Better, faster, stronger

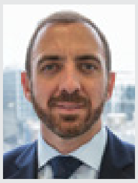
Navigating today's fundraising market has become increasingly complex for both fund managers and investors – but those getting it right are reaping substantial rewards. What does it take to fall in that category? Late last year, *pfm* assembled an expert panel of industry insiders to find out

by NICHOLAS DONATO
photography by JAMES CLARKE

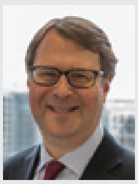
Around the table

Sergey Sheshuryak is a partner at fund of funds investor **Adams Street Partners**. He is responsible for managing the group's investor relationships across Europe, and is additionally an LP advisory board member of 17 private equity firms within the Adams Street portfolio.

Helen Steers is a partner and head of European primary investments at **Pantheon**, a fund of funds investor where she is also active in the group's co-investment program. Steers is a board member of Invest Europe (formerly the EVCA) with 25 years of industry experience.



Nigel van Zyl is a London based partner in the private investment funds practice of law firm **Proskauer**. van Zyl has over 14 years of experience advising private fund managers and institutional investors on a broad range of issues, including fund formations, fundraisings, secondary transactions and co-investment arrangements.



David Tegeler is a US-based partner and global co-head of the private investment funds practice at **Proskauer**, a law firm. Tegeler has expertise in a broad range of matters, including fund formations, buy and sell side secondary transactions, direct secondary transactions, co-investments, restructurings and upper tier management governance issues.

Right from the start, it was obvious that things were going to be interesting – and not just because of the dazzling view of the financial district from Proskauer's London office.

After introductions were made, and pleasantries exchanged, our panel of fundraising experts – a mix of fund managers, investors and legal advisors – were asked a question bound to elicit strong, contrasting opinions: Has the so-called 'power pendulum' swung back towards GPs post-global financial crisis?

It's a question that required our roundtable participants to consider a host of factors, including the estimated 2,000-plus fund managers on the fundraising trail today; the lightning-quick speeds at which top-tier GPs have managed to close multi-billion funds, while others struggle or experiment with different funding models; and the resoluteness of LPs while negotiating investor protection rights and certain other terms.

"At the moment it's swinging back in the favor of GPs," says Helen Steers, a partner at fund of funds group Pantheon, who was the first to offer such a verdict. The pendulum's swing back, however, has been limited, Steers believes.

Delaney Brown, a senior principal at the Canada Pension Plan Investment Board (CPPIB), disagrees, saying that the pendulum is better described as having swung *significantly* back in GPs' direction.

"Managers with a good track record are generally less receptive to what investors want," says Brown. "A more balanced conversation between LP and GP occurs when you go beyond the top quartile GPs – and more and more managers feel that they are in that category."

Brown says that LPs did "a fair job" of influencing terms in the years immediately after the crisis, when the pendulum is said to have gone the other way, but "not as great of a job as could have been done."

Soon after, the roundtable agreed that the question was hard to answer generally, and it varied based on managers' size, strategy, track record and terms.

That's because the market is "hot but still selective" at the moment, says Adams Street Partners' Sergey Sheshuryak. "Many smaller funds, that don't usually need as many LPs to reach a close, are having great fundraising success. Certain mega-funds with good performance and differentiated approach, are accomplishing the same thing with larger pools of LPs to consider. But some managers misread the environment entirely by going out with aggressive size targets and unusual terms, and receiving less demand than expected, despite a good brand name and decent historic performance."

Managers: Proceed with caution

Despite the general market shift in their favor, managers are exercising restraint when negotiating fund terms. The roundtable cited three specific reasons why.

For starters, GPs understand that unfavorable terms can prolong the fundraising process, which isn't typically worth the tradeoff. Equistone is a recent case study in this type of restraint. The pan-European mid-market firm corralled €2 billion in commitments after just six months in market, sealing a first and final close on its fifth buyout fund earlier this April.

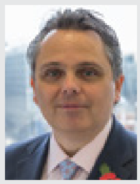
"It does mean you stand in front of your colleagues and say 'Yes, our success here indicates we could have asked for better off-market terms; but do we really want to put additional risk in our business by prolonging the fundraising for an additional six months?'," says Equistone IR partner Christiian Marriott.

Secondly, regulators have entered the mix with greater visibility since post-crisis regulations placed an unprecedented level of scrutiny over the private funds industry. After reviewing managers' marketing materials, regulatory filings, partnership agreements and other records, inspectors are flagging certain practices and expense al-

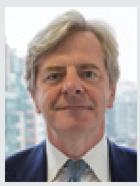
Around the table

Delaney Brown is a senior principal at the **Canada Pension Plan Investment Board (CPPIB)**, a Toronto based pension plan where he evaluates fund investments, secondaries transactions and co-investment opportunities. Prior to joining CPPIB in 2013, he spent eight years at Hermes GPE performing a similar role.

Jeremy Lytle is an investor relations partner at UK mid-market firm **ECI**. He is chair of the British Venture Capital Association's Responsible Investment Advisory Board and is additionally a member of the trade body's committee on investor relations.



Christiian Marriott is a partner responsible for fundraising and investor relations at **Equistone Partners Europe**, the mid-market firm that spun out from Barclays. Before that he was IR director for Mezzanine Management (now MML Capital).



Vince O'Brien is a director at **Montagu Private Equity**, a European private equity firm. He sits on the firm's investment committee and is responsible for fundraising and investor relations. A former chairman of the British Venture Capital Association, O'Brien has worked in the private equity industry for nearly 30 years.

locations as potentially violating GPs' fiduciary duty to investors.

"Transaction fees, accelerated monitoring fees and certain other terms cited specifically in recent SEC enforcement cases are either staying put with additional disclosure to the LPs, or becoming more conservative," says David Tegeler, a US-based partner at Proskauer, who co-heads the group's private investment funds practice.

Thirdly, terms that stray too far in GP's favor can come across as opportunistic to investors. Jeremy Lytle, an investor relations partner at ECI, says that LPs like to see a certain level of consistency from one fund to the next. The UK mid-market firm closed its tenth fund on a £500 million hard-cap in September 2014 following a five month fundraising sprint.

"If we attempted to adjust our terms in our favor, given the current environment, it would have been very difficult to justify why," says Lytle. What's more is that GPs "behaving badly during one fundraise" or ending up "pushing too hard on any one term" risk upsetting their investor base – who are bound to share their experiences with other, possibly prospective investors, Lytle continues.

However, not all terms appear static. For instance, London-based Proskauer fund formation Nigel van Zyl is noticing funds switching back to the US-style deal-by-deal waterfall approach after having conceded a European-style "fund-as-a-whole" approach immediately after the crisis. "It's a trend particularly strong in the large-cap end of the market," van Zyl says. But even here further qualifications are in order: While some European GPs are abandoning their typical per-fund waterfall to dabble in deal-by-deal carry, US managers are moving in the opposite direction, incorporating more elements of the European waterfall into their carry provisions in order to satisfy LPs. "There's a strong contrast to be made here between Europe and the US," van Zyl cautions.

But with the fundraising spigot cranked left, one term in particular is proving hard for managers to resist moving, thus becoming a flashpoint during negotiations.

Bigger isn't always better

Hard-caps, which several roundtable participants pointed to as one of the most important terms during negotiations, are another area where GPs can inadvertently come across as self-serving.

"The key question is: can you commit to a hard cap up front. Because if not, it looks like you're out there to see what the market will give you and then take it all," says Marriott, adding that GPs "who do their homework" and "understand their business and market well" should be able to include a hard cap in their PPM.

Indeed, overall fund size is something GPs don't spend enough time thinking about or trying to justify, despite fund size affecting almost every aspect of a firm's business model (including headcount decisions, internal organization, co-investment and borrowing policies and overall economics). LPs want to know exactly why the target is what it is, and exactly what consequences that has for a firm's strategy and resource base.

For Sheshuryak, there are many cases when rising fund sizes are justifiable, but he questions GPs who contradict themselves by saying that their pipelines are "jammed full of potential" but at the same time ask for longer investment periods (increasingly as long as six years). "It doesn't make sense. If you're justifying a bigger fund by pointing to all these deals in the works, then why do you need so much more time to execute?"

The desire to raise the fund size, though, can come as much from LPs jockeying to enter a popular fund as it does from fund managers, says Steers.

That said, other LPs want to limit fund sizes in order to increase their chances of being offered co-investment opportunities, says Tegeler. "They will want to limit the manager's dry powder, resulting in the need to seek additional capital from co-investors." To that same end, investors are negotiating stricter investment limitations set forth in the fund's governing documents. "So any one deal can't be 15 percent instead of 20 percent of the fund size, which creates that same need to bring on other investors to close deals."

Co-investment challenges

With the roundtable's attention turned towards co-investments, Lytle says that "it's really a trend taking hold in the larger end of the market. The market is seeing bigger LPs quickly lose interest in a fund if the co-investment opportunity just isn't there."

Brown agrees, saying that co-investments, at all levels of the market, can "make or break a manager's chances on the margin."

But there are significant challenges when it comes to managing co-investments. Tegeler says that one major challenge is finding LPs capable enough of analyzing deals and reaching an investment decision within tight timeframes. "If it's a straightforward buyout deal, it's relatively simple to get it done. But if your fund is investing in, for example a complicated infrastructure transaction, or one that includes complex financial engineering, it becomes much more challenging for the GPs to manage the co-investment process."

A temptation for GPs, Lytle continues, is to give the impression that co-investment opportunities will be plentiful, but managers "must be realistic and transparent" about how many they expect to do. "You don't want to give your investors the wrong impression and then that they might expect too much."

And once the fund closes, many GPs now send LPs questionnaires to better understand their level of interest in co-investments, whether they have any deal type preferences and/or their limits when it comes to reviewing transactions, adds Steers. "One indicator that an LP is interested in co-investments is if they bother to answer the questionnaire at all," Steers says.

For van Zyl, the other major challenge surrounding co-investments relates to compliance.

"What we say to GP clients is: "It doesn't matter what your co-investment allocation policy is – you can decide what's in the best interests of your fund – but be sure to clearly articulate how it will be done. So if it's on a size of capital basis, say that. Or if it's based completely on your discretion, then carefully explain that."

Under any policy, however, GPs are going to have to tread delicately when talking to their LPs about the rationale behind co-investments and other preferential agreements, the panelists agreed. That's because co-investment opportunities tend to go to LPs with large sums to put to work, which can create different tiers of investors in the same fund.

The AIFMD effect

As all fundraising conversations go, people's attention inevitably turned towards the impact of regulation, with the Alternative Investment Fund Managers Directive (AIFMD) a strong area of focus.

In 2009, during the initial drafting stages of the directive, there were legitimate concerns that the AIFMD would erect a regulatory ring-fence around outside managers wanting in. Meanwhile, confusing provisions around reporting, near-impossible rules requiring firms to isolate dealmakers from the valuation process and costly depositary arrangements were all cause for concern for EU-based managers. Six years on, where GPs right to be worried?

"From a practical standpoint, it wasn't a great deal of grief," says Montagu Private Equity director Vince O'Brien, whose firm went through the directive's authorization process. That's not to say the extra regulation isn't having any impact at all. For all the hassle of authorization, the AIFMD rewards fund managers with a pan-EU marketing passport allowing for a more seamless fundraising process. But O'Brien says that GP's need to plan carefully. "Registering for AIFMD purposes across Europe can result in significant registration fees being incurred in some countries, so if a GP does not expect to market in certain countries it is worth considering whether there is any necessity to register at all."

Outside of the EU, "smaller GPs less able, or less willing, to meet the directive's challenges are steering clear of Europe," says Steers. Sheshuryak agrees, noting that European LPs are losing access to US mid-market funds no longer comfortable with Europe's new private funds regime.

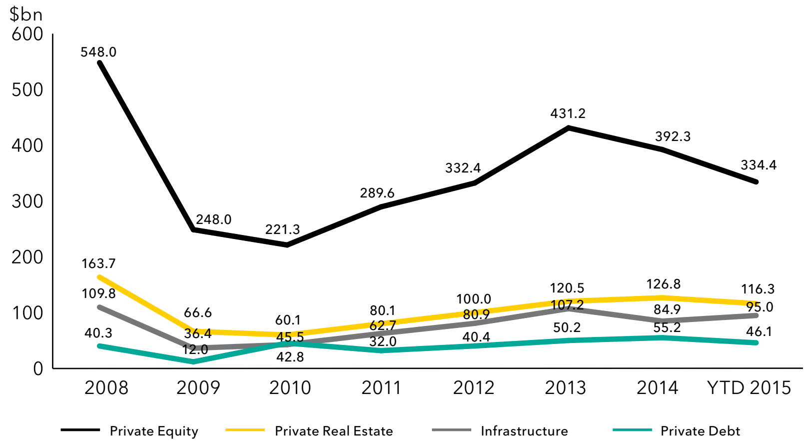
For managers already authorized, AIFMD simply means "managing their reporting, checking their compliance timetables and up fronting the legals a lot more during dealmaking," says van Zyl. For managers outside the EU, van Zyl recommends senior management alongside compliance and legal personnel to "sit down and work out exactly where they wish to market, if they are going to the national private placement route and/or relying on reverse solicitation to seal commitments."

Across the Atlantic, the directive is having a more peculiar effect, adds Tegeler.

"Many US regulations make a distinction between prospective investors and existing investors. It's how US managers are trained to think. Unfortunately, the AIFMD doesn't make that distinction, so it's creating compliance issues when a GP prepares for its next fundraise."

Gaining lost ground

Fundraising levels have rebounded after crashing in 2010, but the peak reached in 2008 is still some ways of



Source: PEI Research & Analytics

The compliance questions brought forth by AIFMD and other recent regulation is resulting in LP advisory boards adding new sections geared specifically to compliance and regulatory matters, says Brown. "Five years ago you didn't have that."

Parting advice

The roundtable closed with each panelist answering a simpler, less unsettled question compared to the one asked at the start. What's the one piece of advice you would give a manager about to hit the fundraising trail?

Some answered the question by describing the fundraising process as on ongoing exercise that shouldn't only be considered six months before fund launch. "Meet with LPs year in and year out, regardless when you're fundraising. And be clear about your timetables. If you say you're launching the fund in the next six months, you need to honor that or risk losing their trust," says Lytle.

Others mentioned ESG reporting as a new priority, and doing more than just paying lip service to responsible investment. "If you look across GPs' websites these days, they all say how much they are embracing ESG. But having specific policies, and demonstrating that your deal executives have bought into the concept as well, is becoming a must-have item," says O'Brien.

Smart and consistent communication, however, was the one common denominator in all the advice given. GPs hoping to stand out from the crowd by promoting key differentiators, such as the promise of co-investments or the expertise of their deal partners, will always capture investors' attention. But the roundtable stressed that a ten-year commitment, like all long-term relationship, should be based on regular and open communication. ■