LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Power Play: Fundraising Conditions And PE Investment

Law360, New York (November 28, 2011) -- Despite the uptick in new private equity fundraising during 2011, fundraising conditions have remained tough for PE general partners (GPs) throughout the year as investors continue to take a cautious approach to the asset class, especially in light of the recent increased volatility in financial markets.

The fact that many GPs chose to delay their fundraising efforts in 2009 and 2010 has further compounded the challenging fundraising environment with more funds on the road competing for capital than at any time in the past few years. This imbalance between supply of PE fund opportunities and demand for such opportunities from PE investors (LPs) has created the conditions for a shift in the relative power of LPs, allowing them to become more assertive in their negotiations with GPs.

The publication of the Institutional Limited Partners Association (ILPA) guidelines on private equity best practices, which called for terms and conditions more favorable to LPs, has in practice played its part in shifting the balance of power, with LPs able to kick-off negotiations with GPs around the ILPA position. GPs looking to raise capital for first time funds or marginally performing funds have felt the brunt of this renewed LP assertiveness and would be well-advised to take the ILPA guidelines into account when formulating fund terms. Such guidelines have now been endorsed by numerous industry organizations, including some heavy-weight PE fund managers.

The current fundraising conditions have also allowed certain larger LPs, particularly those that act as anchor investors in first time funds coming to market, to throw around considerably more weight in negotiating ILPA prescribed terms as well as other terms. While financial terms such as a “whole of fund” carry structure and management fee arrangements are of course in focus, such investors are also tightening the reins on GPs to prevent the reoccurrence of certain painful experiences that may have been felt during the fallout of the financial crisis.

For instance, LPs that may have seen previous GPs go wayward with abort costs are setting rolling caps on such costs, while those that are looking to promote greater transparency with respect to reported investment valuations are imposing greater advisory committee oversight in connection with unaudited valuations.

Despite the clear rebalance of power that is taking place with respect to first time funds, renewed LP assertiveness in the current fundraising environment has had only modest success with top-performing GPs and, to some extent, GPs of funds with highly attractive investment strategies.

Areas where LPs have been able to most successfully negotiate a realignment of interests more in line with the ILPA guidelines include (a) increases in transaction fee offsets usually to no less than 80 percent and in some cases 100 percent, (b) increases in the GP's "skin in the game" from one percent of total commitments to at least two to five percent of total commitments, (c) reductions in the management fee (or in some cases an exemption from the management fee for an initial period) for large buyouts, and (d) preferential access to co-investment rights.

However, in some cases these preferential terms are only being offered as incentives to LPs that are either willing to sign bigger checks or willing to commit early to a new fund.

In terms of hurdle rates and carry arrangements, 2011 did see notable changes to the terms offered by two of the leading players in the industry. In a surprising move, Bain Capital has reportedly been offering LPs in its new Asia fund the option of paying 20 percent carry with a 2 percent management fee, or paying the firm's usual 30 percent carry, but only a 1 percent management fee. Meanwhile, KKR has for the first time agreed to a preferred return hurdle of 7 percent in connection with its new global buyout fund.

While these examples highlight a move in the right direction for LPs, on the whole, the fund terms for many of the top-performing GPs still remain GP-friendly, with most U.S. fund managers continuing to retain "deal-by-deal" waterfall carry structures, despite the ILPA guidelines advocating a "whole-of-fund" model as best practice.

So while the assertiveness of LPs in the current fundraising environment has forced many GPs to recognize that they need to make a satisfactory effort to adjust some terms and conditions in accordance with the ILPA guidelines, the top-performing GPs have been able to resist adopting the ILPA guidelines for all financial terms.

Ultimately, this is not surprising. LP demand for top-performing funds still outpaces supply, and therefore, despite challenging fundraising conditions, the GPs of such top-performing funds still have considerable bargaining power and retain the edge in negotiations with LPs.

--By Edwin Wong, Gibson Dunn & Crutcher LLP

Edwin Wong is a member of Gibson Dunn & Crutcher's investment funds group and is based in the firm's London office.

The opinions expressed are those of the author and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2011, Portfolio Media, Inc.