

# CUTTING CORNERS

**Exclusive** **SCM Terms and Conditions survey:**  
GPs resort to desperate measures as LP capital dries up.

**PRIVATE EQUITY HOUSES ARE RESORTING TO** ever more desperate measures in order to raise funds, according to Stefan Hepp, chief executive of SCM Strategic Capital Management. But some of the tactics that are starting to be deployed could seriously damage investor relations, and may even destroy firms' long-term fundraising prospects.

A number of buyout houses that have been on the road for a long time are struggling to attract capital because of substantial write-downs that have already been accrued on early investments in the fund. LPs are understandably put off by the prospect of having to share in these visible losses, in addition to the retrospective management fee and interest payment penalties they already have to make as a late entrant to a vehicle.

Therefore, in order to part these LPs from their cash, some private equity firms are closing their funds below target and raising parallel funds that enable new investors to participate in future deals on a pro rata basis, while protecting them from the early write-downs.

For those loyal LPs that backed the general partner at the beginning of the fundraising process, this development is a bitter pill that will not be easily swallowed. These investors will become overly concentrated to the initial losses, because the fund will have failed to reach its stated target, but will then also be diluted in future deals.

"I am very worried about this development because private equity firms will offend those that they most rely on - the LPs that were prepared to come into the fund early," says Hepp. "If this trend gains momentum the industry is really going to do itself damage. It is a very short-sighted strategy."

The emergence of this type of innovative - if flawed - structure reflects a desperation that is only now beginning to creep into the fundraising process. Despite the chaos that has reigned in the wider financial markets since mid-2007, private equity fundraising remained in bull market mode for at least the first nine months of last year, Hepp says.

Indeed, fundraising momentum meant the number of funds closed increased by 30 per cent in the year as a whole, according to SCM's annual terms and conditions survey. Furthermore, a striking 40 per cent of those funds were first-time offerings - a finding typical of the tail-end of a boom.

"It is normal to find a lot of new teams trying to get in on the action towards the end of a period of plenty," Hepp says. But the full force of collapse in the fundraising market is now beginning to make itself felt.

"The first-time fund trend is dead in the water. Very few, if any, will be able to raise money in 2009," Hepp says. "Targets - even for experienced investors - have begun to be revised downwards; the time taken to raise funds has expanded and many planned closes are starting to be pulled. If we see 50 per cent of the funds raised in 2008 this year then we will be lucky."

## The con is on

Faced with this fundraising shortfall, private equity firms have a number of tricks up their sleeves, in addition to the "side-car swindle". The first involves the legal definition of investment periods. Investment periods, as stated in LP agreements, have grown progressively longer since the turn of the millennium, while until recently, investment pace has grown progressively faster.

As a general rule, full management fees are payable from the day the first deal is completed. In some cases - only 37 per cent, according to the latest SCM study - the fee level then drops significantly at the end of the stated investment period, but in the majority of cases - 61 per cent - it is maintained until the end of the fund's life.

With the exception of the small number of LPAs that contain a provision ending the payment of full management fees once the last investment from a fund is made - rather than when the official investment period is terminated - this trend has thus surreptitiously enhanced the revenue stream of the GP throughout the buyout boom.

However, now that deal flow has plummeted and private equity houses are expected to make full use of the investment period - typically five years for funds of up to \$5bn and six years for funds of over \$5bn - some firms have shifted their terms yet again, only setting the investment period clock ticking when a final close has been reached rather than when investment actually

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begins. Just over half of funds closed this year employed this method of calculating the investment period.

"The official investment period used to begin at the first close, when the fund begins to be invested," says Hepp. "If the investment period only begins at final close - and bearing in mind the fund may now take a year or more to raise - that is an extra year of the higher rate of management fees that the GP is collecting. This is a trend that is emerging and it is one I don't like at all."

## Empowered LPs

But while some less than scrupulous private equity houses attempt to tinker with fund documentation in order to maximise both funds under management and fees, LPs - for the first time in a while - have the power to say no.

Few exercised this power in 2008 - and so the SCM survey has identified few marked shifts - but as the flood of capital available to private equity slows to a trickle, LPs find themselves at the head of the negotiating table for the first time.

Terms and conditions that have remained set in stone since the dawn of the industry are therefore now up for discussion, with investors having the opportunity to place demands on general partners, and to influence the way their business is done.

"These things take time to filter through," says Hepp. "I expect to see a lot more changes to terms and conditions by this time next year."

The most obvious manifestation of this power will be the size of funds that are raised.

Nine out of every ten follow-on funds closed last year had a bigger target than its predecessor, the SCM survey found. "That may well continue this year," says Hepp. "Firms can ask for as much money as they like - whether they get it or not is another question. At best, private equity firms will be able to raise the same as they previously raised. In many cases it will be significantly lower."

In addition to a simple inability, or unwillingness to up commitments - and in some instances to commit any capital at all - GPs looking to hike fund sizes will also meet far stiffer resistance from LPs concerned about the firm's ability to deploy capital.

"In the past, increases in fund size have been justified because funds were coming back to market after only a couple of years," Hepp says. "But going forward we are entering a different world and no one knows how long that is going to last. Investment volumes dried up by 60 per cent last year. It doesn't make sense to raise even more

money, and LPs won't put up with firms that try."

LPs will also be keeping a close eye on firms prone to a wandering eye - those with a penchant for international expansion or strategy drift.

Globalisation has partly been used to justify larger funds and higher management fees, but with the downturn affecting emerging markets too, LPs are going to be very careful about backing international expansion, says Hepp. "In general, they are going to be much more critical."

Some LPs have suggested that any perceived divergence from stated intention, be it strategic or geographical, could provide an excuse for default, or that it may even end up in a litigious battle or LP revolt, mirroring the debacle at Forstmann Little. But Hepp insists that replacing a GP for cause is a long-winded process that requires a court of competent jurisdiction, and so can take years.

"Soft issues like strategy drift, are, in my opinion, unlikely to provide a strong pretext for the replacement of a GP. GP removals will be very isolated events."

Hepp adds that most LPAs already contain good no-fault divorce provisions that are quicker to implement, but rarely used.

"Even in a recession, with portfolio writedowns becoming more numerous, LPs will still rely on their GPs to get portfolio companies through the downturn. What might increase though is the number of key man provisions being triggered as, in particular, new teams are faced with the prospect of not earning carry on their existing fund and not being able to launch a successor fund. These people may be tempted to abandon ship."

Hepp feels this is more likely to happen in emerging markets than in Europe, or in the US.

### Reading the small print

In addition to key man clauses, LPs will also be paying close attention to the myriad fees that have seeped into standard documentation - among the most hated of which are transaction fees. Some LPs have also indicated that they are keen to have their lawyers look over overpaid carry rules and broader corporate governance protection.

"All that small print is going to become increasingly important," says Hepp. He adds that as the volume of LP interests turning over in secondaries transactions soars, the issue of a GP's right to block a transfer is also raising its head.

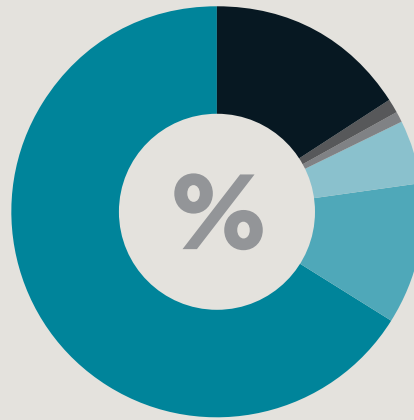
"It remains to be seen how GPs will react to this situation. But depending on how they behave, we may well see LPs insisting these rights are removed from agreements."

However, despite the dramatic shift in the balance of power that is currently taking place, one area where Hepp does not expect to see any significant change is the standard management fee and carried interest structure.

Two and 20, as the remuneration model is known, has evolved very gradually over the years, with management fees decreasing only marginally, while in contrast, the sizes of funds escalated exponentially. In 2008, funds with over \$5bn in commitments charged an average of 1.5

## INVESTMENT PERIOD

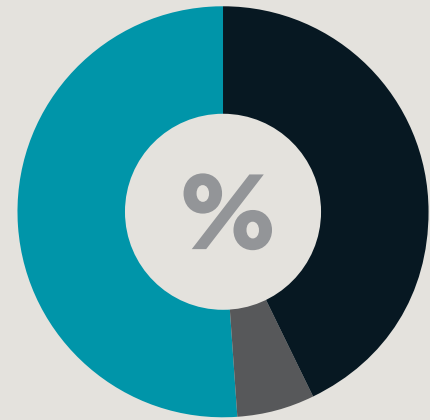
Length of investment period



■ >5 years 16% ■ Evergreen 1% ■ <3 years 1%  
■ 3 years 5% ■ 4 years 11% ■ 5 years 66%

Source: SCM 2008

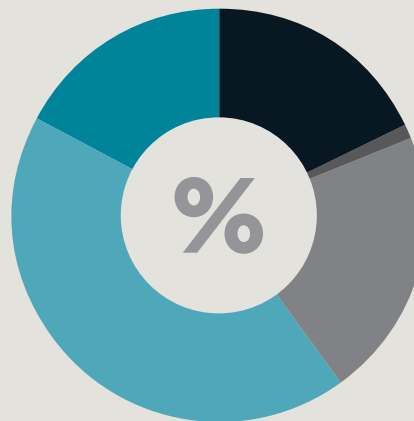
Start of investment period



■ Final closing 43%  
■ Other 6%  
■ Initial crossing 51%

## CAPITAL BASE FOR MANAGEMENT FEE CALCULATION

Capital base after investment period

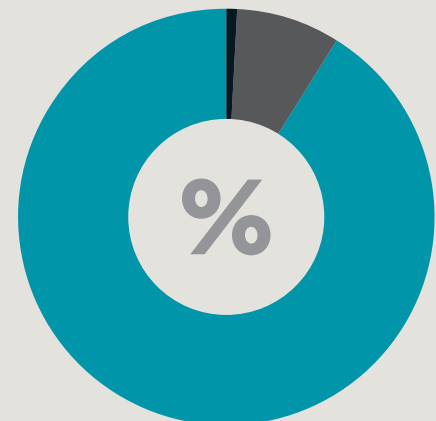


■ Committed capital 18%  
■ Paid-in-capital 1%  
■ Net paid-in-capital\* 21%  
■ Net Invested capital\*\* 43%  
■ Other 17%

\* Net paid-in capital: paid-in capital - return of principal  
\*\* Net invested capital: net paid-in capital - management fees - write-offs

Source: SCM 2008

Capital base during investment period



■ Paid-in capital 1%  
■ Other 8%  
■ Committed capital 91%

per cent, for example, and funds of between \$1bn and \$5bn charged 1.9 per cent. Mega funds actually appeared to raise their fees slightly last year, a trend continued from 2007. Despite the enormous sums of money involved in mega fund management fees, the justification made was often the globalisation of office networks.

And while LPs may be able to influence other areas of private equity terms and conditions, the opacity of the asset class means management fees are unlikely to fall in the future.

"There is a theoretical problem here," says Hepp. "Everyone in private equity claims to be

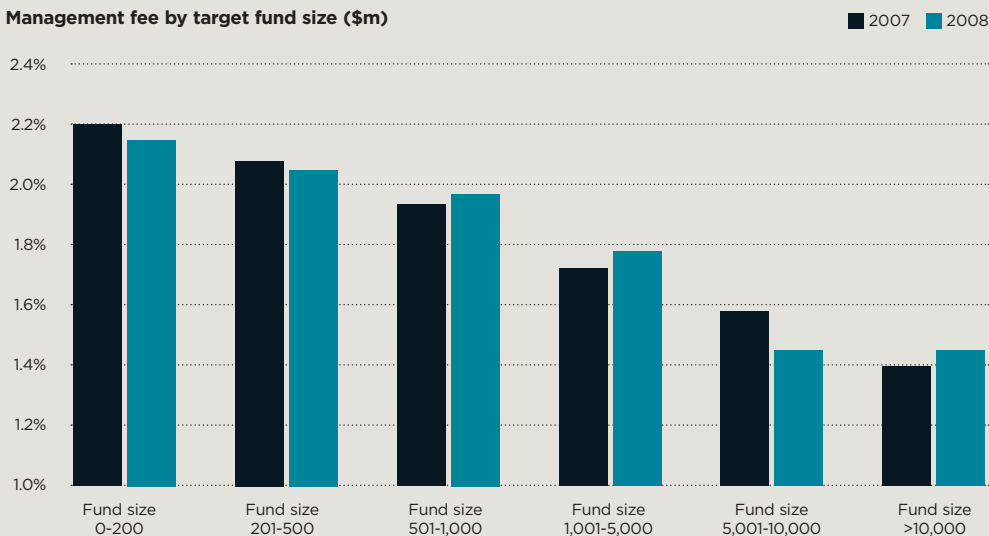
top quartile. And if you are top quartile then these fees are acceptable. If a firm comes along and says we are not that good, but we are cheaper, they won't raise any money. The promise of superior performance costs money, and if you cut your fee you are implicitly admitting you are not one of the best. So management fees can never, and will never, materially change. The onus must rest entirely on LP selection."

The advent of a global downturn does, however, mean that identifying genuine top-quartile performers will only become easier.

"We are about to see another round of

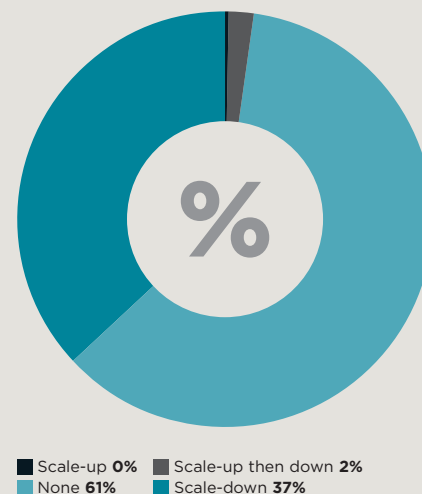
## MANAGEMENT FEES DURING THE INVESTMENT PERIOD

Management fee by target fund size (\$m)



Source: SCM 2008

Fee reversion features after the investment period



differentiation,” says Hepp. “In 1999, you would have mentioned Hicks Muse and Clayton Dubilier in the same breath as Blackstone or Carlyle, and Doughty Hanson in the same breath as Permira, Candover or Cinven. Now you wouldn’t. I see the same thing happening again. There will be a rearrangement of the chairs at the table.”

### Walking wounded

It is clear that some private equity firms are already feeling the pain. In addition to news of struggling portfolio companies, widespread redundancies have now swept through from institutionalised giants such as 3i and Carlyle into the mid-market.

These substantial cuts in resource are a concern for LPs, and in some cases appear difficult to justify. In cases where there has been a significant drop in management fee following the end of the investment period, and the firm has been unable to raise fresh capital, the financial strain may be clear. But in most instances the management fee being claimed by the private equity house should – many LPs feel – be ample to sustain the business.

“For established firms, cash flow streams should be strong enough not to require redundancies,” says Hepp. “Private equity isn’t like manufacturing or banking where your revenue breaks away, so yes, LPs will be very concerned if resources are cut.”

Hepp adds that LP due diligence is heavily weighted towards an assessment of the team.

“This is where the LP is taking a punt on the future because there is no contractual guarantee

that a certain staffing level will be maintained, or that certain talent will be retained. If that talent leaks it is very worrying, particularly when firms are already preoccupied with looking after portfolio companies that have run into trouble.”

Once again, this could prove a short-termist strategy that will damage a private equity firm’s fundraising prospects in the future.

### Consolidation

Ultimately, of course, some degree of consolidation in the private equity industry now seems inevitable, but it is likely to take a long time to make itself felt.

“Just look at the venture capital industry. It has taken a long time to see any meaningful consolidation because these funds run long and the fees attached to them last for quite some time,” says Hepp. “In the venture industry there are still a lot of walking dead clinging onto existence. They may not have the same staffing level. But they have a name, and a name plaque, and they have funds to administer.”

However, the all-pervasive nature of the current economic collapse that has ripped through the LP community, leaving several unable to honour commitments, has led some to believe that firms may disappear sooner than in previous downturns. LP default – if it were to gather momentum – would be the most profound evolution in private equity terms and conditions yet.

TPG Capital is already believed to have reduced commitments slightly to accommodate investors, while Permira has also agreed to reduce fund size

in response to the inability of cornerstone investor Schroders to meet capital calls. Permira offered each of its LPs the opportunity to reduce its commitments on a pro rata basis, but contrary to many reports, LPs that chose to take the firm up on its offer will not have to pay a management fee on their full original stake. Rather, those LPs that have not reduced their commitments do not have to pay a management fee on the slice that they could have opted to forego.

Hepp believes the prospect of default contagion is exaggerated, but adds that in instances where individual LPs are unable to honour contracts, the way in which GPs react will be key.

“In many cases, according to the LPA, if one LP drops out of the fund, the other LPs are liable for their share of the management fee,” Hepp says. “That is the kind of clause that may irritate investors in a bull market, but in a bear market will really be felt.” This is also the type of clause that could severely impair future fundraisings.

It is clear that LPs are in an unprecedented position of power when it comes to negotiating the terms and conditions governing the funds in which they invest. The volume of capital that has disappeared from the market means competition to woo LPs that remain active in 2009 will reach levels never previously seen.

However, institutional investors in private equity have a poor track record of imposing their will. Historically, LP demand for top-performing funds has been so great that any attempts to join forces to effect change have disintegrated when one investor broke rank.

Now that supply/demand dynamics have been flipped on their head, there is real scope for LPs to co-operate in a way that they never have before. Over the course of the next 12 months, LPs are determined to make their voice heard. ●

AMY CARROLL is editor of *Real Deals*.

“If LP default were to gather momentum, it would be the **most profound evolution** in private equity terms and conditions yet”