Buyers' market

With a downturn in the financial markets, limited partners may now find themselves holding more chips at the bargaining table with regard to terms and conditions.

By Jennifer Harris

Late last year Madison Dearborn Partners set out to raise $10 billion for its sixth fund. But by late August the firm lowered the fund's cap to $7.5 billion, reportedly at the request of its limited partners. The firm's investors apparently had no problem with the size of the fund, but the fundraising was proceeding too slowly, and limited partners wanted the team to focus on investing given the current climate.

"I find it unusual that the LPs would actually say to close on less than the original request," says Carl de Brito, a partner in law firm Dechert's private equity group. "It is not unusual for large anchor LPs to say that they only think X amount of dollars is your max, and they do not think you have the infrastructure to handle more investing and they would like you to cap the fund at a certain level."

There are many signs that fundraising malaise is starting to set in. According to data from Thomson Reuters, 59 buyout funds raised just $35 billion in the second quarter of 2008 – a 43 percent fall from the first quarter, and a 16 percent year-on-year decline.

Even the brand-name firms might have to hustle to hit their hard caps in the near future. The California State Teachers' Retirement System committed just $250 million to The Blackstone Group's sixth fund, according to a *Wall Street Journal* report, significantly less than the $1.7 billion it committed to Blackstone Capital V last year. The $161 billion pension fund saw its assets shrink by $10 billion over the last half year, and recently cited the denominator effect as a broad trend affecting institutional investors' commitments to private equity.

In this climate, LPs that do choose to invest will have more bargaining power when partnership agreements are drawn up, particularly with smaller or newer managers. As their influence increases, there are certain areas where LPs are starting to negotiate harder. Here are a few:

Fund size

"Certainly one of the issues that have come into focus with many limited partners is fund size," says Howard Rosenblum, a partner in DLA Piper's fund formation practice. "There are really two issues that LPs are focusing on in that regard. One is that certain limited partners have their own ideas as to what the right size of a fund should be, given the investment focus of the fund, the number of professionals managing that money in the pool of capital, and the potential for returns from that capital base. Another concern of limited partners is how much time the general partners and principals may need to spend on fundraising activities. We are not in the easiest fundraising environment for many funds. As a result, there is the fear among some limited partners that the general partners are may be spending more time fundraising, and not fully tending to the business of investing and taking care of their portfolio companies for an extended period of time."

Given the difficulty of financing large leveraged buyouts in the current market, it's becoming harder to justify mega buyout-sized funds. In Madison Dearborn's case, the firm had said it planned to pursue growth equity investments rather than LBOs, and its LPs ultimately questioned whether the firm really needed $10 billion for that type of investing.

Management fees

Typically, after the active investment period, the management fee for a private equity fund will decrease, Rosenblum says. But there is a certain amount of debate over how much that fee is reduced. How much of that management fee is offset by fees received from portfolio companies also varies from fund to fund, he says, anywhere from 50 percent to 80 percent.

"There is definitely an upper tier of firms which can command their own market terms, and will generally get the same terms from fund to fund, and perhaps even be able to improve their terms a bit," Rosenblum says. "Less well performing or established funds will try to keep the same terms, but may get pressure on certain aspects of their respective agreements where the limited partners feel they have the leverage to have their particular concerns addressed. In a slower fundraising environment, it's easier for the limited partners to flex their muscles."

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Key man provisions

There are two main areas of this provision that need to be negotiated: what will be sufficient to trigger a key man event, and what are the consequences once the clause is triggered. LPs generally have strong opinions on who is essential to the firm, and they want a voice at the table in the process of restructuring the management team after a departure.

"The LPs want stability above everything else," says Ronnie Fox of London-based Fox Soliciters, a specialist in partnership law. "They have normally decided to invest because they're backing the individual judgments of certain managers. And they hate change. And if there has to be change they don't want it done in a rush, they want proper explanations, the chance to ask questions and all the rest of it."

Rosenblum also cites the key man provision as one of the most intensely debated parts of the partnership agreement.

"You see many variations of these mechanics," he says. "Is there an automatic suspension or do the LPs have to take some sort of affirmative action to shut down the investment activity? How long do the remaining partners have to reinstate the active investment period?"

Because the provision is such an important one for LPs, majority of key man provisions stipulate an automatic halt of investment activities once a key man event has occurred. In tough economic times, those firms will likely find themselves held even more accountable to their investors in the event of a senior management shakeup. (See p. 11 for further detail on the key man provision).

Fox: LPs want stability

Rosenblum: GPs will have to fight for fees

Style drift

These days it's not uncommon to see a buyout fund suddenly become a distressed debt specialist. LPs who signed on for equity investments are not always pleased with the move. As the next generation of funds goes out to market, investors are responding by demanding more clarity in funds' strategies before committing capital.

"Some investors may be taking a harder focus, in part because, as a result of the financial market environment, the funds may not necessarily be oversubscribed and so investors have an opportunity to be more judicious in which funds they choose to go into," says Robert Friedman, a partner in Dechert's private equity and venture capital group.

Brito agrees: "I think when some of these funds start up, investors pay a lot of attention as to the types of investments that can be made, investment restrictions on what the sponsor can do... There's more careful scrutiny of the new fund."

Leverage

The most recent golden age of the LBO is indeed over, and now the use of leverage seems like an unnecessary risk rather than a sure way to amplify returns. Consequently LPs may want to stipulate whether a fund can use leverage, how much leverage it can use, and what kind of ramifications and protections are built into terms that allow leverage, Brito says.

"For many funds this is not the easiest fundraising environment. Certainly there are some funds who can snap their fingers and close on a significant committed pool of capital, but not all are in that position."

GPs who could previously name their terms might have to get used to giving some ground on many fronts. It's important to note, however, that even though the industry may be going through rocky times, it still holds plenty of appeal, Brito says.

"At the end of the day if [LPs] like the asset class and they like the sponsor group, they're going to be reasonable and flexible," he says. "They're really just trying to make sure their money is going to be well handled and protected, and not necessarily trying to push certain agendas." ■

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