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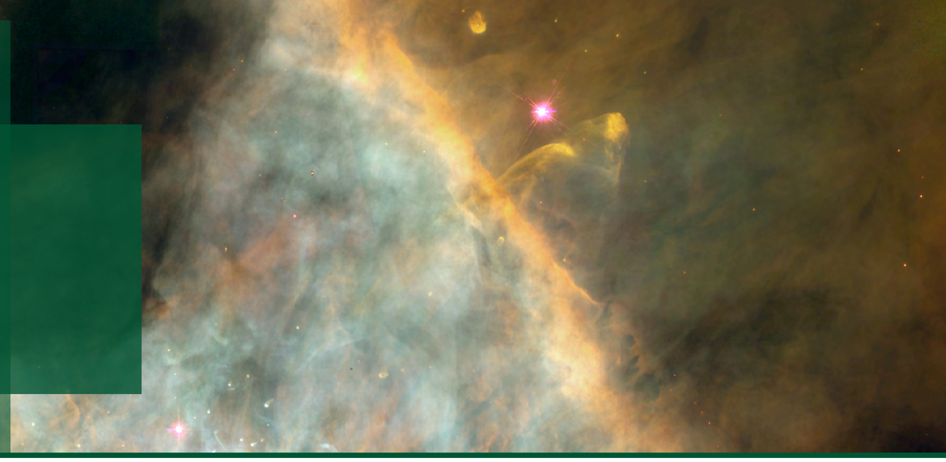

THE RISE OF DARK POWDER

Dr. William Charlton, Ph.D., CFA
Managing Director & Head of Global Research & Analytics, Pavilion Alternatives Group, LLC

Dark matter and dark energy have grown from obscure, radical proposals to fundamental aspects of modern physics. What we are terming "dark powder" has seen a similar transformation in private equity markets in recent years. Before defining dark powder, let's take a brief foray into the concept of "dry powder."

In private equity, dry powder is measured as the difference between the total capital raised by active fund managers and the cumulative amount they have invested to date. Dry powder essentially measures the amount of capital that remains to be invested. Generally it is believed that higher dry powder levels will put upward pressure on private company purchase prices which, in turn, may result in lower returns to private equity fund managers. Over the past several years, the quality of the data in private equity has improved substantially. This has had the residual benefit of increasing the precision and reliability of measures of dry powder. However, the expected negative correlation between dry powder and private equity returns remains an open question and, as we discuss below, may be increasingly difficult to accurately characterize.

With that context, we define "dark powder" to be the total unrequited demand for co-investment from LPs. Anyone active in private equity markets over the past several years has almost certainly observed that the demand for co-investment has been increasing at an astonishing rate. While some LPs have been active in co-investment for many years, much of the recent increased demand is likely from investors with significantly shorter histories of co-investment activity.

The increasing demand for private equity co-investment can be linked to several factors. Firstly, those LPs with the longer histories of co-investment activity have generated attractive returns for their programs which has drawn the attention of other LPs. Secondly, the increasing pressure to lower fees has led some LPs to view co-investment as a way to lower the blended fee load. The "J-curve" mitigation aspect of co-investment is also attractive to many LPs as they can deploy large amounts of capital at their discretion.

It is also possible that we are seeing a natural evolution of LPs. Many LPs start investing in private equity through fund of funds vehicles. After developing a comfort level and becoming more educated on the asset class, some transition to a direct fund investment program. As those LPs gain confidence in their fund managers, some may see co-investment as a viable, lower cost alternative investment opportunity. A final benefit of co-investment worth mentioning is the ability of LPs to control sector/geographic exposures directly in contrast to the blind pool investing that is characteristic of investing at the fund level. Whatever the primary driving factors actually are, the current LP demand for co-investment borders on the insatiable.

Physicists do not have direct evidence of the existence of either dark matter or dark energy. Rather, they impute the existence of both indirectly through specific astronomical observations. The presence of dark matter was deduced from the bending of light from distant stars (known as gravitational lensing). Dark energy was postulated as an explanation to the recent and surprising result that the universe is expanding at an accelerating rate. Similarly, direct evidence of dark powder is elusive but its existence does have consequences. One such effect of the existence of dark powder is how prominently co-investment availability now factors in private equity fund manager presentations. Just a few years ago co-investment was rarely a primary topic and would only be discussed if a potential investor raised the issue. Now, in almost every fund pitch, managers readily discuss the level of co-investment availability. There is some direct evidence of dark powder in individual deals, but the total depth of the market remains uncertain.

The total capital available component of the dry powder calculation can be easily observed using publicly available information on capital raised by fund managers. On the other hand, co-investment capital is not usually raised in separate vehicles and the actual available amount may be known only to the internal investment professionals of a given institution.

Not only are there differences in the sources of the capital, but also there is some reason to believe that dark powder may behave differently than dry powder. The difference might be especially pronounced during significant market dislocations. Fund managers raise a set amount of capital and have a limited time to invest that capital. Our research has shown that fund managers may slow their investment pace substantially, as they did after the Great Financial Crisis (GFC), but they usually deploy the full amount of capital over the life of their fund even if they have to request an extension. However, LPs do not face the structural issues that drive some of the behavior of fund managers, as such, the absence of a consistent co-investment structure makes it more difficult to predict how LPs will behave.

In the event of another crisis, deal flow will probably decrease significantly, as it did in previous crises, which will naturally curtail the available co-investment opportunities. What is unknown, however, is what will happen to the demand for the limited co-investment opportunities in an adverse market period. Will the risk aversion of LPs increase and drive down their appetite for co-investment or will LPs be ambivalent about market conditions and continue investing at the same pace? Or, possibly, would LPs be opportunistic and increase their co-investment demand? While the latter seems unlikely, it remains a possibility. Given the diversity of LPs and the lack of consistent structure, the answer to those questions is likely to be empirical and not theoretical in nature. The increase in co-investment demand has occurred after the GFC, therefore LP behavior has not yet been broadly tested in severe market conditions.

An interesting aspect of the increase in co-investment demand is the potential impact on the aforementioned correlation between dry powder and returns. With the increasing amount of dark powder, the dry powder measure captures less and less of the available capital. The unmeasured component of available capital will introduce noise into the relationship between dry powder and returns which, in all probability, will make the correlation more difficult to measure as well as making it less meaningful.

The concepts of dark matter and dark energy have had a profound impact on the direction of physics over the past decade. It will be interesting to see how the seemingly unrelenting increase in dark powder will alter the course of private equity markets in the coming years. Of particular interest will be how the demand for co-investment changes the behavior of both private equity fund managers and LPs.

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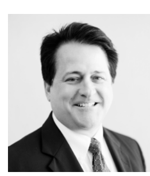

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Pavilion Alternatives Group, LLC
wcharlton@pavilioncorp.com