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Investor Profile: Charles Soulignac, Managing Partner, Fondinvest Capital

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Charles Soulignac on Fondinvest sticking to its guns by continuing to invest in the lower mid-market, on the proliferation of fund of funds players in recent years, on his concern over secondary buy-outs, and on the value proposition this method of private equity still poses for investors if done correctly.

France-based private equity fund of funds manager Fondinvest Capital has managed a total of €2bn in primary funds of funds, secondary funds and three fund programmes for institutional investors.

Fondinvest was one of Europe's pioneers, managing primary funds of funds and secondary funds from 1993 onwards. Managing partner Charles Soulignac started investing in private equity funds years before this, in the late 80s.

Has your investment strategy changed in response to the recession, or has it remained the same despite the downturn?

"No. Our strategy has not changed since the day we started the business. We invest in lower and mid-market private equity funds and have continued with this strategy because these are the type of funds that create most value. If you look at the performance in Europe at the end of 2009, you see that small buy-out funds below €500m gave an average return of 9.1 per cent, compared to the other end of the scale where mega funds generated a -1.5 per cent return for investors. And this is practically the same in the US. So we have stuck to our strategy and are not under pressure to deploy money by investing in different funds."

What have you seen happen in the fund of funds market since you've been involved?

"Where investors had a lot of money to deploy, there were an increasing number of players entering the market. When our team began in the early 90s, we were one of only a few in Europe to be managing private equity funds of funds. Between 2004 and 2009, the number of such fund of funds GPs doubled and now there are somewhere around 250 of them around the world, which is a lot.

This was a consequence of the amount of money that institutional investors had on hand to invest in private equity. When there is a lot of money in the market, it tends, or at least tended, to go to the large funds. What fund of funds GPs should really be doing is identifying and selecting the best performing funds in the market in the countries where they are investing, with a well-defined strategy."

Do you think that, in the past, fund of funds managers have been doing a job that an LP could do by themselves by throwing money at name-brand funds?

"As a GP, if you are putting money in name-brand funds, the most visible, largest funds then you are doing something that an institutional investor is capable of doing. However, what is sure is that as an LP it is difficult to get a lot of diversification in terms of funds. Most LPs will invest in three to ten funds maximum over a ten-year period, versus 40 to 50 for a fund of funds.

The smaller funds operate very differently from the big names – they are not heavily marketed, they do not raise significantly bigger consecutive funds. If you're a high-quality yet small fund in, say, the UK or Germany, then US, Asian and Middle Eastern investors are not going to know about you and be able to compare you with other European funds. It is the job of a good fund of funds to provide access to them, as they are the best performers."

Are you expecting a rationalisation of the fund of funds market, whereby those people who weren't adding value will be killed off?

"I could not say, but I think that institutional investors will increasingly look at those players with a strategic edge, a more focused investment strategy. We will see."

As you say, the mega end of the scale has been disappointing for LPs. Do you think there's a risk of too much money migrating to the mid-market, where Fondinvest is active, and creating a bubble effect?

"I don't think there will be a bubble in our segment, which is the small and mid-market, with funds smaller than €500m in size. What we do see in some cases, from investors who are not used to investing in this area of the market, is a deployment of money in funds larger than €500m without any negotiations on the LPs' part.

It comes down to the discipline of the GP – if they want to raise €300m and no more, as this is what they think they can sensibly invest, that's great. However, GPs get greedy and start raising more money if they can, even in the lower mid-market. This is what we're cautious of. Funds that start raising money easily from investors often change their fundraising targets – and there is then the chance they will start changing their strategy and the size of businesses they want to invest in. This is when expected returns do not end up materialising.

So there is room for development in the next few years. My concern regarding the market and a possible bubble effect is rather the sale of interests from one GP to another GP, with steady prices (multiple of EBITDA) for funds over €500m. These secondary buy-outs are a concern."

A senior executive at a prominent fund of funds group recently said that the fund of funds investment model is in danger and that offering access to funds is not a value proposition anymore. What is your take on that?

"If you are looking at the large funds, it is true that you are not offering any value by investing in mega funds on behalf of your LPs. On the other hand, the €100m to €500m funds in various European countries, for example, are not easy to find. Different countries in Europe have different operating conditions and vary in terms of the growth in different sectors. Because of this, private equity funds like these, the best performers, need to be picked up through a fund of funds.

So it depends. If you're talking about the big guys that just invest in the biggest funds instead of identifying the best performing smaller funds, then I agree – there is no value proposition there."

LPs are becoming ever more sophisticated, bypassing funds and making direct investments into companies themselves. If they are capable of doing effective due diligence on investee companies, is there a need for funds of funds, as surely they can identify the top funds in the market?

"It is a matter of your location. If you are located in the US and want to access Europe, it is not easy to identify who the best performers are and you need someone to do due diligence and to negotiate with the GPs on your behalf. If you are based in the US and want exposure to Europe, there will be a significant cost involved in analysing the market from where you are.

The small- and lower mid-fund market is not based on a macroeconomic analysis but on local analyses with a comparison between all the different players. Such a market depends strongly on the personal and professional objectives of the GP's key men."

CalPERS was recently granted concessions from some of its GPs, namely Apollo. Does this apply to smaller fund investors? Are you better able to negotiate fees today compared to the past?

"In terms of the management fee being around two per cent and the carry 20 per cent, that won't change. First, I don't think the massive number of funds of funds that have appeared in the last five years, nor the different types of LPs in general have the necessary skills or bargaining power to negotiate such fee cuts. Also, investing in funds is a partnership – the GP has a team and we have a team and we represent the LPs' money. You need to have that alignment of interests to ensure you're both on the same boat.

There are examples of fee structures where investors are charged more on the activity, on a deal-by-deal basis, but this applies to the large funds and scarcely to the small- to mid-sized ones. It's at the other end of the market.

At Fondinvest, we decided in 2009 and 2010 not to re-up in funds where we were not satisfied with the terms and conditions. In addition to the management fees, other terms have to be watched carefully, such as the size of transaction fees, the potential VAT of fees, the structure of carried interest, keyman clauses, etc.

One of the biggest accusations funds of funds face is the so-called double fee. It is true that two sets of fees can seem high, with a approximately one per cent management fee for the fund of funds and five to ten per cent on the carry. But if you're investing with a team that knows what they are doing, are professional, have a strategy that doesn't just resort to investing in the name-brand funds, the downside of this double fee is negated. If the team can deliver performance and outperform the market, it justifies the fees involved. If the fund of funds can only perform at the market average, then it's not worth paying the fees on.

Also, investors should never underestimate the costs of internally running a solid private equity programme in a complex segment like the European mid-market. You need to have quite a sizeable allocation already. Because of a lack of resources, many midsized investors who chose to run an internal programme end up limiting their investments to a handful of GPs and so they lose the benefit of diversification. They can be very exposed if there is a problem with just one GP, as happened in 2008 to 2009.

Since inception, we have always set up management fees based on the commitments in the underlying funds. Also, the percentage of the carried interest is based on the net performance delivered to our LPs, as it should be."

Fondinvest also manages mandates dedicated to a specific LP. What are the main differences between a mandate and a fund of funds?

"With regards to mandates, the investment strategy – the size of the fund, investment type, country, etc – is defined by the LP themselves. Such a strategy may change during the commitment period following a discussion between the GP and the LP. The mandate requires a significant amount to be committed over a three- or four-year period. In a fund of funds, the commitment can be of €5m minimum. Management fees are usually less significant in a mandate compared with a fund of funds. Conversely, the carried interest is higher in a mandate than in a fund of funds, while fees and terms and conditions can be negotiated in a mandate."

In conclusion, are you confident in the private equity fund of funds model?

"Yes, absolutely. Despite the current economic situation and the attitude of some fund of fund managers interested in carrying out a volume-based strategy, practiced correctly the model has a bright future ahead of it.

LPs with no experience in private equity will definitely need funds of funds to access the asset class. Also, experienced US, Asian and Middle Eastern investors looking for access to European funds should develop their investment strategy by using mandates. Provided the fund of funds manager is adding value, the model is by no means broken."

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