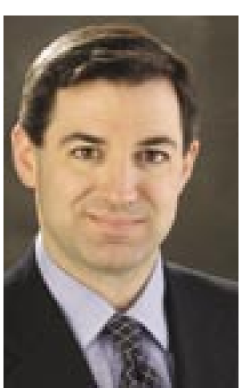
Life at the top

A healthy appetite for European private equity has meant many GPs are now calling the shots. This is unlikely to last. By Kimberly Romaine

Never before has institutional appetite for private equity been so robust. In the early 1990s there was around $15bn under management globally for the asset class – Blackstone's latest fund alone surpassed that value this summer. Myriad funds are being closed in record time, in a market that has seen the once almighty limited partner knocked off its pedestal in favour of the now more powerful general partner – at least for now.

'As the private equity market matures it has benefited from wider acceptance of private equity,' says Steven Costabile of AIG Global Investment Group. 'Investors realise that absolute returns won't solve their problems. They need relative returns, which over 10-year time horizons have been shown to outperform traditional public market investments.'

Europe is riding this wave. 'It's not new that there is a lot of interest in European private equity; it's been well established for around 10 years. What is new is that funds are becoming more international and institutions more diversified. So they're stretching beyond their domestic markets and we're seeing US, Japanese and Middle Eastern investors looking at Europe with more interest,' says Hanspeter Bader at funds-of-funds investor Unigestion.



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Just as this is happening, European institutions are also increasing their private equity allocation – meaning the overall pile of money looking to invest is growing in many ways. Germany's CBR Management, for example, has just launched its latest fund, Equivest II, and expects around 60% of existing investors to re-up at an average rate of four times their original commitments.

'Fewer and fewer investors put private equity in a funny box with hedge funds and real estate at the bottom of a list anymore – it's become a real alternative to public equity. They are seeing private equity as a subsector of equity rather than as a part of alternative assets,' says Bader.

In addition to higher allocations for private equity, the overall pool of limited partners is increasing with over 3,000 in the market globally; over 10% more than last year. 'The number of investors in the market place and their financial firepower is a better gauge of institutional appetite. Five years ago in Europe, one or two LPs could make commitments of €50m. Now a dozen can commit over €100m,' says Moose Guen of placement agency MVision.

'A few years ago, fundraising was a subjective decision-making process. Today it has almost become an objective decision-making process, involving ticking lots of boxes,' Guen says, pointing out that fundraising is not necessarily easy for everyone. 'Whether it's right or wrong, certain GPs tick more boxes than others, and are thus more sought after.' Indeed, AlpInvest mid-market spin-out Taros Capital closed its doors this summer, while Credit Agricole Private Equity recently closed its CACI 2 fund after a year on the road and below target at €140m.

Getting in

With demand for private equity funds exceeding supply, getting into your chosen funds has become a concern. 'Oversubscription and access issues have become far more common. A few years ago it was only really a problem for three or four top-tier US venture funds, but now firms can raise much more money much more easily. This is a young phenomenon and it's seen the tide turn in favour of GPs,' Treena Maguire at Unigestion says.

But while it has become difficult to access certain funds, there are ways LPs can position themselves. 'If you're early to the table and you can accelerate a GP's fundraising process with a chunk of capital and a recognised name, you can negotiate certain economic and non-economic terms,' Costabile says. 'But if you only come in on the second close and are committing less than 5% of the fund, then you are stuck accepting the terms as they are most of the time.'

These terms seem to be worsening for LPs as the shift in power sees GPs ruling the roost. Berkshire, Bain and Investitori Associati are reported to have increased their carry, while HgCapital is believed to have increased its management fee from 1.75% to 2%.

'We'll be seeing more of this,' Antoine Drean at placement firm Triago says. 'The balance of power is in the hands of the GPs and some definitely take advantage of it. If the balance shifts in a few years, then what happens? The LPs will remember who was arrogant. It happened in venture and left scars.'

Costabile points out that many of those venture players that changed their terms changed them back. 'It was mostly the perceived 'top-tier' firms that did that. Then the private equity markets fell dramatically and many GPs actively reverted their terms in favour of the LP again. These are the funds that were thinking ahead to the next fundraising cycle and wanted to build goodwill. These are funds the LPs still like. There are some, however, that are taking a gamble – they didn't change the terms back either because they knew they would not raise another fund, or because they felt their returns would warrant attracting new investors for a follow-on, even if they alienated the current LP base by not renegotiating terms.'

The onus on relationship maintenance has fallen on the investor following this paradigm shift. 'It's important to have strong, ongoing relationships with GPs since official notice on fundraising is very short. If we only listened to official notices, we'd only find out about a close six weeks before. Some LPs simply receive documents saying: "we're closing in six weeks". So we are in constant communication with our favoured GPs,' Bader adds.

The sky's the limit

The increased capacity to raise funds has lured many established players to increase their fund sizes: Cinven just raised a €6.5bn fund, around 50% larger than its previous €4.4bn fund, while CVC increased a similar level to raise €6bn for its latest. Permira has more than doubled its last fund size for its latest €11bn vehicle. Further down the spectrum is a similar story: TDR Capital recently reached a first and final close on €1.74bn for its second fund after only four months on the road – more than tripling its first €550m fund raised in 2002. Duke Street Capital is believed to be in the market for a €1bn fund, substantially more than the €650m it raised at the end of 1999.

'We have seen a number of GPs consistently increasing fund sizes markedly, but we didn't want a hard-cap level that would take us out of our target market – we want to continue doing what we're doing and our customers feel we're good at it,' explains Paul Thomas at Gresham. The mid-market investor recently raised £340m in one month for Gresham 4, just two years after raising £235m for its previous fund. By not venturing substantially upmarket, the GP was unable to accommodate some investors that preferred the larger landscape. 'Some LPs had a different strategy. For example, one didn't want to invest less than $200m, and that didn't make sense for us.' However, the GP was able to benefit from increased LP appetite in another way. 'We had the opportunity this time to look at the diversity within our LP base and see where we could improve it. You can't treat LPs as a homogenous population,' Thomas points out.

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A place for agents

Some argue there is less of a role for a traditional placement agent in some of the best funds, while large funds have in-house functions. 'Many GPs realise that communication with investors isn't only during fundraising, it's ongoing. A placement agent can't do that so they employ this function in-house,' says Unigestion's Hanspeter Bader. Graphite, for example, has reorganised its database to answer investors' questions more efficiently. 'But the fact is that by definition, at least 75% are not top-quartile funds so they still need to really focus and need help in positioning their brand,' Bader adds.

This has meant the intermediaries have had to change their spots to keep up. For example, many placement agents are brought on board to help a GP to access regions they are unfamiliar with or simply to prepare in-house materials, but not to attend meetings. Graphite used a placement agent for the first time on their fourth fund and has continued using one for the two funds it has raised since. 'The role of the placement agent has moved from making initial introductions and presentations to more of an administrative and advisory role,' David Williams at Graphite says.

This changing role is not necessarily any less important. 'If you've raised three funds already, a placement agent might say: "I know you know them, but it will be hard to get them on board this time since they've just invested in a very similar fund",' Graphite's Simon ffitch says. Meaning that while a firm is busying investing money, it is often less busy keeping abreast of the fundraising developments going on simultaneously. This is where a placement agent adds value.

Another important role the placement agent plays is that of marriage counsellor. 'If you've got new LPs lined up and you are over-subscribed, it can be difficult to choose who to take into the fund,' ffitch says. 'So you tell the intermediary the full story and they then relay the necessary feedback to the existing investors and let them think about it.' Triago's Antoine Drean agrees: 'A big role for placement agents is to deliver news. As the end of the day, your job is the please as many as possible, so it's a question of picking and choosing the best ones.'

In addition to a handful of larger funds, there have been newcomers to the market. For example, Vitruvian has been recently launched by ex-Apax, BC Partners and Bridgepoint executives to raise up to €1bn.

Rather than create an uninvestable wall of money, the healthy appetite for European private equity should enable GPs to come up with new dealflow. 'I like private equity because it's the most flexible of assets,' Costabile says. 'GPs can create opportunities – buyout funds can expand their inventory set. This is not the same as in venture, where opportunities are based on technological movements and new discoveries.'

Looking ahead

This new-found popularity for European private equity could wane if market conditions stray from the current benign environment. 'In 2001 and 2002, the buyout fundraising market was very tough in Europe and the US, so LPs could work with GPs. Now, a few years later and on the back of unprecedented returns, GPs can boast of interim IRRs at 50% or more and convince investors there are more deals to be done. However, the deals and economic environment that has prevailed over the last four years will, in all probability, be different than what we will see over the next four years – interim IRRs on the back of refinancings that have left companies very highly leveraged could turn in different economic conditions,' Constabile says.

Bader feels any such change will only augment the access issue. 'If the markets (debt, stock) change, then the situation will change. Investors won't leave private equity but there will be flight to quality. The top-tier buyout funds will have even more demand, while second- or third-tier will struggle. So a downturn will not help the access issue for top-tier funds.'

Nevertheless, any change in market conditions may mean the pendulum swinging back in favour of LPs. GPs would do well to remember this.