

News and Analysis

Analysis | Pension Plans

Institutional appetite drives a rise in PE 'mega-funds'

Institutional investors are making larger, more concentrated commitments in private equity, helping sustain a trend toward ever-bigger buyout funds.
Dietrich Knauth | 24 May 2018

As institutional investors try to ramp up or maintain their commitments to private equity without spreading themselves thin on due diligence efforts, their increasingly concentrated investments have helped support a trend toward private equity mega-funds.

Concentration at the top poses some challenges, but investors aren't fazed: Since 2015, fewer investors have sought to make four or more fund commitments annually and more are gravitating towards making two to three fund commitments, perhaps suggesting an increase in ticket sizes, research firm **Preqin** found. The increased demand, as well as a need to reinvest capital from older private equity investments, and new players like sovereign wealth funds and wealthy individuals, have pushed dry powder held by private equity fund managers to a record high of \$1.09tn as of March 2018.

Private equity managers with good track records are in high demand, and those managers are increasingly able to find enough capital to scale their efforts to previously-unheard of levels, according **Christopher Elvin**, head of private equity products at Preqin.

"There looks to be a trend towards mega-funds," Elvin told *Fundmap*. "The private equity industry is seeing huge inflows, but investors are increasingly choosing to sink their capital in the largest funds. LPs (Limited partners) prefer to be involved with fund managers that have been successful in the past - with the expectation that those fund managers will be able to generate large returns in the future - and generally fund managers don't tend to raise large funds without building up a track record."

General partners (GPs) launched two Asia-focused "mega-funds" in the first quarter of 2018: the **United Overseas Bank** *Sino-Singapore Connectivity Private Equity Fund*, targeting a \$15.8bn fund size, and the **China Minsheng Investment Group**-led *Asian Institutional Investor Joint Overseas Investment fund*, targeting \$15bn, according to Preqin. 2017 saw the closure of the largest private equity fund in history, the \$24.7bn *Apollo Investment Fund IX*, and an eye-popping \$93bn initial close for the **SoftBank** *Vision Fund*, which is aims to be the largest private equity fund with a final target size of \$100bn, according to Preqin.

Those huge funds seem to be an outgrowth of a general trend towards concentration in private equity, Elvin said. Just four years ago, the largest 10 private equity funds accounted for 19% of total fundraising, but that percentage rose to 28% by 2017, and the trend is even more pronounced in the beginning of 2018, he said.

"Although we've seen a trend towards capital concentration in private equity over the past couple of years, it is surprising nonetheless to note that over half (59%) of capital raised in Q1 2018 was secured by the 10 largest funds," Elvin said. "Increasing capital concentration in the top end of the market would imply that the track record of fund managers is more important than ever to investors, as they increasingly choose fund managers that have shown positive results in the past."

The challenge for asset owners

As LPs gravitate towards larger and larger funds, the concentration at the top brings both opportunities and challenges, according to consultants who advise pension funds on private equity investments. For some of the largest funds, maintaining a significant allocation to private equity can be extremely challenging, and mega-funds can allow them to meet pacing requirements that would otherwise be out of reach or extremely difficult to vet.

"There is a symbiotic relationship ... there is an issue on both sides of scaling the use of resources," said **John Haggerty**, director of private market investments at **Meketa**. "As a practical matter, if you're managing a private equity program that runs in the billions, larger funds are quite convenient because they allow for deployment at scale."

Those deployment challenges have spurred the \$354bn **California Public Employees' Retirement System** (CalPERS) to go beyond large private equity and pursue direct investments in private equity, through a separate entity called CalPERS Direct that will manage two mega-funds of its own.

CalPERS also plans to consolidate its private equity commitments with general partners through a "strategic partnership" model, while retaining its support for emerging private equity managers and traditional GP relationships. CalPERS investment staff has expressed doubt that they could meet the roughly \$13bn a year in commitments required to keep its private equity allocation around 10% without taking those steps.

Meketa is CalPERS' private equity consultant, but Haggerty declined to discuss the specific situation of a Meketa client. Still, he said, large pension plans have increasingly sought creative solutions to private equity pacing challenges.

"You're starting to see a lot of creative, bespoke separate accounts, co-investment relationships and the like," Haggerty added.

Scaling due diligence

Beyond the convenience of allowing large-scale capital deployment, larger private equity funds offer other benefits, such as a longer track record of success, the potential to leverage a good GP relationship into better fees, alignment of interest, and a reduction in due diligence burdens, Haggerty said.

"It's hard to scale the cost of due diligence," Haggerty said. "You do the same amount of work, if not more, for a \$50m commitment than you do for a \$200m commitment. If you deploy the whole \$200m to a specific fund, then that's one project, its one relationship, and it's a relationship where the GP really knows that you're an important partner within that investment group."

On the other hand, larger funds are forced to chase larger portfolio companies and larger deal sizes. It's something of an open question whether the "private equity premium" can be scaled up so easily, according to **David Fann**, president and CEO of **TorreyCove**.

"The challenge for mega-funds is that they generally are forced to invest in really large deals and companies," Fann said. "The value add that the PE industry brings to the table in restructuring or re-orienting companies seems harder to implement in large companies."

EXPORT

Investor Profile

CalPERS Supplemental Income Plans

Manager Profile

Preqin

Consultant Profile

Meketa Investment Group

TorreyCove Capital Partners
