Fundraising

A long and winding road?

The popular view is that only masochists are attempting to raise new private equity or VC funds at present. Over-allocated investors and those still smarting from the implosion of IT company valuations are just two groups who have apparently made the fundraising trail a long and painful one for old and new firms alike. *David Hawkins* looks at how accurate a picture this is.

"God, we had to kiss a lot of frogs to find our princes," sighs a road-weary general partner about the raising of his first time fund. How many prospective investors had his team been to see? At least 200. And how much had they closed from whom since they first went out eight months ago? A mere €50m from four investors. "And," he ruefully adds, "it's going to take the next four months to double this." So it's tough on the fundraising trail at present.

Or is it? Ask any private equity or VC firm who have been fundraising recently and they will say that it's much harder work than a few years ago. And if they're a first time fund it's even harder – some will even tell you it's impossible. But there is also the sense that there has been a useful raising of the bar for firms offering their next fund, or others trying to launch a debut vehicle. "The days of the opportunistic fund launched by some bright bankers and consultants are over," says one UK fund of fund investor, "and in my book that's a good thing" (which makes him a bad prospect for the Qualitas team described later in this article). Established firms that have raised money before are also having to spend more time marketing to investors – regardless of whether these are asked to back a firm for the first or for the nth time. The "first come, first served" mood that allowed experienced GPs to take their pick of eager investors queuing for their last fund, has been replaced by a far more reserved and cautious approach.

This is certainly reflected in the latest data being released on fundraising volume and value: data just released by the Private Equity Analyst reveals that US fund raising significantly retrenched during 2001. The US publisher's preliminary data showed that private equity firms raised $99.6bn in 2001, a 43 percent drop from the 2000 figure of $153.9bn (although this was the second largest total ever raised). VC funds managed to raise $35.7bn, a drop of 52 per cent on the $73.9bn figure raised in 2000 – and six of these funds exceeded $1bn as opposed to 19 who beat the billion barrier the year before.

Find the best of breed

Nevertheless funds are still being closed; whether generalist or sector specific, buyout or VC, funds are being committed too. In the past two months alone, a number of significant names have announced closings. HSBC Private Equity held a first close of £490m in January, aiming to reach its final target of £600m by the end of March; Advent International had a final close of €2bn that same month; Axa Private Equity closed its second secondaries fund at $480m in December. Some players managed to do even better than they first expected: Italy-focused VC fund Emerald closed above target at €215m, as did Munich-based TVM with a final close on its life science fund at €336m - way above the

Guen: Everyone is seeing a much slower return on capital than three years ago

€250m it had originally been looking for. The evidence suggests that the right funds can still raise the right amounts: the challenge for them is to track down the right people to talk to.

Mounir Guen, Chief Executive of placement advisor MVision is spending enough time talking to a host of different investors to have a clear view on LPs' mood: "investors have become far more discerning. Now that everyone is seeing a much slower return on capital than three years ago they are being far more rigorous in the questions they ask. The aim always is to find the best of breed," he says. It's also the case that new investors in private equity are spending more time talking to other, more experienced investors in order to help pick the right core assets. This doesn't mean that the buyside is sitting on its hands though: Guen sees an investing pattern emerging that is driven by firms being underweight in Europe, hungry for European venture and special situation and with a marked appetite for mid-market funds (both US and Europe oriented) which are seen as offering better value than the big buyout funds. "Savvy investors are also taking a cyclical view" adds Guen, "and see now as a good time to buy into funds with the right teams who can spot the right opportunities."

Guen also sees the buyside becoming far more international when selecting funds – whereas in the past a Swedish investor would major in Swedish private equity assets, that same investor will now be looking much further afield. This has enabled funds and their placement agents to spread the net far wider in terms of geography, to the point that Guen expects most small to medium size funds (the jumbo buyout funds being a breed apart) to have a geographically predictable spread of investors: "you'll see a third coming from local investors, a third from investors from within the region and a third coming in from the US" he says.

A full pipeline

There is no doubt that the terrorist attacks of 11 September caused many investors in the US to put their investing decisions on hold. This, combined with asset allocation models for 2001 that had become seriously distorted by the collapse in public equity and debt prices, meant that it is only with the arrival of the new year that investors have been in a position to restructure their portfolios and allocation mix. This has created a full pipeline of funds wanting to be fundraising for the first half of 2002.

Bance: We see a stack of product sat in people's in-trays

As Alex Bance, a Director of the Private Equity Funds Group at UBS Warburg comments: "We see a stack of product sat in people's in-trays." Bance is optimistic that the pace of actual commitments is going to accelerate in the coming months. Placement agents, such as the team at UBS Warburg, are hopeful that they can play an increasingly significant role in the fundraising process as funds spread the net wider to catch investors. Munich-headquartered TVM's €336m life sciences fund was the first ever the firm chose to raise with the help of a placement agent. This combination of effort saw 65 per cent of the fund raised by TVM itself from previous investors and the balance (€118m) came from new investors via UBS Warburg.

Enlisting a placement agent when fund raising for the first time can seem to some an unnecessary expense (why forfeit a further two to four per cent of the total raised?) but others regard having an agent onside a pre-requisite: as one partner at a UK mid-market fund commented on his first fund "you get access to their prospects but you also get credibility: more people will listen if you have a major placement working with you." Even the biggest names can see the benefit of using placement agents: Guy Hands, former head of Nomura's Principal Finance business and now going it alone with a €3bn vehicle called Terra Firma II, has hired Merrill Lynch, Salomon Smith Barney and

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Nomura International in Japan to help him do it. According to one placement agent the chillier fund raising climate has prompted many private equity firms who would previously disdain an agent's approaches to now get in touch: "we're getting calls from people we'd never dreamed of hearing from a couple of years ago" he says.

How cold is it?

Firms out raising cash at present are seeing some encouraging signs though, sometimes even in connection with sector specific funds covering allegedly out-of-favour sectors such as IT. Following the success of its life science fund, TVM recently held a first close on TVM V, it's fifth technology-focused fund, which was significantly above target at €83.5m. With a final target of €250m, CFO Bernd Seibel at TVM is optimistic that this fund will exceed expectations as well.

Seibel: The private equity industry will continue to become increasingly sector, rather than geographically, determined

For Seibel, the key ingredient for a successful fundraising is a combination of sector knowledge and track record. Credible sector-specific funds are still in demand and, says Seibel, both existing investors in previous TVM funds as well as new investors told the firm they wanted to see a focused, sector-specific offering dedicated to IT. This prompts Seibel to predict that the private equity industry will continue to become increasingly sector, rather than geographically, determined and that a growing number of investors are wanting to see such specialisation from funds looking for capital.

Another type of specialisation that can yield positive fundraising results is geographic: credible local teams with local knowledge and connections can often tap into investor appetite for exposure to a particular market. One such local first time fund that is working its way along the fundraising trail at present is Qualitas Equity Partners, a generalist fund focused on Iberia run out of Madrid by Eric Halverson, Iñigo Olaguíbel and Thomas Utzmeier. This team has previous experience in companies such as McKinsey, Santander Central Hispano, UBS Warburg and UBS Capital. Halverson, a partner at the firm, has been spending plenty of time on the road and has no illusions as to what makes or breaks a first-time fund's fundraising plans: "Get a credible cornerstone investor" he says, "because besides their capital you can then use their name and contacts to open other doors."

For Qualitas the cornerstone investor was Spanish media group Timón, S.A. who helped the fund announce a first close in December on €30m (the group is targeting a final close of €60m after a 12 month fundraising term). The relationship with a cornerstone investor is usually one that has grown up over time – one or several of the fund's GPs will often already have a connection with the investor and may well have worked for it in the past – and this relationship will continue to exert its influence over the fund going forward. Cornerstone investors often get preferential rights and expect to be offered co-investment opportunities too. They may well also expect to play an active part in the investment making process – as Halverson comments of Timón: "They want to be very hands on."

Halverson: Get a credible cornerstone investor

More than numbers

The issues that matter most now to prospective investors are track record, the experience and compatibility of the team and the degree of value-added a fund expects to bring to its investments. When you talk to Bruno Raschle, managing director at Swiss fund of funds investor Adveq, it's clear that he is looking for much more than a claim to be top-quartile when approached by a fund. He wants to find people running a fund that are "visionaries, ones who can lead a sector and who can make enduring investments." And it's vital that this vision is delivered effectively – and quickly. Says Raschle: “When I look at the PPM I may look quickly at the numbers – maybe 10 seconds – then I read the first page. If I’m not excited it’s gone.” This is not simply because Raschle has learnt to be brutal with funds’ pitches: he is still receiving two PPMs a day and must therefore take a pragmatic approach to preliminary selection. This is because the next step is going to take much longer, as he and a team at Adveq drill either into a private equity firms’ previous investments from earlier funds or anatomise the track record of the team now launching a new fund. And he is not looking for PR: Raschle knows that investments don’t always go to plan: “We can take bad news but we can’t take surprises” he comments.

Chris Manser, head of private equity at Swiss insurance giant Winterthur Insurance is certainly taking things carefully when investing at present. With close to €600m committed to private equity assets Manser probably represents the archetypical European institutional investor in private equity: with a relatively low allocation percentage (if compared to an equivalent US investor) and taking a broad investment approach, he is keen to look beyond the numbers when assessing a new fund. And this makes track record essential. “You need to adjust the numbers to make them comparable and this is never easy - and it’s only part of the picture. I’m also looking for consistency in the fund’s investment strategy, at its overall risk profile, and at how the fund has added value to its portfolio companies. This all helps verify the fund’s strategy” he says.

Raschle: Valuation guidelines as they are practised, especially in Europe, are there to support funds’ marketing efforts

Adveq itself, as a fund of funds, is out raising money from investors at present and Raschle therefore can also comment on the fund-raising environment from a fund raiser’s perspective. The firm raised over $400m in 2001 – a sure sign of investors’ continuing appetite for risk-diversifying FoFs – and is continuing to win support from major institutional investors in Europe. But the market is getting more crowded: Raschle is aware of no less than 50 other funds of funds presently out fundraising. And the same criteria that he applies to funds approaching Adveq apply to Adveq’s approach to prospective investors. There needs to be a meeting of minds between GP and LP, one that will ensure a productive relationship over the long term. (For Raschle this is at least ten to fifteen years). There has to be more than numbers because “numbers can be very misleading,” he says, “and such things as valuation guidelines as they are practised, especially in Europe, are there to support funds’ marketing efforts.”

European assets committed to private equity rose from €13.4bn in 1999 to €26.7bn in 2001.

Perhaps the most telling factor to remember when evaluating the fundraising environ-ment at present is that the amount of investment capital that has flowed into private equity has doubled in the past couple of years. There are now more investors prepared to invest more in private equity so your hit rate can be lower without compromising your closing target. As the latest edition of the biannual Report on Alternative Investing by Tax-Exempt Organizations, published by Goldman Sachs & Co. and Frank Russell Company, reveals, European assets committed to private equity rose from €13.4bn in 1999 to €26.7bn in 2001. The average strategic allocation to the asset class has also risen from 2.5 per cent of fund assets in 1999 to 3.6 per cent in 2001. So expect to see the roster of investing institutions - when disclosed - for new funds being longer and more diverse by both type and geography. These firms will have traveled further and worked harder to close these funds, but few will be complaining. As the road-weary GP quoted at the beginning commented: “I never thought it was going to be easy. I also feel I intimately know the investors backing us and they feel the same about us. That’s good thing.”