

DEALTALK-Buyout funds

By Megan Davies and Nadia Damouni

NEW YORK, June 10 (Reuters) - Private equity funds are shrinking as investors become choosier and funds that have fallen behind in performance could drop off the radar when they return to the market, executives and investors said at a major conference this week.

Data from London-based private equity research firm Preqin in April showed that \$46.1 billion was raised in the first three months of the year by private equity firms -- a quarter of the amount raised at the peak of the latest private equity boom in 2007.

Preqin's April survey showed that, of the 4,300 investors in private equity funds that it tracks, 1,500 past investors are not considering new opportunities in the asset class.

That's bad news for any fund with mediocre returns.

"If you're middle of the pack, you have to convince people that the future is different to the past," said Brian Gallagher, Partner at Twin Bridge Capital Partners, which invests in funds and makes direct investments. "You have to be very open and honest that 'we learnt our lesson.' If the results are horrible, you are just hosed."

Private equity firms raised huge funds during the credit boom of 2005-07, using the money to strike multibillion-dollar leveraged buyout deals.

Fund sizes have, however, been shrinking after the financial crisis limited capital from pension fund investors and diminished the large deal opportunities for buyout firms.

Blackstone Group LP (BX.N), for example, recently raised about \$15 billion for its latest buyout fund -- smaller than the mammoth fund of about \$20 billion raised during the boom.

Firms typically charge a fee of about 1.5 percent to 2 percent of the fund size and take about 20 percent of the profit, which means the larger a fund becomes, the larger the fee income.

"Raising new funds is going to be much more difficult and most (private equity firms) will have to settle for funds that are half the size of that which could have been raised during the credit boom," Guy Hands, founder of private equity firm Terra Firma Capital Partners Ltd [TERA.UL] said in a speech at the Super Return conference in Boston this week. "It will also be much harder for new private equity firms to

establish themselves."

Terra Firma, which made a high-profile, ill-fated investment in music group EMI, has been preparing the ground for a new fund and in a recent letter to investors, said its next buyout fund would likely be 2 billion to 3 billion euros (\$2.9 billion to \$4.4 billion). That would be significantly smaller than the 5.4 billion euros the firm raised in 2007.

Still, about 50 percent of its existing investors are expected to reinvest in the new fund, a source familiar with the firm's plans previously said. [ID:nN08187565]

Stephen Feinberg, the usually reclusive co-founder of Cerberus Capital Management LP [CBS.UL], said at the same conference that some private equity firms were increasing their fund size too much -- potentially hitting the returns for their investors. Feinberg is aiming to raise a smaller fund in the future. [ID:nN07139817]

"I do think there's an issue here in funds that are too large and funds that have acquired too many assets under management ..." Feinberg said. "If your goal is to maximize your returns as opposed to assets under management, I think you can be most effective with a big company infrastructure and a little bit smaller fund size."

Still, interest in private equity appears to be rising when looking at turnout figures for the Super Return conference in Boston. Attendance was up about 43 percent from the previous year, with about 570 attendees, according to organizers .

WHIFF OF DESPERATION

For those coming back to the market to raise a second, third or fourth fund, investors caution them to not sound too desperate.

"Don't push things too hard," said Twin Bridge's Gallagher. "Some groups will call you once a week ... will email relentlessly. I've had some email chains I've had to stop where it gets into a debate back and forth."

Gallagher urged funds not to 'create false scarcity' by pretending to have a lot of interest in their fund, when in reality none exists.

"Don't try to say that so-and-so is in," Gallagher said. "We network and we have reasonable connections to most international investors and we can back-channel almost anything. So don't kid yourself."

Jim Watson, managing general partner at CMEA Capital, a San Francisco-based venture capital firm, is hoping for a radical change where funds will not even charge management fees -- a staple of the private equity industry.

Funds would then be completely aligned with investors, he said, with only profit as the incentive.

"Once you make it to the major leagues and have multiple funds and big management fees you stop working and performance goes down," Watson told Reuters on the sidelines of the conference.

Watson also urged funds to keep close to their investors.

"It's amazing to me how many private equity fund managers don't worry about their investor base," Watson said. "If that gets a cold you get pneumonia and it's got a cold right now. The customer is sick and it's going to be ugly. Wake up." (Editing by [Andre Grenon](#))

<http://uk.reuters.com/article/2011/06/10/fundraising-idUKN1022805020110610>