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With Giants Sidelined, Small Endowments Beckon

Firms daring to raise a new fund this year are wondering where to go for cash. On the endowment front, our advice is to think small.

Big university and college endowments are largely on the sidelines this year, with many short on cash to fund capital calls, over their target allocations, or both. By contrast, some of their smaller siblings just may cut you a check.

Because bigger endowments moved earlier to invest in private equity and had, on average, larger actual allocations to the asset class going into the downturn, they are more likely to be experiencing a liquidity squeeze, said Kristen Krohg, director of non-marketable alternative assets research and consulting at Cambridge Associates, an investment consultant. Many institutions, such as several big schools, among them Harvard University and Columbia University, tried to alleviate the problem last year by selling assets on the secondary market. But those sales, for the most part, did not occur, because would-be buyers and sellers could not agree on pricing.

And it looks like the larger endowments and foundations may be making long-term, or even permanent, shifts away from buyout and venture capital funds.

Kelly DePonte, a partner at Probitas Partners, a San Francisco-based placement agency, knows of a few big universities that are much more actively considering current income strategies, such as mezzanine and infrastructure. “If endowments begin to place more money in mezzanine and infrastructure to better match assets and liabilities, some of this change could be permanent,” said DePonte.

By contrast, smaller universities often have newer private equity programs, with smaller target allocations to the asset class, thus avoiding many of the liquidity issues plaguing the giants. According to June 30, 2008, data from the National Association of College and University Business Officers (NACUBO), the 228 endowments and foundations with total assets of $100 million to $500 million have an average actual private equity allocation of 4.3 percent. Although NACUBO does not provide information about targets, the average target allocation to private equity of the eight sub-$1 billion endowments in a table compiled for this story is 13.3 percent, suggesting plenty of capacity across the smaller university market.

To be sure, most institutions with dry powder, large and small, will be very cautious about making substantial commitments in 2009 because there is a pronounced preference for liquidity now, according to Russ LaMore, president of St. Louis-based Hammond Associates, a consultancy used by many small endowments. “Those institutions with capacity and willpower to make new commitments this year will be very selective, and will likely focus on distressed, mezzanine and secondary funds,” said LaMore.

Still, Cambridge Associates's Krohg believes that many medium-size and smaller endowments see the brutal fundraising market as a chance to upgrade manager quality and to break in with invitation-only funds to which they weren't previously invited. “Institutions with appropriate liquidity may take advantage of this market environment to enhance their portfolios,” said Krohg.

So it’s groups without issues with over-allocation or liquidity that might help fill fundraisers’ coffers this year. Richard Lichter, managing director of Stanford, Conn.-based secondary firm Newbury Partners, said that private equity is a new asset class for many of the 24 university endowments with average total assets of $200 million to $300 million that committed to his firm's $702 million Newbury Equity Partners, a secondary fund closed last March. They are committing money to funds in order to move toward their target allocations, he said.

Among the many small university endowments that continue to commit to private equity is the University at Buffalo Foundation, which, when it combines with the University at Buffalo Endowment, slated for June, will have total assets of about $500 million, and is likely to pledge $20 million to $30 million this year to special situation, mezzanine and venture funds, but will be doing little with buyout funds, according to Les Brun, chair of the private equity subcommittee. Brun feels that the large buyout market is dead, although the mid-market is getting some deals done. The foundation’s target allocation to private equity is 14 percent.

The University System of Maryland Foundation has raised cash in case truly compelling new opportunities become available, particularly in credit, but it is not rushing into private equity commitments. In a quarterly investment report of Dec. 31, 2008, the limited partner noted that it’s spending very little time looking at leveraged buyout, growth equity and venture capital funds, but has spent considerable time looking at control-oriented distressed managers. However, the LP is holding off on any new commitments until possibly later in 2009, anticipating a wave of defaults still to come. The investment report noted that the university has $68 million in outstanding commitments and expects about $20 million to be called in 2009. The foundation had an actual private capital allocation of 13.1 percent at year-end, and has a policy target range for private capital, which includes private equity, private distressed, venture capital and mezzanine, of 5 percent to 15 percent.

Although the University of Colorado Foundation's target allocation to private capital is 20 percent, and the LP is overweight by about 5 percentage points, this is a moving target, said Kent Muckel, senior portfolio manager, since pending private equity write-downs should lower the numerator. The foundation is definitely not on the sidelines, as it is comfortable with its level of unfunded commitments; however, "we are holding a high bar on new ideas, as the cost of capital has risen," said Muckel. "It's not realistic to assume that we can be as active as past years, but we aren't saying absolutely no either."

The Kenyon College Endowment's Joe Nelson, vice president for finance, said that while Kenyon is not forming new relationships with general partners it is maintaining relationships with existing mangers. "But only those that we have the highest confidence in," Nelson said. The endowment's targets for private equity are 6 percent to venture capital; 6 percent to buyouts; and 3 percent to energy and distressed assets. The uncertainty over valuations has served as a brake on making commitments.

Nelson noted that he only has data as of September 30, but assuming a decline of 25 percent to 40 percent from those valuations, the endowment's actual allocations would be 9.4 percent to 11.7 percent venture capital; 9.6 percent to 11.9 percent private equity, including secondary funds; and 1.7 percent to 2.1 percent energy and distressed, putting the LP well over its target allocations to venture capital and private equity. Nelson added that these numbers are extremely soft and completely unreliable for decision making. According to the 2008 edition of the Dow Jones Directory of Alternative Investment Programs, the endowment has commitments to venture capital, buyouts and other private equity assets of $137.5 million, $73.1 million of which has been funded.

Meantime, plenty of small universities have found themselves in the same boat as the big guns. Tom Heck, the CIO of the $190 million Ball State University Foundation, said he's not sure if he will make any additional private equity commitments this year. "It is a balance between illiquidity and the risk of overallocation versus the heightened opportunity of the funds raised during this environment," he said. Most of the foundation's private equity commitments are to funds of funds, but last year it made a commitment to a distressed debt fund and a secondary fund. His target allocation to private equity is 15 percent, which the LP had been building toward since 2004. Now, with losses in other parts of the portfolio, the actual allocation is about 17 percent as of Dec. 31. Heck expects year-end 2008 numbers will reflect a 20 percent decline in value, leading to an actual allocation to private equity of about 14 percent.

And smaller endowments are also not immune to questions about whether they should have as much private equity exposure as they do. They see the distress some of the large endowments are experiencing via too much illiquidity in their portfolios and the problems it creates. "The smaller endowments are concerned that they could find themselves similarly situated and distressed," said Chris Douvos, co-head private equity group, TIFF (The Investment Fund for Foundations), which raises money only from non-profits in a fund-of-funds format. "Some people are asking, 'Why invest in private equity when its fundamental, inherent illiquidity has caused some institutions so many headaches?'"