CIBC PRIVATE WEALTH MANAGEMENT

CIBC Private Wealth Blog

Private Equity: Too Much Demand

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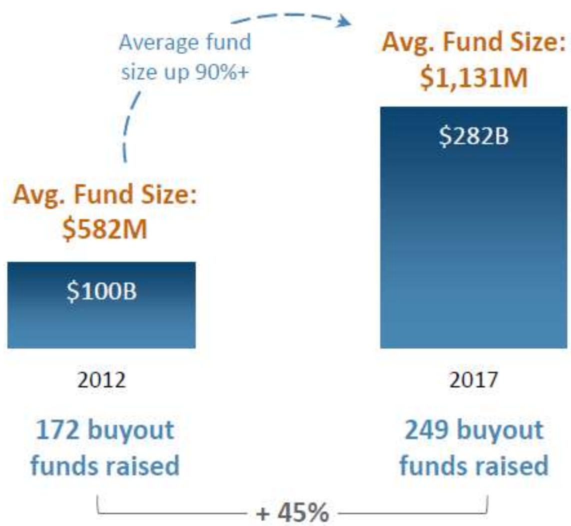
May 22, 2018

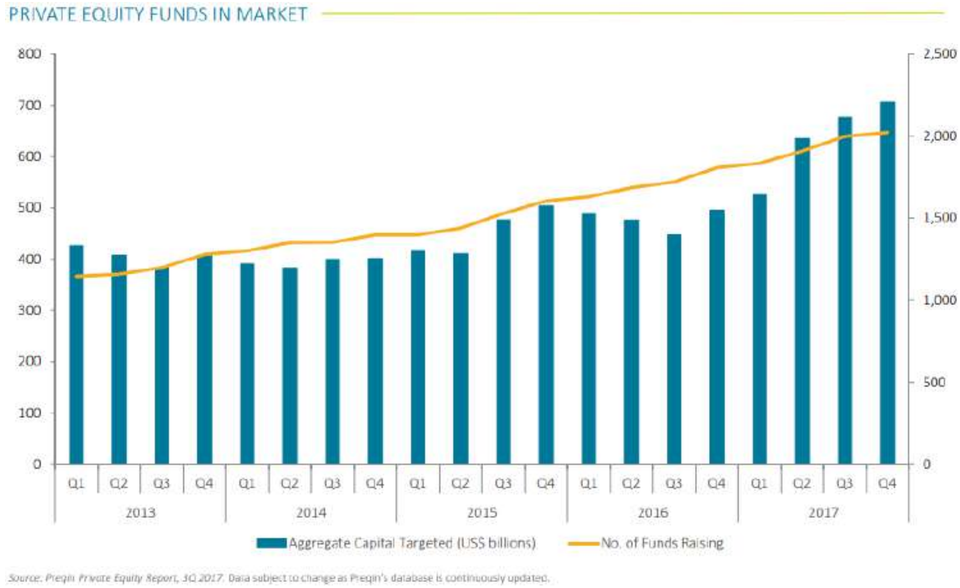
This past year saw record levels of capital being raised by Private Equity (PE) funds. This was the result of more firms coming to market to raise funds and a seemingly universal increase in the size of each fund raised. The graphic below shows how substantial the increase has been in both fund size and the number of funds being raised. This influx of capital has been the cause of much concern in the industry as there is no clear answer as to where and when this money will be invested.



Source: Preqin (March 2018).

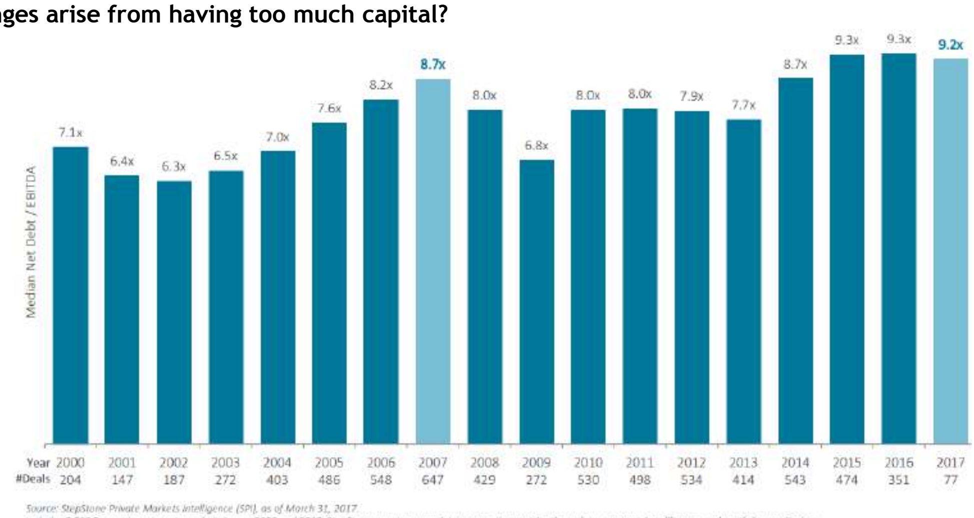
Why are PE funds raising so much money?

The answer to this is relatively straightforward: demand. There has been a large increase in the demand for PE investments. Many investors see high valuations when they look at the public markets nine years into a bull market, and are concerned that the upside may be limited. Private markets are not immune to the same high valuations seen in public markets; historically however, they have been better insulated. While absolute performance of both private and public investments declines in the late stages of an economic cycle, private investments have generally performed better than public, on a relative basis. As a result of this, investors are allocating more to private investments in hopes that this trend will continue. This increase in demand is being filled by firms raising larger funds. The chart below shows the steady increase in both number of funds and as a byproduct of that, the total capital raised.



Most PE firms rationalize the increase in fund size with two arguments. First, that they plan to invest in a larger number of deals than in the past, - and second, that they plan to own a larger share of each company they invest in. A greater number of deals will increase portfolio diversification which can mitigate risk, especially when most PE funds are highly concentrated. Taking bigger stakes in portfolio companies can also be beneficial, but only if the fund has high conviction in its investments and does not stray from its core investment thesis.

What challenges arise from having too much capital?



Unfortunately the secret is out, and it's widely known that PE firms have "dry powder" they want to put to work. This creates an environment that benefits sellers rather than buyers, as too much money chases too few deals. The result can be inflated purchase price multiples. In a time when there are grumblings of valuations being too high, the stockpiles of capital waiting to be put to use offers little to dampen this concern. The chart above illustrates the average purchase price multiple for buyout investments. Notably, since 2015 the average multiple has hovered at levels higher than those of the pre-recession period. Another potential risk is that a PE firm could drop their quality standards if feeling pressured to put investor money to work. The marriage of poor and expensive deals has the potential to negatively impact performance. One way PE firms combat high price multiples is through acquisitions of smaller/cheaper add-on acquisitions. This lowers the price paid on the platform company from an all-in blended standpoint.

How does CIBC Atlantic Trust's due diligence process combat these trends?

Our Multi-Manager Investment Team factors these sorts of market conditions into our investment decisions. At the core, we are avoiding managers who appear to be over extending themselves. We identify red flags during the due diligence process such as an unreasonable increase in fund size, sourcing a majority of deals through auctions, or using financial engineering to drive returns. A fund that displays one of these characteristics is likely to have a harder time producing results for investors.

The characteristics we look for in a firm have a direct relationship with how they plan to produce outsized returns for investors. We tend to focus on firms that invest in small- and middle-market companies, target companies in a specific sector, and add tangible value to the companies in which they invest. Often times when a fund invests in a small- or middle-market company, it is a first-time injection of institutional capital for the businesses. In turn, these investments offer greater upside through the professionalization of the business. Similarly, the opportunity set for potential investments is better as the number of small- to mid-size companies dwarfs that of large companies. Investments in small- to mid-size companies also have more avenues to explore when it comes time to exit as among other things, they can be sold to a strategic buyer, utilize a dividend recapitalization or enlist on a public stock exchange. Fund managers that focus on a specific sector tend to have more experience recognizing and executing quality deals. They typically have a strong network within the industry that creates deal flow as well as exit opportunities. We believe an operational hands-on approach is crucial to the success of the companies and the PE firms, as firms that rely solely on financial engineering to produce returns do not differentiate themselves. In today's environment it is much more difficult to buy a company utilizing a great deal of leverage and then recapitalizing to sell it at a profit. The operating partner model and utilization of advisors with functional expertise can drive value and create long-term business plans that help mitigate or offset elevated purchase multiples. We look for firms that are sought out as partners because of their history of helping companies optimize operations and develop management teams. Being desired as a business partner gives these firms a bargaining chip, allowing them to invest at a lower cost.

Although these trends may appear to be market headwinds, we are confident they can be mitigated through comprehensive due diligence and, in turn, quality manager selection. The Multi-Manager Investment Team at CIBC Atlantic Trust maintains our focus on finding firms that possess the ability to execute on their investment objectives.