FUNDRAISING

A TOUGH BALANCING ACT

BY MARK WILLIAMS

More sophisticated investors are creating a highly selective and demanding fundraising market.

In terms of funds actually closing, the private equity fundraising market in 2003 remained fairly slow throughout the year. Fundraising has become a long process; the average cycle is 18 months. Only a dozen or so firms really stood out as being able to close funds within six months and hit targets.

The overall drop is down to the three main factors: the fall in appetite for venture capital; very few exits, which means institutional investors have not received their money back and are reluctant to commit further capital; and the 'wait and see' approach to portfolio management that stems from high prices being paid for companies in the late 1990s and 2000. Investment cycles have reduced the number of funds currently in the market, with many voluntarily waiting for more exit flow and holding back fundraising in the meantime. It has also been a tough political environment over the last 18 months, and the people who con-

tribute to private equity funds tend to be very conservative, says Jamille Jinnah, Managing Director at placement and research firm Almeida Capital. It took the conclusion of 'active' war in Iraq last spring to turn around interest from institutional investors, which has been curbed again by the intensification of conflict in recent weeks.

"What we have are fewer funds chasing more dollars," says Talbert Navia, head of the Private Equity Group at Chadbourne & Parke LLP and a former founding partner at MapleWood Partners, a US middle-market private equity firm. That has made for a highly selective market in which the funds with consistency of performance and low turnover of key principals are chosen first while the rest are faced with a slow fundraising process, Mr Navia says.

Fish in a big pond

At the top end of the scale, the mega funds are facing increased competition for deals, largely from other private equity firms but also from the re-emergence of strategic buyers. Many institutional investors realise that they therefore need to gain exposure to the smaller markets as well.

The middle and smaller funds have a competitive advantage over their larger rivals. "Appetite for mid-market and small market funds has been increasing, particularly for the more experienced players in these segments," says Michael Bacine, Managing Director of Franklin Park. They are typically very focused on the types of businesses in which they invest and can demonstrate qualitative characteristics. The best firms are able to illustrate that it may be easier to nurture more growth from small and mid-cap companies than from a large cap company. That means more potential for greater returns. Increased interest in the segment is evidenced by the appearance of mid-market auctions, which have amazed many players. But smaller funds, around the $300m mark, have to meet more criteria to satisfy investors. "LPs believe they should be given a higher rate of return to invest in smaller funds, given the risk factors of investing in less mature or potentially less stable companies," says J Lyons Brewer, a partner at CP Eaton & Associates. But such compromise might be a small price to pay for attracting more investors, particularly as institutional investors turn their attention to the bottom end. "Sophisticated LPs are increasingly taking the decision to build a portfolio of funds with narrow investment mandates rather than delegating this responsibility away to those big players who cover a broad range of sectors and geographies," says James Coleman, Director of the Fund Placement Advisory Group at Deloitte.

First time fundraising is never easy, and success usually only comes from spin-outs, when fund managers leave existing funds to start their own. It is essential to demonstrate operational experience, which can be a problem for an investment banker who made all his money from fees. Debut funds entering the market must have a unique thesis and an exceptional team to support it, in order for investors to justify their commitment. "Emerging managers need to offer the best possible terms and the most competitive structure up front," says Bonnie Plunkett, Managing Director of Alternative Investment Source LLC. "They might not have an opportunity to negotiate before LPs move on to the next fund," she adds. However, the prospects have recently improved, with some US institutional investors and fund-of-funds – such as CalSTRS, Parish Capital and RCP Advisers – introducing programs specifically focused on 'emerging' or 'next generation' managers who will lead the funds of tomorrow.

Industry professionals expect to see a lot of funds go out to raise new capital over the next 12-18 months. Fundraising in the US is expected to increase 20-30 percent in 2004 over 2003, and in recent months, interest has grown in European funds as well. "As long as new fund raisings fit the investor programs and match the liquidity perspective of the LP investment programs, different types of funds can be raised," says Mounir Guen, CEO of MVision Private Equity Advisers.

The smart money

Overall, the capital raising figures in 2003 took us back to mid-1990s levels, following the peak of 2000. About half the capital raised last year went into buyout funds. Venture capital attracted about 12-14 percent, mezzanine around 10 percent and fund-of-funds around 10 percent. The rest was divided between secondary funds and niche funds. The prospects for 2004 are widely considered to be a better than last year, with expectations of a 10 or 20 percent increase overall.

Fundraising for buyout funds is steady and rising, and they should account for 50-60 percent of 2004 totals. There is a clear focus of activity on small to middle-market funds, which benefit from less competition than larger segments. But as the interest levels increase in these markets, the opportunities will be more keenly contested, forcing investors to look even further downstream. US and European middle market buyouts are particularly popular, seen as more mature, with better quality players and less risk than the venture market. Large buyout funds are still attracting investors – especially larger investors looking to commit $100m or more to a fund – but some have been out fundraising for a long time.

For long-term investors who are looking for more diversification against a core private equity portfolio, specialist funds have become an attractive alternative. Fund managers have offered highly-focused niche funds, targeting sectors or countries, for example. Due to the demographics of an ageing US population, healthcare is of interest. There are even signs of funds targeting the Hispanic market in the US, in response to statistics showing that Hispanics have become the largest minority in the United States.

One trend that savvy LPs are exhibiting more clearly is to invest with superior general partners showing consistent track records, rather than looking to get involved specifically in a venture fund, a buyout fund or a secondary fund. The smart money is going towards large cap ▸▸

funds producing consistent returns, or the smaller niche funds with good stories. "Investors want to be sold on the investment team, including, and more significantly, the post-acquisition team," says Mr Navia. For example, on the post-acquisition side of a buyout fund it is important to invest in people who can handle a difficult business situation, and often the best selling point for a general partner is to prove they turned around their worst performing portfolio company. While an ability to add shareholder value on the operational side is paramount, LPs are also interested in an investment team with minimal turnover, given the fact that the industry is now subject to greater mobility than ever before, with many principals leaving to start their own funds. Consistency, performance and reliability often supersede fund type.

Trust, terms and transparency

Due to the lack of exits achieved by many funds, LPs are now more demanding, more selective and making fewer investments. They require more information – and better quality information on which to base a decision. The majority are searching for good returns but with earlier access to liquidity across their allocations. "Some investors have recently sacrificed higher long-term returns for reduced short-term gains," says Mr Jinnah. GP performance and credibility has become just as important as the income component, and LPs are working at great lengths to conduct deeper analysis of the funds available. Mr Bacine says that LPs are concerned with compensation programs and succession issues; the value add approach of the manager and how they have generated their returns in the past; and the attractiveness of a fund's strategy and the differentiating factors that one fund has over its competitors. "The due diligence process has become far more sophisticated. This goes partly to assessing past performance but it also goes to assessing the likelihood of that performance being matched in later funds," says Philip Sanderson, a Funds Partner at Travers Smith Braithwaite. 2003 confirmed that due diligence is here to stay – the stirrings of a hotter fundraising market did not reduce the hunger for information or the length of time LPs were prepared to dedicate to analysing it. "LPs can take longer on due diligence because there is less pressure at the moment to work quickly. When the market gets busier, LPs will still perform thorough due diligence. Many form relationships with GPs before they are actively fundraising," says Mr Coleman.

But most of the time all the information from succession planning to investment strategy comes after one primary consideration. "One factor that trumps all the rest is trust," says Raymond Kraftson, Managing Director of Ariane Partners. "If the LP feels that they can not fully trust the GP, everything, even track record, fades into the distance." LPs have to be confident that they can and want to be in business with a GP for the long-term. The relationship between GP and LP is more important than any IRR. If trust has been built over the years, and an understanding of any mistakes made along the way have been nurtured, an LP is far more likely to forgive a GP who falls short. A history of communication inspires an LP to keep investing with the same manager. "Making investments in the alternative arena is like a marriage," says Ms Plunkett, "but GPs overall are not particularly effective with investor relations. Investors are seeking a consistent flow of information and the bottom line is that GPs who are proactive also benefit from having continuous dialogue with LPs."

Aligning the interests of LPs with GPs does not have a single solution, and GPs often underestimate the extent and demands of the process. LPs need to be comfortable with both the legal structure and the commercial side. They are becoming 'intrusive' and expect more of a partner-based relationship with GPs. "LPs are certainly influencing fund terms where they have negotiating power. However, many GPs, aware of the competitive fundraising environment, make their terms more investor-friendly before coming to market," says Mr Coleman.

LPs are especially interested in introducing mechanisms that align GPs to perform. "If they feel that this mandate is missing, they will push the issue to its limits in search of a resolution," says Mr Guen. Fundraising is now seen as a process which starts on the raising of the previous fund and continues until final closing. "The increased amount of time that GPs need to invest into their relationship with LPs will add pressures to the fundraising environment," says Mr Sanderson.

Drawing up terms and conditions can be a sticking point in the fundraising process. Prior to early 2000, GPs with a strong story could push all kinds of terms on LPs eager to invest in their funds. For example, they could introduce carry on individual deals. It was also reasonable to push a clawback escrow reserve of 50 percent of the GPs carried interest. However, to insist on that now makes for a very long fundraising trail – GPs are being forced to accept that 50 percent is the bottom of the spectrum, and it is not unusual for them to be forced up to a 100 percent clawback reserve. These days, LPs want to see that the protection of their investment is a priority.

Fees are another ongoing debate. Transactions fees and post-acquisition fees were split 50/50 between GPs and LPs, they are now more likely to be weighted 60/40 in favour of the LP, or even 75/25 in extreme cases. Particularly in buyout funds, LPs realised that GPs were also charging fees to portfolio companies for advising the board and for M&A work – and making a significant

income doing so. Now LPs want to see the budget and make sure that the fund is not just a cash cow for GPs.

At the formation stage, LPs may refuse to pay management fees that they believe are too high. They may also argue that management fees will not be paid if GPs fail to hit certain targets down the line. "LPs are not happy paying management fees on a large pool of uninvested capital," says Ms Plunkett. As an incentive for GPs, LPs are increasingly willing to reduce high management fees but pay more in carried interest. There is a growing argument that premiums and fees should be at the post-acquisition end of the process, where real value and the interests of both parties reside. In the 1980s, value creation occurred on the investment side. Now it happens on the operational side.

"If LPs want talented operations managers to be on the GP team, and to encourage them to perform, they should create incentives for the GP – either through carried interest or fees tied to performance," says Mr Navia. "As an LP, you want to make sure the post-acquisition team and overall compensation to them is aligned with the interest of the LPs."

From the perspective of GPs negotiating terms with global investors – an increasing necessity in the international market – the difficulty is in meeting their various needs. LPs can be driven by fiscal needs, regulatory needs, jurisdictional needs, reporting needs, and so on. They may demand detailed performance reports or require only minimal updates. With the continued grouping of global investors within the same fund, problems arise when these needs contradict each other. GPs are finding themselves spending more time discussing specific arrangements to accommodate an LP's particularities, which slows down the process. Some GPs have to decide whether or not an LP is worth the effort. When it comes to determining which investors GPs want to introduce to their fund, they want quality and selectivity, but this is not always attainable on a global basis.

The negotiating power in finalising agreements definitely remained with investors in 2003. "LPs have wised up and GPs are treating them as partners, not pigeons," says Mr Kraftson. Negotiations on finalising documents are becoming more protracted as investors seek more 'user friendly' terms, especially relating to clawbacks, fee levels and key man provisions, says Kelly dePonte, a principal at Probitas Partner. "As the market begins to heat up – especially in technology VC, where access is a major issue – negotiating power may move back to the GPs," he says. But LPs are unlikely to give up all the bargaining power they have recently enjoyed. They have grown accustomed to negotiating with GPs, and the results should arguably lead to a stronger deal structure and more favourable returns. "LPs leave the campsite cleaner than they found it," says Paul Denning, CEO of Denning & Company.

Storm in a teacup or teacup in a storm?

The transparency issue is hotly debated at the moment, with a number of institutional investors demanding a greater level of disclosure detail, down to valuations and numbers, and even interim reports and daily updates. Certain funds – mainly top-tier venture funds – have excluded LPs who demand this amount of informa-

tion. But transparency debates, as well as succession debates, have been around for a while, and investors tend to invest in a fund regardless of these issues. New funds may emphasise them positively to attract LPs but generally they are considered merely a bonus, not a prerequisite for joining a fund.

Over the years the standard of reporting has increased and there is no formal disclosure mainly because GPs did not think it was particularly important to LPs. If a well-respected, comparative performance measure is adopted, says one industry expert, the main implication would be to show that funds which people think are good in fact perform to lower standards than they realise. But there is certainly no guarantee that standard reporting will be introduced, and Mr Brewer is one sceptic. "This issue is a tempest in a teapot," he says. "I remember discussing it in a meeting as far back as 1989 – it has never been solved."

LPs will continue to demand transparency and GPs will comply when they absolutely have to. If they have sufficient capital in reserve, they will be in a better position to show insistent LPs to the door. However, if a fund manager cannot afford to be picky, he will be forced to deal with institutional investors and the prospect for performance information on the fund – and even on underlying companies – being made public. Private equity as an asset class and a capital pool has grown so big that it cannot help but attract the kind of investors who may insist on having greater access to information. "Those funds attempting to fight against transparency are on a fool's errand," says Mr Kraftson.

As the private equity market continues to shows signs of a 'survival of the fittest' matrix, fund managers and their investors will continue to challenge existing standards and align their needs. As more investors move into the private equity arena, fundraisers will need to be sympathetic to their needs – or risk other, more attuned funds responding first. The pond may be getting larger, but only so many fish can live in it happily. ■

For more information on specialist advisers involved in the fundraising process, please refer to our Private Equity Adviser Guide on page 39.