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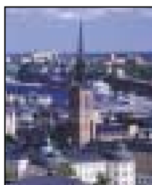
General partners can't just depend on existing investors to fill their next fund, says Mounir Guen of MVision. But as the big firms go on the road, new money is up for grabs PAGE 18

Hunting for funds

Swedish heights



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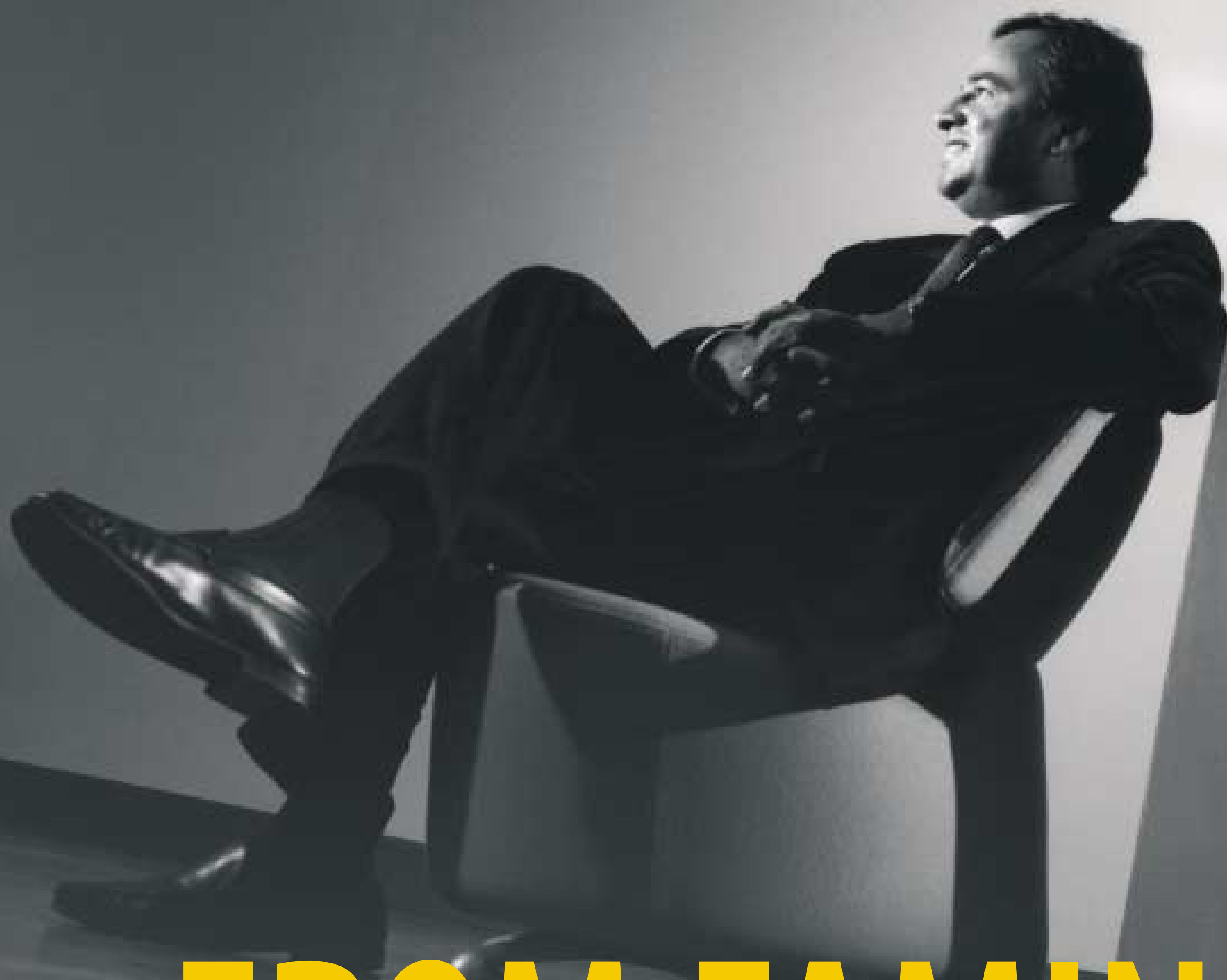
Mounir Guen of placement agent MVision says that limited partners are rediscovering their appetite for private equity: "More and more institutions will get involved with private equity – and those with allocations will increase them"



FROM FAMINE

A glut of cash was poured into private equity at the turn of the century. Then came the hangover – limited partners pulled out in their droves. It's now time for the big players to hit the fundraising trail again. How will they fare in today's cautious market?

BY MARK FRARY

Private equity fundraising has never been an easy or enjoyable process. Yes, there was a time a few years ago when investors became excited about the prospects of the asset class and poured billions into the industry – €48bn in 2000, according to EVCA figures. But many now consider that to be a blip caused by over-exuberance and an inflated idea of what internet and other early-stage venture capital investments could achieve. Back in the real world, most private equity firms have to devote countless months to traipsing around the world attempting to persuade potential limited partners that their next fund will deliver them stellar returns. It's a far cry from the excitement of deal-doing that most professionals signed up for.

In many ways, you could argue that the process has become harder over recent years. It has certainly become more protracted. Limited partners are more cautious these days, many having lost capital from private equity investments made in haste in the late nineties. They are taking longer to decide whether or not to commit money to funds – in some cases a year or more. And they are also more demanding: they want more information and they are asking tough questions. One GP recently commented that they had seen a 500 per cent increase in the number of questions asked by investors they approached for their new fund.

PHOTOGRAPHY (INC COVER): JOHN MILLAR

PERMIRA EUROPE III: NOT BAD FOR "SIX MONTHS' WORK"

Permira's Charles Sherwood says fundraising is an ongoing process: "We received a lot of acclaim for raising a fund in six months, but that is the greatest lie of all. We started raising our third fund the minute we closed our second"

Arguably, one of the most successful fundraising efforts over recent years has been by Permira. Having distributed its information memorandum for Permira Europe III in March 2003, with a target of €4.5bn, it reached a final close just six months later at €5.08bn – a record amount for a pan-European fund.

Timing was a key element in getting the fund raised. A few months before setting out on the fundraising trail, Permira made a stellar exit from its investment in Homebase. It sold the UK DIY retailer in November 2002 to GUS for £900m, making a five times cash return in as little as 20 months at what was a difficult time for trade sales. The realisation received a huge amount of press coverage and won the firm industry plaudits. As one limited partner comments, "there's a lot of PR in this industry now," and this surely was one of the most successful examples of how a good story widely disseminated can boost your fundraising chances.

Yet Permira says that the fundraising process was rather more complicated. "We don't believe that fundraising starts when you send out an information memorandum," says Charles Sherwood, the partner in charge of the fundraising. "It's an on-going process. We have received a lot of acclaim for raising the fund in six months, but that is the greatest lie of all. We started raising our third fund the minute we closed our second. We prepared more for this fundraising than we have ever done before. We're a way off launching fund four, but we're already thinking about it."

Part of Permira's strategy in its latest fundraising was to widen its LP base and attract investors from a wider range of regions. In particular, it expected more money to come in from Europe and Asia than previously. In the event, it managed to get 29 per cent of its capital from 77 new investors. In all, it had 134 investors in fund three, compared with 69 between funds one and two. "We were pleased by the number of new investors," says Sherwood. "But we were quite surprised by the geographic make-up. We had expected to see a shift away from North America being the predominant region and a swing towards Europe and Asia." The final tally saw 38 per cent of capital from the US and Canada, 29 per cent from the UK, 21 per cent from continental Europe, nine per cent from Asia and three per cent from the Middle East.

Investor attitude was quite different to previous fundraisings, according to Sherwood. "We found that investors were much more tenacious in the questions they asked," he says. So what were their concerns? "Investors want to know not just what your returns have been, they want to understand how you made them and how you are different from your competitors. They need proof that your team is stable and they are asking some very pointed questions about governance and alignment of interest issues. Many have been badly burned over recent years and it's not an experience they wish to repeat."

A number of investors have dropped out of the market altogether. Faced with concerns about Basel II and pressure from shareholders regarding private equity's volatile returns, banks have exited the asset class *en masse*. "On average, when a fund comes to market it can expect a natural attrition of about 20 to 25 per cent of existing investors," says Mounir Guen, chief executive of placement agent MVision. "But in many cases this is higher now, especially in the large and mid-market buy-out funds, which would have had a significant allocation of bank money. One fund we know had 40 per cent bank money – and it had an attrition rate of 35 per cent."

Add to this the fact that private equity has become much more competitive over recent years as newer entrants and spin-offs have come into play and you have a tough situation on your hands.

It's against this backdrop that we are about to see one of the largest fundraising drives ever in the European private equity market. About 15 pan-European funds are expected to go out to the market over the next year. Between them, they will be looking to raise a massive €40bn, according to placement house Almeida Capital.

Who's out there?

Apax Partners is currently raising one of the largest funds – it is thought to be looking for between €4.5bn and €6bn for Apax Europe VI. Hicks Muse Tate & Furst is seeking €1bn for its latest European offering. And many more well-established firms are set to join the fray in the coming months. Cinven is one. Since reaching a €4.4bn final close on its latest fund in 2002, it has been involved in some very large deals. The 2002 Unique Pub Company deal had an enterprise value of over €3bn, while gaming company Gala and publishing group Springer in 2003 were both over the €1.5bn mark. So it's only a matter of time before Cinven hits the road. Other firms likely to join it include CVC Capital Partners, Bridgepoint, Candover, Electra Partners Europe, PAI Partners… the list goes on. As Rod Selkirk, head of private equity at Hermes says, "You'll see the usual suspects coming out over the next few months and it'll be the larger funds sucking up the capacity."

With so much competition for institutional funds in the market, general partners are unlikely to raise significantly more this time round than in their last fundraising. Some of the larger funds have actually struggled to reach their targets. Doughty Hanson has had to slash the target for Doughty Hanson IV, citing a tough fundraising environment. It reached a first close of just $800m on a $3bn target last September after a year on the road. Subsequent reports suggested that it had passed the $1bn mark, but at the time of going to press there had still been no official notice of a final close. Industri Kapital managed a first close at €512m last October and subsequently revised its target from €2.5bn to €1.6bn. And 3i had hoped to attract more than the €880m that it raised from external investors for its latest €3bn fund, which it closed in the summer.

Those about to embark on the fundraising trail will have been watching these developments closely. "I think general partners have learnt lessons about fundraising over the past few years," says George Anson, managing director at HarbourVest Partners' London office. "I don't think we'll see anyone looking to increase their fund size significantly." Almeida Capital chief executive Richard Sachar agrees: "The most popular groups can still raise absolutely huge funds. But GPs shouldn't be looking to raise a bigger fund than last time. Most of the big names are looking to raise about the same size fund. I don't think we will see any major fund step-ups from last time."

But will they even reach their targets? It seems a tall order. The whole European market managed to raise just €18bn last year, according to Almeida figures. Some growth is likely, but €40bn seems highly improbable to some. "There is increased demand for private equity," explains Sachar. "But with so many pan-Europeans going to market at the same time, they won't all be able to get their allocations. Even some of the brand names are going to have a hard time."

Roger Wilkins, senior fund manager at Morley Fund Management, agrees that life may be tough for some funds. "Lots of funds will be going back to the market in the next six to nine months because their current funds are reaching fully invested status," he says. "We have had cycles in the past where a number of funds have come to market at the same time and there has been demand. Whether it will be there this time, I don't know. But some funds might not reach their aspirations."

Double jeopardy

Part of this potential shortfall may be caused by some of the concerns that LPs have about the larger funds. As fund sizes have crept up over the past five to seven years, the dynamics at the top end of the market have changed. There are naturally fewer larger companies to be snapped up at that end of the scale. This creates one of two situations – competition between firms or syndication. Neither is particularly appealing from an investor's perspective. "If they compete against each other, they just drive the price up," says Wilkins. "But if they collaborate we can end up getting the same underlying portfolio but paying twice the fees. Whenever we invest in these funds we look at how they match up with our own portfolio to ensure minimal overlap."

Anson says this is one of the reasons HarbourVest has cut back the number of relationships it has at the large end of the fund spectrum: "I think we'll see a continuation of the club aspect to larger deals," he says. "That means that differentiation between the larger funds is decreasing. We don't want to have exposure to the same deals through multiple funds."

Exits – or rather the lack of them – is another issue. Trade buyers are in short supply and the IPO market has been patchy. So despite a pick-up in activity over the past year, there is still an exit overhang. And it's particularly marked at the larger end of the market. Last year saw 13 deals with an enterprise value of €1bn or over completed in Europe, according to HarbourVest figures. The same period saw just three €1bn-plus exits. As a result, recapitalisations have been the name of the game. Although these return cash to investors, they are not an exit. "As an LP, it's great to get money back, but it doesn't reduce the fund managers' workload," says Anson. "If these firms are then going out and raising new funds, where is the capacity to manage it? Who will be making new investments if fund managers are still having to devote time to all the previous funds' portfolios? This is one of the areas on my watch list."

It's a bit of an old chestnut now, but the size of management fees charged by large funds and the impact they have on alignment of interest remains a concern. "LPs looking at funds have to look at the motivation of the fund managers," says Selkirk. "You have to ask whether they are still hungry. I would argue that at the larger and more established end, this is not a hungry industry. There are some very well-fed people around."

"The Calpers of this world have so much money to put to work that they have to write big cheques" Rod Selkirk, Hermes

That lack of hunger, some argue, means that GPs at larger firms are tempted to play safe. It's a point picked up by one LP, who prefers to remain anonymous: "Fees have now become the primary source of income for larger funds and carried interest is secondary. It means that GPs have become risk-averse. Faced with a safe deal and a more risky one, they will go with the easier option because they will still get a large pay packet regardless. It didn't used to be that way."

Put together, these are no small concerns. And yet many people are convinced that the next fundraising cycle will result in success for these established players, regardless of whether their track records or investment strategies warrant it.

Considered complacence

Part of the reason for this is an increase in allocations among LPs. "Among European LPs we polled, 42 per cent said they were planning to increase their allocation. For North American LPs it was 24 per cent," says Sachar. "Most people realise that if you are going to invest in private equity because you believe in the returns, you have to have a significant amount in your portfolio."

Although most European investors will be increasing from a low base – usually between one and four per cent, compared with typical allocations of between five and 15 per cent at their US counterparts – it's an increase all the same. Newer players will also enter the market. "More and more institutions will get involved with private equity – and those with allocations will increase them," says Guen. "Certain large pools of assets still have relatively low allocations to private equity compared to those that have been in private equity longer. However, we don't have the pattern we had a couple of years back when cash was pouring from whichever window you opened – the public markets, asset growth, capital returned, and allocation increases."

One of the more notable recent increases in allocations in Europe came earlier this year. In January, AlpInvest Partners of the Netherlands announced one of the largest private equity mandates ever awarded – €6bn from ABP and PGGM, two of the largest pension funds in the world. This came on top of the €16bn that AlpInvest already managed for the two funds. The combined mandate represents just under ten per cent of the total assets under management of the two pension schemes. And it pretty much matches the private equity firepower of US institutional giant Calpers, which has $20bn allocated to the asset class.

It is the large institutions – particularly those in the US – that will drive the fundraising efforts by the mega-funds. Many of these investors were absent from the market in 2002 and 2003 because lower-than-anticipated returns from other asset classes, such as public market investments, had skewed allocation levels. Private equity exposure, as a percentage of the whole investment portfolio, had increased even if the amount actually invested hadn't. Now that other asset classes are performing better, these investors are back.

"If you look at the whole picture, there is still an enormous amount of capital to be put to work in private equity," says the anonymous LP. Selkirk agrees. "The large US institutions – the Calpers of this world – have so much money to put to work, they have little choice but to write big cheques to large US funds and pan-European players," he says. "There is a wall of money in the large US pension funds. If they are having to deploy amounts of $100m – or even as much as $500m – for each commitment then they can't invest in smaller funds."

It's no secret that funds-of-funds have their fair share of dry powder too. Last year may not have been great for funds-of-funds raising capital, but that is partly because most of them had been out the previous year and raised unprecedented amounts. A study by research firm AltAssets in 2003 showed that there were 120 funds-of-funds worldwide – between them they managed $130bn of assets for their institutional clients. "A lot of the larger funds-of-funds have become asset managers," says the LP. "They have a lot of capital to deploy, so it is easier for them to target larger funds."

Fundraising may have become more arduous over recent years. And it never has been fun. But for the more established pan-European funds, it is by no means impossible. Fund sizes in this group are unlikely to hike up considerably and many believe the market has "normalised". If US institutions remain supportive, there is little reason to suspect that these firms will miss their targets. It may even be that we reach the magic €40bn sooner than expected. Sure, it won't be easy. But then when you're asking for billions of euros, why should it be?

"Who will be making new investments if fund managers are devoting time to all the previous funds' portfolios?" George Anson, HarbourVest

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