PE Companies Wooing Limited Partners

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As private equity (PE) firms find it difficult to raise capital in difficult economic times, they are offering limited partners (LPs) more incentives to put in their money.

Making the most of the situation, LPs are now demanding a greater say in the use of and returns on the money they commit to PE firms.

LPs are entities that include public and corporate pension funds, insurance companies, high net worth individuals, universities and other endowments that are the source of money for PE firms, which then establish funds to invest.

PE fund investors *Mint* spoke with said LPs have collectively turned cautious, are demanding more rights, and subjecting those raising funds to intense scrutiny.

"LPs are now negotiating terms on the fee and share of profits that the fund can take home," said Sandeep Aneja, chief operating officer and managing director of Milestone Capital Advisors, a Mumbai-based real estate fund that is raising a US$400 million fund from overseas, and has commitments of US$220 million.

"The two and 20 structure is being actively questioned," said Akil Hirani, managing partner of Mumbai-based corporate law firm Majmudar and Co, referring to the 2% commission and the 20% carry that PE firms, also called general partners (GPs), typically get. Carry is an industry term referring to the profit from exiting from an investment.

Driven largely by large erosions in the market value of fixed income and equity exposures, many LPs – particularly pension funds and endowments – could suddenly find themselves overexposed to private equity, an asset class that is not marked to market. If they decide to reallocate their funds, PE firms will be hard pressed to garner more.

According to Emerging Markets Private Equity Association, a Washington DC-based research service on private equity, funds focused on emerging Asian economies, including India, raised US$26.2 billion in commitments in the first half of 2008, as compared with US$28.6 billion raised in 2007.

However, the liquidity crisis that began with the collapse of Lehman Brothers Holdings in the US, has cast a cloud over how much of those commitments will be honoured, and how much more they will be able to raise in the second half. Hedge funds, many of which have gone bust, are also not in a position to make fresh commitments. In short, capital is scarce and GPs are chasing whoever has it with multiple incentives.

For instance, CX Partners, a new firm promoted by former Citigroup Venture Capital International head Ajay Relan, is aiming to raise US$750 million for its first fund. The fundraising, which started in September 2008, has so far garnered only about US$150 million of that from two overseas anchor investors. However, Relan declined to say if his fund was offering LPs any extra incentives.

An official with a LP said that a GP recently offered a discount on the management fee and the carried interest, if there was a commitment of at least US$25 million to its new fund.

"They offered us a management fee of 1.5%, a carry of 15%, a seat on the investment advisory board and co-investment rights up to double the value of the commitment," he said on condition of anonymity. He also declined to name the PE firm.

At the same time, LPs are pushing back on the terms of engagement as well as demanding more control over funds they commit to private equity. One way LPs are doing this is by demanding more co-investment rights. "I think one of the sweeteners that people who have money want is a little more co-investment rights," said Akhil Gupta, chairman and managing director of Blackstone Advisors India, the India arm of US asset manager Blackstone Group.

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Gupta said some PE firms do not have to pay any carry on direct co-investments, while others may pay only 10-15%. "There's value that gets created for them if they have direct co-investments," he said,

Milestone's Aneja said another route for co-investments is to commit the money into a separate investment vehicle owned by the fund. In such a scenario, the LP still pays the 20% carry to the GP, but has a say in investments made.

"Investments will be evaluated by the LP on a deal-by-deal basis. The decision to invest is theirs and the money is not on the GP's call," Aneja said. In other words, the investment decision is not left entirely to the discretion of the fund manager.

The so-called clawback – finding a way to take money back from people that they were given in another way – is another area on focus.

For example, if a fund makes a 40% return on a particular investment, it gets to keep 20% of this, and the remainder goes to the LPs. But in case of a clawback clause in the agreement, if the next few exits from the same fund fail to cross the hurdle rate – usually set at around 8-12% by the GPs – the 20% taken by the GP from the profits of the first investment will go back into the mix.

"About 50% of the funds raised had clawback clauses built into the agreement with LPs. But in such a market, more LPs will demand this," said Hirani of Majmudar and Co. Aneja also points to how LPs now want roles in investment committees. "LPs don't really believe the NAV (net asset value) reports that GPs prepare and give them every six months. So there will be more LP advisory committees formed, much like what happened following the year 2000 dotcom bust, so that LPs have more oversight, and they can have informal and frequent meetings to assess performance of portfolio companies," he said.

Hirani also pointed out that LPs are no longer buying into the macro-India story. "Broad-based themes like the consumer story or infrastructure story are not working as efficiently now. LPs are seeking a... micro-focus in GPs," he said.

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