FUND EDITORIAL

IS ALL CAPITAL GOOD CAPITAL?

When it comes to fundraising, many GPs - especially first time fundraisers - will gladly accept money from any source. A well diversified investor base may seem a luxury that only a few can really afford but it is something most GPs should be concerned about to ensure a steady, long-term supply of capital for future funds. As John Barber, a director at Helix Associates, points out: 'Geographical diversification is crucial. Economic problems in specific regions or countries can be a real issue, as are policy and regulatory changes affecting investment in alternative assets.' Anyone who tried to raise private equity assets in the 2000-2002 period will remember all too well the effects that the fall in the public markets had on institutional appetite for the asset class. Although it would be untrue to say that the over-allocation problems of those years only affected US investors, there is little doubt that US LPs were the hardest hit by the decline in the value of quoted portfolios. Similarly, changes in regulatory frameworks or in pension funds' accounting standards may also seriously dent the level of appetite or the ability of investors to be active in the asset class in a specific country or region. Barber is quick to add that diversification by investor type is equally crucial: 'In the late 1980s a then fairly high profile US-based GP told one of my colleagues that he didn't need any fundraising help because he got all of his backing from savings and loan associations, most of which subsequently folded in the early 1990s recession.'

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Mounir Guen of MVision Private Equity agrees with Barber: 'The importance of constructing a well diversified investor base is aimed at ensuring the long-term sustainability of a GP. One should aim for investors that are establishing new programmes, which means that - if anything - they will have more capital available when the next fund comes to market.' The LP composition will inevitably need to vary depending on the type of fund or its size. As Guen points out 'if you are raising a €350m vehicle, 60-70% should ideally come from European sources - a quarter of which from local investors, - 20-30% from North America and 0-10% from the rest of the world. However, what tends to happen is that local investors often crowd out the others. In much of continental Europe, where markets may lack access to pension funds, this means that a fund may become reliant on the financial sector, for instance.' The ideal breakdown would be significantly different for GPs raising funds in the €2-3bn range. The greater number of large US-based investors relative to their European counterparts would significantly alter the balance in favour of US investors. This, however, is not without its pitfalls, as pointed out by a leading European buyout house: 'When we started our fundraising two years ago, we concentrated an important part of our efforts on US investors. As the value of the US dollar kept falling against the Euro the pool of capital available for our Euro-denominated fund shrank by around 40%.'

There is a broadly held view that the portion of capital raised from funds-of-funds should be somewhat limited, as their own reporting needs may often demand intense investor relations efforts. This is clearly not a choice that most European venture funds can afford to make, as explained by Guen: 'Funds-of-funds represent a very important source of funding for venture vehicles. For a €200m venture fund, it would not be unusual to raise 60-70% of its capital from this type of source. That's not because fund-of-funds managers are greater risk takers but simply that institutions often outsource the venture portion of their portfolios.'

For any top quartile fund, however, a new fundraising push does not mean starting with a blank sheet of paper, as pressure from existing LPs to re-invest in follow-on vehicles may perpetuate imbalances in the fund's investor composition. As a placement agent points out, the number of general partners that can boast a well-diversified investor base are very limited, quoting Cinven as one of the few groups that would fall within that bracket. Among those players that may boast a loyal investor base, many face a rather peculiar challenge: how to rebalance the LP composition of your next fund without jeopardising existing relationships. As one market source indicated, CVC's investor base, weighted strongly as it is in favour of the US, is typical in this respect. Going forward, the firm is likely to attempt to readdress the balance, bringing in a European investor whenever an existing US investor drops out. However, a significant shift in the LP balance is going to require a much more long-term effort. It is no surprise therefore that many European and US buyout houses, whose fundraising would normally be assumed to be relatively plain sailing, have recently boosted their investor relations capability. Managing the expectations of investors seeking to reup is certainly going to be an important task for anyone seeking to rebalance the breakdown of their investor base. Having access to a skilled investor relations team that can diplomatically balance the needs of existing LPs, while introducing new ones in order ensure a future supply of funding, is a must.