

Recent trends in Swedish fund formation

Peter Alhanko, Carl-Johan Ehn and Andreas Wisser of Mannheimer Swartling Advokatbyrå examine the latest key developments in fund formation in the Swedish private equity market.

The growth of the private equity market in Sweden in the last 15 years has been striking.

Even though the Swedish private equity market in the last three years has undergone a dramatic downturn, Sweden ranks third in the world in terms of venture capital investment, surpassed only by the US and

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UK. In addition, fundraising in Sweden has been very

active compared with most other countries, with some 30 funds being raised in the last few years.

Recently, the Swedish private equity market has become more international with several US and UK-based private equity houses establishing offices in Sweden. Only around one-third of total fund capital raised now comes from Swedish sources, compared with a couple of years ago when the vast majority was committed by Swedish investors.

In addition, a very large proportion of commitments by Swedish investors is

committed by just a few institutions - a fact that has concerned some players in the Swedish private equity market.

In addition, major Swedish private equity providers have been much more active abroad by allocating significant amounts for investment mainly in US and UK-based funds. Due to the market becoming more international, the terms under which Swedish funds operate have become more similar to those that prevail abroad.

Also, following the general downturn in the market

and in particular the poor exit market, many first-time funds have experienced difficulties in building up a track record. This has made it impossible for them to raise new funds and has led to a consolidation of the market driven to a large extent by Swedish institutions that have seen a need to merge the traditionally small management companies into bigger units in order to reach a critical mass in terms of management skills and experience.

There has also been a widespread debate regard-

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ing corporate governance issues in Sweden that has mainly concerned the largest corporations listed on the stock exchange, but

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which has also influenced the small, unlisted companies active in the private equity industry. Thus, the role of management teams has been subject to debate between the management teams and major investors - as a result of which, investors have been given increased influence in various matters related to the governance of the funds. Although there are large variations in the terms and conditions under which Swedish private equity funds operate, there are some interesting specific trends that can be observed.

General observations

Generally, players within the Swedish private equity

market are acting more professionally than in the past. Investor due diligence prior to making investments in funds has become more extensive and there are fewer opportunities to deviate from the mainstream as regards the terms of fund agreements. Terms and conditions for management have clearly become tougher and investors are taking a more active role during the lifetime of their investment.

This does not only affect newly established funds. In addition, funds that have been active for many years have experienced an increased pressure to renegotiate terms that are perceived by investors as being outside of normal market practice. The stronger role that investors are taking in the market is reflected particularly in the following issues:

Management fee

Management fee percentages for Swedish private equity funds are still generally in the range of 1.5 to 2.5, but more than ever depend on the type of fund

and the track record of the respective management team. Generally speaking, management fee issues have become a more important topic in negotiations between limited partners and management.

Recent development shows a downward pressure on the size of the management fee even though investors may have very different views on how the management fee should be established.

Some of the major institutional investors argue that the management fee should be based on a budget set up for the management team while others prefer a percentage-based management fee combined with a cap on either the size of the fund or the management fee.

Carried interest

While the 80/20 carried interest split still remains the benchmark structure in Sweden, the method of allocating the carried interest has gradually changed. Shifting from a rather formal, standardized deal-by-

deal allocation method, most funds today base their carry allocation on a sophisticated fund-as-a-whole approach providing for a prior return of the invested capital.

Some private equity structures also provide for different complementary incentives for the management team, e.g. some bonus payments upon a certain IRR, which will then be offset against future

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payments of carried interest. Only funds with exceptional track records can count on a catch-up.

Clawback clauses

Investors are increasingly aiming to reduce their risks by requiring clawback provisions. Clawback provisions allowing for a repayment of carried

interest payments have not, despite a-deal by-deal calculation of the carry, been standard in Sweden but have become more common in recent years. As to the percentages of such clawback provisions, no common practice

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seems yet to have been established and they vary from 15 percent to 100 percent.

Governance

Typically, there are some provisions that provide limited partners with control over the management of the fund. Such provisions include key-man and no-fault divorce clauses. Key-man provisions have historically been customary in private equity funds, but it

appears that the role of key persons in the activities of the fund are now much more specified. For example, in the vast majority of cases, the management shall devote all of their time to the fund, not only most of their time. Also, terms relating to the replacement of key persons have been to a greater extent subject to investor control.

No fault-divorce clauses allowing for the termination of the management function have for long been a part of Swedish private equity fund agreements. But investors have previously accepted that they will make use of such clauses only after a grace period of a number of years. Nowadays, Swedish fund agreements regularly state that these clauses can be used at any time.

Transparency

Investors have clearly increased their demand for transparency and reporting of the fund's activities. Nowadays hardly any fund can use different valuation and reporting standards

than those generally applied in the industry. Therefore most Swedish private equity funds apply the EVCA's guidelines on the reporting and valuation of private equity portfolios and the code of conduct that all EVCA members should follow.

Other market trends

There is a significant decrease in seed and start-up financing and a concomitant increase in focus on buyout and replacement capital investments. There has been some concern in Sweden regarding this development in terms of the economic impact, making it almost impossible for start-up companies to receive funding.

The Government has stated that it shall co-ordinate its activities within the Swedish private equity industry and it is consequently expected that the Government shall play a more active role as a provider of private equity funds to those companies that have severe difficulties in obtaining funds for early-stage investment.