Care for a top-up?

Fundraising remains as challenging an activity now as it was 12 months ago. Many signs of life have been in the form of top-up funds – a signal that many LPs are not only honouring their commitments but also supporting their GPs. By *Francinia Protti-Alvarez*

It's a jungle out there; even funds that were closed prior to the current drought are facing limitations when it comes to deploying capital. In certain instances, some have been forced to reduce their size. Take the case of France's PAI partners, which has offered to return up to 70% of undrawn commitments back to investors in its fifth €5.4bn fund, following the departure of chief executive Dominique Mégret and his right-hand man Bertrand Meunier, and the ensuing trigger of a key-man clause.

But other funds are getting bigger. Portfolio company earnings are now more visible and predictable, meaning LPs feel more confident that valuations have bottomed out. This may be why we have seen a few annex top-up funds raised in recent months. "Despite today's fundraising challenges, annex/build-up funds and top-up vehicles are a good idea – it is in the best interest of LPs to continue to back the managers that they support," asserts Charles Lemon of mid-market placement agent Matrix Group.

Build-up or top-up?

In October, Southern European private equity firm Investindustrial closed its Build-Up vehicle for its third fund on its €100m target after five months on the road (*see page 6*). US-based buyout giant KKR also closed a €400m annex fund to support additional equity investments for portfolio companies of its second European fund, which closed in 2005 on approximately €4.5bn.

But not all are convinced bigger is better, especially when size is built incrementally. For a start, annex funds are destined to support existing portfolio companies, which for one reason or another are/could be facing difficulties. Cynics argue that GPs either mismanaged the portfolio in the first place, or that not enough cash was reserved for follow-on funding – either way the term "good money after bad" is often synonymous with annex funds.

LPs are therefore unlikely to participate in annex funds unless they get offered better terms – for example no management fees – on the new equity invested. "It sounds logical and practical but you would be surprised by the number of annex funds out there trying to raise without amending the terms and conditions," exclaims Mounir Guen, CEO of placement agent MVision.

Meanwhile, top-up funds raised to reinforce the value of the existing portfolio via new acquisitions have enjoyed a bit of a better reputation. "Top-up funds tend to maintain the same terms as the primary fund but no fees are charged until there's capital drawn," comments Guen.

In September this year, turnaround specialist KPS Capital Partners increased the size of its Fund III from its original $1.2bn to $2bn. New commitments were subscribed to by the fund's existing LPs as well as a select number of new investors. The new capital was raised to benefit from current market conditions and will be deployed for new investments in turnarounds, restructurings, bankruptcies and other special situations.

In the UK, lower mid-market investor Inflexion Private Equity closed its LP co-investment fund, which was oversubscribed on its hard cap of £75m. The new vehicle will co-invest solely in new deals alongside the £165m 2006 buyout fund and will continue the strategy of investing in sub-£100m growth buyouts in the UK. The purpose of the fund is to allow Inflexion to buy without debt and/or to increase the equity component

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in its deals. As it is to invest in new opportunities, instead of pumping additional LP money into existing companies, many investors are warmer to the proposition.

But despite these notable successes, fundraising remains difficult. "LPs have gained some visibility on their portfolios, but the fact remains that in the current market, exits are still few and far between. LPs are carefully evaluating their existing relationships, assessing cash flows, future commitments and re-ups," observes Lemon.

The raising of annex and top-up funds is not 'stealing money away' from primary fundraising *per se*... if the top-up fund allows the GP to improve and develop its track record, it will help market their primary fundraising in the future

Reality check

Fundraising will remain difficult in the months ahead. Indeed, there are many questions being raised today that were not really a consideration a few years back. For example, when will the market start moving again? And what will be the most interesting market sectors and segments?

Such difficulties are not sufficient to ward off GPs from fundraising altogether. Italian LP IDeA is currently raising ICF II, a €300m fund-of-funds that reached €175m in August this year. "The vehicle seeks to profit from the various opportunities currently out there. The vehicle will mostly focus on funds investing in companies with EV ranging from €50-300m across the world as well as on special situation and turnaround projects," says Franco Mosca, managing director at IDeA Capital Funds. In July, IDeA closed its Co-Investment Fund I on €217m to focus on expansion and buyouts.

By nature these co-investment funds are designed with preferred conditions embedded in them, thus there is a guarantee that if the LP "loses" on the primary fund, the co-investment still performs well. If the primary performs well, then the co-investment does extraordinarily well. Co-investment funds may allow LPs to cherry-pick the best/strongest companies within the GP's portfolio. LPs will tend to opt for the one that allows them to reap the higher returns at a lower cost.

Re-examining the model?

The current market shock has many rethinking the entire funding model. Already most annex and co-investment funds are without management fees, something unheard of a few years ago as the market was coming of age. Terms and conditions have long been a hotly debated topic but never more so than now. "There will always be a negotiation between LPs and GPs vis-à-vis remuneration and fees and this will oscillate in accordance to the strength of the market. We believe that fees for lower mid-market funds – those at or below €500m – are generally fair and interests are aligned," notes Lemon. Mosca adds, "It is not so much a change in the terms that we are witnessing, more so a reality-check."

Also under threat is the 10-year closed end vehicle model. We could be seeing instead five-, three- or even one-year (evergreen) vehicles; funds that approach investors every six months or so in order to raise capital. Like with everything, there are pros and cons to shorter investment horizons. Some fear GPs could deploy hastily in order to invest the majority of the funds raised. Also, raising funds every six months would require a lot of effort on the investor relations side, which is not something all GPs can afford and which could serve to detract from optimal deal-doing. "There are risks certainly but these can be mitigated, and in the end it comes down to managing the LP-GP relationship," says Lemon.

As some postpone fresh vehicles with top-up funds, others are announcing new funds. So is the raising of annex, top-up and co-investment funds affecting primary fundraising? There doesn't yet appear to be a clear answer to this.

Recently, international private equity house Hellman & Friedman announced the final close of its seventh and largest fund, HFCP VII, on a little under $9bn. They are not alone: TA Associates also recently closed its latest fund, TA XI, on $4bn, comfortably surpassing its $3.5bn target; while GI Partners held a final close of its latest vehicle, GI Partners Fund III, on close to $2bn, representing more than a 35% increase from the size of its predecessor (though shy of its $2.5bn target). Secondaries specialist Pomona Capital and buyout house Gilde Buy Out Partners have also had successful fundraisings of late, with the former comfortably passing its $1bn target to close on $1.3bn and the latter reaching a first close on €217m. "The raising of annex and top-up funds is not 'stealing money away' from primary fundraising *per se*. Furthermore, if the annex/top-up fund allows the GP to improve and develop its track record, then it will help market their primary fundraising in the future," says Guen.

Despite all the negativity in the market, upper mid-market buyout funds are far from extinct. They are innovatively adapting themselves to survive this crisis. "However, the reduction of fund sizes may become a trend. This could potentially lead to some problems, as GPs that developed their track record in one segment of the market find themselves having to operate in lower market segments, for which they don't necessarily possess the skills," concludes Guen. ■

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