New funds: new order?

After several years of record-breaking fundraising, firms in emerging markets are facing an altogether tougher environment. How are LPs likely to allocate their scarce capital? And what does this mean for T&Cs on new fund structures? Vicky Meek reports

Private equity firms in emerging markets have seen something of a breakthrough over recent years as limited partners, flush with boom-time cash, have increasingly sought exposure to high growth markets. The results have been clear: several years of record-breaking fundraising figures. From under US$3.5bn raised by funds in emerging markets in 2003, the figures shot up to nearly US$60bn in 2007, according to the Emerging Markets Private Equity Association. Enthusiasm wasn't even dampened in the first half of 2008, which saw a staggering US$35bn raised. Back then, many investors clearly felt emerging market economies really had decoupled from the rest of the world.

Yet since the collapse of Lehmans and the crumbling of Western financial institutions, emerging markets have found themselves far from immune to the woes of the US and Europe. A recent World Bank forecast put growth in developing economies at 4.5% for 2009, down from 7.9% in 2007. World growth will slow to 0.9% in 2009, according to the figures, as high income countries move into negative territory.

At the same time, LPs are finding themselves cash-constrained. Not only have they lost large sums on the public markets, denting their liquidity and putting their allocations out of kilter, but they are also receiving next to nothing in distributions from private equity investments as exits have dried up. All this will have a profound impact on fundraising activity across the globe.

"LPs are just not committing new money at the moment," says Matthew Judd, partner at White & Case. "Fundraising is going to be considerably down as you see a retrenchment among LPs, particularly those in the US and Europe. Even if they had the appetite to invest, some just don't have the funds. Investors such as endowments that need capital to fund projects are facing liquidity issues. Other investors are actually hoping that their private equity fund investments have reduced in value because that would mean they are not over-allocated to private equity."

Yet some funds will get raised. "It will be tough for any type of fund to raise," says Ralph Aerni, CIO and head of private equity at SCM. "There will be some exceptions; the few that have 20-year track records and that have been in the top tier for every single fund. LPs will open their books again in 2009, but they will be looking to continue relationships with the best performing funds."

In developed markets, we've seen some funds reach, or even exceed their targets, over the last few months, against the odds. The Carlyle Group is believed to be close to its target of US$15bn on its fifth US buyout fund, TowerBrook Capital has reached its hard cap of US$2.8bn on its third fund, Nordic Capital has raised €4.3bn, comfortably exceeding its target of €3.7bn, EQT has raised €1.2bn for an infrastructure fund, Zurmont Madison Private Equity has just closed at CHF250m, and ECI Partners raised its ninth fund in the three months of financial turmoil that characterised the end of 2008, with £430m of commitments; well above its £400m target.

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It's clearly possible to raise funds in developed markets, even if considerably more difficult than over the last four or five years. But what about funds in emerging markets?

There are two schools of thought. Some believe it will be harder than ever because, however irrationally, LPs may well retrench from what they perceive to be risky markets at a time of global uncertainty. "It will be harder for emerging markets funds because, as in the past, we will see LPs withdraw from emerging markets first," says Aerni.

"There is quite a bit of scepticism around at the moment because some investors were inclined to believe that Asia had decoupled from the world economy. Now that's proved not to be true, investors will be much more wary of any investment story from there and other emerging markets."

"There is no doubt that the global liquidity crunch and the crisis of confidence is affecting, and will continue to affect, fundraising efforts by managers in emerging markets," says Judd. "US pension funds that might have put money into Russia and China, for example, may well pull back."

Efforts by teams in some emerging markets will not be helped by other recent events, either. "In Asia you are seeing a significant slowdown in growth, with GDP

Mounir Guen, MVision

forecast figures being revised steadily downwards,” says Aerni. “China’s has recently dropped from 9% to 6% and the worrying point here is that the country needs 6% growth just to keep the economy stable and prevent a rise in unemployment. But it’s not just that. Political instability is also playing its part. The recent events in Mumbai and Bangkok are making GPs and LPs very aware of the risks of investing in some of these countries.”

The other argument against emerging markets is their relative youth. “One of the problems emerging markets face is that there is no maturity; private equity funds are generally managed by younger teams with little track record,” says Aerni. “In a downturn, that’s not the kind of story that gets LPs excited.”

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Yet there are others who remain more optimistic about emerging markets in particular because they are the markets that will see growth at a time when other economies are in recession. “We’re seeing a reconstruction of investors’ private equity portfolios,” says Mounir Guen, CEO of MVision. “Limited partners are reassessing their exposure to different markets. Over the longer term, they are seeking growth, which means that emerging markets will become an important component of their portfolio. Our view is that emerging markets are currently between 10% and 15% of LPs’ private equity portfolios; we think that will rise to 30% over the next five years.”

“There is a paradigm shift,” adds Guen. “Investors are looking for growth, not financial engineering, to generate returns. The financial crisis will accelerate that trend.”

Guen points to the myriad of investors that have established offices in Asia over recent times as an indication of where capital may flow in the future. Canada Pension Plan Investment Board, Morgan Stanley, Goldman Sachs, Cambridge Associates, LGT, AlpInvest, MetLife and Axa are just some of the investors that have spread eastwards.

Others point to the Middle East as showing particular promise. Global Private Equity, for example, is actively targeting the Middle East and North Africa region as a place for new business. “We’re in advanced discussions with three or four groups there at the moment and we are looking to take on a mandate there in 2009,” says Global’s president and CEO Patrick Petit. “LPs may have stopped investing for a few months and certainly won’t be back in the early months of 2009, but they will be looking for markets with good growth rates, high population growth and low inflation. The Middle East will offer them that opportunity, but with less volatility than you tend to see in other emerging markets.”

And, despite his pessimism about the investment patterns many investors may follow, even Aerni believes limited partners should be looking seriously at emerging markets as a means of exposure to growth. “The question LPs have to ask themselves is whether, in the downturn, they will achieve the same returns as European funds have in the past,” he says. “If so, then there is no reason to invest in emerging markets. If they can get more, they have an incentive to invest there as they will be adequately rewarded for the risk of investing in these countries.”

There certainly seems to be cause for optimism among emerging markets fund managers. While only a fraction of LPs currently invest in the Middle East (just 3% of North American investors and 10% of Asia Pacific investors), nearly half of Asia Pacific, a third of North American and just over a fifth of European investors are planning to commit capital there over the next three years, according to the Winter 2008-2009 Barometer, published by Coller Capital.

Ralph Aerni, SCM

Asia Pacific is set to be a beneficiary of the shift of capital, too. The survey found that, while less than half of US and a third of European investors allocated 6% or more of their private equity portfolio to the region, almost 70% and 61%, respectively, expected to increase their allocation to at least 6%. Asia Pacific buyouts were ranked by investors as the most attractive area for GP investment over the next 12 months.

And there have been some decent emerging markets fundraisings over recent times, too. Aureos’s Central Asia fund has reached a US$67m second close, China’s FountainVest has raised US$1bn and Actis managed an impressive US$2.9bn, well above its US$2.5bn target.

“We exceeded our target and this reflects the increased appetite for emerging markets private equity among LPs,” says Actis partner in charge of fundraising Jonathan Bond. “They are looking for diversification; possibly even more so now that the crisis has deepened.”

“LPs haven’t been turning away from emerging markets,” adds Bond. “In fact, the current crisis is an opportunity for newer private equity markets to demonstrate that they can continue to outperform more established markets. This will be a coming of age.”

Yet despite the apparent longer-term push towards emerging markets, fundraising is still going to be tough. General partners are likely to find that potential investors will be much tougher in negotiations than they might have been used to in recent years. The pendulum of power has swung firmly back to LPs after several years of GPs calling the shots. "The LPs have definitely got the whip hand," says Andrew Bentley of Campbell Lutyens. "They are demonstrating that by either investing or not, although they are also able to negotiate nuances in the terms and conditions."

As with previous downturns in fundraising, no one is expecting revolution. Yet there are some more subtle changes that look set to move to LPs' advantage. Investment limitations is a particularly hot topic at the moment. "GPs are looking to get more flexibility over their investment policies," says Judd. "They want to be able to do turnarounds and debt investments. The attitude of LPs varies: some understand the need to respond to market conditions; others are naturally concerned about strategy drift."

"We may see movements in terms and conditions in 2009; it's too early to tell yet what the effect of the crisis and downturn will be. We would hope to see improvements, not necessarily in the economics, but in areas such as investment limitations. We would like more say over investment in PIPEs, for example: why are we paying a 1.5% management fee on money that is being invested in public equities? Overall, private equity managers' track records with PIPEs have not pleased us."

But there are other areas where LPs are agitating for change. "The terms and conditions will come through this recession, as in past ones, relatively unchanged," says SJ Berwin partner Josyane Gold. "That's because the private equity model works. But there will be pressure on certain areas. No fault divorce clauses have been under scrutiny for a while now, for example. There may be some move towards removing the compensation element in these."

Aerni agrees. "There will be pressure on divorce clauses," he says. "In the past, GPs have received carry on investments already made, and in some cases on new investments, where there has been removal for cause. Our view is that if there is a removal for cause, the GP shouldn't get any carry."

The last few years have also seen a move among some funds towards the US model of deal by deal carried interest. Many believe LPs will demand this shift back; GPs on the other hand may argue they need to keep their people incentivised during tough times. And, in response to economic conditions, there is a move to increase fund timescales. Altor has reportedly increased its fund life to 15 years, for example, although most GPs are seeking an extra year or two, according to lawyers.

While we may not see the record-breaking fundraisings in emerging, or developed, economies for some time to come, the picture for fund managers in less developed private equity markets seems generally rosy over the longer term. Yet those that have to hit the road over the next couple of years at least should expect some robust conversations with investors.

"LPs have the time and inclination now to consider each opportunity at their own leisure," says Bentley. "The ones with capital will be able to dictate the terms." We might even see new models of private equity emerge.

"Established investors may be out of the market for some time now," he adds. "In their absence, fund managers are either going to have to find new sources of capital or they are going to have to find innovative structures; we may see more pledge funds, deal by deal structures or sponsored semi-captives, for example."