Mid-Market Focus

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The global nature of private equity is very apparent: a relatively small regional private equity fund will attract investors from the four corners of the world whilst some of the larger PE platforms have operations that span multiple continents. But the size, diverse nature and regional differences of the industry mean it is difficult to make generalisations on changes to fund terms. As a consequence, this article will focus on fundraising and fund terms as they apply to mid-market buyout funds, in particular in Europe.

Current Economic Conditions

2012 was recently referred to as the fourth year of the Long Slump. For private equity fundraisings, a better phrase would be the Lumpy Slump. Against a backdrop of a sustained fall in the amount of capital raised, some managers with stable teams and a good track record have still had a positive response from investors and fundraising targets have been achieved. Taking global figures, the aggregate capital raised has been falling for the last three years and has remained over 50% down on the boom years of 2006 to 2008. As would be expected in these conditions, it is an investor-led market and fund managers have had to work hard to raise additional capital.

European mid-market fundraising in 2011 was not as strong as for the larger buyout funds. The amount of capital and the number of funds raised were both the lowest since 2002, and that off the back of difficult years in 2009 and 2010. The start of 2012 looks set to remain patchy and sluggish but investors still appear to support the mid-market as an investment proposition, with Preqin's December 2011 investor study finding 49% of investors intend to commit to funds in this sector in 2012. The practical consequence for fund terms is that negotiations with investors are taking longer and the process needs to be skilfully handled. Momentum, especially towards a viable first closing, is vital.

Trends in Fund Terms

An interesting development to follow in 2012 will be whether some of the terms agreed in fundraisings for the larger buyout funds are translated into similar changes in T&Cs for mid-market funds. An example would be discounts of 5% to 10% on annual management fees that have been offered to investors prepared to participate at first closing (sometimes called 'early bird discounts'). This has been a useful tool to gain momentum for the fundraising. Whether mid-market GPs will see the need for this concept is unclear: they will generally have a smaller surplus (if any) of fees to play with and do not need to attract so many of the larger institutional investors to hit their target. However, if the challenging conditions continue and an incentive like this would provide impetus, anything is possible.

The ILPA Private Equity Principles are also continuing to shape the market. These principles do not provide a 'one-size-fits-all' approach to fund terms. But they have influenced a number of the key areas of debate between GPs and LPs. In general, investors will expect the fund to follow market practice on fund terms (including being 'compliant' with ILPA) and this will need to be presented in a clear and professional way.

Economics: European mid-market buyout funds have tended to favour whole fund carry models, but the trend away from deal-by-deal is now more pronounced. There is also greater attention from investors on the amount of the GP commitment to the fund and how it is being financed. For fees, an annual management fee of around 2% still seems to be the norm for a mid-market fund, but most investors will now expect 100% offset of transaction fees. On carry, there has been little, if any, shift from the rate of 20%.

Governance: Negotiations tend to centre on key-man and no-fault divorce clauses. Investors expect a well thought out key-man provision. If triggered, the investment period being automatically suspended is now market practice; after six to twelve months, it's increasingly common for the investment period to automatically terminate if the LPs do not positively vote for continuance. Managers will now accept a no-fault divorce GP removal, although there is debate on the consequences. Despite it being an ILPA requirement, GPs are resisting a no-fault right to suspend or terminate the investment period.

Transparency: Reporting templates (including standard drawdown and distribution notices) have provided a level of consistency in the market, which should benefit the industry as a whole. The flip-side is the increased administrative costs that funds now incur to provide this information, which is, proportionately, a greater burden on mid-market funds than for the larger platforms.

Legal and Regulatory Issues

The legal and regulatory changes taking place in Europe over the next 24 months will shape the industry for a generation.

The most obvious development is the Alternative Investment Fund Managers Directive, which is due to come into force in mid-July 2013. This is not the place for a detailed analysis of the Directive, but three issues to note are: (i) the timeframes for implementation of the Directive will encourage some funds (especially those managed offshore) to hold a final closing of their new funds by July 2013; (ii) it's possible that, at least in the short term, fund managers will move offshore so that they can continue marketing a new fund under private placement rules up to around October 2015; and (iii) European fund managers caught by the Directive will need to comply with more prescriptive governance and transparency requirements, resulting in increased costs not only for the fund manager but also for the fund itself.

Other developments that mid-market private equity funds will need to take into account include possible changes in VAT structuring in the UK, changes to regulatory requirements such as MiFID II and the impact on the industry from a number of pieces of legislation coming out of the US, including the Dodd-Frank Act and FATCA.

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