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Private Equity Navigates Shifting Fundraising Dynamics

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Private equity (PE) fundraising across the private capital markets spectrum slowed down in the first half of 2022 amid significant macroeconomic and geopolitical volatility. Investors are adopting a more cautious approach to new fund commitments, taking care to monitor their PE allocations and doubling down on core relationships with blue-chip managers in a crowded market.

In the face of rising interest rates, stubborn inflation and intensifying geopolitical tension, PE fundraising has seen a downturn in the first half of the year.

According to *Private Equity International*'s *(PEI)* H1 2022 Fundraising Report, global PE managers across the spectrum of private capital asset classes raised US$337 billion in H1 2022.[1] While down 27% year-over-year from H1 2021 levels (US$459 billion), this figure still compares favorably to previous years.[2]

Established PE managers generally continued to secure large pools of capital through H1 2022. In May, Boston and London-based PE firm Advent International raised US$25 billion for its tenth global PE fund, exceeding its predecessor flagship fund, raised in 2019, by 40%.[3]

A month earlier in April, KKR closed its flagship North America PE fund on US$19 billion,[4] while The Carlyle Group has reportedly gathered over US$13 billion toward its new US$22 billion flagship buyout and growth fund, as stated in its second-quarter 2022 earnings.[5]

Looking ahead, the pipeline for new fundraisings remains robust, with buyout, growth equity, venture capital, secondaries, fund of funds, co-investment and distressed/turnaround funds currently out in the market seeking more than US$1.2 trillion in the aggregate, according to *PEI*.[6]

Different dynamics: From the denominator effect to a build-up of bottlenecks

After a blow-out year in 2021, which saw PE managers across private capital strategies raise US$780 billion, according to *PEI*,[7] and a strong pipeline of fundraisings this year—some managers are still having to run harder to get fund closes over the finish line.

The denominator effect—when the value of one portion of a portfolio decreases faster than others, leaving investors overweighted to certain asset classes (e.g., PE)—is one factor that has caused investors to pause and reassess deployment plans.

With equities falling through the course of this year (the Dow Jones Industrial Average[8] and the S&P 500[9] have both seen double-digit declines over the first half of 2022), investors have been paying close attention to their PE exposure and making sure they are not overallocated. Fund investments continue to go ahead, but limited partners (LPs) are taking the time to assess where portfolio valuations settle and rebalance portfolios to free up capital for new commitments.

"This is an interesting time for LPs. The denominator effect is on the radar. Some LPs are overallocated but are still very positive about making new commitments to PE," says **Isabel Dische**, a New York-based asset management partner at Ropes & Gray and co-head of the firm's institutional investors team. "Investors don't want to be sitting out. They recognize that they need to find the capital, from a returns perspective and a relationship perspective. Some LPs are even looking at offloading older positions via the secondaries market in order to secure liquidity for new commitments."

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At the same time, a series of blue-chip managers have been raising record-sized vehicles, creating a bottleneck on LP capital.

In addition to Advent International, KKR and The Carlyle Group, the fundraising card for 2022 includes new funds from top tier managers Apollo, Thoma Bravo and TPG Capital, among others.[10] High-quality managers that have already closed new funds this year, meanwhile, include Insight Partners, which raised US$20 billion for its twelfth flagship fund, and Blackstone, which raised US$11 billion for a new Asia-focused vehicle.[11]

The high number of large funds that have closed this year, coupled with upcoming fundraises from sought-after managers, mean LP allocations for 2022 are already stretched, and LPs are pressed for time just trying to manage their re-ups to key managers. LPs are also keeping a close eye on distributions from

managers, which have slowed this year partly due to a decline in exits, leaving LPs with less cash in their coffers to redeploy for new investments.[12]

"The flurry of activity in 2021 means some LPs have already deployed what they wanted to for 2022," says Debra Lussier, a Boston-based asset management partner at Ropes & Gray and co-lead of the firm's buyout and growth equity funds teams.

The upshot for managers on the road is that, while LPs still want to deploy, it is going to take longer to close funds and timetables will need to be adjusted accordingly. Apollo, for example, is targeting US$25 billion for its next fund and has given itself about a year to raise the capital, according to *Bloomberg*, even though it raised its previous vehicle in half that time[13] (per its second-quarter 2022 earnings, Apollo has collected over US$13 billion toward its goal[14]).

For some managers, fundraising timetables have been prolonged even further.

"There are managers who closed prior funds in 'one and done closings' at or above their targets but are now facing lengthy fundraising periods and multiple closings," Lussier says. "LPs aren't reducing their programs. Mid-market firms are raising bigger funds, coming back to market faster, which has squeezed LP budgets this year."

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Big is a bonus: Large versus mid-market

The combination of the squeeze on LP time and capital, amid a volatile macroeconomic backdrop, has also seen investors fine tune allocations.

One trend that has already taken hold this year is the investor pivot toward larger, more established managers. In the U.S. PE buyouts market, for example, funds targeting US$5 billion or more accounted for 58% of capital raised in H1 2022, according to Pitchbook.[15]

This has been particularly significant for mid-market and emerging managers, with genuine differentiation and track record becoming even more important to secure LP attention and capital in a busy market.

"Mid-market managers are still very important to LP programs, but my instinct is that investors are looking at the size of a manager and calculating whether declining to increase a commitment to a big manager is more costly to the long-term relationship than declining to increase the commitment to a mid-market manager," says Lussier.

While LPs are writing bigger checks to fewer managers, there is still space for new players to come through, although the bar is set high.

Fundraises by first-time managers have been more challenging than ever over the last 24 months. New managers had to first convince investors to form relationships and back new teams without being able to meet face-to-face through lockdowns and are now trying to get their attention on a busy fundraising calendar.

Despite these hurdles, debut managers have successfully raised funds this year, including Knox Lane,

which exceeded its US$600 million hard cap with a US$610 million close, and GHK Capital Partners, which closed its first ever fund on US$410 million.[16]

"Investors always want to add new managers. Many are looking to invest in newly-formed firms with fresh ideas," says **Laurel FitzPatrick**, a New York-based asset management partner at Ropes & Gray and head of the firm's credit fund and hedge fund teams.

New firms are also bringing innovative, flexible fundraising structures to market to secure investor support. According to *Buyouts*, Leon Capital, for example, a firm formed by a team of dealmakers from KKR, Blackstone and McKinsey, is offering investors a pledge fund structure that allows LPs to invest in a closed-ended fund but decide which deals to support. The firm is targeting mid-market tech-enabled services companies.[17]

"Some investors are trying to concentrate their relationships, but others are still very much trying to find new opportunities and continuing to invest broadly," says Dische.

New York-based Ropes & Gray asset management partner **Bryan Hunkele** points out that, apart from a manager's size, another key factor for LPs is the deal pipeline a manager brings to the table.

"Flight to quality is obviously a focus for every investor, especially with the potential of a down market looming, but there is nuance to it," he says. "If a major sponsor is coming back to market because they have a deal pipeline that requires capital, LPs are going to want to get into that fund. But if a manager is back raising a larger fund, but with no push on the deals, it doesn't resonate as strongly. That analysis impacts whether you secure a 'one and done' closing up front, or whether investors drift in over time, because you don't really need the capital right away."

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Refining strategy: Seeking stability in uncertain waters

The changing risk outlook and impact of rising interest rates are also shaping the fundraising landscape from a strategy perspective.

Buyout funds accounted for 21% of the capital raised in H1 2022, according to *Bain & Company* research, followed by venture capital at 17% and growth equity at 13%.[18, 19] Venture capital's and growth equity's shares of the fundraising pie have contracted during the course of the year,[20] as anecdotal evidence suggests investor appetite is increasing for strategies that are viewed as offering more stability, such as private credit, infrastructure and real estate.

Real estate and infrastructure, for example, are seen as good bets in an inflationary environment, supporting fundraisings such as Hamilton Lane's successful first-ever infrastructure fund, which closed above target at US$590 million.[21]

"LPs invested significant sums in tech and growth funds in 2021, so they are reorienting on the margins toward other strategies. There is not a pullback from any strategies, just a reassessment and reallocation," Hunkele says. "Real estate and infrastructure are hedges against inflation, so there is more interest there."

Private credit fundraising has also proven popular, providing investors with an opportunity to benefit from rising interest rates on lending and to consolidate equity exposure.

According to *Creditflux*, U.S. direct lenders have raised US$60.27 billion in the first six months of 2022, not far off from the US$81.78 billion raised in the full year 2021 and already higher than the US$49.12 billion raised in 2020.[22] Direct lending fundraising is expected to face more headwinds in the second half of this year but has proven remarkably resilient up to now.

Another strategy that is emerging is distressed debt—Stepstone, for example, closed a debut distressed debt fund on US$600 million in May.

"There has been barely a pause in fundraising on the credit side. Managers are still raising significant funds, and the velocity of capital coming into credit is still very high. There has been no pullback from LPs on the credit side at all," says FitzPatrick.

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Investors and managers are also exploring their options when it comes to fund structures, FitzPatrick says. "There is a real interest in evergreen funds, especially on the credit side. These funds just keep recycling capital so LPs don't have to go to their investment committees every two years. Also of great interest are contingency funds, designed to call down and deploy capital in the event of a downturn. We have a number of clients actively raising these vehicles," says FitzPatrick.

Documentation and negotiation: Staying on top of the paperwork

In addition to shifts in LP priorities, managers are also adjusting to working with larger groups of LPs to fill increasingly larger funds and rising investor demand for more bespoke reporting.

The growth in the number of investors with PE programs is a testament to the asset class's success but cultivating new relationships and bringing new LPs into a fund take time. This is also contributing to longer fundraising timelines.

"Some investors are bumping up against the ceiling of their 2022 allocations, so if managers want to raise larger funds, they have to develop more LP relationships," says Lussier. "It is not just one meeting. It involves several meetings and travel to get to the finish line."

In addition to the extra time taken to engage with new LPs, negotiations can also be more complex than with existing investors. Negotiations are increasingly bespoke and the inclusion of side letters (additional, separate agreements between individual investors and funds) are commonplace.

"When it comes to negotiations, everything is on the table because the new investor is not beholden to any

previous agreements. The GP is starting fresh and oftentimes those negotiations are lengthier," says Lussier.

"The existence of side letters is nothing new, but their length does keep growing," adds Dische. "The scope of what is included in a side letter will vary from investor to investor and will be influenced by the size of commitment the LP is making, as well as the internal requirements of the particular investor."

For example, a sovereign wealth fund will look different from a North American pension fund, which will look different from an endowment. They will all have developed specific requirements of the sponsors in which they invest. If new LPs are coming into a fund, it helps to have counsel that has worked with them before and knows what to expect.

"What is interesting is that the focus isn't always on the commercial terms like fee breaks or rejigging the carried interest," says Hunkele. "Many of the requests will be around operations and confidentiality. It requires careful thought in advance, so that you're not agreeing to terms that the back-office teams just can't support."

The rise of environmental, social and governance (ESG), where standards still vary from investor to investor, is a particular example of how managers are having to produce a higher volume of information and reporting to secure investor support.

"ESG is something that is now of interest to investors globally. Historically, it would be something European investors were mainly focused on, but now it is on the agenda across the board," says Dische. "Adapting to various ESG requirements through the fundraise—some investors are big on the 'E' while others are more focused on the 'S' and 'G'— as well as adapting to the ongoing evolution in individual LPs' approaches to ESG is something managers are having to get used to."

Flexible fundraising is essential to the future

With some LPs pushing up against their allocations and large managers soaking up budgets, general partners (GPs) are having to adjust their expectations and be more dynamic in fundraisings.

GPs can navigate these developments by preparing for some existing LPs to drop out of fundraises, investing in relationships with new investors and taking a flexible approach to documents and the fundraising process.

For all the challenges that shifts in the fundraising market have brought for GPs, good managers are still hitting their targets, even if it is taking a little longer.

"It can take a little while for a sponsor to figure things out and recalibrate, but you can adapt and end up in the place you want to be, even if the route may have to be a little more circuitous than you want," concludes Hunkele.

Private capital fundraising levels have fallen in the first half of 2022 against a backdrop of macroeconomic uncertainty. Investors are taking a more cautious approach to new commitments and rejigging portfolios to account for drops in public equities.

The fact that a cluster of blue-chip managers have come to market with new funds simultaneously has also stretched investor budgets and resources. Nevertheless, appetite for private capital remains durable and managers are still getting funded, even if it is taking longer than in prior fundraising cycles—but the window for new commitments might open up again next year.

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ENDNOTES

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