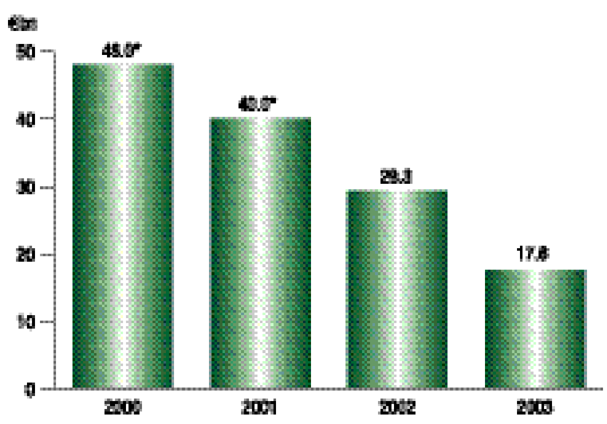
When does a fund raising go stale?

European fund raising in 2003 continued its path of decline recording 37 final closes worth a combined €17.6bn compared with 72 fund closings worth €29.3bn in 2002, according to Almeida Research. This year has seen fund raising momentum pick up, but the increasing number of big names on the market struggling to meet their target begs the question, 'When is a fund past its sell-by date and how can you prevent a fund raising going stale?' *Angela Sormani reports.*

Fund raising took longer than ever in 2003 with less than 10% of funds managing to close in six months or less and almost 60% of funds taking over 16 months to reach their final close. In addition, many fund raisers last year, particularly those without track records or with a focus on early stage or development capital, postponed or cancelled their new fund raisings. More alarmingly, some fund raisers who in previous years had completed successful fund raisings and who had strong track records of investing in mature, cash generative businesses struggled to launch successor funds in the amounts and to the timetables they would have liked.

What is disconcerting is that big names such as 3i, Doughty Hanson and Industri Kapital have been in the market for more than a year, excluding the pre-marketing phase, which suggests they are having problems attracting investors to their funds. This leaves them to ponder whether they will be able to recover from the stigma attached to a lengthy fund raising alongside having to compete with players in the market offering a newer, fresher product. Over the next 18 months prominent buyout players such as Candover, CVC and BC Partners should all come back to the market with new funds, potentially adding to the burden of those marketing an older product.

European funds raised, 2000–2003 (€bn)



*Source: Almeida Research, EVCA**

The two fund raising success stories of last year were Permira Europe 3's mega fund, which raised over €5bn in six months and Altor Equity Fund, the first time fund from Industri Kapital's Harald Mix, which managed to raise €650m in four months, excluding the pre-marketing phase.

Keeping it fresh

Timing and communication are key to achieving a successful fund raising and keeping it fresh, as is a developed in-house investor relations programme or the use of a well-connected placement agent, in particular for first time funds. Knowing who your competitors are and when they are likely to be in the market is also crucial.

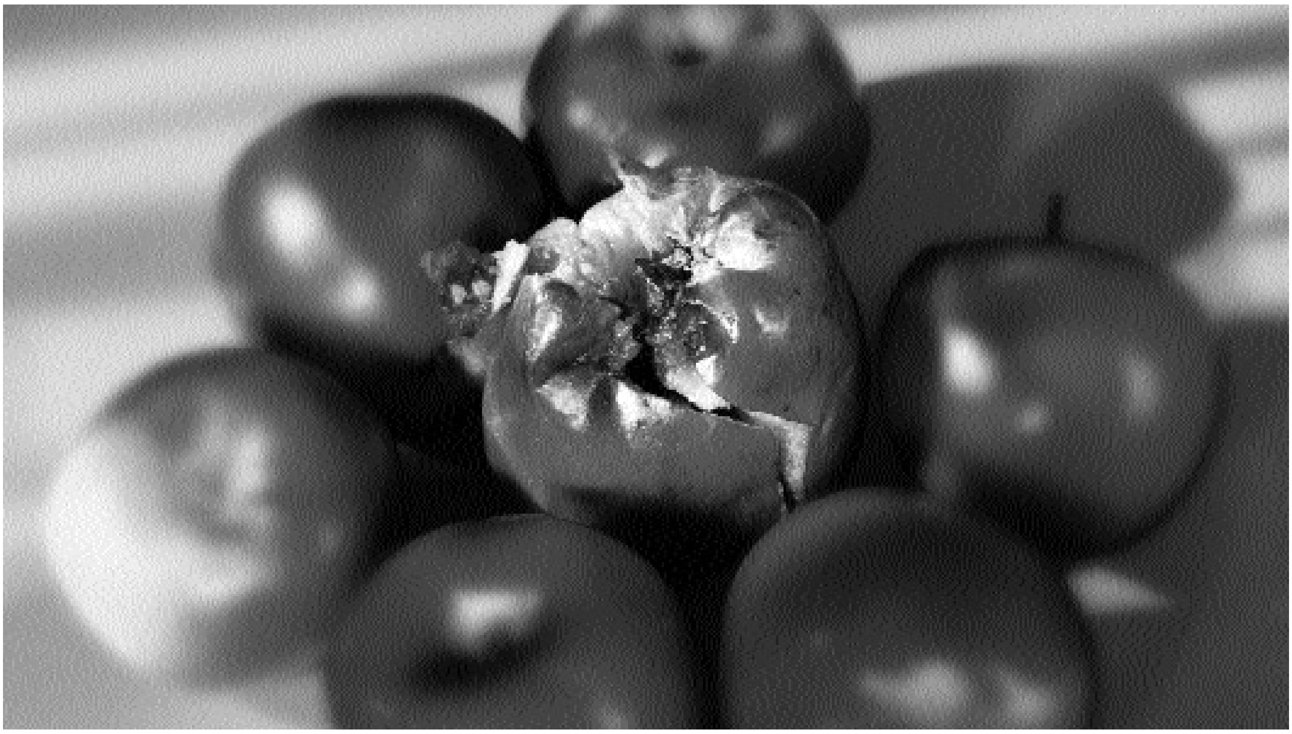
General Partners are judged in three key areas during their capital-raising campaigns, says Anthony Romanello, director of investor services for Venture Economics. "LPs are looking at people, process and performance when evaluating a GP and its fund. If the GP receives top grades from LPs in these areas, then the fund raising is relatively fast and painless," he says.

With the managers an LP will look for continuity in a fund; with the process an LP will look at the structure and strategy of the firm; and with performance a good track record is essential or, in the case of a first time fund, a good track record of the managers. But ask any GP the key to a successful fund raising and the answer is always the same. Momentum is extremely important. If you can build momentum then you can close a fund pretty quickly.

Matthew Judd, partner of private funds group Clifford Chance, says: "Momentum is key to any fund raising and generating momentum for any product in a competitive environment is challenging. However, those funds that really fly can find themselves in the happy position of demand outstripping supply and being forced to scale back investor commitments."

Do you remember the first time?

Fund raising effectiveness is all in the preparation and unfortunately many managers do not spend enough time on pre-marketing efforts. Pre-marketing involves telling all the GP's existing investors and those with which it has developed



Best before?

a close relationship of its intention to go on the fund raising trail and, ideally, securing indicative commitments from at least the former group. Even when pre-marketing has been undertaken often potential flaws in the new fund proposal haven't been thought through.

There are almost 200 funds in Europe fund raising at the moment, but not all of those will succeed. According to Almeida Research there were 37 fund closes in Europe last year and it is a fact that only a small proportion of the funds that are in the market actually ever reach a final close.

In the case of a first time fund it is actually important to move fairly slowly, to ease into the market. Running before walking substantially increases the liability of having a negative impact on the fund raising. For a first time fund an acceptable fund raising time limit is 18 months, while a successor fund should ideally be up and running within 12 months.

At the end of the day it's all about process and managing process. GPs should identify their placement agents and legal advisers early to establish the structural, tax and contractual requirements for fund raising that are important to put into motion as soon as possible.

Michael Halford, a senior assistant in SJ Berwin's corporate finance department, says: "Our experience is that going out into the market with the right terms is an important part of a successful fund raising process. It is not, however, usually our experience that the terms in themselves would cause a fund raising process to go stale. Commercial factors such as the investment record of the team and the proposed investment strategy are likely to play an important role in a successful fund raising"

He adds: "The right choice of placement agent is important too in our experience, and clients like to ensure that the selected agent covers the right target investors to maximise their chance of a successful fund. Presentation is also a priority and clients try to ensure that the terms and other sections are presented in a succinct and user-friendly way."

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For a first time fund a cornerstone investment can be crucial in accelerating the fund raising process, Englefield Capital being a prime example. Last year the team secured €660m from Bregal, a subsidiary of the Swiss holding company Cofra, and closed its fund raising at €700m following €40m in commitments from investors including AXA Private Equity, Dutch Shell Pension Fund and Delta Lloyd.

Another example is Stirling Square Capital Partners. Citigroup put up $250m as a cornerstone commitment to back the first time fund launched by a team of high profile pan European players with 50 years' private equity and investment banking experience.

There are two reasons a cornerstone investor provides a fund raising boost. First, the investors need the cash and second, it's a form of endorsement and a good marketing tool. The latter becomes a moot point if the terms of the cornerstone are such that they cause concern and ultimately deter other investors from joining. Striking the balance of conferring cornerstone status without making other investors feel second tier is complex and difficult to achieve.

A main part of the fund raising process is being prepared for the onslaught of institutional investor questions that will inevitably surface. GPs one-step ahead might pre-empt investors by sending out questionnaires with the answers to questions they might have asked. So from a manager's point of view it means they can spend more time fund raising when they officially launch the fund and avoid those questions during the fund raising. Mounir Guen of placement agent MVision says: "GPs need to realise that LPs take longer to work through their due diligence. It takes much longer than a few years ago. But the GP can facilitate that process by having questionnaires at the ready."

It is true LPs now require more extensive and higher quality information. In the last few years there haven't been as many exits so LPs have to dig deeper with their due diligence process to understand value creation.

How to keep a fund raising fresh

- Market timing. Hold back until investor appetite improves (this is what a number of large buyout houses have done)
- Provide impetus by exiting an existing investment at an impressive multiple (e.g. Permira with Homebase)
- Evaluate the positioning of the fund relative to other offerings. Avoid style drift and play to the strengths of your existing track record rather than ambitions for the future (although there is a balance to be struck here)
- Use key targets in the existing investor base to sound out appetite and build consensus on key issues, which may need to be addressed before going to market (e.g. succession, although it's generally too late to put a succession programme in immediately pre fund raising)
- It helps to have in place a developed investor relations programme so ongoing dialogue is maintained with all existing investors following the predecessor fund raising
- Anticipate investor information demands (e.g. consider providing, as part of the investor pack, an investor questionnaire with the kind of detail many investors will inevitably require to pre-empt hold-ups caused by unprepared investor due diligence)
- Set realistic closing targets
- Use an experienced legal team with the resources to meet deadlines, reaching a first close quickly delivers real value to managers as they can only draw management fee (and organisational expenses) when the fund closes.

Jamille Jinnah of Almeida Capital says: "LPs require much greater evidence of differentiation today. They really want to see how you differentiate yourself and how you're going to compete in the market. They want to see that the GP knows how the business is going to develop over the next three to four years."

Succession is also an important issue. Private equity can be a personality-driven business and the concern for investors is whether the partner most heavily associated with a firm will still be around doing deals for the lifetime of the fund. And, if not, are the younger mangers capable of taking the helm and how are they being incentivised?

"There is significant PR value in effecting a speedy first close."

As far as documentation is concerned before fund raising a manager will compile benchmarking information to compare with its peers and present the information to current and prospective investors. There are a wide variety of approaches taken by the GP here. For example, how much performance information is presented in the document and how the performance compares to the peer group.

Certain firms can be skimpy with the information they provide in their offering memorandum, says Anthony Romanello. Some will skew the information they provide and will report only gross IRR, which is much higher than net IRR. "The mega firms (VC mainly, to a lesser extent, non-venture groups) are much more likely to include net IRRs since, generally, they have done quite well and they have quite a story to tell," says Romanello.

A final obvious point to ensure a fund raising runs smoothly, which many first-time managers may overlook, is to set a realistic fund target. Many first-time funds do themselves a disservice by setting an over-ambitious fund size. Matthew Judd of Clifford Chance says: "There is significant PR value in effecting a speedy first close, although fund sponsors and managers will be mindful of the private placement restrictions which impact their ability to make statements in this regard. On the flip side, the effect of struggling to reach an over-ambitious first close can be very negative."

Jamille Jinnah says: "You have to generate a level of momentum. Investors have to feel you are moving forward. Most LPs are reluctant to make a commitment if they don't see this. This can be done by closings. Try to have as many closings as you can, it shows you're continually moving forward. But multiple closings can be cumbersome to deal with in practice. Another way of promoting your fund raising is by exits from previous funds and new hires."

Respect your investor

For a successor fund the most important thing is the partnership; the relationship the fund has with its investors. "A crucial part of the fund raising is getting the existing investors on board," says Charles Sherwood of Permira.

Nick Archer of CVC agrees: "The relationship with your existing investors is crucial. We are going to be fund raising within the next few weeks for our second Asia fund and the starting point is always the existing investors. CVC works particularly hard with existing investors. They are our supporters and the bedrock of our future funds."

"Nurturing your existing investor base is one of the most important things in fund raising after you have raised your first fund."

Timing and market conditions also play a crucial part in attracting investors. The GP should listen carefully to feedback from existing investors before going out into market again. Michael Halford of SJ Berwin says: "In particular [the GP] will look at the demand and supply in their particular market, i.e. who is currently fund raising and the investor appetite for their fund type. There is also a tendency to try to truncate the investor review process to avoid the possibility of the fund going stale with tight timetables being placed on the closing process."

Permira got it right last year. It was able to fund raise on the back of a hugely successful exit (Homebase) and there was also not as much competition in the market from the larger buyout players such as CVC and Candover, which are due to come out to raise funds in the next 12 to 18 months.

Sherwood says: "Permira raised its fund in six months, which is technically true. From the time of the launch of the information memorandum in March to the final closing in September was six months. But in reality it started marketing its fund the day after its finished raising its previous one."

Archer agrees: "It is justifiable to say the large institutions are always fund raising. That is to say they maintain regular dialogue with their investor base. Nobody can take their investors for granted these days; you need to keep them up-to-date and that is part and parcel of the fund raising process."

Sherwood explains how important it is to go and see existing investors before publishing the private placement memorandum (the central selling document) and to ask what they think the fund should offer. Before publishing the memorandum it is important to agree the principles of the fund with the existing investors. That is one of the reasons it is so tough for a first time fund because they don't have such a relationship with investors.

Matthew Judd of Clifford Chance says: "Once you've got an investor on board and your fund performs well, it's easier to repeat sell. Nurturing your existing investor base is one of the most important things in fund raising after you have raised your first fund."

What makes a private equity fund go stale in this scenario is complacency, the way the GP treats existing investors and if the attention they give them is not adequate. Jinnah says: "You must never forget who helped you in the first place and must always remember you were once a first time fund and these investors were the ones to give you a first chance. Always be clear about the success you have achieved but never forget how you got there."

It is a delicate game promoting a fund and making sure your voice is heard in a crowded marketplace, but at the same time avoiding over-exposure. Some funds don't promote the fact they are in the market because of this. A reluctance to announce a formal launch is a recognition that you can go stale and damage your fund raising campaign. Well-established groups are aware of this and most have a carefully managed fund raising campaign to avoid it.

At the end of the day you have to create a sense of urgency, says Sherwood. "Raising a fund is like marketing anything else, you have to create a demand for the product and persuade your audience there are more buyers than there is stock on the shelf. You do have to create a little bit of competitive tension," he says.

However good the product and the partnership, if the investors feel the product will still be available in a year's time, they may try to wait a year to see that fund start investing. There is always another stone the LP can turn so the GP's job is to persuade the investor to move.

Problems arise when there are a lot of groups coming out to fund raise coupled with the fact that many investors would rather go with a fresh fund than those that have been out there for some time. Getting the product right first time is essential because to go out and be rejected makes it very difficult to come back to the market.

Archer says: "My sense is that there are going to be a lot of buyout houses going to market in the next 18 months and the fund raising market is going to be very competitive. Fundamental to the success of the process is not to be too ambitious with the fund size and to ensure that you have existing investors on board."

But there is a sense that in the later stages of 2004 and moving into 2005, the climate for fund raising will improve. Contributing factors here include improvement in the equity markets increasing exit potential and an increase in alternative assets in a balanced investment portfolio.

Matthew Judd says: "The IPO window is starting to open and this is a good thing bearing in mind that in order to fund raise you need to get rid of existing stock on the shelves. This is because investors want to see exits and returns before committing to another fund."

Buyout funds raised 01/01/2003–31/03/2004

Fund name	No. of funds	Total target ($m)	Gross period amount raised ($m)	Net period amount raised ($m)	Amount raised to date ($m)
Permira Europe III	1	5,234.9	5,946.0	5,946.0	5,946.0
3i Eurofund IV	1	2,737.5	2,488.5	2,488.5	2,488.5
Nordic Capital V	1	—	1,637.1	1,637.1	1,637.1
Terra Firma Capital Partners II LP	1	3,000.0	1,490.2	1,490.2	2,480.0
Charterhouse Capital Partners VII	1	2,673.9	965.6	965.6	3,045.9
Englefield Fund, The	1	410.0	807.2	807.2	807.1
Mezzanine Fund 2003	1	808.1	802.1	802.1	802.1
Doughty Hanson & Co IV, L.P.	1	3,400.0	800.0	800.0	800.0
Altor 2003 Fund	1	588.5	765.0	765.0	765.0
European Strategic Partners II (AKA: ESP II)	1	1,098.2	734.7	734.7	1,359.6
Close Brothers Private Equity Fund VII	1	—	649.6	649.6	649.6
Clessidra Capital Partners	1	1,346.0	649.4	649.4	649.4
Graphite Capital Partners VI	1	476.4	595.5	595.5	595.5
Industri Kapital 2003 Fund	1	2,944.0	590.0	590.0	590.0
Italian Private Equity Fund IV (AKA : IPEF IV)	1	590.5	556.7	556.7	556.6
Carlyle Europe Partners II, L.P.	1	2,258.0	508.1	508.1	508.1
Indigo Capital IV	1	357.3	424.3	424.3	424.3
Capvis Equity II, L.P.	1	352.6	399.6	399.6	399.6
Polish Enterprise Fund V, L.P.	1	384.6	381.0	381.0	381.0
Nordwind Capital GmbH	1	—	372.0	372.0	372.0
Pragma Fund FCPR	1	291.8	370.2	370.2	370.3
Abingworth Bioventures IV (AKA : ABV IV)	1	350.0	350.0	350.0	350.0
Hermes Private Equity Partners 1	1	—	330.8	330.8	330.8
CS Capital Partners II L.P.	1	287.5	326.6	326.6	326.6
Change Capital Partners Fund	1	—	324.7	324.7	324.7
Pacific Equity Partners Fund II (Australasia)	1	—	295.5	295.5	295.5
Nordic Mezzanine Fund II	1	195.3	275.2	275.2	275.2
Gresham III, L.P.	1	353.1	240.5	240.5	240.5
Danske Private Equity Partners II (DPEP II)	1	541.5	235.3	235.3	614.6
Robeco Global Private Equity Fund	1	431.0	219.5	219.5	374.2
ESD Fund III	1	—	212.9	212.9	212.9
Waterland Private Equity Fund II N.V.	1	—	209.4	209.4	209.4
Euromezzanine 4	1	374.7	205.7	205.7	501.9
Activa Capital Fund FCPR	1	161.0	200.0	200.0	200.0
Greenpark International Investors I	1	200.0	200.0	200.0	200.0
Pantheon USA Fund V LP	1	200.0	183.0	183.0	313.0
New Economy Development Fund S.A.	1	146.4	177.4	177.4	177.4
AtriA Private Equity Fund II	1	251.8	176.3	176.3	176.3
EA Partners Fund	1	576.1	172.8	172.8	172.8
Life Science Partners II BV	1	—	167.0	167.0	167.0
Procuritas Capital Investors III (PCI III)	1	252.9	154.9	154.9	253.9
Innovacom 5	1	117.7	141.5	141.5	141.4
AXA Private Equity Fund of Funds II	1	291.3	307.1	139.8	307.1
Deutsche Beteiligungs AG Fund IV (AKA : DBAG Fund IV)	1	246.6	136.6	136.6	255.0
Sagitta Private Equity Partners III	1	93.3	130.7	130.7	130.7
Schroder Private Equity Fund of Funds II	1	408.3	128.9	128.9	128.9
OPERA	1	132.4	126.3	126.3	244.7
Argantis Fund	1	248.8	124.4	124.4	124.4
Iris Capital Fund II	1	—	124.1	124.1	124.1
MPS Venture I	1	—	115.7	115.7	115.7
Nmas 1 Private Equity Fund	1	160.4	114.7	114.7	187.2
Cape Natexis Private Equity Fund (AKA : CNPEF)	1	130.1	110.5	110.5	110.5
Accent Equity 2003	1	326.6	108.9	108.9	108.9
AGF Private Equity Holding	1	215.2	107.6	107.6	107.6
Partners Group Secondary, L.P.	1	456.0	105.1	105.1	105.1
Royal London Private Equity (RLPE)	1	289.0	101.6	101.6	101.6
Edmond de Rothschild LBO Fund	1	195.2	98.8	98.8	98.8
Dania Capital K/S - Fond I	1	187.1	93.6	93.6	93.6
Equity Harvest Fund	1	124.4	93.3	93.3	93.3
Halder GIMV Germany Fund	1	172.7	91.7	91.7	91.7
Close Brothers Growth Capital Fund II (Fund II)	1	179.8	89.9	89.9	89.9

Buyout funds raised 01/01/2003–31/03/2004 (continued)

Fund name	No. of funds	Total target ($m)	Gross period amount raised ($m)	Net period amount raised ($m)	Amount raised to date ($m)
Robeco Sustainable Private Equity	1	200.0	88.8	88.8	88.8
Four Seasons Venture IV	1	—	85.1	85.1	85.1
SGAM/4D Global Energy Development Capital Fund	1	150.0	81.0	81.0	81.0
Siparex SPF III Middle Market Fund	1	131.1	78.4	78.4	157.7
DBG Eastern Europe II LP	1	87.0	72.4	72.4	72.4
Astorg III	1	332.1	72.1	72.1	121.8
Kleinwort Capital Partners IV	1	368.9	71.9	71.9	163.0
Baring Iberian Fund II	1	104.8	68.1	68.1	68.1
CapMan Equity VII	1	—	64.8	64.8	330.2
Presidio I	1	—	61.7	61.7	61.7
Accession Mezzanine Capital LP	1	129.0	57.0	57.0	129.8
Inflexion Private Equity Fund 2	1	113.3	56.7	56.7	56.7
Lion Capital Partners I	1	75.0	55.0	55	55.0
Lead Equities I	1	43.8	53.7	53.7	53.7
ICSO'1 Fund	1	—	51.5	51.5	51.5
MB Equity Fund III Ky	1	—	48.5	48.5	135.4
Credit Lyonnais Fonds Secondaire I	1	81.0	43.1	43.1	43.1
North East Co-investment Fund	1	—	41.6	41.6	41.6
Growth Capital Fund	1	195.3	39.3	39.3	39.3
Isis Equity Partners III	1	276.3	38.7	38.7	239.1
Northzone IV K/S	1	102.7	38.6	38.6	87.9
Finadvance Capital III	1	—	37.7	37.7	37.7
Reuters Greenhouse Fund (RVC 1)	1	—	36.6	36.6	436.6
OTC Innovation 3	1	—	35.1	35.1	35.1
Aberdeen Murray Johnstone Private Equity Fund	1	220.7	34.0	34.0	120.0
European Fund Investments II LP (EFI II)	1	—	33.8	33.8	94.3
Poteza Adriatic Fund	1	83.4	33.4	33.4	33.4
Advantage Growth Fund	1	—	32.5	32.5	32.5
Create East of England Fund	1	48.1	32.1	32.1	32.1
Promotion Equity I Fund	1	—	31.9	31.9	31.9
Credit Lyonnais Innovation 5	1	—	31.1	31.1	31.1
Salento Venture	1	—	28.9	28.9	28.9
Siena Venture	1	—	28.9	28.9	28.9
EMBL Technology Fund	1	—	18.3	18.3	27.3
Proof of Concept Fund, The	1	—	18.1	18.1	18.1
PolyTechnos Venture Fund II	1	—	17.4	17.4	135.4
Venture Capital Rheinland-Pfalz GmbH & Co KG (AKA : VRP)	1	—	16.1	16.1	16.1
Natexis banque populaire	1	—	15.7	15.7	15.7
Kisvallalkozas-fejleszto Penzugyi Rt.	1	—	15.1	15.1	15.1
Nord Est Investment Partners	1	34.3	14.6	14.6	32.3
Axa Expansion I	1	—	11.2	11.2	24.9
Power Fund I	1	—	10.9	10.9	10.9
gamma II Beteiligungs-AG	1	27.0	10.8	10.8	10.8
Sigma Innovation Fund (East of Scotland)	1	—	10.1	10.1	10.1
Euroventures Hungary III	1	72.7	9.9	9.9	38.9
Recycling Fund,The	1	—	8.6	8.6	8.6
Trinity Fund I	1	—	8.1	8.1	28.1
Close Brothers Development VCT PLC	1	—	7.9	7.9	29.2
Enterprise Equity Investment Fund	1	—	7.9	7.9	7.9
Bank of Ireland Kernel Capital Partners Private Equity Fund	1	22.0	7.5	7.5	18.5
Quester VCT 5 PLC	1	36.5	5.6	5.6	35.3
NESTech (AKA : North East of Scotland Technology Fund)	1	—	4.8	4.8	4.8
Alice Lab	1	—	3.7	3.7	21.5
Uninvest Fondo I+D	1	14.0	3.5	3.5	3.5
Midinvest Fund YPY I Ky	1	—	3.0	3.0	3.0
HotOrigin Software Ventures Fund II	1	11.1	2.3	2.3	2.3
Capricorn Venture Fund II	1	88.4	2.2	2.2	22.7
Avenir Finance Developpement II	1	—	1.6	1.6	1.6
Czech Top Venture Fund B.V.	1	—	1.2	1.2	1.2
Total	**120**	**40,297.0**	**30,941.4**	**30774.1**	**37,753.8**

Source: Thomson Financial Venture Economics / NVCA