Taking the plunge

By Julien Hall

As LP allocations to alternative assets continue to rise, it is no surprise that some GPs, entrepreneurial by nature, are tempted to set up their own shop. But the road to independence is long and arduous, both in venture and buyout. Understanding LP behaviour and adapting to it should go a long way to ensuring a smooth take off. Although every case is different and generalisations are perilous, some trends can be identified.

Track record is the first thing that comes to LPs' minds when they are asked about their investment criteria in first-time funds (FTF), but this is not enough. "Above all, our decision to invest in an FTF will rest on the readability of the team's track record," says Charles Soulignac, CEO of fund-of-funds Fondinvest.

FTF managers must have documentation to validate 100% of their achievements. Beyond simply disclosing their returns, new GPs will have to provide figures relating to the companies they were in charge of, clearly highlighting EBITDA increases and growth. Many FTFs are spinouts, where a team of several investors move together. These teams usually have the paperwork to prove their worth and are more likely to receive investments. Fondinvest, like many LPs, invests in first-time funds, but not in first-time teams.

In the absence of a clear track record, the fund's investment strategy becomes crucial. Nowadays, however, there are few ways to differentiate yourself in terms of investment criteria. The market has matured and methods across the industry are increasingly standardised, leaving few opportunities to innovate. "Articulating your philosophy and process clearly is a fundamental first step in establishing a constructive relationship with an LP," says Mounir Guen of placement agent MVision. Guen, who raised FTFs for Orlando and Mid Europa Partners among others, mentions having patience as another key requirement.

Safety in numbers

It is difficult to quantify the time needed to raise a first fund. Typically, industry experts estimate that it takes close to two years. The reason for this is the flock-like behaviour of LPs. A fund that has already attracted a handful of top investors is more likely to be considered. Although the thorough due diligence processes that LPs conduct prior to investing helps clarify and confirm the strategy and team, a cautious approach is usually favoured.

"A new investor group or secondary fund-of-funds will usually consider a commitment if a fund is 20-30% invested," comments

First-timers

OFI PRIVATE EQUITY is the private equity arm of the Ofivalmo Group managed by Olivier Millet, former managing director of Barclays Private Equity France. The firm's first fund, Oficap I, was launched in 2001 and raised €12m. Fundraising for Oficap II has just begun with a target of €100m. The GP invests in equity and mezzanine in fast-growing French SMEs in all sectors. Its core target lies with companies whose enterprise value is between €15-75m and which have already been backed by other financial institutions (secondary buyouts). Its investors include MAIF, MATMUT, COVEA and family offices.

After securing an investment from its sponsor Crédit Mutuel – CIC, assembling its team and closing its first deal in May 2005 (Carré Blanc), **CIC LBO PARTNERS** began raising its own fund in June 2005. Mid-cap buyout fund CIC LBO Fund held its final close one-year later on its hard-cap of €135m. In the end, the sponsor's commitment represented 23% of the fund's total value, with private individuals and family offices contributing 35% and investment from institutions representing 42%. Institutional investors included AXA Private Equity, ACM, Caissed d'Epargne and SMABTP. The team was assisted by Claude Harmant, formerly of Crédit Lyonnais Private Equity, in the context of discussions with several investors. With four majority buyouts completed, the fund, which invests €5-25m per deal (up to €40m with sponsor's contribution) is now 29% invested.

COBALT CAPITAL was created in July 2004, after its team spun out from UK-based mid-cap buyout investor Legal & General Ventures. The team raised a first fund of €150m and co-led its first deal, Médi-Partenaires, with Barclays PE in May 2005. The deal was successfully exited in March 2007. The firm, which specializes in MBOs, MBIs and growth capital transactions, invests €10-50m per deal.

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Guen. LPs want to see the GP executing. This is a chicken and egg situation, where LP money is needed to reach a first close and begin building a convincing portfolio, which is needed to attract more LP money.

Money vs freedom

Having a cornerstone investor can help to break this deadlock faster, but one should weigh the advantages against the drawbacks before committing to this route. "We did not look for a sponsor because of the restrictive demands they tend to make, and because they can be a source of instability and inflexibility, given their weight in the fund," says Fausto Boni of Franco-Italian venture investor 360 Capital Partners. A well-known example was the sudden withdrawal of France Telecom as cornerstone investor during the fundraising of Innovacom 5 in 2003 and 2004. As a result, the fundraising took a year longer than planned. It is no surprise therefore that GPs prefer to raise sponsorless funds and that those that have a sponsor try to reduce their dependency over time (such as Banexi Capital Partenaires, or Partech International).

Prenuptial agreement

Another consideration when fundraising is the quality of your LPs. "LPs offering the best subscription terms and conditions are usually less reliable in the case of a market downturn," says Boni. First-time fundraisers should, however, expect stricter subscription conditions. "In most cases, for cause divorce and no fault divorce clauses are more favourable to LPs, deal-by-deal carried interest payments are impossible and there are limitations on management fees," says Arnaud David at SJ Berwin. It is a delicate balancing act for LPs, who have to be careful not to strangle GPs with small fees, demotivating them in the process.

Having a placement agent usually encourages LPs to look into a specific fund, as the agent will have conducted a certain amount of due diligence, which the LP will be able to benefit from. Prestigious legal advice can also make a difference. "The 'brand' of your chosen law firm is important, but it should not detract from selecting someone you feel comfortable with," comments François Tison of 360.

Painting a simple picture of the conduct of the different types of limited partners is rather difficult. Tison says: "There are not many teams with a good consolidated track record in Europe. Therefore, one would expect LPs to put extra emphasis on track record analysis and to promote promising young teams. However, in practice, it seems many investors prefer to commit to established or institution-backed funds, even if their performance is not great, emphasising stability over track record." This is a common frustration for GPs, which want to be fairly evaluated for their work. "Inertia is common among LPs, that often prefer to re-invest fund after fund, despite the frequent slip in performance witnessed with fifth- or sixth-generation funds," says Bertrand Fesneau at CIC LBO Partners.

Latest trends in subscription conditions

- Hurdle decreased slightly from 6-8% to 6-7%.
- Management fees, usually set at 2%, are now being used as a competitive battleground to attract LPs. Funds of €600m to €1bn often have management fees of 1.75%, while funds of €1bn+ can have fees as low as 1.5%.
- While the carry usually remains at 20%, there are signs of a shift towards deal-by-deal carried interest in larger European funds. Standard in the US, these conditions are important to attract and retain the best talent, particularly at junior level.
- As has been the case for several years, there is a continuing focus on investor protection and corporate governance issues. LPs are claiming their right to be more selective by demanding key-man protection and no fault divorce that have now become standard in almost all funds. Key-man clauses may provide for an automatic suspension of new investments when a defined number of 'key' executives leave. No fault divorce – allowing a vote of investors to remove the GP – is usually accompanied by a requirement to pay compensation of between one and two times the annual management fee.

Information from Arnaud David, partner at SJ Berwin.

Positive outlook

There is hope that this trend will dissipate over time, as investors become more proactive in restructuring their portfolios. The proportion of LPs that have declined to re-invest with one or more of their GPs has grown steadily during the past couple of years, from fewer than half (45%) of LPs in summer 2005, to 76% in winter 2006-2007, according to a study conducted by IE Consulting for Coller Capital. This is especially noticeable in North America, where 84% did not re-up with some funds in the past 12 months. These statistics suggest LPs are moving away from a 'box-ticking' mentality, where a fund with no 'demerits' is considered investable, to a more competitive environment, in which LPs have the capacity to switch funds according to performance. This is encouraging for first-timers, who would relish having equal opportunities to established funds.

Boni believes the playing field is fairly even in the venture segment. "French and Italian venture capital firms will have good returns in the next year or two, meaning a favourable fundraising environment. I can imagine an FTF becoming the top European venture capitalist within 10 years," he says. Heartening words for those thinking of embarking on such a journey. ■

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