Tough times: fundraising in 2004

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These are not easy times for many European private equity and venture capital firms. Aside from the usual business of sourcing dealflow, adding value and identifying exit opportunities, investment executives admit to an extra degree of anxiety driven by the fact that many firms are currently fundraising - having last been out to market in the 1999-2002 period - and many more are expected to be out in the coming 18 months. The current fundraising environment is certainly characterised by a degree of nervousness on the side of GPs. This apprehension appears to be exacerbated by the widely held belief amongst investment houses that LPs are unlikely to commit until the majority of offerings within a particular market segment have come to the fold. Blair Thompson of SJ Berwin refers to the current environment as 'the calm before the storm' and goes on to underline the increasing anxiety amongst a number of groups managing current funds that are between 60% and 80% invested.

As a general trend, however, LPs exposure to the asset class is on the increase, meaning that there should be no shortage of liquidity given the right product offerings. Institutional interest is undoubtedly increasing as European LPs gradually reposition private equity asset allocations in line with those in the US, with many LPs freeing up asset allocations in anticipation of a busy period ahead. Nevertheless, some established GPs are likely to be surprised because re-ups from existing investors will be less automatic than in previous funds due to increased competition, according to Scott Church at Lazard. One thing is for sure: the private equity and venture capital landscape could radically change shape in the coming two years. For many groups, the ultimate test in the investment cycle - fundraising - may prove to be a challenging hurdle to conquer.

Invariably, the exact temperature of the fundraising environment will differ between the various segments and geographies of the market. The mid-market and bulge bracket can expect a small proportion of GPs to be overwhelmed with commitments, while others will be frustrated by under-resourced LP private equity teams which simply do not have the time to conduct the necessary due diligence on each individual product offering. Despite a significant decrease in overall allocation to venture capital vehicles, the industry is divided upon the likely fortunes of fundraisers in this area of the market. The fight for venture money may not be the initial battleground, however. 'We expect groups across all segments of the market to be out fundraising over the next 18 months, although venture players are likely to be out in force towards the latter end of this time scale', say Grant Roberts and David Morton of Newgate Partners.

In recent years, in what was an altogether more difficult economic environment, there was a marked enthusiasm amongst LPs towards funds managed by the most experienced GPs with established track records. As the bulge bracket continues to become institutionalised and the market becomes more perfect, the challenge for players in the area is to differentiate. John Daghlian of O'Melveny & Myers (OMM) believes that a number of investors seem to have gone cooler on larger funds in the last 12 months. Grant Roberts concedes that despite apparently waning institutional enthusiasm, successful mega-funds will do well as there is more institutional supply than opportunities to invest. 'This is because many LPs have fund concentration limits, which will skew investment from larger institutions towards the pan-European buyout houses', he says. Financial markets are not as active as they were in the 1990s due to weaker corporate valuations and little currency for M&A. This trend has facilitated the transfer of M&A activity to buyout houses, particularly in the bulge bracket and upper mid-market. Corporates are still less active at this upper level of the European market and most industries in Europe are more fragmented than in the US, which continues to make the European market attractive for buyout funds, comments Magnus Christensson of Atlantic-Pacific Capital. Mounir Guen explains that LPs have always had desire to gain exposure to the cycle and the bulge bracket has consistently provided the opportunity to do this. 'The challenge for the bulge bracket is to

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raise volume - there will be stagnation if it stays at the same size', he adds. Andrew Sealey strikes a note of caution, however, believing that investment diversification beyond just a handful of funds at this level of the private equity landscape can see returns very swiftly digress to the mean.

There is certainly the general belief in the market that cross-border opportunities in the fragmented European mid-market will persist at favourable levels. The challenge for sophisticated LPs is to select the best two or three funds within each country. As with all other segments of the market it is the groups which demonstrate proprietary dealflow, clear value add and a strong exit record that will prosper in the mid-market, explains Paul Marson-Smith at Gresham in London. One industry commentator believes that many LPs are employing an ever more cautious approach to the asset class and consequently are becoming increasingly focused on the upper mid-market, which can be summed up by the old adage that 'nobody ever got sacked for buying IBM'. While many domestically focused GPs should raise funds relatively easily, Mounir Guen emphasises that there is a danger in this 'superhot' lower mid-market area that fund-of-funds will crowd everyone else out.

European venture, meanwhile, has provided little substantial exit record to speak of over the last 24-36 months and, as a result, it becomes increasingly difficult for LPs to justify future investment in this subdivision of their private equity portfolios. Whereas five years ago the majority of investors within the asset class would have had direct exposure to a range of venture funds, these days most coverage is weighted towards fund-of-funds investments. 'The European venture industry lacks a track record and it appears that many groups are unlikely to raise new funds', comments Jenny Fenton at Altius. As Solomon Wifa of OMM points out: 'If a venture fund has no exits, what type of track record information will it go out on?' He goes on to say that pledge funds might provide one potential solution whereby investors can make commitments on a deal-by-deal basis. Yet, as Ian Simpson of Helix points out, it is very difficult to pitch to LPs on unrealised returns as many of them were stung in the technology bubble - a market that was based on such valuations. Magnus Christensson believes that fundraising for European venture capital will continue be tough as LPs view the GP teams as not as experienced as their US counterparts as well as the fact that the overall VC industry in Europe is less established. 'The environment in Europe for venture capital is not as advantageous as in the US with its well funded universities, positive attitude to entrepreneurs and large market for the portfolio companies to offset their products' concludes Christensson. It is not all bad news for venture, however. 'Despite the fact LPs prefer second tier US venture firms rather than first tier European, the segment should see improved investment as LPs seek to diversify private equity holdings as exposure to asset class increases', points out Mounir Guen. Other commentators take a contrarian investment approach: David Morton is reasonably upbeat about prospects for venture asserting that it should be an area of focus now as it has been left out in the cold for so long. On the down side he emphasises that venture managers have in recent years been focusing on their existing portfolios, using un-invested commitments in support of their most promising portfolio companies as exits have been difficult (if not impossible) to achieve thereby making fewer new investments. This trend is a function of a difficult exit environment and subsequently increased holding periods for venture enterprises. Good news from other geographies is also produced to suggest that the worst may be over: 'As a general rule Europe follows the US with a bit of a lag and there are several strong US venture houses that are currently out raising or have raised money recently', points out Blair Thompson. The successful first and final close of Benchmark Europe II in mid-September on $375m should also give the sector a much-needed fillip.

Emerging managers make waves

Following the success of several first time funds over the last 18 months, notably Altor in Sweden and Exponent in the UK, question marks still remain over the competitiveness of emerging managers when pitted against an abundance of established funds with long track records. Grant Roberts, for example, has noticed a softening in LPs 'flight to quality' and a more proactive approach to the way they hold their assets with increased interest in new managers; other commentators point to a current trend in the US venture market, in particular, to back newly formed teams of experienced deal-doers. Some analysts argue that the majority of the longest established players generated their top returns on debut funds, although this somewhat diminished the effect of the many groups which never raise a second fund. The argument comes down to whether subsequent funds have performed in line with a market that, as a whole, has seen returns squeezed, or whether the extra volume of subsequent larger funds has offset the likely discrepancy in returns. Anne Gales at CP Eaton certainly agrees with the latter argument: 'First time teams with a more niche investment focus, spinning out from larger funds are highly looked after by some investors with larger mature portfolios, as they feel that the more focused approach combined with hunger to succeed is a successful formula.' Conversely, Bridget Barker at law firm Macfarlanes doesn't feel that first time funds are hungrier: everyone she knows who is involved in fundraising at the moment, whether first time managers or not, is taking it very seriously indeed.

Industry consensus is that the most important factor governing the likely success of a first time fundraiser is the individual track record of the investment professionals. Julie Bradshaw, a partner at Lovells, however, points out that there is an argument to suggest the individuals should be judged on the performance of the fund as a whole rather than just the investments that they were involved in: 'The argument comes down to factors such as the networks of those funds, the amount of proprietary dealflow they received and the motivation behind investment decisions, all of which are likely to have influenced the individual's decision to some extent. No GP would dispute that a large part of a successful fundraising is down to timing'. Certainly the

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actual date of a fund launch is crucial to its success or failure. 'There are funds that were raised last year that wouldn't stand a chance of getting raised in the current fundraising environment', explains Craig Donaldson at HgCapital in London.

Emerging manager funds are not suitable for all though and are frequently not welcomed by other groups in the market. Such vehicles are largely neglected by pension funds and insurance companies as viable direct investment opportunities due to the long and laborious procedures required to get an indictment from trustees to invest in these relatively risky vehicles. New funds also increase the workload for LPs which would have to conduct more due diligence on a new fund rather than a vehicle with an obvious track record. Armando D'Amico of Acanthus Advisers estimates that first time funds account for around a third of the private equity landscape by volume. 'Not only do institutions have to complete more due diligence, but new funds also erode the returns of existing vehicles in the market by increasing competition and typically taking on more risk', he adds. Scott Church sees it from the GP side: 'The spinout of high quality investment professionals can certainly exacerbate the fundraising for groups they leave. This is a particular problem for groups whose founding partners have not made adequate plans for the growth and development of investment teams, equitable compensation, or group strategy.' While they may grab the headlines when they hit target, debut fund launches are certainly not for the faint-hearted: 'Although Exponent was a great success, due to the level of risk associated with an emerging manager fund, one spinout fund a year is enough for us', comments Rachel Wood at Helix.

To the winners: the spoils. And to the losers?

There will undoubtedly be winners in the forthcoming spate of fundraisings that are approaching as a benign economic environment in the UK and improving economy on the Continent conspire with excess liquidity in the hands of LPs to provide a stable platform for GPs to attract commitments. There is also likely to be a large number of failures. As one commentator queried, 'First time groups have failed in the past but what happens when an established player fails?' Andrew Sealey argues that the groups that will not raise at all in the current fundraising environment will have been advised as such. There are a number of groups, including names such as Industri Kapital and Doughty Hanson, which are thought to be unlikely to reach their targets. 3i and Terra Firma, for example, have both recently raised less external money than they had initially targeted. It is difficult to see, however, how the strategies employed by groups which don't hit their intended targets will differ unless they raise dramatically less than was initially targeted. Armando D'Amico points out that we have already seen a fallout in the venture segment, in which fundraising is now skewed towards five to ten quality players across Europe. He continues by saying that he doesn't expect to see the same level of fallout in the buyout market due to the fundamental differences in the nature of the investments that are made at that level. Anne Gales at CP Eaton agrees. 'Outcome of venture investing is more binary and you need a couple of winners to make it work. Venture capitalist investors left the market when they understood that the unrealised values of their portfolios were close to worthless. Buyout investors have a very different risk-return profile and typically invest in larger, more stable businesses with cashflow, which even in adverse market conditions will be worth something' she explains.

Many groups that fail to raise will either simply manage their current portfolios of assets through to exit, employing less resources and eventually winding themselves up, or defer fundraising until they decide that their product offerings are again an attractive proposition in the market. Alternatively, a GP might become a target for secondary investors which will buy the portfolio of assets and liquidate the business in that manner. A less likely option is for the GP to merge with another private equity house, although, as Scott Church underlines, this type of consolidation can be difficult in the context of an LP structure. On balance the least likely scenario

continued on page 6

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appears to be that the LPs will replace the GP or terminate the fund. One of the problems facing a proactive institution is that there are always a variety of investors from different geographic regions with different motivations. Given that most European LPs will not have an asset allocation to private equity of more than 5% with maybe one or two individuals who are responsible for managing large fund investments, it is easy to understand the passive nature of these investors. Replacing the fund manager will typically require a majority upwards of 75% of LPs on a capital weighted basis. Anne Gales points out that during the venture capital fallout it was much easier for most investors to walk away than to restructure. Although active dialogue amongst institutional investors and high-net-worth investors to restructure or merge funds took place, in the end it all seemed too complicated. In the buyout arena investors don't generally complain, they just vote with their feet and offload investments in the secondary markets.

Grant Roberts and David Morton allude to a different angle and ask: What will happen to the LPs' interests (commitments) in previous funds when a GP fails to raise a subsequent fund or falls well short of target resulting in the GP's business model flipping from one with an unlimited life span to one with a finite and relatively short-term life span? They argue that the situation could lead to conflicting motivations for LPs and GPs (especially if the GPs' profit participation, i.e. carried interest, is under water). LPs will continue to want the fund's investments to be realised at the maximum potential value as soon as practically possible, while the GP may be happy to continue to manage the existing portfolio with little, if any, motivation to realise portfolio investments, as every time a realisations occurs the GP's profit share (or management fee) will reduce. Dis-alignment of interest can also occur over time, without breaching the LPA and often without ringing alarm bells with the LPs, but the effect can be the same. There are a number of actions that LPs can take to address this issue but they need to consider carefully the potential effects on existing investments in funds where the GP fails to raise a subsequent fund.

One obvious trend over the past ten years has been for mid-market players to raise larger and larger funds. This has meant that mid-market groups, which have been successful at generating returns from investments within a specific value range, have moved up the value chain into larger deal sizes. It would appear a natural evolution, albeit into an increasingly competitive area of the market. The issue is not style drift (many managers would point out that they are making similar investments just in slightly larger size companies) rather the ability of the investment executives to generate the same level of value in these types of business at higher valuations. Value will only be created if the reduction in IRR is more than offset by the increase in volume. Scott Church argues that firms who fail at this level could 'go back to basics' whereby they realign their focus and gravitate back to the area of the market where they initially operated. Fundraising difficulties of some of the more established, stable groups are likely to be exacerbated by bold movements of commitments on the part of fund-of-funds, which are likely to increase their weighting to high return products offerings such as emerging manager funds, funds focused on new EU entrants and other niche offerings.

Terms and conditions in a competitive market

In the 1990s - when many private equity houses were generating record returns - LPs were seemingly much more relaxed on the question of fund terms and conditions. These days, in an altogether more difficult return generating environment, movements in fund terms and conditions can provide a useful indicator to the balance of power in the LP/GP relationship. The laws of economics suggest that fund terms will fluctuate depending on the supply of capital from LPs relative to the demand for GPs. Taken on face value this alludes to a story of ambiguity, whereby the level of supply of funds to the market is increasing and similarly so is the demand for commitments. Scratching the surface reveals a clear bifurcation, whereby GPs

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with good track records that can raise easily will have the option to squeeze LPs on terms, as well as those GPs that are nervous about the fundraising environment are likely to offer more favourable terms in order to make the proposition more attractive. 'Smaller funds can be more aggressive regarding stretching terms and conditions', comments Ian Simpson. 'If the fund is going to be oversubscribed GPs can be tighter on terms'. He continues by citing the example of Graphite Capital, which could conceivably have pushed terms and conditions to the limit but 'knew morally it was not the best way to go.' Year-on-year, however, there has only been limited movement in the area of terms and conditions. 'There have been no real changes in the headline terms but there has been a sharpening on smaller terms such as the sharing of transaction fees and a strengthening of no fault divorce - these more vigorous provisions favour the investing institution', says John Daghlian. Blair Thompson, too, underlines a trend towards more LP protection provisions.

The carried interest model has definitely evolved over recent years, with few funds now taking carry on a deal-by-deal basis, which is highly favourable to the GP, and adopting either the standard European 'fund as a whole' system or a hybrid version between the two. The debate is very much underway. Exponent reportedly sought a US style deal-by-deal carry mechanism on its debut fund, but LPs were very resistant, not so much to the idea that they would not accept it for Exponent, but they believed it would set a precedent for the many funds that they are likely to see in the coming months. Certainly, the isolation and under-resourcing of LPs counts against them. 'I am amazed that more LPs don't talk together and conspire to put pressure on GPs with regard to terms', says one commentator.

Craig Donaldson underlines that there is a need to a focus on alignment of interests when fund terms and conditions are being negotiated: 'It shouldn't be an 'us' and 'them' thing, it should be a 'we' thing.' Whatever the balance, there is substantially more dialogue between LPs and GPs now than ever before. Mounir Guen points to a growth in legal representation for LPs that has increased as lawyers have become more focused on LPs' needs and views. Many LPs continue to argue that there is an incentivisation issue for GPs which raise large funds and make their income from fees in comparison to smaller funds, which charge a similar percentage fee but make their money from carry. The early fixing of a cap to a new fund has now moved to the top of the agenda for many LPs that want to know that an investment team is suitably focused on the potential gains from carried interest, rather than living from the management fee. 'It makes little sense for GPs raising mega-funds to be too aggressive on terms and conditions as they endeavour to appeal to marginal investors in a such a competitive space', adds Patrick Petit.

Management fees are another sticking point between LPs and GPs. Peter Moon of the Universities Superannuation Scheme (USS) emphasises that fee structures are holding back private equity: 'If private equity houses were willing to raise hurdle rates and reduce carry it will encourage those institutions, like ourselves, with no asset allocation to private equity to take a serious look at the asset class.' Moon continues to assert that 'Fees should be flat or inflation led rather than on an ad valorem basis.' Gary Steinberg of The Wellcome Trust agrees that fees are high, but also states that 'There is an ongoing dialogue between the Trust and our GPs which helps to align interests and allow us to see where fees are being spent.' Steinberg also outlines access issues stressing that 'Many of the quality funds are oversubscribed so the threat of walking away holds little sway.'

Taking the LP perspective

Considerable discussion has been focused in recent months on key issues for institutions, including returns, benchmarking and the battle between competing alternative assets. There does now appear to be a consensus amongst the private equity community that LPs are becoming more realistic on future returns in what is a lower interest rate, lower inflation environment. Many LPs are happy with a 500 basis point premium above long-term expected returns for listed equities - something which, as David Morton points out, can be achieved without a 25% gross IRR. Morton cites a figure of between 17-19% gross IRR. 'LP and GP views on returns are pretty well aligned across the buyout sector, but not necessarily in the venture capital market', explains Patrick Petit at Global Private Equity in Paris. In contrast to the bull market of the 1990s, it can no longer be a viable strategy to go long in an asset class with an aggressive risk/return profile and 'ride the wave'. Sophistication is now required. 'The critical decision comes down to selection within private equity itself, rather than the extent of exposure to the asset class in general', points out Brian Blakemore at BPE. 'Despite increases in levels of competition, there is still Alpha to be made', says Gary Steinberg.

Predicting those sectors likely to produce the best returns is haphazard, to say the least. 'Returns within each segment of the market will be all over the shop', says James Moore at UBS. 'That said, it is more important for smaller funds to demonstrate better returns, given the less stable nature of the businesses that they are likely to invest in.' Scott Church, meanwhile, argues that as returns and multiples revert to the mean in the market, there are always niche offerings that will offer more aggressive risk/return profiles which will drive private equity market returns across the board. He cites geographies such as Japan, Australasia and Eastern Europe as well as contrarian plays, new sub-sector focuses and special situation strategies, as particular drivers.

Many pension fund and insurance company's benchmarks do not contain a private equity component and given the long term nature of the asset class it is clear to see why, historically, so many European LPs have been cautious regarding private equity investment. That said, pension fund benchmarks are likely to evolve to contain a private equity or alternative asset component as more dynamic standards are introduced. One question that is consistently a topic of debate among the private equity

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community is whether returns should be measured against a relative or an absolute benchmark. If benchmarking is done by relative or absolute returns comes down to the issue of whether the public and private markets are aligned. Investors that benchmark with absolute returns are happier with longer holding periods, whereas those looking at relative returns will have a short-term focus on IRR and the performance of the listed market. Paul Marson-Smith is clear: 'Absolute return is the benchmark - there is a risk and liquidity risk premium but this should not be linked to the stock market.' Scott Church, meanwhile, argues that absolute returns will never be the complete benchmark because many pension funds will measure their alternative asset portfolio relative to the listed market. A certain divergence of views is certainly likely, reflecting the character of the investing institution. Large insurance companies and government institutions may favour the use of relative benchmarks, while other investors such as fund-of-funds may prefer to benchmark against absolute returns.'

Undoubtedly, alternative assets are receiving increased attention across the board from European institutions. One important issue for GPs is how the asset class stacks up against hedge funds and real estate when competing for institutional money. Due to the fact that many LPs are underfunded in alternative assets in general, there is no reason why both private equity and hedge funds should not benefit from this cash injection, according to Jenny Fenton. Provided also that public and private markets perform in positive correlation with each other there should not be the allocation problems for pension funds and insurance companies that have been witnessed in the bear market of recent years. Peter Moon at USS is clear: 'Given the benign economic outlook for Europe and the inclination of defined benefit pension schemes to meet liability in a more risk diverse manner, the alternative asset class should continue to gain increased exposure from pension funds.

Scott Church, meanwhile, outlines that hedge funds and private equity are not always competing for the same pound of LP money: 'Hedge funds are typically classed in neutral or other exposure in alternative assets, whereas private equity is part of most institutions equity component.' Peter Moon points out that many consultants are advising for investments in hedge rather than private equity due to the link between private equity and the quoted markets. 'Private Equity has to start showing consistent returns similar to those of hedge to compete more aggressively for institutional money. USS would not consider private equity a risk diversifier unless it achieves a 10% premium above interest rates', he adds. Liquidity is also a major issue for most institutions. Julie Bradshaw argues that the extra liquidity in hedge fund investment relative to private equity makes it an attractive proposition. Anne Gales from CP Eaton, which recently closed two real estate fundraisings, cites real estate as another competing asset class and alludes to the new 'REITs' initiative in Europe, which she believes will make the asset class more accessible and therefore attractive to European institutional investors, as has proven to be the case for US investors. European investors have historically chosen to invest direct in property and an effective fund vehicle will be beneficial to provide institutional investors with broader access and geographic diversification. The REIT initiative allows participants to invest in a professionally managed portfolio of real estate properties. REITs qualify as pass-through entities: companies that are able distribute the majority of income cash flows to investors without taxation at the corporate level.