UNCOMMON **MARKET**

Fundraising has been undeniably brutal in the past two years as supply far outstrips demand. Six top players from all sides of the industry discuss tactics, the art of humility, and a last-minute reprieve for Europe.

CHAIRED BY **AMY CARROLL**
PHOTOGRAPHY **RICHARD GLEED**

Luck appears to have played a big part in private equity firms' ability to weather the downturn. Those firms that happened to have raised funds, or at least to have built up momentum, prior to the collapse of Lehman Brothers, have had a far easier ride than those that have been forced to go cap in hand to LPs. There is no doubt that it has been a tough time to go fundraising – but just how tough has it been?

Guen: The market right now is brutal. What we are seeing is a lot of funds out there that aren't moving, and a lot of funds set to come to market that won't move either. First closes are hard to secure and a lot of firms won't hit final close targets. Those limited partners that were investing €500m at a time are now investing €150m. That means for every LP you lose, certainly as a mega fund, you need three or four to replace them.

It is tough at the small end too. There is a sweet spot fund size between €500m and €1.5bn, but even then you have to tick a lot of boxes or else it just isn't going to happen.

Hugh, you have been in the market this year. How relieved are you that it's all over?

Lenon: Delighted, of course. It was a fundraising with different phases to it, but in the end we raised our £450m with another £300m of unsatisfied demand on top. That's not to say there weren't some bumps along the road! It did take us around a year, all in all, which is longer than expected.

ON THE PANEL
(Clockwise from top left)

David Smith
Capital Dynamics
Smith is a managing director and co-head of the co-investment team at Capital Dynamics. He has more than 20 years' experience in private equity.

Hanneke Smits
Adams Street Partners
Smits is chief investment officer, in London, at Adams Street and responsible for global investment strategy. She also oversees primary and secondary investments globally.

Hugh Lenon
Phoenix Equity Partners
Lenon is managing partner at Phoenix and has more than 20 years of UK private equity experience. He is also chairman of the BVCA.

Jeremy Lytle
ECI Partners
Lytle is investor relations director at ECI, having joined the firm in 2007. He is also a member of the BVCA's Responsible Investment Advisory Group.

Robert Coke
Wellcome Trust
Coke is co-head of absolute return and buyouts at Wellcome Trust. He is also chairman of the BVCA's nine-strong LP Advisory Board.

Mounir Guen
MVision
Guen is chief executive of MVision, which he founded in 2001. Previously he spent 13 years at Merrill Lynch, where he was a managing director. Guen currently serves on EVCA's International Relations Committee.

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Jeremy, was ECI quite lucky with its timing? You just slipped through a closing door.
Lytle: We raised our fund in Q4 2008, so yes, our timing was slightly better. But clearly things were starting to deteriorate throughout that three-month period. I think anything that tipped into 2009 was in trouble. If we had been a month or two later with our launch, the fund would undoubtedly have taken a good deal longer.

And if all those funds that have been pulled or postponed over the past few years start to come to market, is that going to mean an even bigger chasm between supply and demand?
Coke: We haven't really seen a rush of funds coming to market yet though. A big reason why investors aren't putting money into funds is that they have so much undrawn capital at the moment and they don't want to add to that. A lot of large funds are taking a long time to invest their tail and so drawdowns are happening very slowly. At some stage there will be a glut of funds coming to market, but it doesn't seem to be happening yet.
Guen: And distributions are slow too. Remember those massive exit flows in 2006 and 2007, with all the recaps. Investors couldn't reach their allocations, however hard they tried, because the money was coming back so fast. That's not happening any more. Investors want to get their return and it is difficult to access their commitments, which is making some GPs hesitate in coming to market.

Is there also an argument that when GPs do start getting money out of the door again, we will see a second wave of LP distress?
Coke: The markets have rescued a lot of LPs. The denominator effect has gone away and liquidity pressures have eased. There have been some secondaries sales too. The LP community is actually in quite good shape, although you're right, you do get the sense that we are still quite close to the edge of a precipice.

What about the implications of new regulation on the limited partner community. How big an impact will that have?
Lytle: There are certainly groups of LPs that just won't be investing going forward. The UK clearing banks for example.
Lenon: The banks are holding back for regulatory reasons. The insurance companies are holding back for accounting reasons. The other way of looking at the LP market is in terms of legacy and non-legacy investors. My impression is that many investors that have been in the market a long time are now over-allocated and suffering from a lack of distributions. But then there are new investors which, for one reason or another, have not been in the market before – be they new sovereign wealth funds or just slow off the mark – they have, by dint of good fortune or shrewd judgement, capacity. It was key for us when we were fundraising to identify which investors had the capacity to invest and which did not.

So the make-up of the active LP community has changed significantly?
Guen: Absolutely. The investor market is now one-third European, one-third US and one-third Asia Pacific. It used to be two per cent Asia Pacific. What's also interesting is that these new investors don't necessarily fit with the ten-year partnership model. They work better in special-purpose vehicles. They also consider segregated accounts. And there's a knock-on effect from this as the US pension funds, which are very active right now, and the UK pension funds see what's happening and are starting to request those types of investment too.
Lytle: But that's just on the larger funds is it not?
Guen: I'll tell you something that will surprise you. Some of the smaller funds that we are working with, which in the old days would have had 15 to 20 LPs, now may have just two or three, because those LPs want to write tickets of €100m.
Lytle: But why would the GP accept that? We would be very wary of any investor taking more than ten per cent of a fund, simply from a risk and diversification perspective.
Guen: But if you manage those few relationships really well, they are locked in for life. We have funds with as few as three LPs and they refuse to meet any other investors, so their waiting list is massive. The model works very well. Just think about the IR. You just have three people to take very good care of.
Lytle: I can see how it works when everything is going well, but you have got to plan for downside risk. If you have a few difficult deals or something happens to one of those LPs, you are in deep schtuck. If you are building an institutional business you must have diversification. You have got to be aware that an LP might step away. We had investors pencilled in for five or ten per cent of our last fund who just didn't have the money when it was time to sign. You have got to be prepared for the unknown.
Guen: But if something happens to one of those LPs they are very easily replaceable, because you've built up a waiting list. And anyway, if you are not performing well you shouldn't be in the market. Of course, sometimes you just have a bit of bad luck. But these are sophisticated LPs. They are not going to drop you at the first bump. They'll give you another chance.
Smits: But don't you think that within these large, sophisticated institutions, it also comes down to individual relationships between the LP and the GP? If that individual leaves, there is an awful lot of re-education to be done. And if that LP represents 20 per cent of your fund, there is an awful lot riding on that re-education process.
Guen: That's our job. Our job is to have an insurance plan in place because of course it does happen. We had a case with one of the foundations where someone new came in with a different view on exposure and GPs were shed. That's just how it works.

"All of a sudden, investors have realised they are **technically underweight to Europe**. That could **benefit** some funds"

Obviously one of the biggest challenges in this market is getting a fundraising off the ground. How do you get investors in at a first close?
Guen: There is no such thing as a first close any more really – it is a question of operating zones.

Lenon: We probably had a dozen mini-closings in reality. If someone was ready to commit we would accept their commitment.

It has been widely reported that BC Partners is offering an early-bird rate. Is that a strategy that works?

Guen: The problem for an LP is that if you invest, say, €100m in a big fund like BC at a first close, you will bear the brunt if they call down any money in the next six months. You'll be subsidising those LPs that come in later. Why should your cash flow be penalised? That said, there have been GPs that have had to make deals with LPs, offering lower management fees, and the implications for their business have been quite extreme, because their budgets no longer add up. They then have to let people go, and all of a sudden the strategy is not the same one that investors signed up to because the resourcing has changed. These are the nuances you have to consider.

Lytle: I think it sets a dangerous precedent. Ideally you try to treat all investors the same whether you are talking about fees, terms or transparency.

Another issue for investors looking to come in at a first close in this environment is that you never really know how big a fund will end up being.

Guen: That's absolutely correct. And that's why for first closes nowadays it is very common to include a minimum fund size.

Smits: The problem is when the minimum threshold is calculated pro rata – where an investor says they will not go beyond ten per cent of the final total.

Lenon: Oh yes, we had that.

Guen: That situation is a real nightmare. We could all be committing but we will never get to that critical number, because we are all ten per cent of one another.

Smits: We have certainly been involved in pro rata situations before where we never got to the minimum.

Smith: So have we. But some of that may not be choice, it may be policy.

Lenon: The setting by LPs of a minimum fund size is entirely reasonable. You must have the fee revenue to support strategy.

Coke: Of course, the rationale for coming in at first close used to be that if you wanted a decent allocation and an ability to influence terms, you had no choice. Now there just isn't a reason, so you have to give people incentive. The risk for the LP of a failed fundraising is massive.

Smits: You are also starting to see more restrictions on how long a GP can market a fund post-first close.

Lytle: I think fundraising extensions are being put in place in exactly the same way as investment-period extensions though, aren't they?

Smits: But there are restrictions. No new marketing is allowed because you don't want GPs tying up resource when they should be investing your money.

Smith: But I think it's worth saying that despite all this talk about the challenges of fundraising, there are significant exceptions. If you look at some of the top-decile US venture names, there is one closing, and if you want in you have to let them know by such and such a day. The whole thing is wrapped up in a matter of weeks.

Guen: They have a waiting list. They have people who have been waiting for access for 15 years. All they have to do is say "here's the form. Can you sign it?"

Smith: It's the exception but it does exist.

Guen: I think that sets a bad example though. Being boastful and arrogant doesn't suit us in this industry any more. In fact, if a GP goes in that direction we don't want to work with them. It's a time to be humble, a time to work hard and a time to be fair.

Mounir, as a placement agent, are you having to groom GPs in the art of humility?

Guen: A lot of GPs have figured it out for themselves. Last year was a real awakening for the industry, and we won't work with anyone who didn't get the memo. So it is not so much a question of coaching GPs in humility but making sure their message is clear. A lot of GPs completely misread their existing investors. When we pitch a potential client it can be a nightmare. They say they have €500m lined up. Lo and behold we sign them up and they can't even find €50m. Talk and action are very different when it comes to LPs and private equity funds.

Coke: There have been some real mistakes made by GPs – people giving a demanding deadline of a final close at a €1bn minimum by the end of March and then completely failing. That sends the fundraising all the way back to the beginning and gives them a huge PR campaign to fight. That arrogance has really caused people to suffer.

Smits: There are two things at play here though. There is the question of GPs not knowing their LPs. But equally, LPs are sometimes not all that transparent. Many are still very reluctant to share their allocations. They want to keep dialogues open even though they are not in a position to sign.

Coke: I don't think LPs are very good at saying no either.

Guen: He's absolutely right. And often there's no reason to say no. It's easier to fade away. If an LP says no and then the GP actually does quite well, the GP will remember that rejection. If the LP just fades away, the GP is far more likely to be generous to them next time around.

Lytle: I disagree. When someone is straight with you and says we haven't got any money, but they make a call and you can take them off the list and not waste time, we really appreciate that. It is when you have been through several meetings with an investor, you know they have got capital and that they are deploying elsewhere, but then they come up with some spurious reason as to why they are saying no. That really grates.

Treating people the way you would like to be treated is the way we operate and if someone messes you around, you really resent going to a lot of trouble, travelling abroad and then after all that having an unexplained no.

Lenon: I agree with all of that, but from a purely fundraising tactics point of view, there can be times when an LP fading away is preferable to them saying no. It all depends on the reason for that no. If it is because, after they have done all the work, they don't like what they see, and

they are a big existing investor, I would almost prefer them not to make a decision. When a GP is talking to other prospective investors about where a big existing investor stands, it is always easier to say the decision has yet to be made. If a no is because an LP simply has no allocation to the asset class, that's absolutely fine. In fact, it has become far easier to justify why existing investors haven't re-upped than it was in the past.
Guen: To be honest, we've been told by investors that they don't want to deal with explaining the real reason for a decline, because it is going to take a lot of time and effort and you are still going to fight them all the way. That's another reason why it can be easier just to fade away. Investors find it very painful when they have to decline. The GPs are almost on their knees begging and offering concessions on terms. They just don't want to have that conversation.

But the other thing to note is that they may share the real reason for the decline with another investor. We've had a situation where all of a sudden a fundraising began to unravel. It was probably at the fourth decline that we figured out a reference call had changed. A prior colleague decided to go the other way and try to hurt this GP.
Smits: What we have done in some situations is reach an agreement with the GP whereby the official line is that we are still doing work, but the reality is we are a no.

David mentioned earlier that some US venture houses are fundraising as easily as ever, despite the macroeconomic chaos that reigns around them. Which other areas are faring relatively well and which are really struggling?
Smits: Europe and mega buyouts are certainly more challenged than other areas. By contrast, US venture and US small buyouts can raise relatively easily. And in Asia the market is actually quite frothy. There are two funds that we committed to last year that got stuck, or that are moving very slowly, and both are European.
Guen: It's funny though Hanneke, we have discovered the exact opposite over the past couple of weeks. I used to think exactly the same way you did, but Q4 is upon us and investors are realising that they haven't met their allocations for Europe. As a placement agent, one of the big issues we face is that there isn't enough quality product. So all of a sudden, investors start looking at their end-of-year numbers and realise they are technically underweight to Europe. By default, that could really benefit some of the funds in the market at the moment.
Smith: We are seeing appetite in one or two niche areas: access-constrained venture is one; emerging markets are also becoming much more prevalent. Another theme we are seeing is clean energy, and infrastructure, which is becoming a new sub-asset class in its own right.
Coke: What we find interesting with emerging market investing is this question of whether the traditional fund structure is the right way of doing things. We are looking at managed account structures in these regions. There is so much volatility and growth that getting in and out within ten years may not be appropriate.

Do you think that is just an emerging market issue, or is the ten-year fund model coming under scrutiny everywhere?
Coke: I think the ten-year fund makes sense in mainstream private equity because there is a natural life cycle to investments.
Smits: It can be an issue in biotech venture.
Coke: In venture it's definitely an issue, yes. We haven't got much choice but to hold on to some venture funds for much longer than ten years. But I think an investment life cycle of four or five years for a UK mid-market buyout, for example, is still reasonable.
Lenon: Even if investment holding periods extend, which I think they will, from four years, on average, to say six years, that can still be easily accommodated in a ten-year fund.

Have LPs' priorities changed in this environment when it comes to their criteria for GP selection? For example, when it comes to assessing track record as an indicator of future performance, just how reliable is the rear-view mirror in today's market?
Smits: Historical performance is one element we look at. But then we also look carefully at the team, and in particular at who actually generates that track record. We also look at process, but we try not to get too caught up in that. If you don't have the right people sat around the table working through that process then you're not going to deliver.
Smith: Process can just be another word for bureaucracy.
Smits: It's a balance really between process, people and track record. Obviously some well-known groups in Europe and the US are going through some generational transition, and that's another area where LPs tend to focus. Will the next generation be able to replicate what the firm has done before? At a lot of these bigger firms, the founders were highly entrepreneurial, but the next layer coming through seems to lack edge.
Guen: That's because in 2006 and 2007, a lot of GPs were given everything on a plate by M&A bankers. They just became stock pickers. That is why the first thing we look at is pipeline. We want to understand the competency of their sourcing capability because otherwise there is no future performance.

The other thing we look at is the formation of the J curve. A big problem we have today is that J curves are flattening and so performance plummets. If a firm is active, then we need to understand its stars and losses. Where deals excelled, how were they sourced? What were the drivers? Who were the people involved? What was the process used? Then we revert to the losses. And if they don't want to talk about them, we'll walk out the door. We want to see what went wrong, how resilient they were, and if they fought.

There can be real pressure on GPs to demonstrate realisations prior to going on the road. Would the LPs here ever encourage a GP to bank a solid exit today, even if they may be able to secure a higher price later on?
Smits: We would never push a GP to exit. As a fund of funds we don't need distributions in order to make new commitments. I am always concerned when GPs feel the need to sell companies early because they are going to fundraise. It can be hard, though, because different LPs have different objectives.
Lenon: In the mid-market you couldn't possibly sell a portfolio company without the absolute support of the management team running that business, because they have a 20 or 25 per cent stake and this may be their one opportunity to maximise their own capital gain.
Guen: But you can time your fundraising relative to that event. What we are seeing is GPs holding back while they try and get that exit in place.
Smith: They will turn to co-investment, for example, to try and stretch their existing fund out until the fundraising timing is right.
Lytle: From a GP's perspective, I think there

"Being boastful and **arrogant doesn't suit** us in the industry any more. It's a **time to be humble**, a time to work hard and a time to be fair" would also be a lot of pushback from the team if you tried to sell early.

Team members are focused on carry, so they want to get the best possible price for an asset. If a business is going well, there is a lot of focus and expectation internally.

Guen: But you are talking on a deal-by-deal basis there. Investors aren't looking for superstar GPs anymore. They are looking for safety and consistency. If a GP locks in a 3x gross portfolio return and still has four companies left, they have already secured top-decile performance. LPs will be ecstatic about that and will support them in their next two funds, no problem. Then that becomes a difficult decision.

I would suggest that many GPs would rather wrap the fund up than deal with the admin and hassle of managing out those companies. It is a lot of extra work, possibly for relatively little added gain.

Lytle: But I go back to carry being a big motivator. It's also about an individual's track record. People are very concerned about that.

Guen: Ultimately, though, it comes down to carry versus management fee, versus management fee on the new fund. We mustn't forget that GPs are running businesses.

Smith: I'm with Hanneke on this one. Yes, real exits are important. But with FAS 157 we are seeing far better transparency in terms of valuations of current portfolio companies, so we would never want to force a GP to sell. Hugh's point is bang on the button. The last thing we would want to do is alienate portfolio company management, because they are the source of wealth.

Guen: You say that, but we know a GP that decided to hold on to a company because while they had 4x on the table, they were convinced they could get 6x. Guess what happened? They ended up with nothing.

Smits: It happens a lot.

Guen: And then, of course, the existing investors didn't re-up. To be very frank, our experience is that people work with triggers. And the moment you have got that 3x and are into the top decile, you are indifferent.

What about the size of fund being raised? Are LPs being proactive about setting limits? There certainly appears to have been some surprise that both BC Partners and Montagu are targeting the same size funds that they have in the past. Is it a question of pride?

Smits: We are in BC and in their defence I would say their 2000 fund was €4.3bn. Their 2005 fund was not that much larger at €5.8bn. And so their target of €6bn doesn't seem that unreasonable. We look at each GP on a case-by-case basis and consider whether the proposed size makes sense for the strategy and the resources available.

> "**Transparency is key** to fundraising. We opened our books to whoever asked. We **showed** them **who earns what** and set out the pay-progression models"

But there have been a number of mega-fund closings over the past year, albeit mostly below target. Is the mega fund obsolete?

Guen: These firms have no choice but to go after those sums. They have 250 employees to pay for and ten offices.

Lytle: Budgets aren't a justification though. This might sound a bit naïve, but we decide on our target fund size by looking at what we have been doing for the past five years, working out how many portfolio companies we would like in the next fund and doing the maths. With some of these big funds, it seems like they look at their cost base first and then pluck a number out of the air.

Coke: What's interesting about some of these larger guys is that they will probably end up doing fairly small deals, so you're going to get funds full up with endless small investments and when it comes to the next fundraising, LPs will say they don't want such diversified portfolios. You have an inappropriately sized fund.

Smith: Something else to bear in mind is what has happened in the acquisition debt markets. In the European mid-market, we're now seeing average debt multiples of 3.5 to four times Ebitda. That is manifestly different to the debt multiple you would have seen in 2006 to 2007. That means that even if a firm is doing deals with the same enterprise value, it will be writing much bigger equity cheques. Fund size needs to take that into account.

What about fees, and terms and conditions? Where is pressure being applied most strongly, and where are GPs being forced to acquiesce?

Guen: The first thing an LP looks for is transparency. After that, deal breakers for me are fund size and transaction costs. Any problems there and they'll walk straight away. They will also check budgets to make sure there isn't too much excess, and on the flip side they want larger GP commitments.

Lenon: Certainly we found that transparency was key. We opened our books to whoever asked – which was at least a third of prospective LPs. We showed them who earns what and set out the pay-progression models.

Then, as Mounir says, it comes down to transaction fees. We were negotiating fund terms at a time when the ILPA guidelines were in the spotlight, so we had quite vigorous discussions with investors. It can be a very emotive point. We do have a small share of transaction fees, but I think that's a reflection of the size of our group. I think if you can explain and justify why you should have a share then people are more open to a grown-up debate. If you refuse to open your books and simply say this is the way it has always been, then you're in trouble.

Smith: ILPA is having a profound impact, particularly with the state plans in the US. If there are significant derogations from the ILPA guidelines, you need to have a good reason why.

But it is understandable that LPs are being demanding: the stakes have been raised, have they not? It is not just about making sure the GPs you invest with are top-quartile – it's about making sure they survive at all. How extensive do you think industry contraction will be?

Guen: By definition, 50 per cent of firms should not be able to raise again. But whether they will survive is a different question because they've got ten years of fees to fall back on. They will just shrink their teams and work out their portfolios.

This actually takes us back to my LP concentration point. If you have a concentrated LP base, it is not in the interest of those LPs to have you collapse. We have already seen GPs in Europe saved by just that.

Lenon: In our marketplace, we have had one or two that have already gone. By our calculation, some 70 per cent of our marketplace will need to raise money in the next two years. The vast bulk of our market will be tested in the next 24 months, so I think we'll know then.

Smits: Maybe a third of that 70 per cent won't raise anything at all, another third will raise a lot less than in the past and a third will be on target. We will also see some spin-outs and new firms emerging. We already have.

Lytle: Everyone agrees that it takes time for firms to die, because the model means you can just wait it out if that's what it takes. There have been one or two high-profile collapses in the past two years, but those were mainly because of a quoted element.

Smits: But remember, returns for other asset classes are relatively low. From a top-down perspective, consultants are still recommending that the average pension fund has an allocation to private equity. They are projecting average returns for private equity at around ten per cent. But they are expecting seven or eight per cent from equities. That might mean there are a lot of groups that still get funded even though their return expectations are down.

Smith: This industry has always been Darwinian and it will stay Darwinian: the dodo will die; the new beast will emerge; and the existing beast that can adapt to its environment will thrive. ●

Real Deals **would like to thank MVision for making this roundtable possible.**