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Prevailing Trends in Private Equity Fundraising

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2017 was an extraordinary year for private equity fundraising, and 2018 is seeing continued buoyant activity. The negotiation of terms between general partners (GPs) and limited partners (LPs) is taking place in a divided market of highly prized offerings, on the one hand, and firms that are struggling to reach their target sizes, on the other hand. Nevertheless, overall market terms remain largely unchanged. In this context, a number of trends are prevalent in today's private equity marketplace:

Balkanization and innovation in fundraising. The fundraising focus of private equity firms seems to be more fragmented and specialized. GPs are increasingly fundraising along regional and industry lines, and forming multi-strategy, retail and other bespoke products. In particular, several GPs have offered "long-dated" private equity funds with 20 to 25 year terms that offer a continuing supply of long-term and patient capital through making larger investments with longer time horizons than are permitted by the typical middle-market private equity fund.

Handing over the keys. Although many private equity firms remain tightly controlled by a few partners, the aging of founders, the ambitions of "next generation" professionals and the maturation of the industry are forcing sensitive discussions about succession across the marketplace. Because the key assets of private equity businesses "walk out the door" at the end of each day, GPs increasingly appreciate that a controlled, thoughtful and well-communicated transition process can avoid a talent vacuum and shore up LP confidence.

Growing appetite for investment management M&A. The number of transactions involving majority or minority investments in managers is at an all-time high. This trend is fueled both by increased demand from a wide range of investors, as well as by GPs who are not only increasingly open to the idea of such a transaction, but also intently focused on growing their businesses and, in some cases, seeking monetization opportunities. Given the growing number and size of interested investors alongside the essentially fixed number of potential targets, the marketplace for these investments has become more competitive. As a result, valuation and transaction terms have become more seller-friendly.

Private Funds Practice

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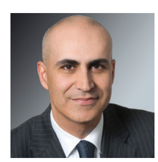

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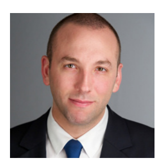

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Reconsideration of the hurdle rate. A few top performing GPs have successfully argued for the removal or lowering of the traditional 8% hurdle rate in this low interest rate environment. It may be time for GPs and LPs to revisit the concept. There is some appreciation in the marketplace that the ticking clock of the hurdle rate could factor into the timing of investment decisions, creating an inadvertent misalignment of interests. Some GPs have addressed alignment in alternative ways (such as the so-called "net asset value" test common in venture capital funds).

Evolving management fee arrangements. GPs are increasingly offering alternative management fee arrangements and discounts that are consistent with their business goals of attracting large and diverse investors, and closing funds quickly. There is growing market precedent for fee discounts based on investment size, relationship or "early bird" status (*i.e.*, first closer). Some GPs are creating multiple classes with varying rates of management fees (including options such as management fee "holidays" early in the life of the fund or a "J-curve" mitigating fee class that "back-end loads" management fees).

Fund recapitalizations and demand for secondaries. Fund recapitalizations and secondary transactions are being used to extend the life of certain portfolio investments. The secondary market is providing a myriad of options to GPs as they seek to offer liquidity to their LPs in mature funds. A "GP-led" fund recapitalization involves an external secondary buyer offering LPs in the fund an option to exit and simultaneously provide new capital for existing investments. This provides additional time, capital and incentives to the GP to maximize value and manage existing portfolio companies to disposition.

Technological Innovation. The rapid spread of technological innovation through the commercial world creates a new and unique set of risks and opportunities for the private equity industry. GPs and LPs alike are racing to address the challenges posed by ever-advancing technology at both the fund and portfolio company levels – including the corresponding proliferation of cybersecurity risks, in particular – in order to unlock what many view as unprecedented potential to improve research, knowledge-sharing, operations, communication and overall efficiency . . . not to mention technology-related investment opportunities.

There are many more trends at work in the marketplace, including the emergence of environmental, social and governance issues, ever-increasing demand for co-investments, the increased use of subscription line credit facilities and the ongoing search for the "holy grail" of permanent capital. Nevertheless, the opportunities presented within an ever evolving and maturing industry have never been more dynamic.

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