The best and worst of times

There were two types of private equity funds raising new capital in 2003: the ones that did exceptionally well, and the ones that didn't. *Ricky Morton* looks at why some succeeded, others failed, and what LPs were looking for as both types sat before them.

It was the best of times, it was the worst of times: a small elite enjoying speedy, heavily oversubscribed campaigns, the remainder scratching around for the crumbs, while a few unfortunate others go to the wall. 2003 was the year when private equity fundraising became polarised.

"We saw a significant bifurcation of the market," says Andrew Sealey of UK-headquartered placement agent and advisory house Campbell Lutyens. "A few funds were very successful, but many were not. Some described the year as a flight to quality but a better definition would be a flight away from risk."

So what were investors looking to back? "The market is still focused on mid-market buyouts in Europe, and select mid-market and top VC in the US," explains Mounir Guen of placement agent MVision. "There is also a tendency to select the large funds in Europe as well as a growth in the popularity of country-specific funds."

Buyout appeals

Evidence of these trends is widely available. Among the biggest successes in 2003 was Graphite Capital, the UK-focused mid-market firm which closed at the very top end of its £375 million (€549 million; $682 million) target. "Graphite's fundraising was very impressive," comments one fellow European GP. "There was a lot of interest from institutional investors which would have pushed the size of the fund up but they resisted raising too much just for the sake of the management fee." A placement agent concurs: "Country specific funds are popular because they enjoy strong local support and play into the hands of funds of funds which are looking for more specific mandates."

Graphite is one of a number of firms that have benefited from maintaining their focus as other firms increased their investment scale, raising ever-bigger funds. Another such focussed firm is Activa Capital, the French mid-market firm which closed its debut fund above target in December on €162 million ($201 million). "Although it was our first fund, we targeted the same size of deals as our track records at previous firms," said Michael Diehl, a general partner at Activa. "A lot of our competitors had moved up significantly in size, changing their investment focus."

Sealey: flight away from risk

Elsewhere, BS Private Equity, the Italian private equity firm, was also attracting significant amounts of money, closing its fourth fund, IPEF IV, ten percent above target at €550 million, but perhaps the most talked about fund, in the first half of the year at least, was the debut Nordic buyout fund raised by former Industri Kapital co-founder Harald Mix, which closed a €650 million fund in only four months. Commenting on the fundraising, Fredrik Strömholm, one of Altor's four founding partners, said: "We had an extremely positive, spontaneous reaction from investors. Once they had bought into our regional focus, they looked at the team dynamics, and many became quite excited. The fact that we were never going to be a billion plus fund also meant that there was a lot of momentum among investors looking to commit early."

Venture matters

Defying the thesis that the key to successful fundraising in no small part lay in being a mid-market buyout fund, Abingworth Management, the UK-based international life sciences venture capital firm, enjoyed a fruitful fundraising campaign for Abingworth Bioventures IV. The firm's sixth life science venture fund significantly exceeded its original $275m target to close on $350m, and was described by one source as an "outstanding achievement". According to Stephen Bunting, managing director of Abingworth, "it was difficult not to take additional money from some very good investors but we decided that $350m was the limit that we should work with."

Of course, Abingworth's successful fundraising was something of a blip in an otherwise difficult year for VC fundraising. "European IT venture capital fundraising was extremely slow going," says MVision's Guen. "It is now an anomaly because the situation in the US is the reverse." The point is backed up by the fact that US venture capital funds, according to Venture Economics data, actually increased their fundraising to $10.8 billion in 2003, compared with $9.05 billion in 2002.

Problems faced by firms that struggled during the year were varied. In France, investors were confronted by a flurry of fundraising firms. "Because firms are taking longer to raise capital in this climate, there are more funds being raised at any one time," says Activa's Michael Diehl. "At one point last year, we were competing with 18 French mid-market funds all looking to raise capital. LPs were starting to ask if the French market was becoming overheated."

Searching for exits

The other major stumbling block faced by firms was a lack of that most persuasive of fundraising tools: a steady flow of exits. "LPs basically had to make decisions that were not as simple as they had been before," says Guen. "Exits diminished and LPs had to judge a firm on competence and potential performance. As a result, the due diligence process has increased and won't revert back in future even when the number of exits increases."

According to Stephen Marquardt, head of the fundraising team at Doughty Hanson, "The fundraising market changed in the last year with investors becoming over-allocated in private equity due to the fall in the value of their quoted portfolios. In the past it was commonplace for funds to achieve first closing of at least half of their target." Doughty held a first close on €700 million, some way below its final target of €3 billion.

In fact, a fairly lengthy list of firms concluded their fundraising efforts below their original target and this included some of the biggest – and highest profile - firms. Charterhouse Development Capital closed its seventh fund on €2.7 billion, below its initial €3 billion target, while Terra Firma, which suffered a number of high-profile departures during the year, also announced a downwardly revised final target for its debut independent fund of €2 billion and held a second close on €1.7 billion. "Doughty and Industri Kapital [which held a €500 million first close on the way to €2.5 billion] had a really tough time last year," says one fund advisor.

Diehl: more funds being raised at any one time

Winning strategies

In a two-tier fundraising climate, it is perhaps unsurprising that the year threw up winners and losers, and undoubtedly the year's most successful and most lauded fundraising was Permira. "That was a landmark," said one GP of Europe's largest fundraising effort to date. After only six months of marketing, the London-based private equity house closed Permira Europe III at €5.1bn, attracting 134 investors of which 77 were new to the firm. Part of the firm's success seems to have been attributed to an upfront agreement over the terms in the partnership agreements.

Speaking at the time of the fundraising, Permira partner Charles Sherwood said the firm had written a number of terms into the partnership agreement governing the fund that were intended to accommodate investors' requirements for greater disclosure and transparency. "The position we've accepted, and which is reflected in our legal documentation, is that investors in the fund will have to reveal returns and performance in terms of cash flow, IRR and multiples," said Sherwood. "We've drawn the line is disclosing the performance of underlying portfolio companies, which we feel would be damaging."

The bifurcation of the market has also impacted on efforts to confirm commitments from investors. "GPs continue to hold the whip hand in negotiations for oversubscribed funds," says Campbell Lutyens' Sealey, "but in other funds LPs are exercising more power than before and are seeking to better protect their interests in the documentation to ensure that there is an alignment of interest between both partners." LPs are protecting themselves in a number of

Fundraising

Sherwood: investors will have to reveal returns and performance

ways, including the insertion of no-fault divorce clauses, key-man clauses, lower management fees and a shift in the balance of power for transaction fees. "The target for entry has altered for LPs. Were it was once cash on cash, investors are now more performance-driven." That, according to one source, is not the only factor in the fundraising process. "GPs misjudge their existing investors. GPs should take their existing LPs' perceived interest in their fund, and halve it. At present they are increasing it and a few are getting stuck."

Altor was one firm seeking to find the right groove with LPs. "We tried to hit the middle-ground with our LPA terms very quickly," says Altor's Stromholm. "Firms liked where we were in the market and some investors, particularly those in the US, were able to move fast in order to conclude agreements. In Europe, investors tended to be slower-moving and many missed out on the fund."

The year's speediest fundraising efforts seem to have been completed by those firms doing the greatest amount of preparatory work. Both Altor and Permira spent months in advance of fund launches laying down the groundwork for their successful campaigns. And a solid track record is also a key determinant. "Consistency is the byword," says Andrew Sealey. "Consistent teams with consistent track records and strategies have raised capital fairly easily."

Opinions for the coming year are fairly united. "The outlook for 2004 is the same as last year," says Mounir Guen. "Certain European funds will continue to attract attention and some large funds will come to market and do fairly well. Italy and the Nordic region are likely to be very popular this year."

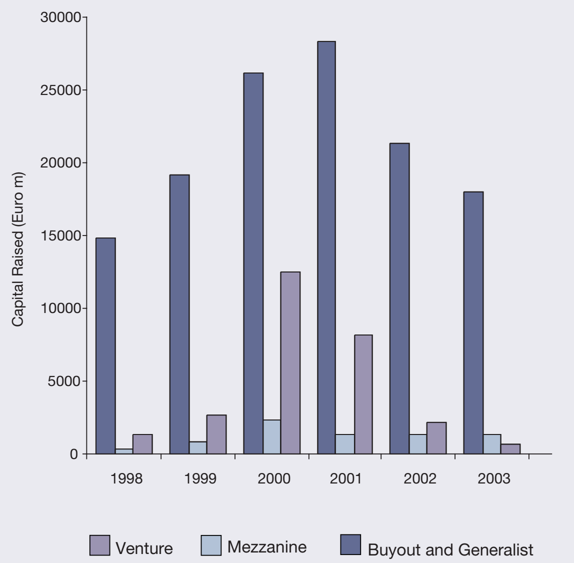
"Some funds will do well and we may see some success for niche strategies and spin-out firms such as the former 3i buyout team, which is currently fundraising, and Balmoral Capital [set up by Richard Winckles and Alec D'Janoeff – former heads of CSFB Private Equity's European operations]."

2004 is also expected to be a big year for fundraising in Asia. Carlyle has already held a final close of its Y50 billion Japan buyout fund, while other big investors in the region, including Baring Private Equity Partners, CVC Asia Pacific, Affinity Capital, formerly UBS Capital (Asia Pacific), MKS (the former Schroders Japan business), Asiavest Partners and GS Private Equity all planning fundraising programmes for this year.

Although the predicted surge of fund raising private equity firms coming to market in 2004 has yet to materialise, it's clear that investors are going to encounter a wide variety of diverse funds. The mood has lightened – amongst GPs and LPs – and allocations to the asset class have been bolstered as a result (influenced too by the upward valuation trend for investors' public equity holdings). But investor attitudes are now more hardened: don't expect all funds to be regarded as equal.

Guen: judging firms on competence and potential performance

European capital raised by stage and year, 1998-2003



	Buyout and Generalist	Mezzanine	Venture	Totals
1998	14834	287	1333	16454
1999	19203	905	2601	22710
2000	26121	2410	12432	40963
2001	28351	1265	8202	37818
2002	21408	1298	2112	24817
2003	18054	1377	638	20069
Totals	127971	7541	27318	

Source: Initiative Europe