CAPITA
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Private Equity Fundraising Trends

The private equity industry has been hit hard by the financial crisis. Although 2010 started more positively than 2009 ended, a return to the industry's heights in 2006, fuelled by cheap debt and significant private equity fund contributions, still seems a long way off. Deal flow remains inconsistent and debt difficult to obtain. Investors are looking more closely than ever at risk and return. Regulators are focusing greater attention on the industry, and alternative competing structures and asset classes are becoming more common. As a consequence, fund managers are having to be increasingly creative and work that much harder to ensure that fundraising efforts have a successful outcome.

Investment levels

Globally, 2009 fundraising totals were down 65% compared to 2008. European Private Equity and Venture Capital Association (*EVCA*) members raised a combined total of €13bn last year (which by comparison is less than that raised by the two largest funds in the previous year). Only about one-third of fund managers are planning to launch a new fund in 2010, and we expect there to be an increase in consolidation between fund managers alongside institutional investors continuing to defer or suspend private equity asset allocation programmes. In addition, government-linked investors such as state pension funds have been pressured into focusing on domestic investments generally and sovereign wealth funds have been asked to assist with inward investment activities, such as the bail-out of financial institutions.

Regulatory developments

The private equity industry is facing reform in regulation and accountability in both the US and the European Union, with the aim of minimising systematic risk and forcing fund managers to be more transparent. This is likely to lead to an increase in compliance costs, at least part of which will be passed on to investors. In addition, tax reforms are reducing the options for fund managers to structure funds in tax-efficient ways.

Investors, facing increased regulation themselves, are placing more emphasis on corporate governance, demanding increased transparency, better information and clearer policies on dealing with conflicts of interest. This trend is in line with guidelines published by industry associations such as the Institutional Limited Partners' Association and the International Organization of Securities Commissions.

New fund structures

Following the collapse of Lehman Brothers, the number of simplified fund structures or "club deals" has increased considerably. These deals arise in the following types of situations:

- A management team spun out of an existing private equity house wishes to start its first fund on a limited budget by managing "friends and family" money; or
- An investor wishes to "syndicate" its assets by placing them into a fund structure as a form of capital contribution, and then offer further interests to investors in exchange for cash. Existing investors can take cash out of the structure and achieve an instant return.

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These types of fund structures tend to be much easier and cheaper to manage. Constitutional documents can be simpler, and the funds require less complicated contractual arrangements. Ongoing reporting obligations are minimised and a full marketing campaign is not necessary as investment monies are already in place.

Many larger investors are also exploring new investment models, such as managed accounts, pledge funds, deal by deal funds, part-ownership structures of GPs and direct investments into portfolio companies.

Marketing developments

We are now seeing that, even where fund managers are targeting a broader range of investors than for a club deal, they may still want to guarantee in principle commitments from investors before drafting and negotiating documentation. To widen access to funds beyond its own contacts, a fund manager frequently uses a placement agent as an intermediary, who works on a commission basis but may also ask for a share of the carried interest or request equity in the manager.

It should be borne in mind that the US authorities are proposing regulation aimed at limiting such deals in respect of US pension funds, following the "pay to play" scandal. Indeed, many US pension funds have already instituted a complete ban on the use of placement agents.

Another marketing development is the use of the cornerstone investor. A new fund manager who finds it difficult to attract investors because of a lack of an institutional track record may seek to secure a pre-commitment from a "name" investor (possibly on more preferential terms).

Power shift

As a consequence of all these changes, investors are becoming far more selective in their choice of fund manager, and negotiating more aggressive terms such as:

- *The level of management and performance fees* - Investors are requesting both a reduction in the management fee (to nearer 1.5%) and either a share in the performance fee, or a tiered performance fee that steps up once certain performance thresholds have been met.
- More rigid *Key man clauses*.
- *Fund manager removal provisions* - giving the right for investors to remove underperforming managers, suspend managers' ability to make investments or even to wind up the fund.
- *Investment restrictions* - Clauses regarding the amount of capital that may be called annually, the size of individual portfolio investments, geographic or industry focus, and investments in debt publicly traded securities and pooled investments are given much greater attention.
- *GP commitment* - Investors are requiring fund managers to invest alongside them in new funds and so share the risk

Change in investment strategies

Fundraising for specific asset class funds appears to be easier than for traditional private equity buy-out funds. Last year only 15 infrastructure funds were launched raising a total of $7bn (down from 38 funds and $34.6bn in 2008), and numerous other funds were abandoned or suspended. Demand is now rising again as governments look to stimulate their economies with new education, healthcare, transport and energy projects. From the institutional investor's perspective, infrastructure assets offer a greater likelihood of steady returns.

Secondary funds are also proving more popular as funds seek value in interests in other funds or legacy assets of funds that have reached the end of their life. It is hoped by managers that the returns that sellers in the secondary market make will eventually find their way back into the industry as fresh commitments to new funds.

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Lastly, investment in "green tinge" funds, for example, renewable energy funds, is growing as an increasing number of US and Western European institutional investors specifically set aside a portion of their investment programme for these types of assets.

The year ahead

The financial crisis, and the reaction to it, has no doubt caused the rules for private equity funds to be rewritten, at least in part. Fund managers are finding that they need to look at new structures, negotiate different terms and be prepared to use new marketing techniques during fundraising.

However, it has been our experience that, for those managers who have been successful in raising funds, or who continue to benefit from existing investor commitments, portfolio deals have been completed on very attractive terms, and many believe that funds launched in 2009 and 2010 may well prove to offer some of the most attractive returns of recent years. Those fund managers that are able to launch funds in the next year or so may well find themselves with a happy investor base that will stay loyal to them in the years ahead.

The views expressed in the article are those of the author's which may differ from those of Capita Financial Group.

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