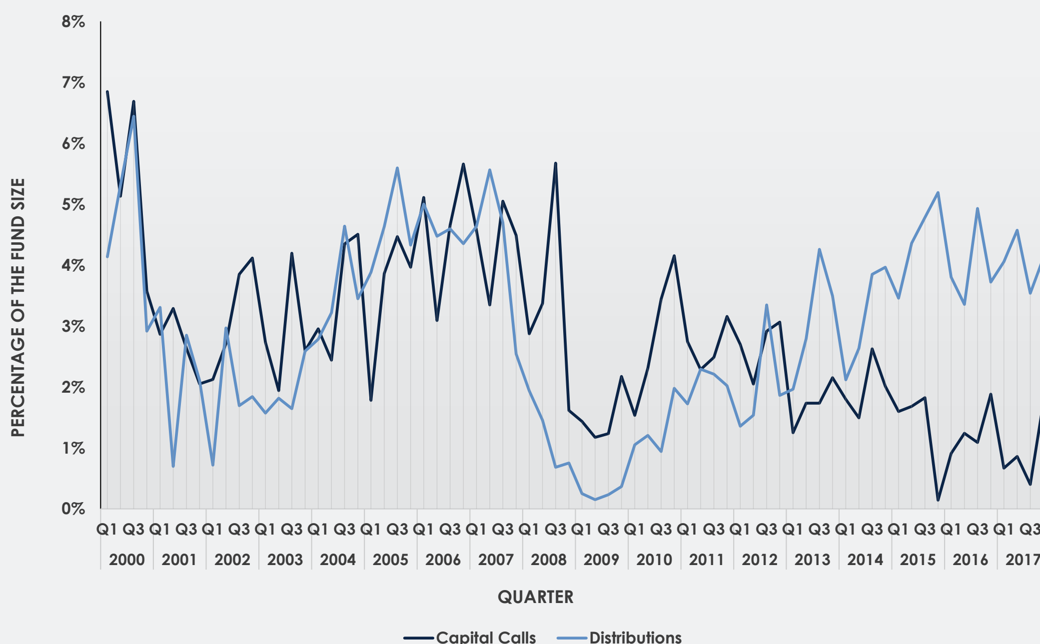
Figure 5 – Capital calls and distributions of US LBO funds by quarter



Source: eFront INSIGHT, as of Q4, 2017.

The significant dip in distributions at the beginning of 2016 is a clear indication that distributions are sensitive to the climate of capital markets. It will be interesting to observe how the correction of early 2018 will affect distributions, but also capital contributions as funds seem to have been affected as well (with the notable exception of US LBO funds). An interesting perspective on market disruptions is provided by US Distressed debt (Fig. 7).

Figure 6 – Capital calls and distributions of Western European LBO funds by quarter



Source: eFront INSIGHT, as of Q4, 2017.

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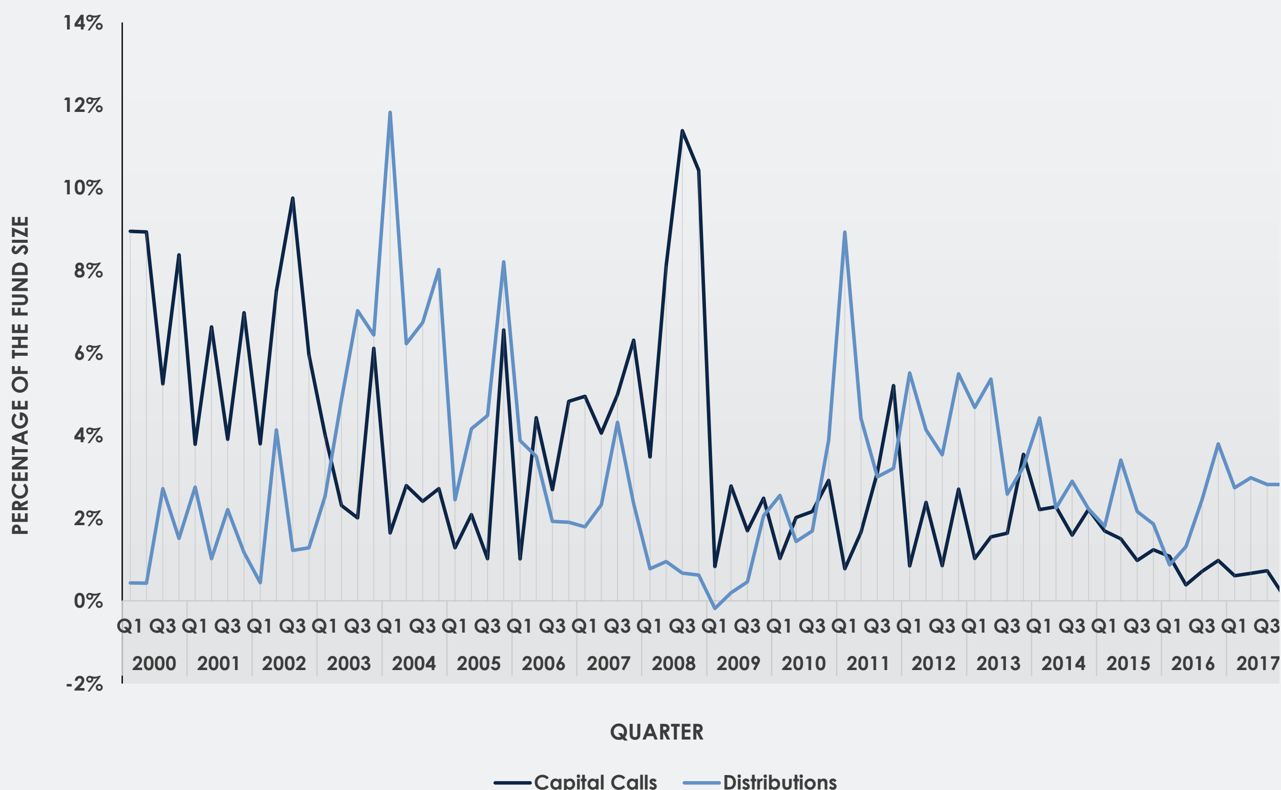
Capital calls and distributions of US distressed debt funds provide additional insights. First, the recession of 2001-2002 materialized in a capital call peak in 2002. There was also a clear boost of activity in 2008. This shows that distressed debt tends to be particularly active when other LBO funds are not. Favourable conditions for exits have materialized in 2003-2005, as much as for US LBO funds. Conditions were particularly attractive in 2011 and remained attractive until 2013 and then exits declined. This diverges significantly from the situation experienced by LBO funds, which have seen their significant net distributions starting in 2013. Distressed debt confirms its role as a differentiated source of returns in a private equity portfolio.

Figure 7 – Capital calls and distributions of US distressed debt funds by quarter



Source: eFront INSIGHT, as of Q4, 2017.

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Conclusion

If net distributions are assumed to be a reliable and valid proxy for short-term fund commitments, then the record net distributions of 2017 foretell significant commitments in 2018. This assumes that fund managers will raise large funds able to accommodate this cash inflow. One of the findings of the analysis of capital calls and distributions is that, in practice, portfolios are shrinking, beyond the optical illusion of fair market values. This has multiple practical consequences. First, a significant and durable correction will also deflate residual values significantly as the number of portfolio companies will have decreased.

Since 2014 capital calls have remain below the lowest point of 2009 and are minimal since 2015.

Second, fund managers continue to exercise a strong discipline in their investments. This would lead to stronger mid-term performance as they limit their exposure to high valuations. Finally, in case of significant market correction, distressed debt funds are expected to react fast and strongly, as was the case in 2002 and 2008.

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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