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International**

# Perspectives 2020

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*What really matters  
to private equity LPs*



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# Insight

Seven LP perspectives that matter **At a turbulent time for the industry, LP opinions are more important than ever. Here are the charts from Private Equity International's Perspectives Survey that reveal what they think of today's major talking points**

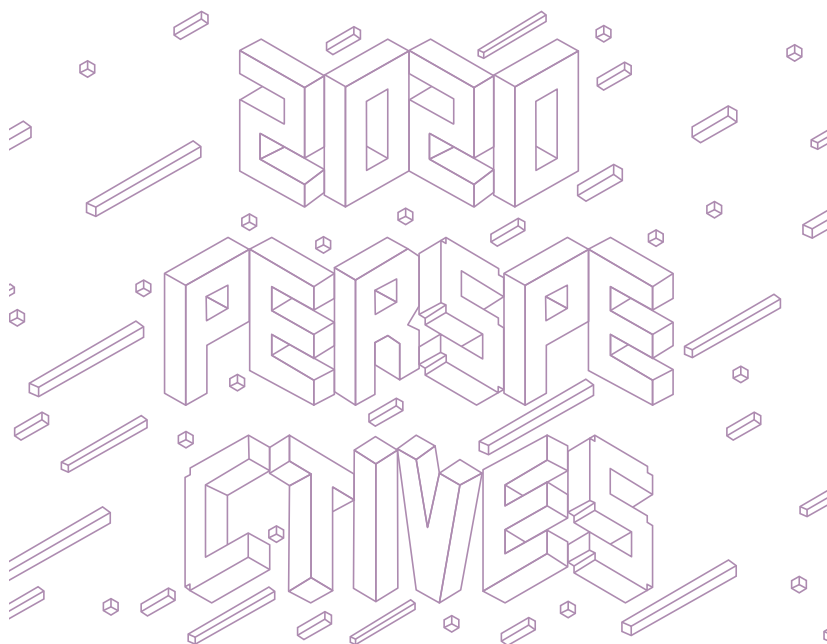
**A**s this magazine went to press, the industry's US lobby group American Investment Council was speaking at a House Committee on Financial Services hearing entitled 'America for Sale? An Examination of the Practices of Private Funds', *writes Isobel Markham*.

The hearing was the latest in a back and forth between the industry and the political sphere that arguably kicked off with the collapse of Toys 'R' Us in late 2017 and escalated mid-2019 when Democratic presidential hopeful Senator Elizabeth Warren unveiled a bill she co-wrote called the Stop Wall

Street Looting Act. If enacted, it would fundamentally change the way the private equity industry operates.

This dialogue between private equity and politics is set to continue – and reach new heights – in 2020. At times like this, getting into the minds of limited partners is more important than ever.

That's where *Private Equity International's LP Perspectives Survey*, one of the most comprehensive of the private equity investor universe, comes in. For this 2020 study, PEI's Research & Analytics team surveyed 146 institutional investors to find out what's driving them, what's worrying them, and how they see the future of the asset class.

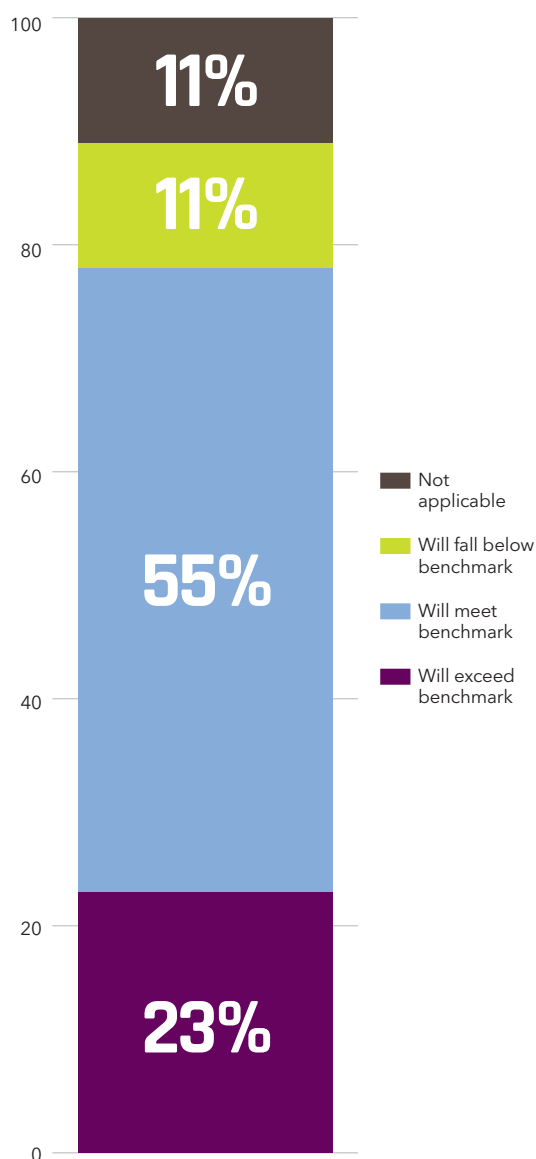


## CONFIDENCE IN PRIVATE EQUITY

While the headline numbers look strong, investor confidence in the asset class has actually dipped slightly from last year: 23 percent of LP respondents expect their private equity portfolio to exceed its benchmark in the next 12 months, compared with 41.5 percent last year, while 11 percent expect it to fall below, compared with 8.5 percent last year.

This may be a reflection of both the strength of public markets and increased valuations, leading many to think the last few years' vintages are likely to post lacklustre performance.

To what extent are investors confident in the performance of their alternative assets? (%)

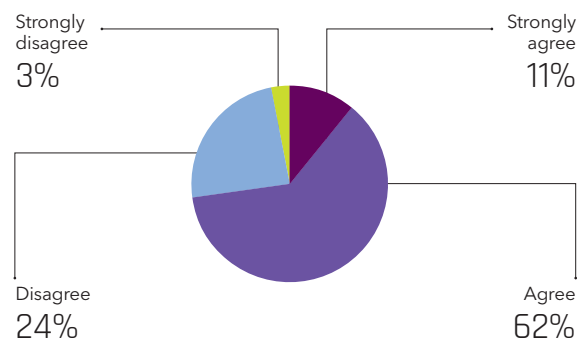


## A TOUGHER SELL

With LPs clamouring to put more money into private equity as it becomes harder for them to meet their actuarial returns through more traditional investments, it's easy to think investors must have made their peace with the asset class's relatively high fee burden.

Not so: in perhaps a sign of increased scrutiny on the industry in the last year, 73 percent of investors agree that fees charged by private equity funds are difficult to justify internally – up 10 percentage points from last year.

To what extent do you agree that fees charged by private equity funds are difficult to justify internally?

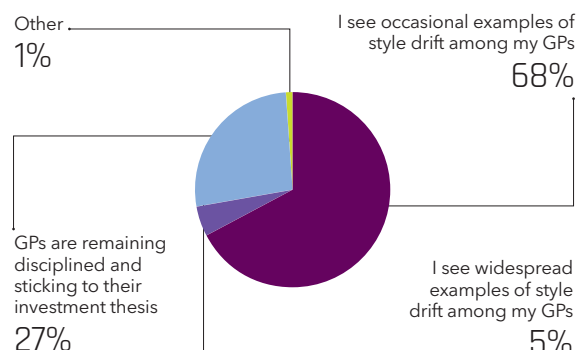


## DRIFTING FURTHER AWAY

Last year we wrote that 'style drift' – GPs extending their strategies into different sectors, market segments and geographies – was a tell-tale sign that we're late in the cycle, and 2019's robust fundraising environment has again seen managers strike out into adjacencies, either within the confines of their flagship fund or through new vehicles.

That alarm bell has grown louder this year, with 68 percent of respondents indicating they're seeing occasional examples of this among their GPs, up from 55 percent last year.

Two-thirds of investors have experienced occasional examples of style drift among their GPs in the last 12 months

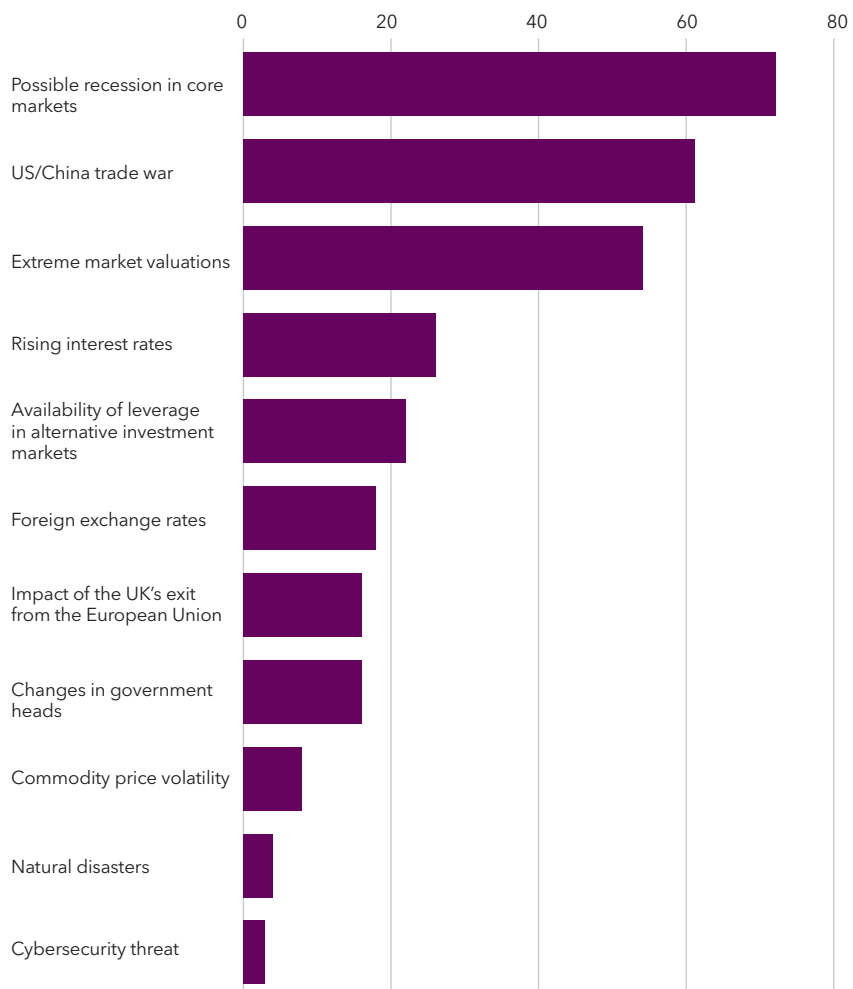


## THE RECESSION IS A LOOMING SPECTRE

Private equity has been stuck in a perpetual state of 'late cycle' for the past few years. For some, that has led to a false sense of security. But this year was different. In mid-August, the yield curve inverted – long considered a harbinger of a recession – but then in autumn it righted itself. Could 2020 be the year the market finally turns?

LPs are certainly concerned about it – almost three-quarters of respondents list a possible recession in core markets as the factor likely to have the greatest impact on performance over the next 12 months. This was followed by the US/China trade war.

Thinking of your private markets portfolio, which three factors will have the greatest impact on performance over the next 12 months? (%)

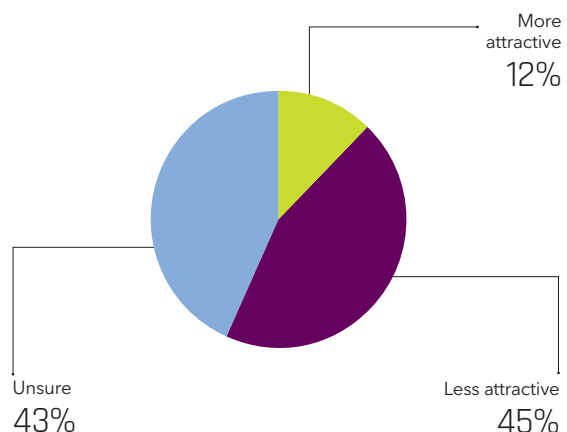


## LPs ARE NOT A FAN OF GP STAKE SALES

GP stake sales have been big news in private equity over the last 18-24 months. According to data from Bain & Co, firms focused on the strategy expect to raise around \$14 billion this year.

But LPs aren't necessarily fans of the practice; in fact, 45 percent of respondents to our survey indicated that selling a stake to an outside investor makes a GP a less attractive investment partner. Just 12 percent said it made a GP more attractive.

Does selling a stake to an outside investor make a GP a more or less attractive investment partner?





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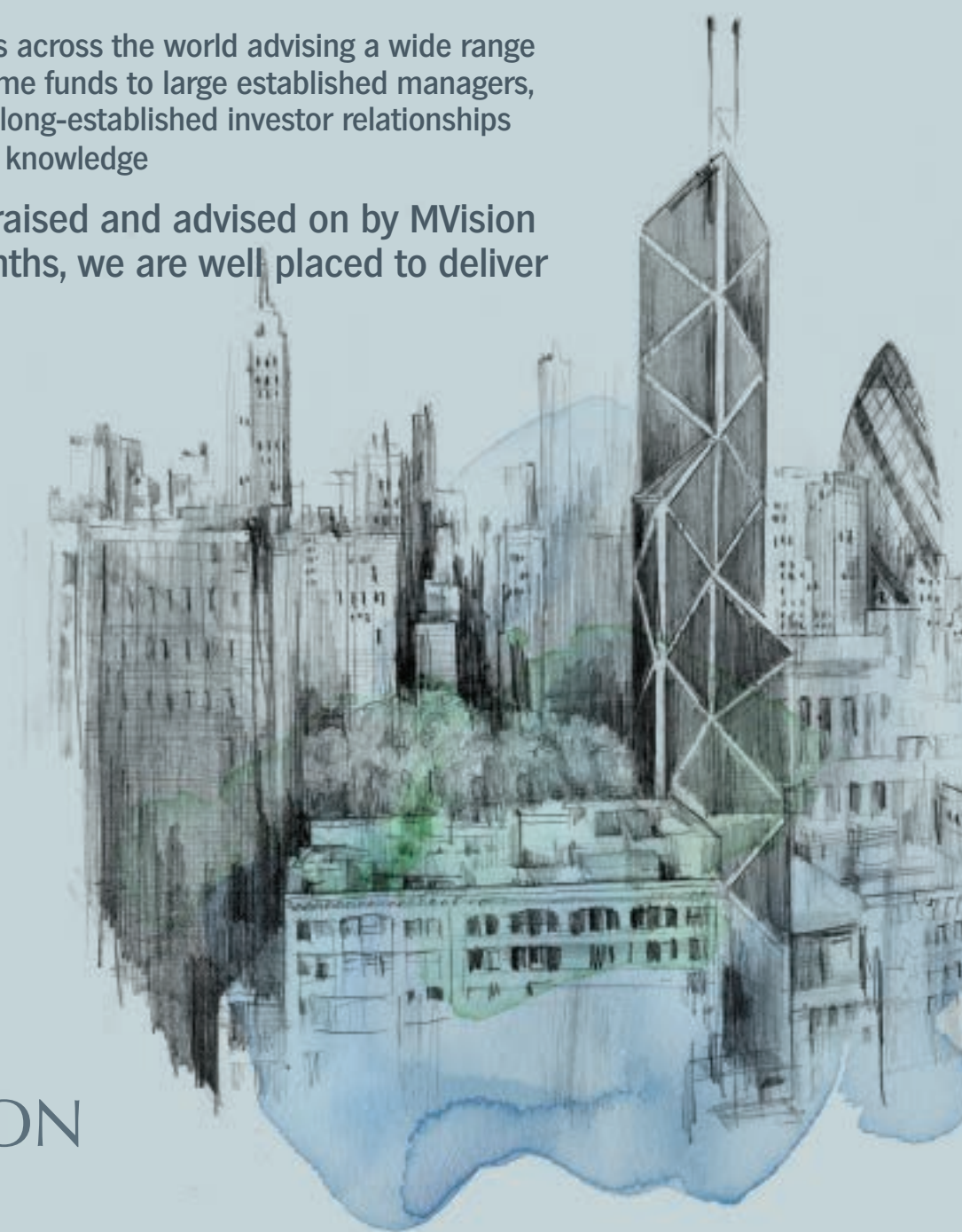
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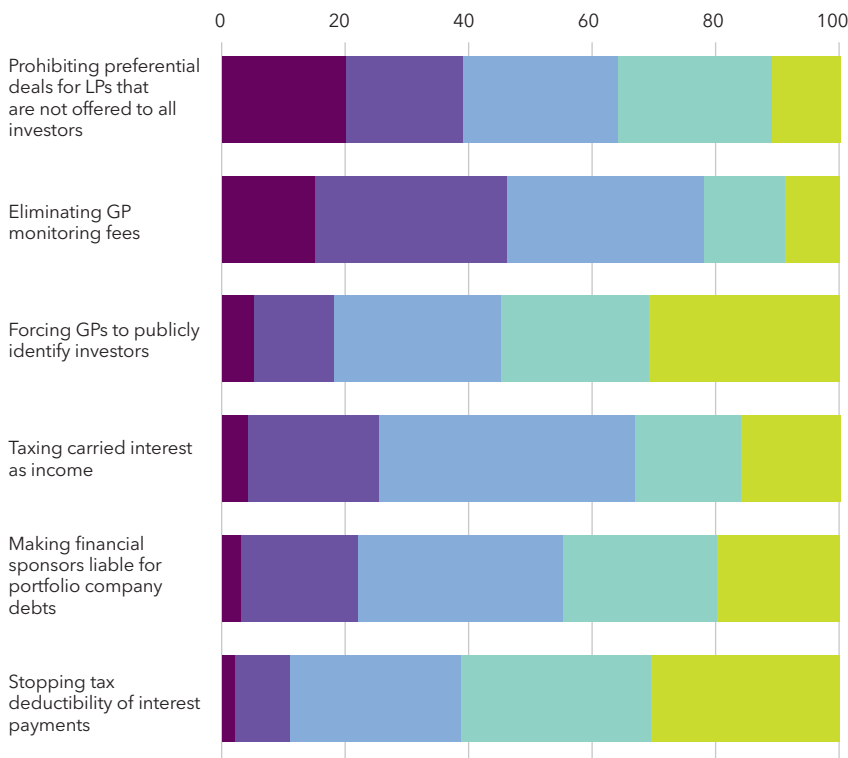


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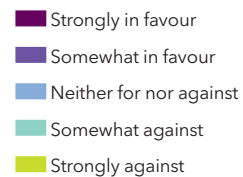
### Investors display mixed feelings towards the policy change ideas proposed in the Stop Wall Street Looting Act of 2019 (%)



### WARREN ON THEIR MINDS

Warren's proposed Stop Wall Street Looting Act has easily been one of the biggest industry talking points this year, so we asked LPs how they view several policy change ideas proposed in the act.

Respondents were most in favour of prohibiting deals for LPs that are not offered to all investors and eliminating monitoring fees. At the other end of the spectrum, investors were most against stopping tax deductibility of interest payments and, unsurprisingly, the provision forcing GPs to publicly identify investors.

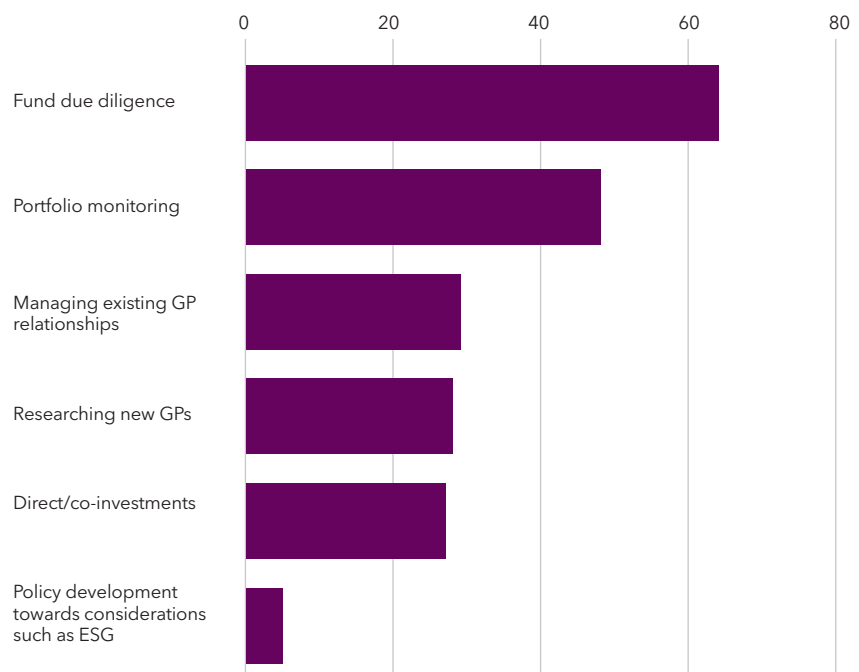


### GOOD DILIGENCE TAKES TIME


LPs are notoriously short of time, with very small teams – sometimes just a couple of people – fielding hundreds of calls and PPMs and co-investment requests. In fact, respondents indicated that for private equity they are presented with an average of 98 fund opportunities per year. But what's taking up the most time?

For 64 percent of respondents, fund due diligence requires the greatest amount of their time, followed by portfolio monitoring at 48 percent. What's not a big time suck? Policy development towards considerations such

### Fund due diligence requires the greatest amount of time for over half of investors (%)







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## Editor's letter

# Focusing on net returns may not cut the mustard



**Toby Mitchenall**

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In November 2019's House Financial Services Committee hearing on the private equity industry, one pension trustee was repeatedly asked the same question: what was the best performing asset class for his pension?

"Let's see. I think this is the seventh time I've had to answer this question," said Wayne Moore of the Los Angeles County Employee Retirement Association in response to Ohio representative Anthony Gonzalez. "It's private equity."

Moore was visibly frustrated, as the issues he wanted to raise about transparency and fees seemed to be drowned out by this one fundamental point. Net returns – as far as some on that committee were concerned – trumped every other talking point.

This may not be the right stance to take. Moore made the point that – notwithstanding the net returns – the PE programme constitutes more than half the pension's investment management costs. You can argue that the net returns make this point irrelevant, but his unease is shared by other investors in private equity funds. Seventy-three percent of LPs asked in this year's *LP Perspectives Survey* agreed that private equity fees are "difficult to justify internally" (see p. 40): last year it was just 63 percent. Meanwhile, 60 percent have asked their GPs for greater fee transparency in the last 12 months.

Yes, net returns have been exciting enough to keep institutional investors coming back with bigger cheques, but other noise – objection to the absolute cost of private equity and increasing public suspicion of its role in the "real economy" – may well be damaging to the industry in the long term.

As we head into 2020, the private equity industry is going to have to work to justify its licence to operate. The corporate world is making noises about working for all stakeholders, rather than just shareholders. For private equity to focus on net returns alone to justify its existence may not cut the mustard.

**“ As we head into 2020, the private equity industry is going to have to work to justify its licence to operate ”**

**Toby Mitchenall**



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## KEYNOTE INTERVIEW

The 'virtuous circle'  
driving secondaries

*The secondaries market has seen more innovation than almost any other area of private equity over the last decade, leaving investors with some intriguing choices, says **Charles Smith**, managing partner and CIO of Glendower Capital*

Limited partners now have an almost bewildering array of secondary investment options, with new strategies ensuring the secondaries market has become an important tool for managing the private equity lifecycle. While today's secondaries can help investors achieve more granular and finely tuned private equity exposure than was previously possible, LPs need to understand how the risk-return characteristics and cash-flows differ according to strategy.

We caught up with Charles Smith, managing partner and CIO at Glendower Capital, a secondaries firm that earlier this year reached final close on its latest fund at \$2.7 billion, to discuss market developments, what they mean for LPs and where secondaries are heading next.

**Q The secondaries market has grown considerably over**

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**the past decade. What would you say have been the most important developments?**

We've seen tremendous growth in the market driven by a virtuous circle in the post-crisis years. In the aftermath of the crisis, we saw an increase in sellers on the secondary market, attracting more buyers. Assets were exchanging hands at rational prices so you got to a stage where buyers and sellers became comfortable with the market and the virtuous circle gained momentum through the 2010 decade.

This helped fuel a proliferation of different deal and strategy types. In addition to straight LP position trades, you now have GP-led deals, single asset deals, preferred

equity, early secondaries... and the list keeps growing. The market has evolved so that the problems it can solve and the exposure LPs can achieve have broadened significantly – secondaries have become a flexible source of liquidity to the private equity world. This development has also been boosted by growth in private markets at the expense of public markets; companies can now stay private for longer, while LPs are still able to achieve the liquidity they may require through accessing the secondary market.

**Q One area that's seen a lot of activity recently is GP-led secondaries. Why do you think this is?**  
GP-led deals have been around for a long time, but the current wave dates from around 2013 or 2014. Its development is a rational response to the concept of a typical 10-year fund life for private equity funds.

Initially, these deals were structured around portfolios but, as these transactions have become more accepted and mainstream, we've recently seen single asset liquidity solutions. The secondary market has become a means for private equity GPs to own assets for longer – firms and their investors are no longer tied to the 10-year life – and that means they can do what's right for value creation rather than being under pressure to sell earlier than might be optimal. For LPs, the development of the market has led to the emergence of funds that are specifically dedicated to GP-led deals, widening their investment options.

### **Q Given the evolution of the market, how can LPs use secondaries within their private equity allocations?**

Historically, LPs tended to invest in secondaries for two reasons. The first was when they were just starting to build out their portfolios – secondaries offered a way of deploying capital quickly, achieving both quick returns and instant vintage year diversification. The other was when they were targeting distressed opportunities during market corrections when forced sellers boosted secondaries dealflow.

Things have moved on significantly from there. Today, secondaries can provide an attractive risk-return profile for mature investors, which may also be seeking additional diversification, as well as new investors. Secondaries are not driven just by distressed sellers anymore – we've been in a benign environment for some time now. Secondaries funds have proven that they can provide attractive and stable returns across the cycle. That said, they can be an attractive strategy currently as they can also provide a hedge for when the cycle turns, and many believe we are not far from that point.

### **Q Can you explain how risk-return and cashflow profiles vary according to some of these strategies?**

Let's start with the more traditional LP portfolio secondaries. Here, you have rapid deployment of capital and rapid return of capital – they are shorter duration strategies and they can provide LPs with instant diversification because they are usually spread across a number of funds and underlying investments. These can offer strong IRRs, mitigate the J-curve and be particularly suit-

### **Q How should LPs be approaching the market now that they have a broader variety of choices in secondaries?**

A first step is to scope the market to understand what's out there since strategies can vary significantly. Some strategies are designed to deploy large amounts of capital by buying hundreds of LP positions – that's like the ultimate private equity index and it's a type of secondary investment that can offer a relatively high level of liquidity.

Yet you can now also target different phases of secondaries investment through tail-end portfolios, or at the other end of the spectrum, early secondaries, which target positions early in a fund's life, and everything in between. You can also invest according to type of private equity investment, such as buy-out, venture capital and growth capital, and we're also seeing side cars developed for real asset strategies. Then, there's preferred equity and debt-like products that offer investors a different point on the risk-return spectrum from more traditional equity strategies.

It's worth noting, though, that while some of these strategies may look or feel similar, when you peel back the onion, they have very different risk-return and cashflow implications for LPs. LPs need to clearly understand where a particular manager expects to play – what type of cake they're looking to bake.

able for investors that are concerned about the reported returns from their investments – they may not want to experience several years of negative returns.

GP-led secondaries, by contrast, are more like primary buyout investments in that cashflows tend to be lumpy and investments are much more concentrated. This type of secondary is more likely to offer stronger multiple returns and sits further out on the risk and duration spectrum. Meanwhile, preferred equity related secondary strategies are more akin to mezzanine with a lower risk, lower return profile.

### **Q What about different forms of leverage – that clearly has an impact on all this, too?**

Yes, leverage can be used in different ways by secondaries managers and LPs would be well served to understand how this may impact risk and returns. One area that has received a lot of attention over recent times is the use of subscription lines in the broader private equity market. Secondaries funds were early adopters of this type of credit line because it is perfectly suited to the cashflows inherent in a secondary fund. The holdings are so diversified, secondaries funds have cashflows virtually every day, so it makes sense to use subscription lines so you can accumulate cashflows each quarter and make capital calls in one go to simplify the administrative process.

This has extended over the past few years to more permanent types of finance and into

*“We don't see returns being under pressure because there is now so much variety in strategy”*





*“I think we’ll see the market reach \$100 billion, or very close to, of annual deal value this year”*

deal structuring, allowing funds to shift both where they play in the risk-return spectrum and the cashflow profile they generate for investors. So, for example, if you have a deal that could be attractive in IRR terms – it is mature with short investment duration – but less so in terms of multiple, you can use leverage as a recycling tool to invest the capital twice to increase the multiple. In this instance, you’re not increasing risk; you’re merely increasing the duration of the investment for your underlying investors. On the other hand, if you have a longer duration asset and you’re looking to boost the IRR through leverage, you are increasing risk, so LPs should potentially be putting that in a different bucket of their portfolio.

**Q To what extent do you think there is an understanding among LPs around of the use of leverage among secondaries managers? And how can they navigate this?**

I think there’s still some education work to be done by the industry as, from where we sit, some LPs are clear about this, while others aren’t focusing enough on this yet. Investors need to have a dialogue with fund managers to understand how they will use leverage and the impact this will have on the risk-return profile of their investment portfolios. We certainly see more LPs picking apart this aspect during fundraising processes, but for the benefit of robust and transparent GP-LP relationships, managers

really need to be clear with their investors about what they’re doing.

**Q As the market has grown, so has the number of players. How has competition affected returns?**

We don’t see returns being under pressure because there is now so much variety in strategy. Indeed, 10-15 years ago, I’d say secondaries deals were all priced the same, but today, there’s much greater sophistication in the understanding of risk and pricing. While there are more players, there are that many more niches to play in and so much more dealflow, so the actual level of competition for deals has largely remained the same and our return targets haven’t changed in the past 15 years. We see secondaries as an absolute return strategy which can achieve attractive returns across the cycle.

In addition, each player will have their own angles on different deals and portfolio construction objectives and so they tend to treat the various types of secondary as you would ingredients to make a cake – the way you blend those ingredients will dictate how the cake turns out. For example, we combine LP position transactions with GP-led secondaries to benefit both from the cashflow profile of LP deals and the strong multiples in GP-led secondaries.

**Q How do you see the market developing over the next few years?**

I think we’ll see the market reach \$100 billion, or very close to, of annual deal value this year – it was around \$75 billion in 2018. More broadly, however, the secondaries market will continue to be the liquidity solution to the private equity world. As private companies increasingly seek to stay private, I can see a point where GPs will own assets for 20 or even 30 years, backed by different groups of investors, as liquidity will be offered through the secondaries market at varying points along the way.

I think we’ll see GPs find a way of baking in liquidity solutions to their funds at, say, year 10, even if they plan to hold some assets for longer. I know some GPs are already thinking about how this might work. Ultimately, that could well mean that they use the secondaries market as a fourth exit route alongside the traditional IPO, trade sales and secondary buy-out. As a result, four-track processes may not be that far away. ■

# LP PERSPECTIVES SURVEY 2020

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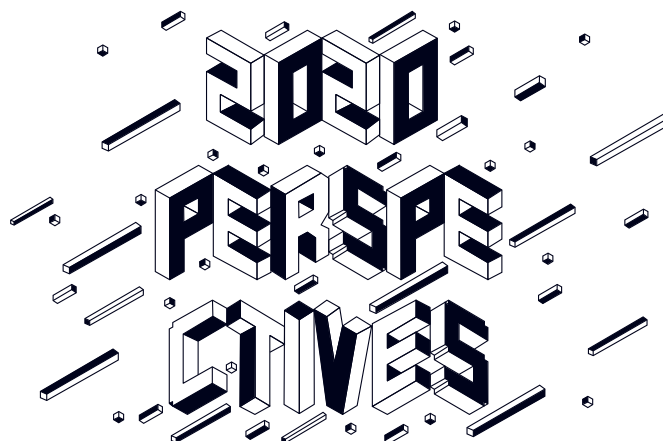
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ESG yet to take centre stage

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# Alternatives continue to tempt investors

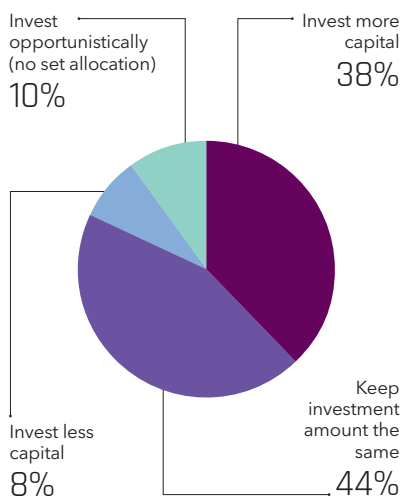
*As investors continue to see outperformance in the private equity asset class, allocations and commitments are expected to rise accordingly, writes [Chase Collum](#)*

This year's *LP Perspectives Survey* shows investors eager to deploy additional capital across private equity: nearly two in five plan to increase allocations in the coming 12 months and only about one in 10 plan to deploy less capital. Just under one-third of this year's respondents report they are under allocated compared with one in five respondents in last year's survey.

Further, nearly one-third of respondents plan to increase their commitment sizes to private equity opportunities over the next 12 months, whereas only 4 percent plan to decrease their commitment sizes and more than half plan to continue committing at their current level in 2020.

Sam Metland, head of private equity for Citco Fund Services, offers a potential

**How much capital do you plan to invest in private equity in the next 12 months compared with the previous 12 months?**

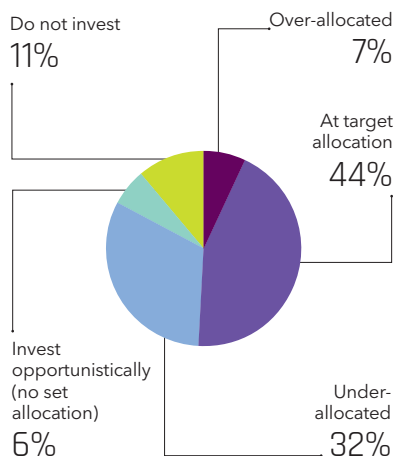


explanation for these feelings of under allocation and the plans to beef up exposure across alternative asset classes. Instead of grouping alternatives at the bottom of the allocation column, as has historically been standard industry practice, Metland says, “the way that people are looking at it now is, you take that private debt allocation, for example, that you had in the bottom 5 percent and you lift it up and put it in a row next to bond ETFs, bond funds, syndicated loan funds and private lending funds”. So, rather than having to squeeze alternative investments into a 5 percent bucket, investors can grow them into a relatively larger piece of a much larger bucket.

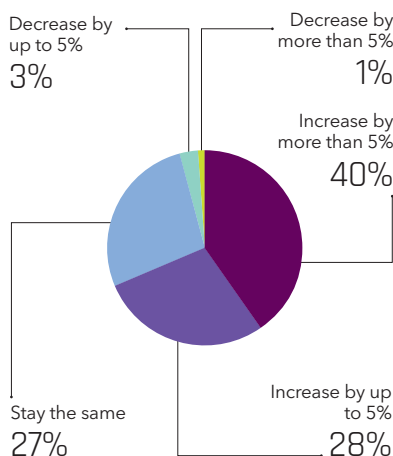
Another explanation for the larger allocation targets in private equity may be found in the survey results. Forty-seven percent of respondents indicate that private equity

## Analysis

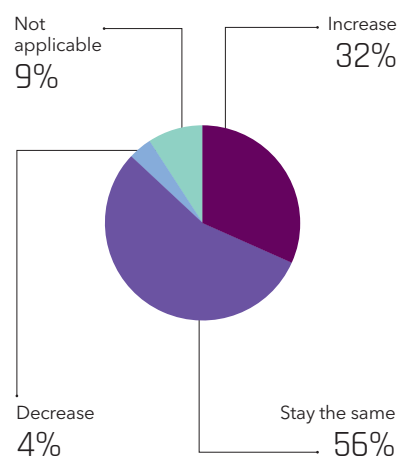
Please indicate your current allocation position for private equity



How do you think the proportion of your total assets under management allocated to private equity will change in five years' time?



How will your average commitment size change over the next 12 months?



exceeded performance benchmarks over the past 12 months, with 23 percent convinced that the trend of exceeding benchmarks will continue over the next 12 months. Thirty-one percent of respondents report that private equity performed in line with expectations, while only 8 percent say private equity fell below benchmarks over the past 12 months.

*Private Equity International* reported in November that the 10 largest funds closed in October raised a collective \$53.5 billion, the most collected during a single month so far this year. If the industry continues at this rate, the three months to the end of the year will comfortably outstrip the \$134 billion raised in the fourth quarter of last year.

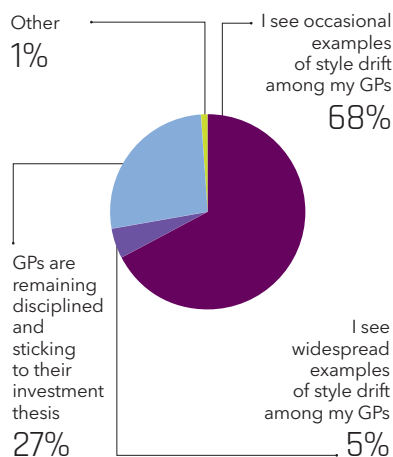
But GPs appear to be doing more than just launching new funds for deal-thirsty LPs. More than two-thirds of respondents say they have seen at least occasional examples of style drift from GPs as strategies, teams and resources are shifted to keep up with the demands and preferences of a constantly evolving market.

### Eye on risks

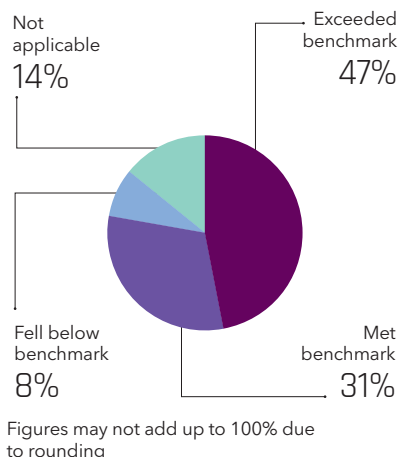
Buyout and distressed strategies are high on LPs' priority lists: one-fifth plan to increase capital allocations to buyout strategies and one-quarter plan to increase allocations to distressed strategies.

This may be a reflection of investors' interpretation of the economic cycle, as 72 percent list a possible recession as the most likely risk factor in terms of performance in the coming 12 months. But it may also be that investors are playing a game of "catch

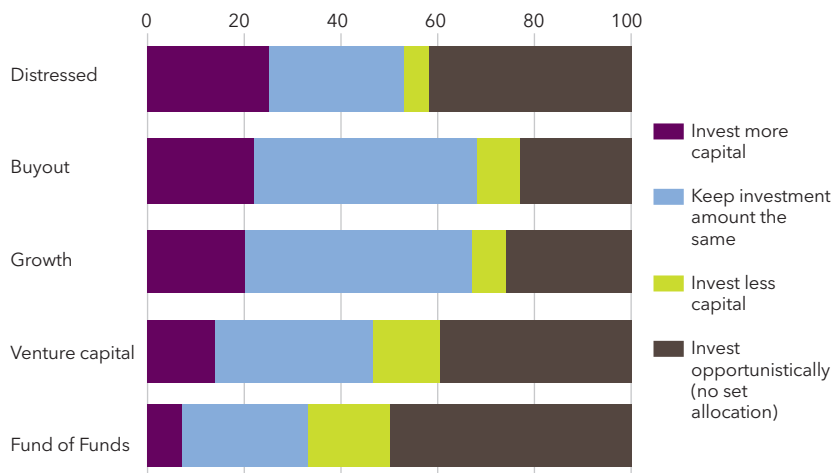
Which of the following best describes your assessment of GP investment behaviour in the last 12 months?



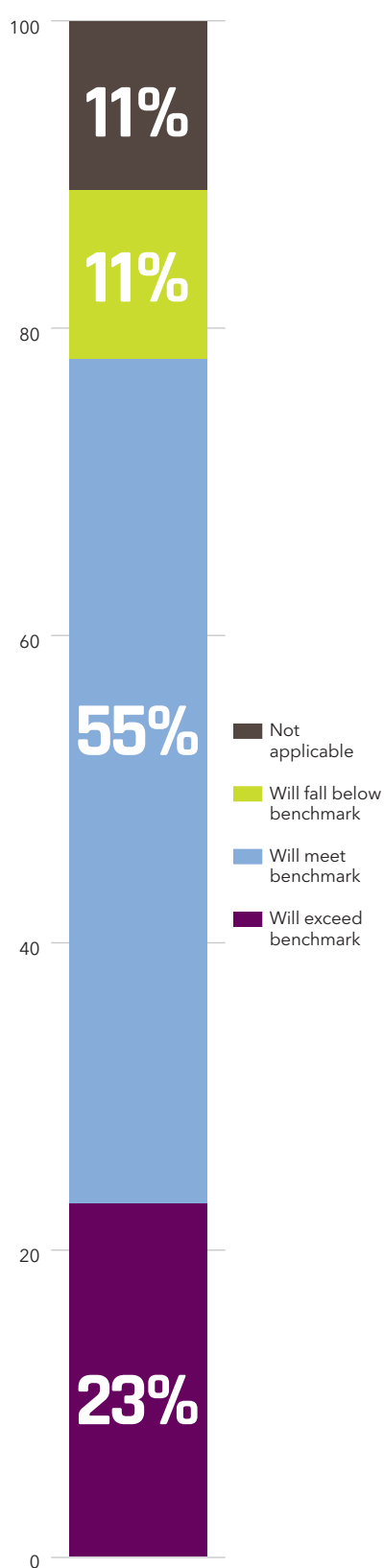
How has private equity performed against its benchmark over the past 12 months?



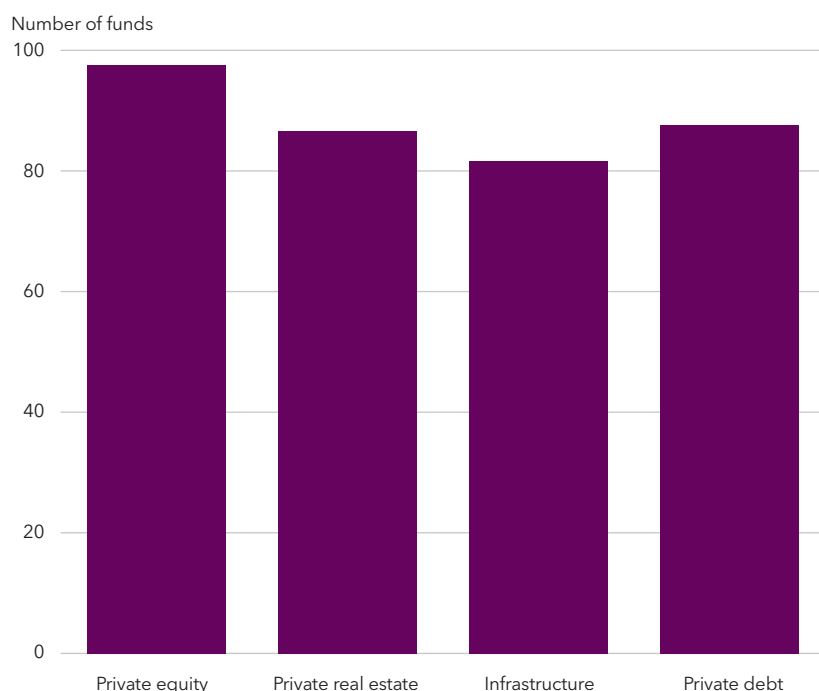
Regarding private equity, how much capital do you plan to invest in the following strategies in the next 12 months compared with the previous 12 months? (%)



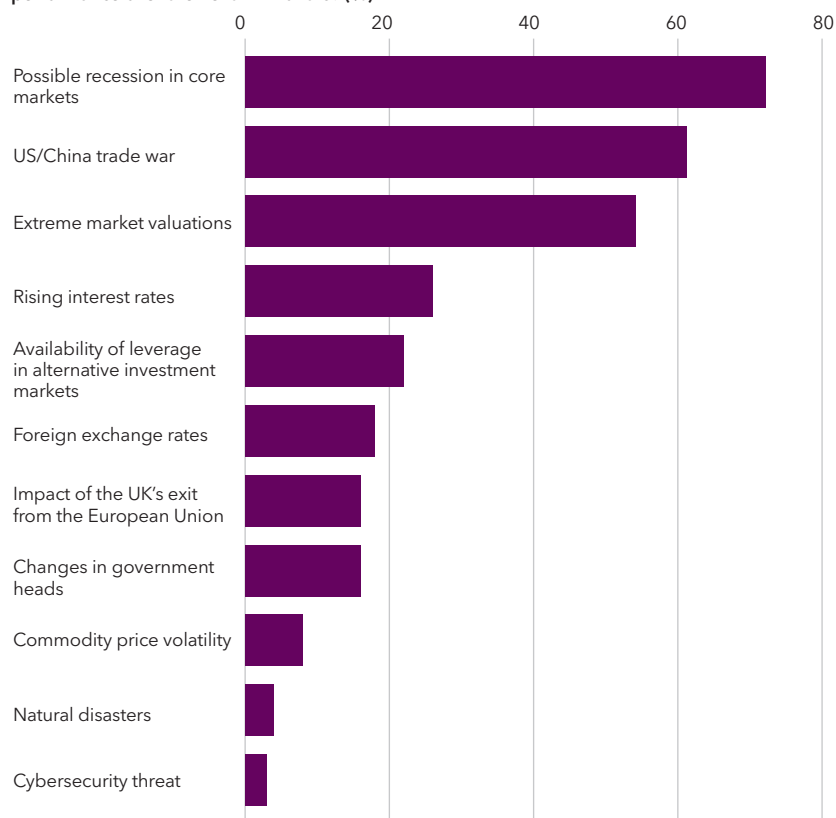
How do you feel private equity will perform against its benchmark in the next 12 months? (%)



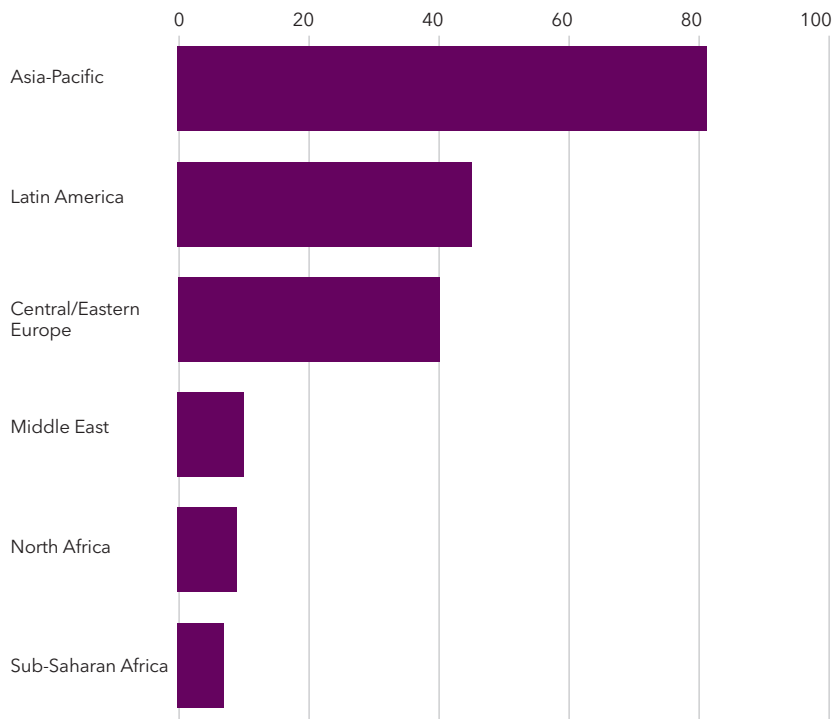
On average, how many fund opportunities are presented to you per year?



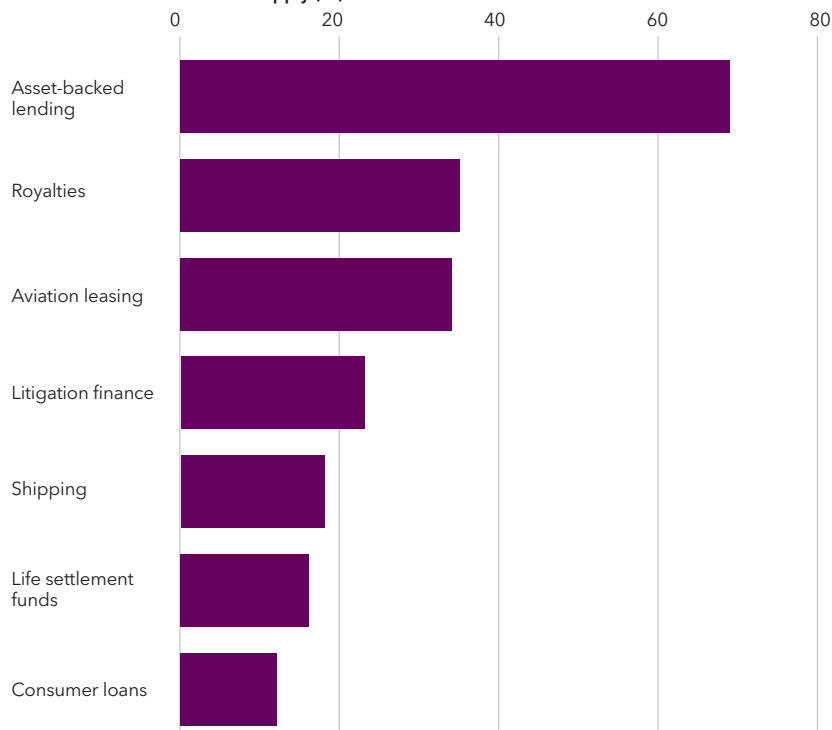
Thinking of your private markets portfolio, which three factors will have the greatest impact on performance over the next 12 months? (%)



Which of the following emerging market geographies will you consider for investment over the next 12 months? Please select all that apply (%)



Which of the following emerging asset classes do you plan on committing to over the next 12 months? Please select all that apply (%)



Source: Private Equity International

up”, according to Jennifer Choi, managing director of industry affairs at the Institutional Limited Partners Association: “We saw a surge in allocations to growth funds over the last decade because we were in a booming economy, and the survey results probably point to a potential overallocation to those strategies to the detriment of having some of these diversifying strategies in the portfolio.”

Also weighing heavily on investors’ minds is the ongoing US/China trade war. Sixty-one percent of respondents indicate it will likely have a negative impact on performance. While less concerning than fears of a looming recession, a trade war between these superpowers could be particularly impactful given that more than 80 percent of respondents are considering investments in the Asia-Pacific region in the coming 12 months.

Not all investors may be inclined to enter the Chinese market against this backdrop and amid the ongoing violent protests in Hong Kong, but Choi notes China is probably core to any Asia strategy and very hard to ignore for an LP that wants to have exposure to the region. “The relationships that the Chinese economy has across the region are critical,” Choi notes, and there is “a very deep set of investment opportunities” within the country. “I think investors are eager to see resolution and some progress made in the trade relationships between the US and China.”

Turning to niche strategies, respondents indicate that asset-backed lending and royalties are piquing their interest – 69 percent express interest in the former.

Metland notes that clients in the illiquids community with well-established private equity and private debt strategies are not often prone to stepping into asset-backed lending.

However, he has seen managers traditionally focused on liquid to fairly liquid bonds in the fixed income markets dipping their toes into the waters of illiquid markets through deployment of capital into strategies such as asset-backed lending, which, says Metland, “is a good way for people to come one step down, because you’re still a little bit remote. You’ve still got almost a securitisation vehicle there in the middle to make you not as directly exposed to the underlying assets, but you are picking up a little bit of that higher return”. ■

# How we conducted our LP survey

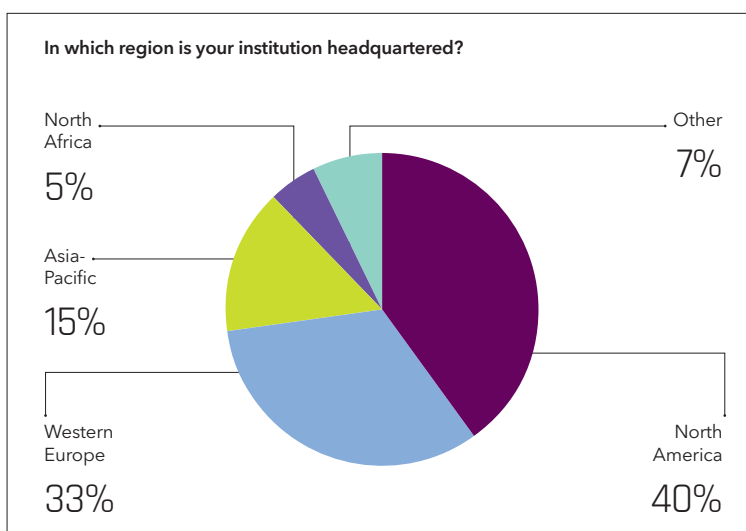
*In its eighth year, the LP Perspectives Survey is Private Equity International's annual study of institutional investors' approach to alternative asset classes*

The *PEI LP Perspectives Survey 2020* aims to provide a granular view of the alternatives market, both current and future, by gathering insight on investors' asset allocation, propensity to invest and performance predictions.

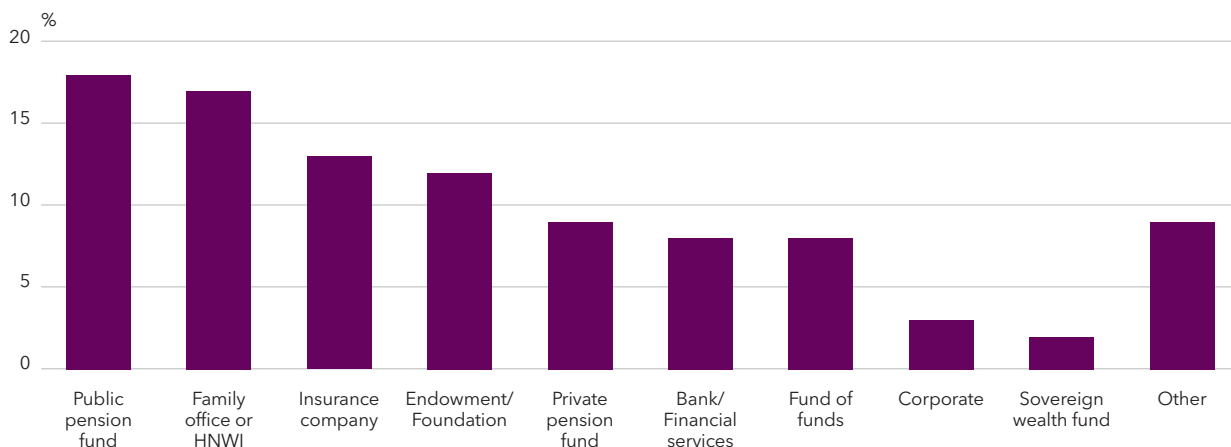
It is a global study, reflected in the question set and the respondents, which allows for meaningful global views and cross-regional comparisons across alternative asset classes.

The survey questions are reviewed annually, with the objective of reflecting market developments and shifts in sentiment.

For this edition, *PEI's* Research & Analytics team surveyed 146 institutional investors. Fieldwork was carried out from August to September 2019. Participation is anonymous, with the findings amalgamated and presented in this supplement.



## What type of institution are you?



Source: Private Equity International

## KEYNOTE INTERVIEW

# Why investors are going big on the US



*LPs are lapping up mega-funds and emerging managers, making life tough for mid-market players seeking to raise capital, says **Mounir Guen**, chief executive officer of MVision*

**Q** It's been another huge year for fundraising - \$177 billion raised in the first half, according to PEI data. As 2019 comes to a close, where are LPs focused?

Globally, private equity allocations stand at around 70 percent US, 20 percent Western Europe, 5-10 percent to China, and 0-3 percent to the rest of the market. And within that, investors are very orientated toward larger funds because they take the view they are a safe pair of hands. They are sensitive to volatility, rate of deployment and consistency of returns and visibility over communication they have the GP.

**Q** What's driving this?  
The US is flushed with cash. In addition to mega funds, a large amount of

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capital, particularly from public pensions, is allocated to emerging managers with funds of \$1 billion and below. Why is this happening? Consultants advise their clients that private equity firms early in their formation are outperformers. It's systematic and embedded in the structure of programmes in a way it's not in other countries. When LPs look beyond the US ecosystem they face a limited choice of first time funds to invest with because there isn't that growth. So the US private equity system keeps growing.

Come with me now to Europe, where early in the year a handful of mega funds absorbed a huge chunk of capital. That leaves

very little available in general for other European funds. Unless you are a small GP targeting a specific investor group, it's going to be hard work to raise a raise a €1 billion-€3 billion vehicle in Europe. There's limited cash capacity and it will all just take longer

**Q** Where else is fundraising tough?

As we look toward 2020, in general, the growth of private equity in emerging and new markets is somewhat stunted. In Latin America, for example, unless GPs receive development finance institution funds – and that is constrained by volume – the absence of domestic and large international investors is constricting the growth of the GP community. In these markets, GP access to local LPs, of which there aren't many – bar China



– is constrained by currency and regulatory controls. Asian and Western European LPs have limited capital to invest there, and the US is focused inward. GPs in newer markets have to reinvent themselves and use different structures to tap different sources of capital.

### Q Where are new LPs emerging?

The US. There are new foundations and tech entrepreneurs setting up family offices. US public pensions are increasing their allocations. Every now and then there is a movement elsewhere and new investors appear. Japan was quite active for a couple of years. Taiwan, South Korea and China have appeared. They have all settled down now. There's lots of upside in those markets, but their allocations to alternatives are very small.

### Q Will the broader picture change next year?

I don't see a big difference; 2020 is going to be dominated by large funds again. Some investors might be near their US limits and may invest more into Europe. I don't see new markets grabbing anyone's focus. For the little bit of money that is unallocated, Latin America will still be fairly hard, Africa and other emerging markets will be even harder. Japan might see a flurry of LP interest, but it's small numbers.

### Q As LPs look to put ever-greater amounts of money to work in private equity, what issues do they face?

Deployment is the biggest focus. If an LP has a 15 percent allocation to alternatives, that money has got to be deployed to meet their target return criteria. And when you are dealing with such large sums of money, it puts pressure on investors regarding fees.

For those investors that need to commit more than they are allocated or want to improve their J-curve and reduce fees, co-investment can help. Then the problem is, what is the formula for deciding which LPs gets what? And if LPs want to write large, \$200 million-\$300 million tickets and there are 20 of them wanting in, that's another \$4 billion of firepower at least – where's that going to go? An LP can only put so much money with a GP before there is concentration risk. The challenge for funds is why some of the largest investors in the world have chosen to go direct. Direct investment has increased massively over the past year.

## Shifting talent

### As more LPs develop direct investing programmes, what's the impact on domestic GPs?

In some markets like Canada and Australia, large direct investors have absorbed their GP community by hiring its talent from captives many years ago. From an individual partner's perspective, you could be out raising funds every three to four years as a GP, or, working for one of the largest pools of capital in the world that is increasing in size.

From a compensation perspective, the waterfall mechanism has changed so GPs do not make money as quickly as before. A GP won't touch capital for a very long time. A young partner in a large private equity firm is one of hundreds of staff, so why not move to a significant pension plan and join a team of 50-60 with lots of firepower? It's a very attractive option.

### Q Are LPs in a position to exercise any leverage over terms, fees or pricing?

Investors need to allocate to the best funds. Interest rates are low – negative in some countries – and they need to be able to generate returns and can only do that through alternatives and private equity specifically. Private equity is their saviour. Core funds have the upper hand. The mega funds lead the way and the LPs follow along; they don't negotiate.

That said, all funds seek a big first close. As a result, a LP is in a position to open discussions: if I give you a \$1 billion commitment at first close, I want to be treated differently from an LP that gives you \$50

million. This raises an interesting question about the alignment of LP interests within a fund, but that's how it works.

### Q What is your view on a downturn? How are LPs geared to protect themselves?

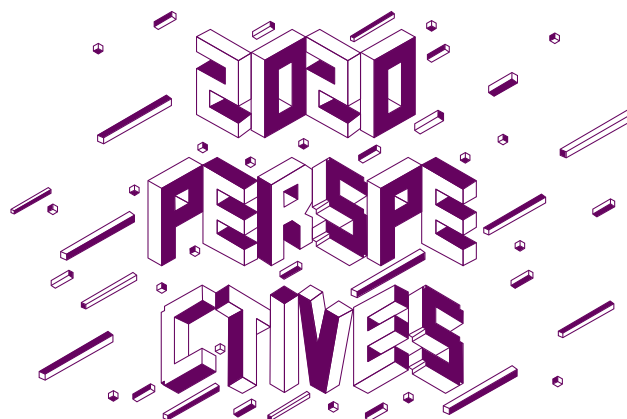
They are dynamically using primaries, secondaries and co-investments to manage their exposure and returns and the elasticity of the J-curve. LPs are concerned about toppy-ness in the market, but the way to run a programme is not to try to time markets. LPs want to find GPs that can work their companies. Deal flow is still very healthy. A great company is a great company. GPs are less sensitive to the price on entry and more focused on what they can do operationally to generate value.

### Q How do LPs measure operational success?

Two ways: one is the running of the management firm. That has risen to top of mind. LPs are looking very carefully at checks and balances, chief executive responsibilities, the chief financial officer's remit, how the investment committee makes decisions, valuations, how cashflow is monitored and recorded.

All this scrutiny is generating detailed reporting. And second, LPs have always asked a lot of questions in due diligence about value creation. They want to understand how the GP will develop a three to five-year plan with the management team, and how data supporting performance metrics is compiled. ■

*“The challenge for funds is why some of the largest investors in the world have chosen to go direct”*



# Red lines in the LP-GP relationship

*LPs are still wary about change of control and alignment of interest in the growing GP stakes market, writes [Carmela Mendoza](#)*

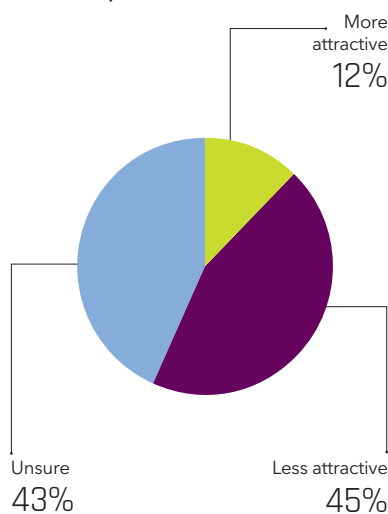
**F**und managers selling a piece of themselves has been on the rise and transitioned away from a minority activity to some of the most successful platforms in the industry today including Dyal Capital Partners and Goldman Sachs Asset Management's Petershill unit.

"It's the reflection of the fact that GPs are pretty good businesses and are attractive investment opportunities," said Rede Partners co-founder Adam Turtle in a panel at the British Private Equity and Venture Capital Association Summit in London in October.

Yet limited partners are not too hot on this, according to *PEI's LP Perspectives Survey 2020*.

Nearly half (45 percent) of investors believe that selling a stake to a third-party

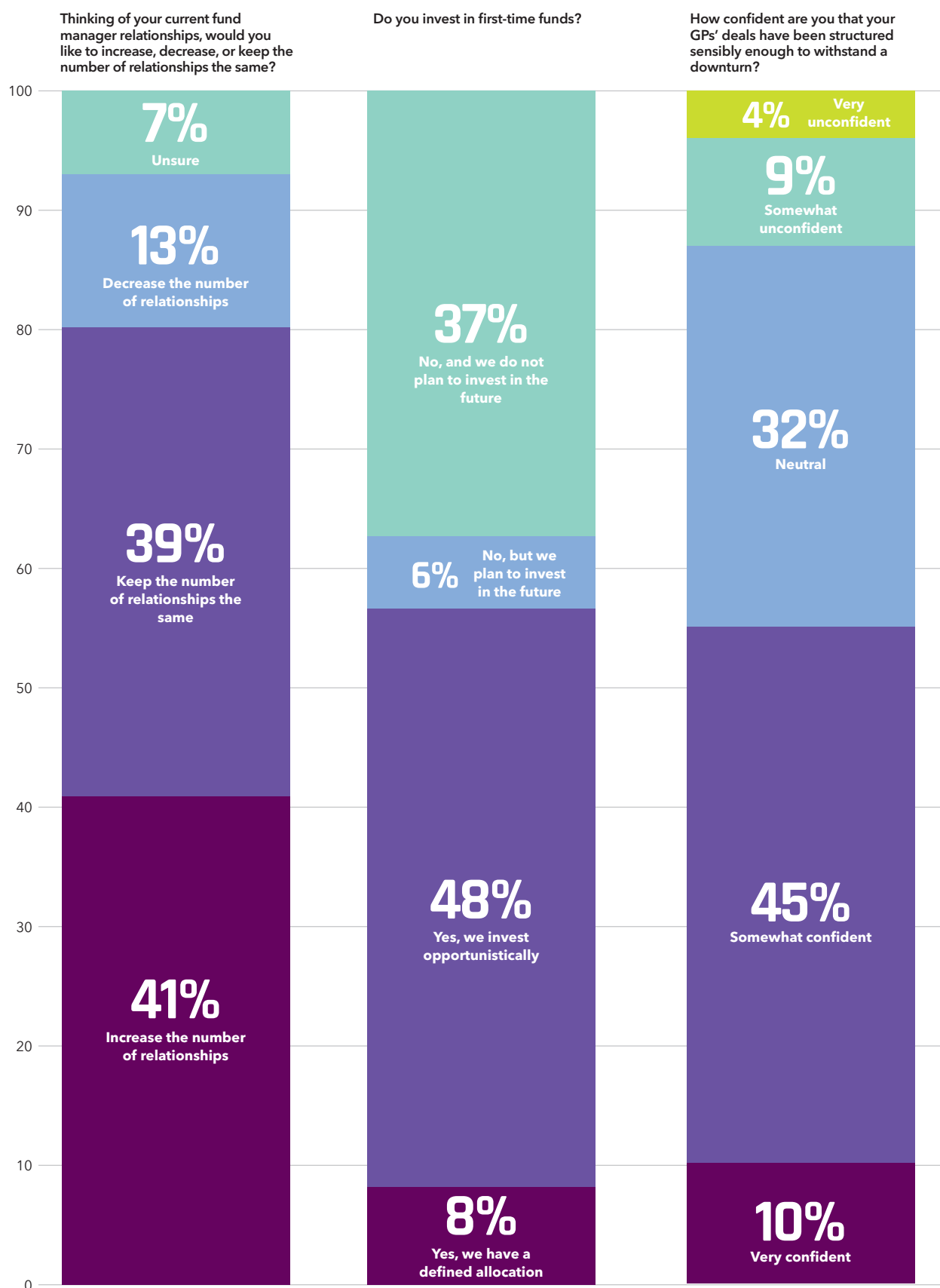
**Does selling a stake to an outside investor make a GP a more or less attractive investment partner?**



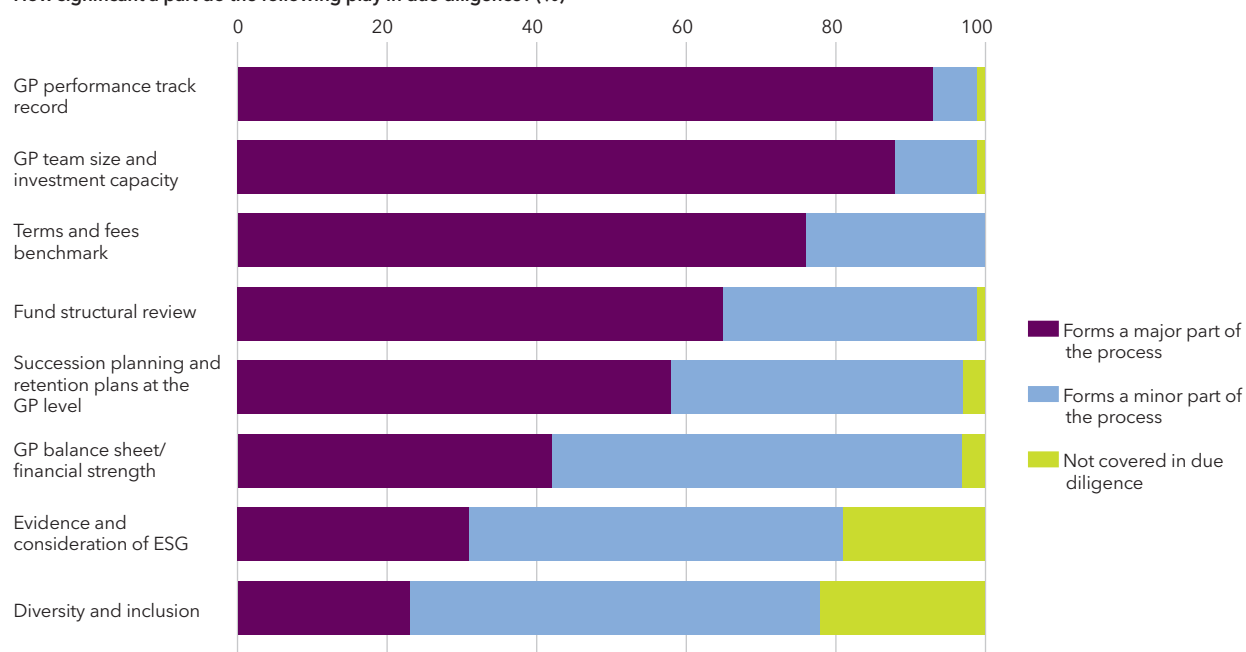
investor makes a GP a less attractive investment partner, while only 12 percent of LPs surveyed believe GPs which do so make more attractive investment partners.

Not all LPs are keen on GP stakes investments as limitations on transferring and changing of control, governance and questions around the management fee stream and GP commitment are potential issues.

"The basic principle that investors want to see is alignment with people running the business they are investing in. And where you have third-party ownership in a GP... what you don't want is a third-party owner that has a lot of say in strategy, which essentially causes a lot of value leakage and even turnover in the investment team level," Alexander Wolf, a principal at HarbourVest



How significant a part do the following play in due diligence? (%)



Source: Private Equity International

Partners, said in the same BVCA Summit panel.

Wolf added that LPs in general like to see a purer relationship between the people running the business and the ownership of the firm. “The devil will be in the detail in these transactions. And it’s still pretty early in the life of these deals,” he said.

Looking at fund manager relationships, this year’s *LP Perspectives Survey* shows a decline year-on-year in LPs looking to increase their GP relationships, from 53 percent to 41 percent.

## Mixed views on first-time funds

Similar to findings from the previous year, nearly 50 percent of LPs say they invest in first-time managers opportunistically and 8 percent say they have a defined allocation. The portion of investors that have no plans to back first-time funds has increased nearly 7 percentage points compared with last year.

Launching a first-time fund is not for the faint-hearted, especially in a fiercely competitive environment. Track record and experience from an established manager does not always translate to a successful fundraise, Janet Brooks, managing director of placement firm Monument Group, told *Private Equity International* earlier this

*“Diversity is a big word which means different things to different people. Investors look for the best managers, period”*

**GILA COHEN**  
MUFG

year. GPs also need to show a differentiated strategy and the ability to generate deal-flow. To secure capital, first-time managers also need to be prepared to give up terms, co-investment rights and discretion, she noted.

## Top priorities

When it comes to LPs’ selection criteria for GPs, track record forms the most important part of the due diligence process (93 percent), similar to last year’s findings. This is followed by team size and investment capacity (88 percent) and terms and fees (76 percent).

ESG considerations as well as diversity and inclusion, although often talked about these days at most industry events, only form a minor part of the diligence process. In fact, 22 percent of LPs surveyed said diversity and inclusion was not covered at all. Findings from last year’s study showed the gender pay gap was also most likely to form a minor part.

As Gila Cohen, managing director for real estate and private equity at MUFG, said at the *PEI Women in Private Equity Forum* in London in November: “Diversity is a big word which means different things to different people. Investors look for the best managers, period.” ■

## KEYNOTE INTERVIEW

# The need for transparency in GP-led secondaries



*Many LPs are being called on to make significant decisions about whether to hold or sell positions in older funds. EisnerAmper's Robert Mirsky discusses the potential for conflict*

Sponsor-led (or GP-led) secondary deals – which see GPs roll over assets with potential future upside into new funds, offering LPs either liquidity or a position in the new vehicle – are clearly here to stay. Last year saw a record \$22 billion of completed GP-led secondary transactions globally, according to research by Lazard Freres, comfortably beating the previous high of \$16 billion seen in 2017. And in 2019, we've already seen large numbers of GP-led transactions, including those led by blue-chip names, such as Ares Management, Oaktree Capital, PAI Partners, Warburg Pincus, Bridgepoint and Blackstone.

This is something of a turnaround: in the not-too-distant past, they were largely transactions of last resort, struck when there was misalignment or when other types of issues between LPs and GPs arose. Yet GP-led secondaries are now well-es-

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tablished tools for fund managers and their investors to find a way around some of the structural characteristics of the private equity closed-end fund. Today, they can help meet liquidity needs for investors at the end of a vehicle's life, while offering those with longer horizons the opportunity to benefit from future value creation in a company or handful of companies that remain in the portfolio beyond the 10-year fund duration.

Yet, given their complexity, these deals can throw up an array of conflicts of interest and tax issues for all concerned. We spoke to Robert Mirsky, principal and head of the asset management group at EisnerAmper, to discuss the issues that can emerge and

how LPs can gain comfort they are striking a good deal.

## **Q Why do you think we've seen such an increase in GP-led secondaries?**

They have increased exponentially and I think this is because, when managed and structured well, they can be a win-win-win for the parties involved – the GPs, the existing investors and the new investors. Historically, GP-led secondaries tended to be used in situations where there was a misalignment of interests between the LPs and the GP, but we've now seen many of these deals executed successfully and so there are now significantly more investors actively seeking out opportunities in this space.

However, I would caution that this is not a solution that suits all scenarios that can arise. Sometimes, it may be better to seek

a fund extension or directly sell a stake, particularly if you only have a small minority of investors seeking liquidity.

### **Q Yet these deals can throw up issues around how assets are valued, can't they?**

Yes, which is why there has to be transparency around these types of deal to ensure all parties are satisfied that an appropriate valuation has been arrived at. There are four constituent parties to this – the existing LPs that want liquidity, existing LPs that want to roll over, the new investors and the financial sponsors. Each of these has a different interest and incentive on valuations – leaving LPs will want maximum value, new investors want an attractive price and so on. Valuations are at the heart of these deals because if they are not arrived at reasonably and fairly, either the deal doesn't get done or there is a risk of being sued further down the line. So, not only should there be a valuation carried out by the GP, one by the secondary buyer and one by existing LPs, there also needs to be one done by an independent party to give comfort that a fair price is being paid.

### **Q To what extent are independent valuations now a standard part of the process?**

There is now an acceptance that independent valuations are necessary. After all, these are free market transactions and the independent work can act as a bridge between the various LP valuations and that of the GP. It gives comfort that someone outside

of all the parties, with no interest in the deal, has come to a reasonable view based on the available information. It's not quite standard practice, but it is good practice.

### **Q ILPA issued guidance on these deals earlier this year – how is that affecting processes?**

The Institutional Limited Partners Association has taken the stance of providing best practice guidelines for GP-led fund restructurings and, while some of it may seem like common sense, it is really helpful to have the process set out clearly. ILPA took the starting point of looking at how these transactions were running and asked the question of what the appropriate standard should be as far as how valuations should be reached, how to ensure full transparency and how to avoid conflicts of interest. It recommends, for example, that LP advisory committees should be involved, third-party valuations be used and sets out the information that needs to be shared and a timeline. It also offers guidance on how fees should be apportioned so that whoever benefits from the transaction should pay part of the fees.

These guidelines are increasingly being used and they are helping to standardise transactions around good practice. Previously, there was a dichotomy between deals being done in the US and those in Europe. It was already fairly standard in the US; in Europe, however, there was much more variation in terms of information provided, timelines, etc. There had been instances, for example, where LPs were given just a week to decide whether they wanted to sell or roll over – that's not a reasonable amount of time. The guidance means that transactions in Europe are now more consistent with what we were seeing in the US.

### **Q Why do you think US transactions were previously more standard than those in Europe?**

Many US GPs were already inadvertently following what has now been recommended by ILPA in large part because the Securities and Exchange Commission had been watching these deals for several years. There have been instances where the SEC has issued fines and investigated instances alleged violation of reasonable standards or where full disclosure had not been made to LPs – I think the threat of SEC enforcement helped raise the standards in the US before ILPA issued its guidance.

### **Q So, under which circumstances would you say GP-led deals are most appropriate?**

These deals are best suited to situations where a fund is reaching, or has reached, the end of its life, yet there is an asset or a few assets that still have growth to go and have the potential to generate significantly more value over the coming years. You need investors that want to benefit from the upside and roll over their stake and you need new investors that are interested in buying out the positions of existing LPs that need liquidity. And, of course, you need a GP with a clear plan for how to maximise the value creation potential in the business.

These can be extremely effective transactions and are proving to be very attractive for LPs with longer time horizons that prefer to be able to benefit from upside than seeing the GP forced to sell assets – that can end in fire sales of businesses. Some sovereign wealth funds, for example, have a time horizon of 100 or more years and so they don't need their money back after 10 years; if they keep their holding for a further five years, it's beneficial because it's keeping their capital at work and enabling them to take advantage of further value addition.

### **Q ILPA has some recommendations around advisory appointments – how do these help?**

Let's take the valuation issue as an example. GPs obviously owe a fiduciary duty to the LPs in their original fund and need to maximise the value from the remaining assets, yet they are also incentivised to keep the valuation low so they can gain more upside from the new fund, where incentive structures will be reset – there's a clear conflict between these two. Yet the biggest conflict here is that the only recourse an LP has if it is not satisfied with the price offered is not to sell.

ILPA recommends that an advisor to the fund (separate to that for the GP) be appointed to protect the interest of fund investors and that this should be in addition

*“There is now an acceptance that independent valuations are necessary”*





*“These can be extremely effective transactions and are proving to be very attractive for LPs with longer time horizons”*

to the LP advisory committee’s advisors and those of the LPs. Clearly, this can be expensive, but the issue is that, unless reasonable steps are taken to protect all interests, it’s easy to see how you can arrive at an adversarial position.

**Q There are other conflicts that can crop up, aren’t there?**

Yes – tax is a big issue here because not all investors are created equal. The tax implications of selling or rolling over into the new fund will be different for a US investor, from those for a UK investor. US investors are subject to tax on worldwide income and may be subject to withholding tax, for example, and you have to ensure that you are not prejudicing one investor over another. Existing LPs in particular will need to consider whether there is a recognition

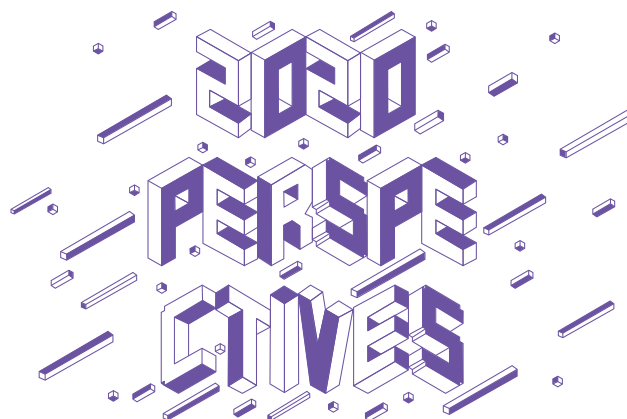
event if they sell or roll over and they need to be aware that these deals can have significant tax consequences for original investors if they are not structured well. These are complex transactions and you have to understand the whole picture to structure them appropriately.

**Q How do you see this part of the market developing over the future?**

We will see a continuation of the trend towards a greater standardisation of the way in which GP-led fund restructurings are undertaken – the ILPA guidance is a great start in this regard. In the US, regulators will continue to watch closely, but the question is whether the European regulators may also become more involved. If we see one or more transactions go wrong, that may happen.

Overall, I see tremendous opportunity in the future and I expect the growth in volume and value to persist, especially given that the expected IRR in these deals is around the 15 percent mark.

If we see a recession over the coming years, these deals will come even more into their own because they will be a more attractive proposition than a fire sale. There’s so much liquidity around this part of the market, selling LPs may well generate higher returns through GP-led secondaries’ even at a discount. If a quarter to a third of secondaries are currently GP-led, I’d expect that to move to closer to 50 percent over the next five years. That’s significant growth when you take into account the amount of capital that has been raised over recent years – we’re in the baby-boomer phase of private equity. ■



## Big names remain key for secondaries

*Though the secondaries market continues to grow apace, sentiment dampened slightly in 2019, with cost concerns around GP-led deals a sticking point, writes **Rod James***

Secondaries transaction volumes are set for another record year. According to advisor Greenhill, they hit \$42 billion in the first half of 2019, 56 percent up on the same period last year.

The amount of capital being raised for the strategy suggests a drop-off is unlikely. July saw Strategic Partners VIII hold a final close on \$11.1 billion, the first of several huge secondaries funds in market to wrap up. Lexington Partners and Ardian, targeting \$12 billion each, the joint-largest pools yet raised for the strategy, are to close imminently.

These firms, along with other giants in market such as HarbourVest Partners, Collier Capital and Goldman Sachs Asset Management, are clearly finding limited partners receptive to their offerings. Yet this year's investor sentiment survey suggests that things could be turning.

Just 33 percent of survey respondents say they are planning to commit to a private equity secondaries fund over the next 12 months, 43 percent say they are not and 23 percent are unsure. Only 15 percent of respondents report they are planning to commit to a real estate secondaries fund, 15 percent to an infrastructure fund and 11 percent to a private debt fund.

Twenty-nine percent of private equity investors are planning to buy, sell or do both in the next 12 months, with 71 percent doing neither or don't know. In the other

three asset classes, a combined 80 percent of investors are neither buying nor selling or are unsure.

Secondaries fundraising has always been lumpy, dominated by the largest names. Their success is due to relationships built with GPs over the years as well as the large amounts of fund data they've accrued, which allows them to quickly and accurately price a wide array of stakes.

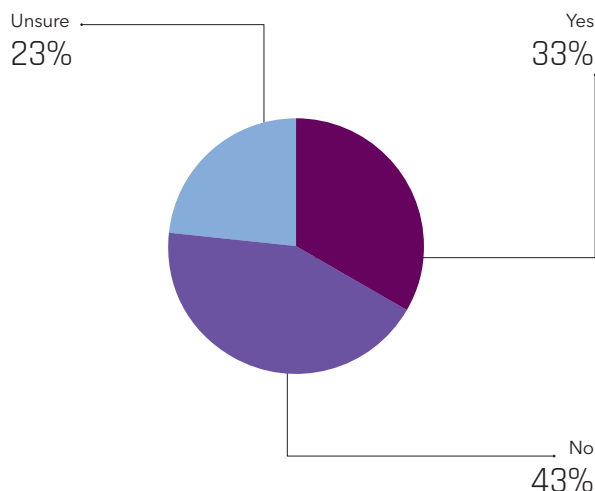
Sunaina Sinha, managing partner of secondaries advisor Cebile Capital, said at the start of the year: "I think we'll see a big bump in 2019. We'll probably see 2020 as another down year for fundraising volumes because all of the small guys combined can't match the volume of these \$10 billion to \$12 billion fundraises."

A bright spot is that 11 percent of respondents are planning to commit to private debt secondaries, a strategy so new that there is only one vehicle completely dedicated to it, managed by Pantheon, and one set

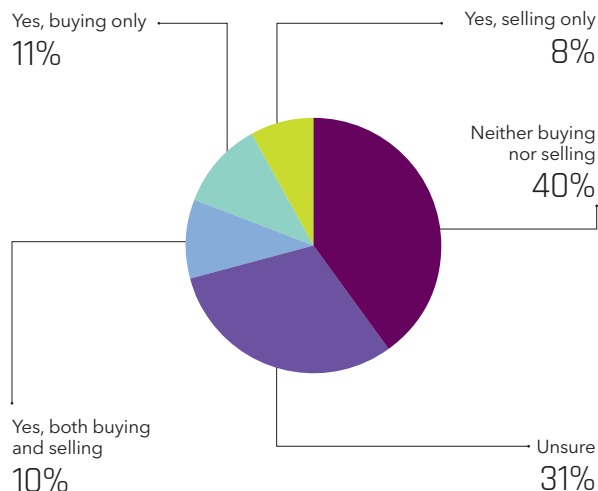
**\$42bn**

**H1 2019 secondaries transactions volume (Greenhill)**

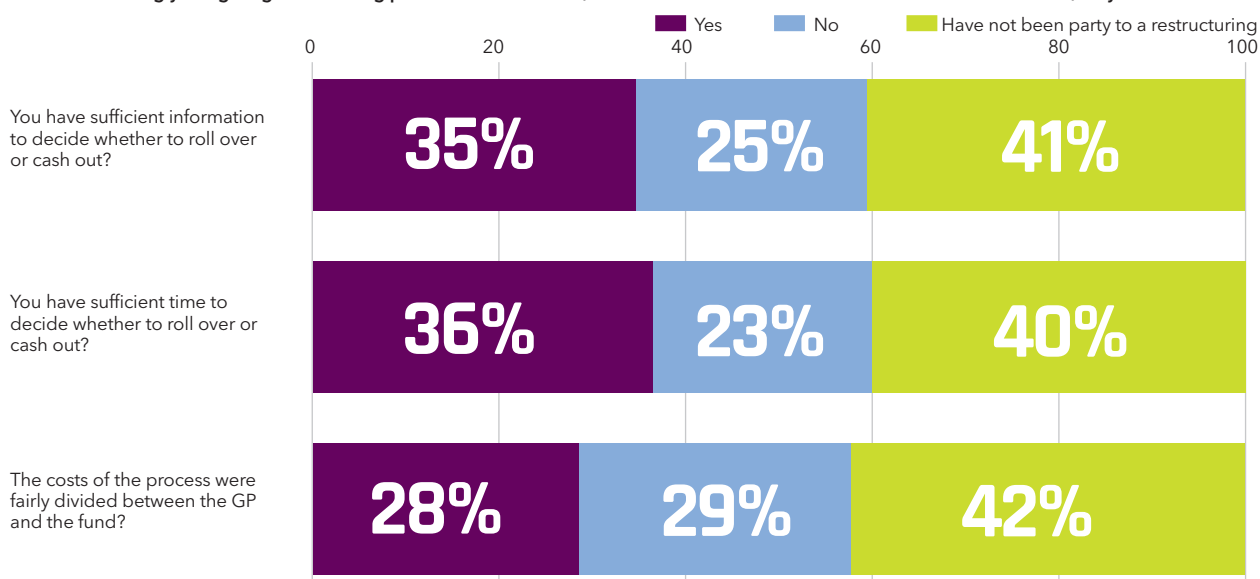
Do you plan to commit to private equity secondaries funds over the next 12 months?



Do you plan to buy or selling fund stakes on the secondaries market in the next 12 months?



GPs are increasingly instigating restructuring processes on old funds, to move assets into a new vehicle. In these circumstances, do you believe:



Source: Private Equity International

Figures may not add up to 100% due to rounding

to be raised, managed by Tikehau Capital.

“The private credit secondaries market is enormous, arguably bigger than the \$75 billion private equity secondaries market,” said Jeff Hammer and Paul Sanabria, now global co-heads of Manulife’s secondaries business, in August.

That few real estate and infrastructure investors are planning to sell on the secondaries market is unsurprising. These investors value income generation over a long period of time, so would be less tempted to opportunistically sell a portfolio of assets,

even if the price was right. That 40 percent of private equity investors have no intention of buying or selling is a little more concerning. For many LPs, selling a portfolio of stakes just means more cash that has to be deployed elsewhere.

The data are also indicative, however, of the way the secondaries market has changed. GP-led deals accounted for \$14 billion of transaction volume in the first half, equivalent to around 33 percent of total volume, and double the \$7 billion they represented during the first half of 2018. GPs are now

some of the biggest sellers, accounting for 33 percent of all sales by value in the first half of 2019, Greenhill notes.

More than 40 percent of respondents have not taken part in one of these processes. Of those that have, a small majority believe they had enough time and information to make the right decision. The issue of cost is a sticking point, with 28.5 percent believing the costs weren’t fairly divided, compared with 29.2 percent that did. This is something for secondaries buyers, GPs and advisors to chew over. ■

## KEYNOTE INTERVIEW

# Private debt secondaries: A fast-emerging market



*For LPs looking to diversify, the secondaries debt market presents some tempting opportunities, say Pantheon's **Francesco di Valmarana** and **Toni Vainio***

Private debt primaries are a staple of any LP's alternative asset portfolio, and now investors are narrowing focus to an expanding market niche: private debt secondaries. According to Setter Capital, in the first half of the year, the volume of private debt secondaries reached an eye-catching \$2.2 billion completed transactions, up from \$580 million the year before.

This surge of almost 280 percent far outstrips rising secondary volumes across the private asset spectrum, where \$46 billion of transactions in the first half of 2019 signals another record year, according to Setter.

We asked Pantheon partner Francesco di Valmarana and principal Toni Vainio what is fuelling this momentum.

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### **Q** How would you describe the market for private credit secondaries in terms of size and maturity?

**Francesco di Valmarana:** It is a market in rapid development. It maps almost directly to primary fundraising three or four years ago and already exhibits the characteristics of the more mature private equity and infrastructure secondary markets, notably a shift from heavily LP-led to including more GP-led processes. The more mature fund positions tend to be larger US vehicles, but we are seeing more European transactions by virtue of fund vintage. The type

of fund stakes in the secondary market has also changed from, give or take, 80 percent of subordinated, mezzanine, distressed and turnaround to 50-60 percent senior debt.

### **Q** Given direct lending positions are typically short-dated, self-liquidating loans that pay a coupon, why would an LP sell?

**FV:** We see a similar dynamic to the other secondary markets – LPs are not being forced to sell but are choosing to sell. There are very few distressed sales, instead, it's high-level portfolio management. LPs that are seeking to manage factors like cashflow and exposures are paring their holdings, or reducing excess exposures, while for others it maybe a reaction to merged programmes or a chief investment officers switching

strategies, like moving from an indirect to a direct model. We've seen the evolution of a secondaries market first in private equity and then in infrastructure debt. In that context, there's no reason you wouldn't see a similar dynamic develop in private debt.

**Toni Vainio:** The other way to think about it is, with any private illiquid asset class where investors are committing themselves for seven to 10 years, there's around 1-2 percent annual churn in the LP base. Where there is strong primary private fundraising activity, the natural consequence of that is a secondary market, where 1-2 percent AUM per annum is changing hands.

As well as LPs, we're also seeing private debt GPs being more active in the way they manage their portfolios. All the techniques and tools being applied in private equity can also be applied to private debt. A GP may have a tail-end fund at its seven-year expiry still holding a number of loans, or wish to accelerate liquidity to their investors. As funds become more mature that's a natural thing for a GPs to want to manage out.

### Q So, who are the buyers of the secondaries?

**TV:** Historically, the buyer universe is private equity-focused secondaries funds and existing investors that want to top up their exposure. From a solely private debt secondaries perspective, a limited amount of dedicated capital has been raised compared to the opportunity that's out there.

It makes sense for those LPs embarking on a private debt programme that may want more diversification and yield from day one to invest in private debt secondaries, where there are potential discounts, deployment can be accelerated and greater diversification can be achieved. It can also be a useful way for investors to complement an existing programme that's more direct in nature.

### Q Where do you see opportunities in this space and how do you go about getting exposure to them?

**TV:** Our key sourcing methodology is to speak with private debt GPs, explain to them the types of transactions available and position ourselves as a preferred partner, either as an LP replacement or as a solution in a tail-end situation or a strip sale of loans. We also work very closely with intermediaries to ensure that they show us debt



### Q Are the risks in private debt secondaries more complicated to understand than those of private equity secondaries?

**TV:** As a private equity investor, you are looking for upside potential and those two or three companies that are going to drive outperformance. As a private debt investor, you are thinking about downside risk and keeping an eye out for those two or three loans that could deteriorate. You're thinking about whether you will recover the cost and principal on those loans. In a typical direct lending fund, a single loan concentration can represent up to 10 percent of a fund. In a private debt secondaries fund, the single exposure risk should be lower because of the diversification you get across GPs, funds and loans.

**FV:** Many subordinated debt, mezzanine and special situations funds are incredibly opaque, and the risks are much more difficult to understand than a private equity fund. With senior debt, it's easier to get comfortable with the downside risk. If a company is performing to plan, amortising its debt and has a lot of headroom, then it is easier to make sense of the risks.

transactions. This could be a mixed asset class portfolio of 10-30 funds that includes, say, up to five debt vehicles, which we might acquire as part of a mosaic bid. The third strand is speaking directly with LPs about rebalancing their portfolios and acting as a replacement LP for them.

**FV:** To date, private debt funds have generally been sold as part of broader private

equity secondaries portfolios, principally because the immaturity of the market hasn't warranted private debt being broken out. However, these funds have typically attracted a higher discount because of their lack of upside, particularly for senior debt. As secondary buyers, we are able to bid at a price more in line with the expectations of a debt buyer [rather than a private equity buyer], which improves the pricing of the

overall portfolio for sale. This benefits both the vendor and the intermediary.

### **Q How liquid is the market - how easy is it to find deals?**

**FV:** There's a growing amount of dealflow in the market, which is a derivative of the growing volume of primary fundraisings and has a familiar profile to private infrastructure and private equity secondaries in terms of legal structures and transfer documents. The big difference is the lack of familiarity of the private debt GP universe with the players in the secondary market and with the way it functions. We spend a lot of our time proactively reaching out to GPs and explaining to them how we see the private debt market maturing and how we can help them get ahead of the curve in terms of proactively managing secondary processes and anticipating the issues involved.

### **Q How easy is it to come to a price?**

**TV:** There's a bifurcation between private debt managers regarding reporting detail. In general, the information provision on distressed debt funds is not typically as robust and transparent as those in direct lending where the reporting on a line-by-line basis regarding yields and key financial metrics is easier to diligence. This is why it is so important that secondary buyers should have access to GPs who can walk them through their portfolios to enable them to analyse potential risk and upside.

### **Q Which part of the market are you targeting?**

**TV:** In line with Pantheon's overall investment platform focus, we're looking at funds in direct lending primarily in the small and mid-cap buyout space. In general, these managers have historically received a return premium and benefited from more robust financial protections from a covenant perspective than at the larger, syndicated loan end of the private debt market.

**FV:** In general, we're looking to see that these aren't syndicated loans. In a mid-market deal, GPs are much more likely to be a sole lender [to a business], meaning that should things go wrong they are in control of the security and so investors are typically better protected. Rather than having to try and get seven or eight people [in a syndicated deal] to agree on a way forward, the

*"Back in 2008 there were around 30 GPs in the direct lending space, now there are more than 350"*

lender is in control of its part of the capital stack, and we like that control dynamic.

### **Q The primary market is packed with new managers. What does that mean for the secondary market in terms of risk?**

**FV:** We're sitting at the back end of a nine-year bull market where every manager who comes to you shows you a 10-year track record with a very low default rate. That makes diligence and market mapping difficult, especially for investors new to the asset class. That's the key risk. You need to be able to differentiate between the groups that have set up shop in the past five years and don't have much expertise, and those that have experience managing a downturn. It's the same way we look at first time funds in private equity. We need to be sure that they are not going to be learning on our clients' capital.

### **Q What is your view on a possible downturn and how prepared are private debt investors to deal with it?**

**TV:** In terms of leverage ratios, we're at or close to the peak seen before the financial crisis. In the mid-market, the leverage ratios tend to be a turn or so lower than at the larger end so that should mitigate some risk. Back in 2008 there were around 30 GPs in the direct lending space, now there are more than 350. Not all of them will survive a downturn to the extent the default rates are high and recovery rates on the loans are not. GP quality and resilience are important to us when we're looking at backing a secondary investment.

### **Q Are you concerned about default rates?**

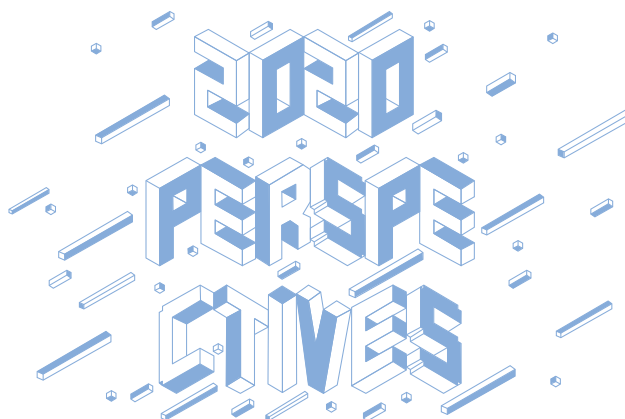
**FV:** Naturally. But primarily because for the past nine or 10 years we haven't seen a real default environment. A number of private debt franchises particularly the younger ones, haven't navigated a crisis before; inevitably for some there will be lower recovery rates. There is a lot of discussion around the benefits and drawbacks of covenant-light structures. Certainly, one of the dynamics of being in a covenant-light structure is that you tend not to have the warning signals that would allow you, as the lender, to step in and begin to address the capital structure ahead of a full default. The risk is that everything will look fine until it doesn't. And then it really doesn't. ■

# 280%

Rise in private debt secondaries in H1



*Three investors give their thoughts on what to expect in 2020*



# What investment issues keep you awake at night?

*“As the rally continues and future market gains surge forward, I’m concerned about what this means for the future return environment”*

**Todd Cohen**

Director, New York Presbyterian Hospital

Cohen oversees the venture and growth equity portfolio for the Office of Investments, as well as making direct investments through the hospital’s venture capital arm, NYP Ventures. The New York Presbyterian Hospital manages around \$9.5 billion of assets supporting capital expansion projects, research and development activities across the hospital system. Cohen featured on our inaugural 40 Under 40 list of future leaders in private equity earlier this year.

*“Low expected returns for the next 10 years and high valuations”*

**Raphaëlle Koetschet**

Head of funds investment - private equity, Caisse des Dépôts

Koetschet joined Caisse des Dépôts in 2014 as an investment director. She was promoted to head of fund investments after five years in the role and now covers buyout, growth equity, infrastructure, real estate and mezzanine. Named on PEI’s Future 40 list earlier this year, she is excited about strategies that have a “clear value focus” be it transformative buy-and-build strategies or growth equity, which, she says, offers buyout-like returns without the need for high leverage

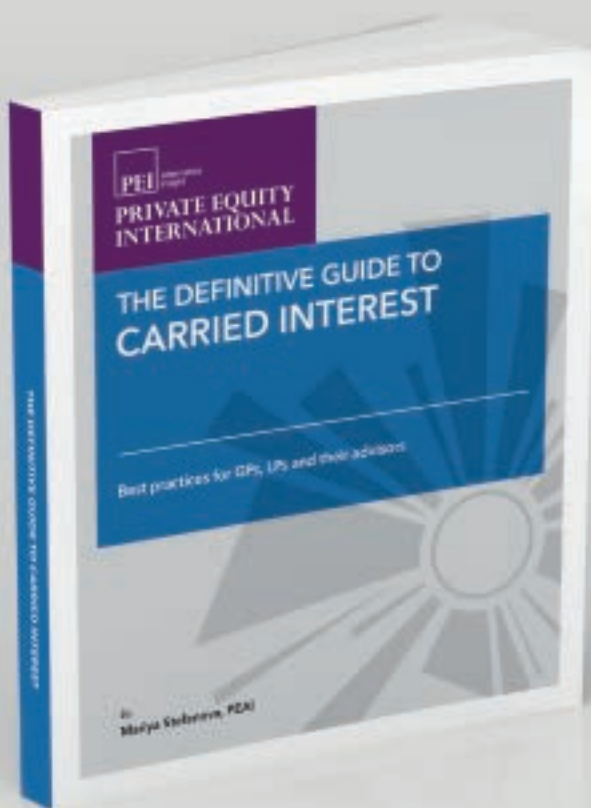
*“Very early processes that move at a lightning pace, metrics that require more and more scrutiny, harsh negotiations along the way: LPs have seen better days”*

**Jim Grossman**

CIO, Pennsylvania Public School Employees’ Retirement System

Grossman is responsible for management and administration of the investment program at the \$55 billion Pennsylvania Public School Employees’ Retirement System, which has a 16 percent target allocation to private equity. Recent commitments include \$150 million to Summit Partners Growth Equity Fund X, \$75 million to Sante Health Ventures III, and \$75 million to Sante Health Venture IV.

# The Definitive Guide to Carried Interest



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## What surprised you most in 2019?

**RK:** When an egg picture became the most liked photo on Instagram. Other than that and the ever sky rocketing prices for good quality assets, the need for GPs to be (too?) innovative in order to adapt to an overabundance of capital (minority funds, long term funds, buyout funds moving to growth).

**JG:** The performance of the US equity market.

**TC:** The strength of the bond rally and Fed rate cuts surprised me in 2019; I expected a much more neutral environment in both.

## What's the biggest challenge in 2020?

**RK:** Low growth, low yield, the tremendous growth of private capital, high valuation and volatility could persist for longer than planned. That's not an easy environment to invest into. I believe portfolio construction should be emphasised more than ever. Diversifying funds across sectors, deal size, investment thesis and consistent deployment across vintage years is key. Besides, GPs should prepare their existing portfolio for the clouds arriving on the horizon.

**JG:** The largest challenge for PSERS with a limited private equity budget for commitments is deciding which PE funds in the market to say no to. We have said no to some very promising funds in the market.

**TC:** The ability to navigate uncertainty – elevated valuations, election year, the trade war – will continue to complicate investors' ability to have conviction about any market/strategy or asset class.

## What are the most promising regions and strategies in 2020?

**RK:** The world is changing and there is no going back. Changes in the global trade framework, ageing of population, digital transformation, urbanisation that leads to an increasing usage of the sharing economy. Some sectors do have strong tailwinds which are usually fully priced. Rather than specific regions or sectors, above all, it's about selecting the best-of-breed managers. We expect returns to be diverse but the best performers will continue to do well.

**JG:** PSERS has had the best recent PE performance from our US funds. I continue to believe the best opportunity for PSERS is in the US, although we have some nice opportunities to invest in Western Europe too. Being a dollar investor helps currency-wise too with our US commitments.

**TC:** I expect there to be some pockets of value in certain US-focused asset-backed credit products.

*“GPs should prepare their existing portfolio for the clouds arriving on the horizon”*

## Finally, one piece of advice for GPs?

**RK:** LPs are increasingly looking beyond the financial performances and are aiming to have a positive impact on society at large through their PE commitments. The question now for a number of LPs is not whether a GP is capable of achieving a high multiple anymore. It's also about how this return is made and what or who it can impact. GPs should be strategic about that and not reactive.

**JG:** Don't get greedier with fund economics (ie, don't raise your management fee, drop your preferred return, etc).

**TC:** Put money to work, but don't feel pressured to do so. GPs/LPs get frustrated when capital isn't called as expected, but we should all be cautious. Patience will be rewarded. ■

## KEYNOTE INTERVIEW

# The return of the emerging markets



*Private equity investments in emerging markets tailed off in the wake of the financial crisis and were further challenged by currency trends. But there are signs of a return, says Debevoise & Plimpton partner **Geoffrey Burgess***

**Q How would you describe the risks and rewards for LPs of investing in emerging markets?**

There are a million ways to get exposure to emerging markets. Some limited partners get exposure no matter what they do because they invest in companies that have big interests in the emerging markets, and in fact almost every multi-national company today will have some level of growth or supplier relationships coming out of those markets.

That said, the general approach of most LPs is to invest across geographies and industries, as there is a need to balance and hedge in case the developed markets recede. That's when most LPs look to high-growth markets, as a place of much higher top-line growth in portfolio companies and poten-

tially much greater profit. Those emerging markets are not as fully developed as others, whether because there is a smaller middle-class population and less wealth, or because there is greater political risk or other risks. On the risk-reward spectrum, most LPs like to have some exposure to that end of the investing range.

At any given time, returns in a particular market may fall below the acceptable threshold and not be commensurate with the risks being taken. In Africa today, private equity returns are lower than they are in Western Europe (by some measurement), so there is higher risk but lower reward. LPs need to

look at countries or regions and if returns are low, they need to understand why that is and how it might change over time. The pendulum swings back and forth – it comes down to the supply and demand for good companies, and the supply of good companies in most frontier markets is pretty thin.

**Q Despite growing fund sizes, why do opportunities in some emerging geographies still appear to be limited?**

It is difficult to generalise. For example, people were really piling into India until six or eight months ago, but now that has slowed down, even though it is still a super healthy market. Africa slowed down about five years ago and I wouldn't say investors are yet increasing the investment pace, though they

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### Q Is there an argument for longer timescales for private equity in emerging markets?

Certainly, these days more and more people are questioning the standard life of funds, with an investment period of two or three years and then a hold period of seven to ten years. Many GPs would like that to be longer, because of course you can find and close a deal much faster in Sweden than you can in Sierra Leone, for example, so it makes little sense to adopt the same timescales for the two markets. A lot of funds get to the end of their lives, having extended as much as they can, without yet being in a position to make the returns to investors that they had anticipated.

Depending on the story, some investors will want to roll out or have some kind of structured secondary transaction in that situation. There is another time pressure compounding that, too, which is that if you think your portfolio company's currency is going to appreciate in the next couple of years, then it's going to be so much better to hold onto the asset than strictly observe the limited fund life.

We are likely to see more and more end-of-life restructuring opportunities in the emerging markets as a result. There have already been a number in India, and I think we will see more.

haven't taken their eyes off that market.

In some of the places I have been working, I would ascribe lower returns to currency variations. Certain countries had very strong currencies before oil and other commodity prices went down, but those currencies fell by as much as 20 percent against the dollar as prices receded. The impact was intensified by economic recovery in the US, such that suddenly the companies in those jurisdictions don't look so attractive to investors who are working in dollars.

The other reason is that when things were hot, prices got very high and it was hard to make big returns when you had paid a lot for certain assets. That's not to say there haven't been some excellent returns, because there have been, but it is a mixed story. There has been a dearth of interesting businesses that are being chased by ready capital such that demand has been outstripping supply, which has the effect of people either paying high prices or not deploying the money raised. I am speaking here of the whole market – there are many exceptions with very good GPs finding deals at reasonable prices.

### Q Is there a trend towards more LPs investing directly via co-investments in these markets?

Yes. Fifteen years ago, in many markets the only private equity opportunity was a minority investment alongside a family or a local industrial group. That model has evolved, so funds now have more opportu-

nities open to them today to take control, which means deal sizes have got bigger and funds have de-risked by removing the need to always work with a local partner.

If a private equity firm is buying 80-100 percent of a company, then there is more opportunity for LPs to co-invest, and LPs obviously feel more comfortable investing in companies where the GP has control. There were fewer co-investments in the past because LPs were weighing up going

in alongside minority stakes and the ticket sizes were smaller, but as the markets have matured into larger control deals, there are certainly more LPs interested in co-investment opportunities.

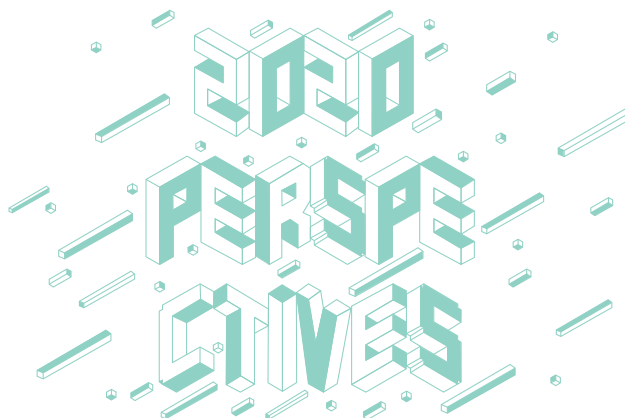
### Q How do you see the outlook for private equity into emerging markets in 2020?

I'm bullish on global growth in the long run, but I can't tell you if investors will put more into emerging markets in 2020 than they did in 2019.

From our perspective, we are seeing a lot of activity in Africa, I think despite the market. East Africa has been very interesting to people over the last five years, and West Africa is always going to be very interesting given the size of the Nigerian economy, which is seething with opportunities and resources. We are also seeing people looking at more deals in North Africa now, too, where things have been a bit quiet.

India has been very busy, and Russia is obviously interesting because of the sanctions imposed in the last few years following events in Crimea and Ukraine. Those sanctions have done a lot to improve the economic infrastructure in the country – Russia now produces a wider range of goods than it used to and there is more diversification of the economy and less reliance on foreigner suppliers. When that economy opens up again, it will be much more robust and there will certainly be more opportunities for investors. ■

*“People were really piling into India until six or eight months ago, but now that has slowed down, even though it is still a super healthy market”*



## Co-investments continue to be hot

*Institutional investors are changing policy and hiring more internal talent to increase their co-investments, writes [Preeti Singh](#)*

Co-investments have become a preferred method for investors to reduce management fees and maximise returns, but LPs also benefit from developing closer relationships with their GPs and flexing their diligence chops. Not surprising then that investors across private market strategies are aiming for more co-investments.

Nearly 59 percent of LPs plan to invest in co-investment opportunities, according to the *PEI LP Perspectives Survey 2020*. While only 26 percent of private debt investors plan

to participate in co-investment opportunities over the next 12 months, more private debt investors were interested in co-investment than last year.

Investors have reason to be bullish on co-investments. Alaska Permanent Fund Corporation is one of the few LPs to publish their co-investment returns; most investors blend them into total private equity returns. APFC's co-investment programme was delivering a five-year annualised net return of 61.5 percent, according to its latest annual report for the fiscal year ended 30 June 2019. But across the board, LPs affirmed

their co-investments had performed well. "Our co-investments have absolutely outperformed our regular funds. The deals we have been seeing have outperformed the funds themselves," Tamara Polewik, director, principal investments, private equity, Teacher Retirement System of Texas, said earlier this year.

Arizona Public Safety Personnel Retirement System's co-investments generated a net internal rate of return of 12.2 percent and a total multiple of 1.53x since inception in 2006, as of 31 March. Over the same period, the net IRR and net multiple of the

Do you plan to participate in co-investment opportunities in private equity over the next 12 months?



private markets portfolio was 9.95 percent and 1.3x, respectively, documents show.

There is plenty of activity afoot at both big and small pension systems. Some like New York City Public Pension Funds are building brand new co-investment programmes. Others, like California Public Employees' Retirement System, which suspended its co-investment programme in 2016, are re-focusing their attention on the strategy, while California State Teachers' Retirement System, Arizona PSPRS and Pennsylvania Public School Employees' Retirement System are expanding their co-investment programmes.

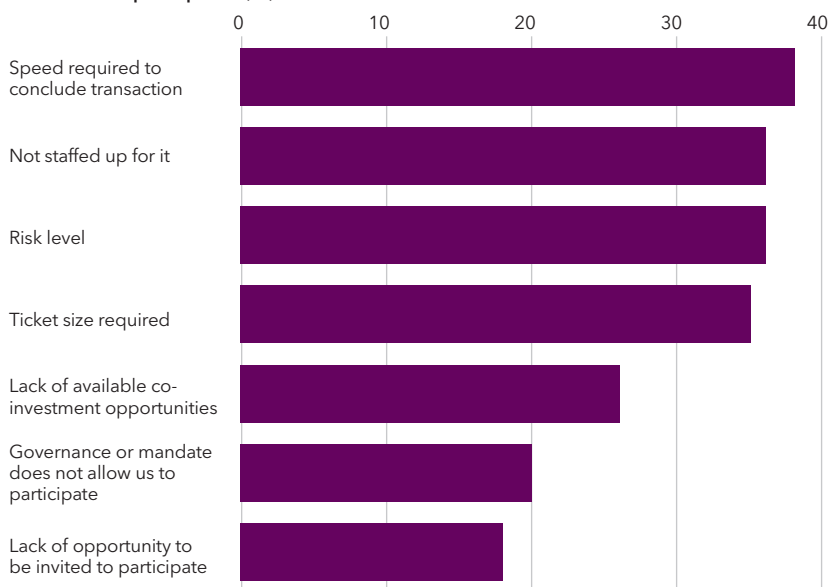
### Change to suit

Investors have made policy changes to become nimble and responsive to co-investment opportunities that often come with small windows for investing. For instance, speed is a critical issue in making co-investments; CalPERS' new policy states that for investments below \$100 million, staff do not need a prudent person opinion and discretion rests with the managing investment director. For co-investments up to \$200 million, staff needs chief investment officer approval or a prudent person approval.

Meanwhile CalSTRS made lots of changes to its co-investment policy in 2018. It can now make co-investments with managers across strategies instead of being limited to its private equity GPs. Importantly, CalSTRS can engage alongside general partners earlier in the investment process and commit to transactions with break-up fees. CalSTRS also increased the limits in the sizes of commitments made under delegation of authority to up to \$250 million and hired AlpInvest Partners to reach the smaller end of the private equity spectrum.

Similarly, South Carolina Retirement System Investment Commission also teamed up with an external manager, Chicago-based asset manager GCM Grosvenor, in July to ramp up its co-investment activities.

### Speed of transaction and not being staffed up for the opportunity are the most likely to hinder co-investment participation (%)



Source: Private Equity International

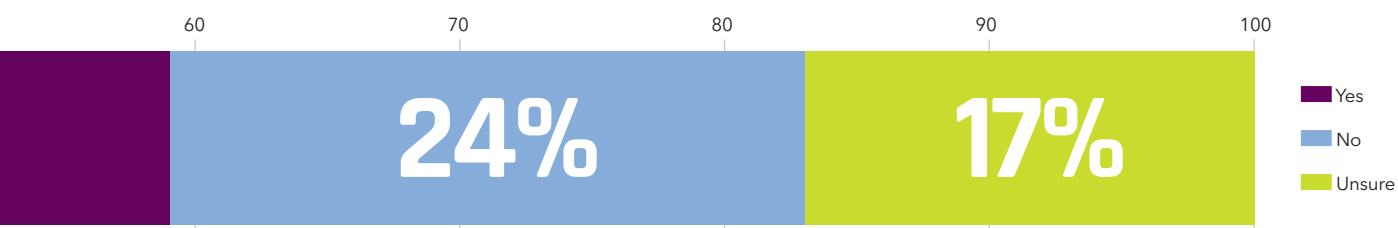
Teacher Retirement System of Texas' co-investing programme, that started in 2009, accounts for between 20 percent and 25 percent of the portfolio; the allotment is set to increase to 35 percent of the portfolio, according to Neil Randall, managing director, private equity. Likewise, Arizona PSPRS, which began its co-investment programme in 2008, is expanding its co-investment programme from 10 percent of its private markets portfolio to 20 percent. "We are scaling up our programme so that it becomes big enough to move the needle," chief investment officer Mark Steed says.

Investors are also expanding internal resources and enhancing skill sets to deal with co-investments. For instance, Texas TRS is doubling its team in the next three to five years to 30 investment professionals. The majority would be supporting co-investment work, Randall says.

CalSTRS and CalPERS also plan to hire more people for co-investments. CalSTRS

has eight senior staffers for private equity, and four of them are currently trained in co-investing, according to director of private equity Margot Wirth at the 30 January meeting. "We are not novices at co-investing and we are not new to the game by any means, but relative to our size we are leaving a lot on the table," Wirth said. "If we want to go from 10 percent to 20 percent co-invest, we would need to cross-train our team ... it's basically extending what we already have, scaling up."

Transaction speed and staff capacity, followed by risk level and ticket sizes, are the main factors that deter LPs from participating in co-investing opportunities. Still, LPs are not daunted by lack of opportunity to be invited to participate, which is the least likely to hinder participation. As supply and demand continue their upward movement, investors will gravitate towards opportunities that provide them with the ability to diversify, hedge against risk, and enable out-performance, according to the survey. ■





## KEYNOTE INTERVIEW

# Satisfying LP demands for transparency



*More complex reporting requests are increasing the compliance burden for private equity firms, says **Mark Law**, chief commercial officer at SANNE*

As institutional private equity investors flex their muscles, they are demanding greater transparency from general partners on a wide range of topics. Not only are they looking for more granular and specific data, but they also want the ability to access investment information on demand. This has led to increased outsourcing to service providers like SANNE, according to chief commercial officer Mark Law.

### **Q** What trends are being seen by private equity asset management?

We are seeing several trends: Buoyancy and resilience in the alternatives market; a rising number of private equity funds; and, the increasing popularity of VC, particularly in the US. We are encountering LPs who are increasing their allocations, and many large

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investors who are asking for co-investments and want to be more cooperative strategic investors with funds. Consequently, the use of leverage is trending down.

We are also starting to see the rise of secondary managers, and more groups selling secondary investments. Private credit is featuring more prominently as a way of diversification.

In terms of strategies, buy and build is becoming more common, and GPs are finding that this approach requires more active portfolio management. Technology is increasingly important as exits are being expedited by digital transformation and technology at all sorts of portfolio companies.

### **Q** How is the LP base changing and affecting the way GPs behave?

GPs and LPs are becoming more global and that is something everyone has to keep up with. There is increased investment in the US from overseas funds, with a growing interest in markets like China and Southeast Asia. The LP base is expanding globally and investors are looking for market diversification. Globalisation presents opportunities for SANNE to use its global reach and expertise across asset classes.

As the LP base expands, firms need people to ensure that companies and fund structures make the proper annual filings, are incorporated correctly, have the right constituents on the board of directors, and get audited according to the right timelines. In terms of investor services, LPs need to get reports accurately and on time.

## Q Are GPs equipped to meet more complex reporting requests?

The reality is that it is very expensive and it's a non-core activity, as it's not revenue generating for them. As they fight fee compression, one of the options is to outsource to providers like SANNE to handle the middle and back office responsibilities.

If you look at a GP's treasury, finance or COO function, its job is to support the investment team and the LPs. To perform all this reporting in house, they have to do a lot of additional things. They need to keep pace with complex regulations that cross many jurisdictions; they have to keep pace with latest accounting principles, whether that's generally accepted accounting principles (GAAP) or ILPA reporting; they need to handle HR issues and keep technology up to date; and then they need to deal with auditors for the annual financial statement. That's a lot to manage while the fund is making investments or looking to attract LPs around the world.

This is before we even factor in investor views on outsourced providers. As LPs are getting larger and more sophisticated, they want transparency and appropriate segregation of duties. That's compelling them to request things, such as carried interest calculations, financial statements and NAV calculations, to be outsourced.

## Q Where do you see transparency going in the future?

Fee validation is becoming a critical issue. Investors want to ensure GP fees meet the LPA terms. LPs realise they have significant influence and will likely continue to challenge fees, particularly when performance might not justify high expenses.

For the GPs, it is very important that they maintain transparent dialogue with LPs about the costs of running their businesses. LPs are not being unreasonable – they don't want management fees to be a profit centre, but they do want to ensure the manager can support the appropriate infrastructure.

Self-service reporting will become more common as LPs will want information outside regular reporting times. Being able to access a portal and download the latest financials is going to be more important.

## Q Can you give an example of how service providers are adapting to those changing needs?

One example is our strategic investment

## How are investor demands changing as the industry grows?

**Investors' core demands stay the same: Returns. But we are seeing evolution in management fees, transparency and reporting as those are the top contemporary investor demands for GPs to keep pace with.**

GPs are accommodating institutional investor calls for additional disclosures and fee breaks. Fees are already under competitive pressure, and we see further pricing pressure on margins across all alternative asset classes, including private equity.

Another topic on the rise is ESG reporting. This is not new – it was initiated largely by the big public sector LPs – but it is becoming more mainstream. The challenge with ESG reporting is that there is no one size fits all approach. As the field develops further we will get all the right data points to meet this evolving demands, such as carry linked to ESG reporting.

into a company called Colmore, which has developed a technology solution in response to LPs' needs to monitor and validate fees. They collate multiple data streams from LPs' investments to actively produce reports that monitor and validate fees as part of ongoing LPA compliance and best practice.

It's really exciting for us as it's pushing out the added value capability not only to LPs, but also GPs. We are working with the Colmore team to tweak their offering so that GPs can use it as well. Managers who want to attract institutional money – especially large, public sector investors – and benefit from the cachet that brings,

will need to provide this reporting. It's a fair trade.

In addition, we are also working on our own portal, this is probably the most outward thing clients will see. The portal will allow much more self-service access for both LPs and GPs, providing them with transparent access to information whenever they want.

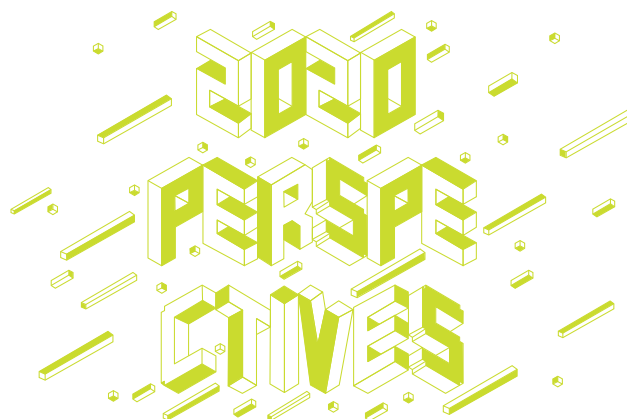
## Q How important is the technology element to the service you provide?

Technology is very important but we try to ensure that it is largely unseen by our GP clients. Technology is not the object; the object is to deliver reporting accurately and on time.

We deal with significant amounts of data that needs to be gathered, classified and then processed. In the background, we are working on workflow management to keep track of all the data that goes out to our various teams. If there are any manual processes, they either need to be automated or be exceptionally controlled. We are investigating robotic process automation for rules-driven jobs that are repeatable and can be done by a bot.

But just as importantly, we need to have the right people. We recruit qualified accountants with relevant industry experience. Technology frees up their time to deliver more value-add services. Our clients look to us for stability and a partnership approach – they need to trust us and use us as part of their extended teams. Our company culture needs to gel with the GPs. ■

*“As LPs are getting larger and more sophisticated, they want transparency and appropriate segregation of duties”*



# The more things change...

*Industry players say fee transparency has been increasing. So why are more LPs asking for more of it? [Graham Bippart](#) reports*

Something is eating at investors' patience with their GPs. Management fees appear to be in line with, or better than, the historical average of 2 percent. Management fee offsets against other fees can range up to 100 percent. And transparency and disclosure of various fees has generally increased in recent years.

Yet 73 percent of LPs in this year's survey say the fees charged by private equity funds are difficult to justify internally – up from 63 percent last year. And management fees once again top the list of fund terms that cause the most disagreement with GPs when conducting due diligence.

## A fee minefield

So what's going on? In part, industry players say investors continue to get miffed about

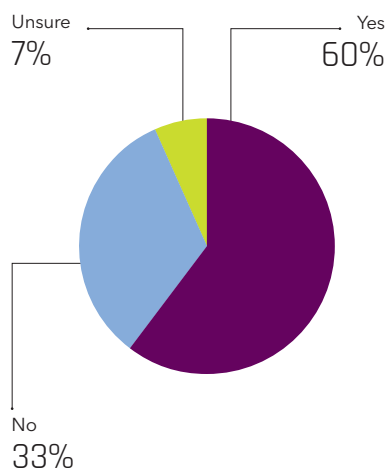
*"I'm sceptical about the industry adopting [the ILPA model LPA] on a large scale"*

**CHRISTIAN KALLEN**  
Hamilton Lane

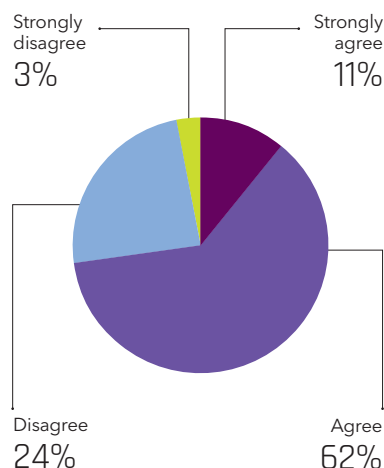
fund sizes growing, resulting in ever-increasing management fees in absolute terms coming out of private equity funds. And as limited partnership agreements get longer and more complex, some LPs may be getting exasperated trying to find out exactly what's what. That may illustrate why, even though many industry players say transparency and disclosure has improved, 60 percent of LPs – down from 65 percent last year – still say they have asked their GPs for more of it in the last 12 months.

There's more transparency, but more complexity, too. "LPAs are often written in code," says Eamon Devlin, partner at MJ Hudson. LPs are constantly just trying to catch up with changing fee definitions, he says. While two LPAs may charge the same rate on the same nominal service, the definitions of those services often differ from LPA

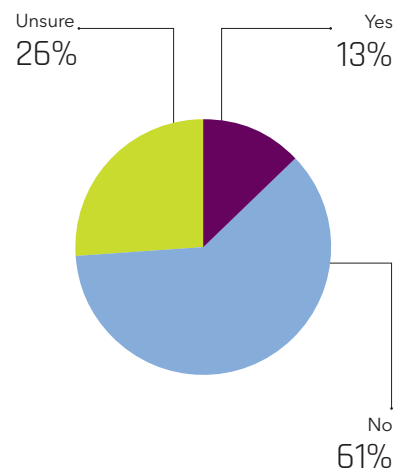
Have you asked for greater fee transparency and disclosure from your GPs in the last 12 months?



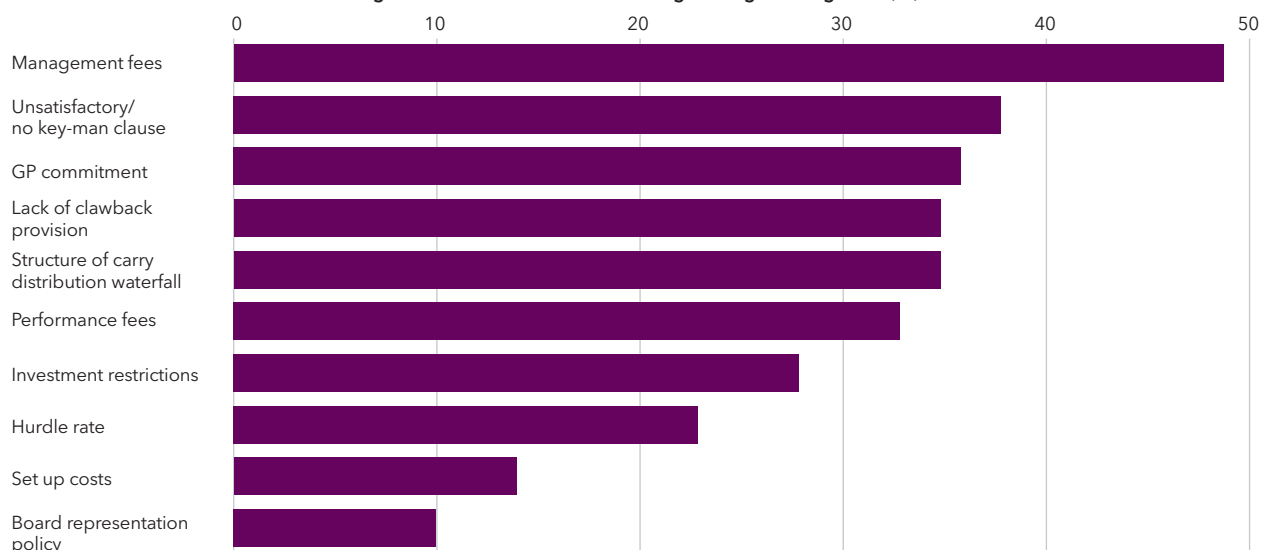
To what extent do you agree that fees charged by private equity funds are difficult to justify internally?



Over the next 12 months are you planning to seek external help when it comes to fee validation?



Which three LPA terms cause the most disagreement with GPs when conducting funding due diligence? (%)



Source: Private Equity International

to LPA, making it difficult to quantify exactly what is being paid for out of the funds.

And LPs are more aware of just how much money is being made from their investments. The trend in recent partial management committee sales illustrates how profitable they are, Devlin says. But it isn't just uncapped management fees galling investors; it's also revenue GPs are making off related business. "That's definitely a sore point," says Tim Selby, partner at Alston & Bird, speaking about GPs generating commissions off portfolio companies, which

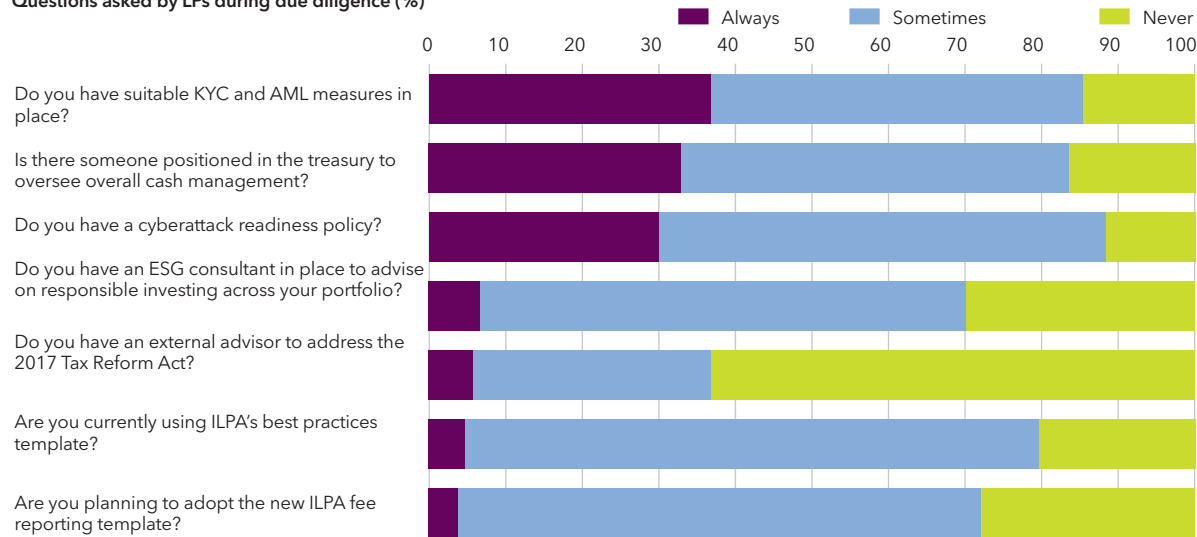
may not flow back into the fund. "The investment manager is using their investment dollars to get outside business opportunities ... those should offset management fees."

All this may go towards explaining why, even if LPs want more transparency on fees, 61 percent are still not likely to seek external help for fee validation. True, it is a new phenomenon, and many market players still do not even know what such a service might entail – though the California State Teachers' Retirement System did exactly that, seeking to better understand whether the fees it pays

## The CFO view: What LPs really want

**Our latest CFO survey reports a rise in due diligence requests from LPs as fund sizes grow**

Questions asked by LPs during due diligence (%)



Source: Private Funds CFO Insights Survey 2019

This year has been another bumper year for fundraising – and that means dealing with more investors. At the same time, those investors are seeking more information and demanding greater detail from GPs, suggests the *Private Funds CFO Insights Survey 2019*.

For the annual survey we polled 124 US fund CFOs in July and August 2019. Two thirds of respondents – dominated by mid-market firms with vehicles in the \$100 million-\$500 million bracket – expect their next vehicle to be larger than their current fund.

More transparency is increasingly important to LPs, according to survey respondents. LPs are “generally asking for more transparency into fund information”, said one CFO. Another elaborated that LPs also want transparency into “track record, reporting quality, and safety of electronic data”.

On due diligence, roughly a third of respondents reported that investors always ask about know your customer and anti-money laundering policies, cash management oversight and readiness for a cyberattack. Demonstrating good governance is clearly key.

But performance and track record data remain, unsurprisingly, the core requirements for LPs: Paramount to LPs are, “one, consistency of returns; two consistency of team, including next generation succession; and three, consistency of strategy and how you execute against that strategy, ie, – LPs do not like to see strategy stray”, one respondent said.

During due diligence, LPs like to interact with the CFO in person. The proportion that always demands to meet the CFO is rising (16 percent), while a solid majority (72 percent) sometimes ask. “Operational due diligence has increased greatly over the past few years too,” said one chief compliance officer.

are in line with the LPA terms. But also, investors don't just want more transparency about what's taking place in the fund, they want to know what's happening outside of it, too.

“These are all truly related-party transactions, whether it's within the fund or outside of the fund,” says Jeffrey Rosenthal, partner at accounting firm Anchin, Block and Anchin. That's leading to greater scrutiny of all a GP's revenues by regulators, auditors and investors alike.

After management fees, at 49 percent of respondents, LPs said the terms that caused

the most disagreement with GPs were unsatisfactory/no key-person clauses (38 percent), the GP commitment (36 percent), lack of claw-back provision (35 percent) and structure of carry distribution waterfall (35 percent) – all fairly consistent with last year's poll.

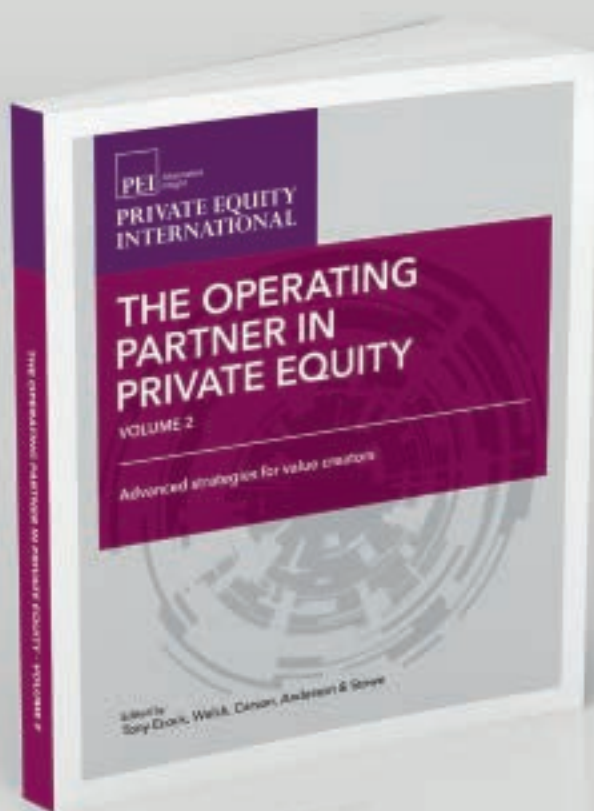
### Levelling the field

To an extent, the level of improvement in various fund terms may depend on an LP's industry weight. And since LPs do not know who else is in the fund, it is near impossible to tell whether they are getting

good terms relative to their peers. To that end, in October the Institutional Limited Partners Association introduced a model LPA that could help level the playing field and make fund terms more consistent.

Unfortunately for LPs, the model LPA is not getting a lot of traction with private equity funds and their lawyers, although it is still early days. Christian Kallen, managing director in the fund investment team at Hamilton Lane, says the model LPA would be great for the whole industry. But, he added, “I'm sceptical about the industry adopting it on a large scale.” ■

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## KEYNOTE INTERVIEW

# Preferred equity: A flexible form of leverage



*Adapting the balance sheet of the investor to the various risk profiles of the underlying assets makes a lot of sense, says **Pierre-Antoine de Selancy**, managing partner of 17Capital*

**Q There's a marked change taking place in the way LPs construct their portfolios. What are you seeing?**

Institutional investors are increasingly trying to think outside the box. They are trying to find new areas, white spaces between markets. That's a really interesting change and relatively recent.

17Capital does not chase the same returns as a secondaries fund and we don't have the same features as a credit fund. We sit in the middle, providing fund managers and investors with flexible leverage in the form of preferred equity. In the past, most of our investors have had to put us in a space that was not pre-allocated – we're not a buy-out fund, we're not a secondary fund and we're not a pure direct lending opportunity. More and more we are working with inves-

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tors who have the capacity to create that catch-all allocation.

**Q What form does this allocation take and which other strategies might be included?**

There are many more opportunities that fall between markets. Institutional investors will increasingly have what might be known as 'alternative alternatives', or 'alternatives square'. They might put us in with the hedge fund portfolio, next to reinsurance or next to litigation funds.

It's really the pensions that are driving this. They have so much pressure to deploy

capital that they have to be very creative. They have to find places with less competition, where there is less institutional money flowing in. The Canadians have always been ahead of the rest of the industry, alongside some US pensions and endowments.

**Q What role does 17Capital play in the preferred equity market?**

The secondaries market is for people who are looking to sell; we tend not to work with sellers. We work with people that want to keep their portfolio and improve its capital structure. In a private equity portfolio, you will have different levels of risk in each of the underlying companies. Some will be fairly mature and are ready to be sold in 12-18 months. Some will have been acquired more recently and come with much

higher development risk. Adapting the balance sheet of the investor, whether it's a fund or a limited partner, to the various risk profiles of the underlying assets makes a lot of sense.

We've been operating for 12 years now and done 50 transactions, 23 full exits already. We've seen over \$10 billion of deal-flow last year, to give you an idea of the size of the market. And we see growth of 20-30 percent every year. The more players you have in the market, the more awareness grows among investors.

**Q How has the typical preferred equity deal evolved since you formed in 2008?**

Some of them look very similar [to how they did then]. Some clients we have worked with two or three times and we even use the same legal documentation. But we try to innovate and find more ways to be helpful to clients. Being helpful means providing the right amount of capital, making it available in the right way and having the right level of flexibility over time. In one transaction, we actually managed the portfolio on behalf of an investor. They had a very small team and did not want to sell. You need to understand why the transaction is taking place and what the driver is.

I don't think you can define a transaction by the legal documentation. It is defined by the level of risk taken and the type of return it should deliver for the investors. You can do preferred equity transactions with a 25 percent target IRR, where you take a lot of

*"The Canadians have always been ahead of the rest of the industry, alongside some US pensions and endowments"*

risk. You could have a big senior piece on a portfolio of venture assets. That's not what we do but it can work out very well.

**Q Has the point in the cycle had any impact on the needs of potential clients?**

We've started to see some institutional investors thinking, 'there might be market turbulence ahead.' Some of these managers remember 2009 and it was not a pleasant experience. If you were an LP with a portfolio at the limit of your exposure, it meant that you had to sell. All the people who bought then made a lot of money. People that remember these times want to have in place a structure where they can access cash just in case. It's not a trend yet – it probably accounts for a quarter of deals we see – but we are working more and more with limited partners in that direction.

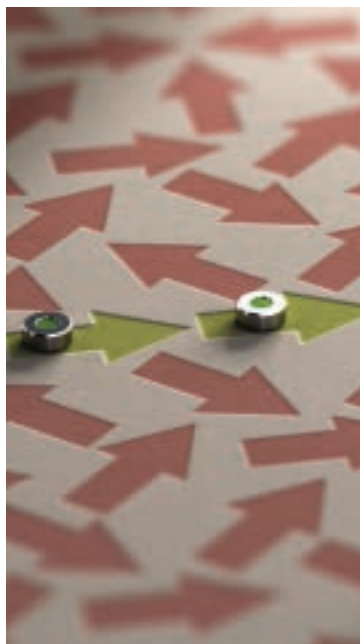
You don't want to wish for a downturn but would we be ready? Yes. At the very beginning we were focused on solving problems and helping people to not have to sell. Today it's much more focused on funding growth, but it can shift back.

**Q How do you see the attitude of LPs towards preferred equity developing?**

If you look at the ways in which companies held by buyout funds are funded, they will have short-term working capital, long-term equity, asset-backed financing, high-yield or convertible debt. There's a wide range of tools available.

One level up, among the shareholders, it is strikingly simple. It's long-term equity and sometimes a little bit of leverage. We are bringing tools that are already used at company level into the private equity industry. In the medium and long term, the prospects are massive.

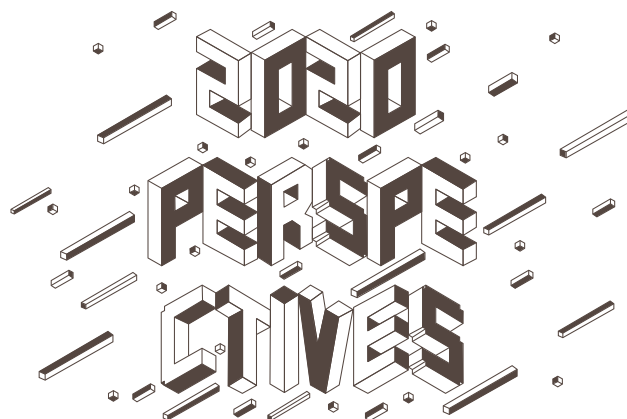
I met with a pension plan in the US a couple of months ago. The LP started by saying, 'we've been looking at your space for a few years now and we like it'. I did not even know it was already a 'space' for institutional investors. But they decided, in the same way that Dyal Capital and Peterhill created an interesting part of the market, we are part of the same development in helping the industry improve its capital structure. I think a lot of institutional investors see that and will make room available for it. ■



**Q How do you ensure alignment in preferred equity deals?**

If you're putting leverage on a portfolio, you need to make sure that you are creating more value for the cost and that the deal driver is healthy. The world of private equity is built on leverage. It's a tool everyone knows intimately. You only use leverage if the value you can generate is higher than the cost of that leverage. Otherwise you should not do it.

People we work with are increasing their exposure. They take our money because they want to invest more in their next fund. It's a form of leverage in that it's increasing their commitment, and it reinforces the alignment of LPs and GPs. We don't claim to be cheap but we are the best and most relevant for good investors.



## ESG and diversity yet to take centre stage

*Few LPs are prioritising sustainability and a lack of gender balance in GPs is rarely a deal-breaker, writes Ben Payton*

ESG and diversity are rarely out of the headlines these days. It feels like almost every fund manager boasts of ESG considerations being part of the firm's DNA. But our latest *LP Perspectives Survey* reveals a minority of institutional investors consider ESG and diversity as central concerns when deciding on investment opportunities.

Just 31 percent of LPs say evidence and consideration of ESG form a major part of their due diligence process – a figure that has decreased from 39 percent last year. Half of respondents said ESG formed only a minor part of the process, while 19 percent claimed not to consider ESG at all.

Part of the problem may be that there is no standard way to measure ESG outcomes across the industry. In the absence of a clear framework to benchmark fund managers' performance, LPs lack an obvious starting

point for integrating ESG into due diligence – beyond undertaking 'tick box' exercises. Speaking on a panel at the Spanish private equity and venture capital association ASCRI's Forum in London in October, Maria Sanz Garcia, managing partner of Yielco Investments, commented that "the quantitative side of this is very thin," and that the way forward is for funds to have measurable goals on specific ESG measures, such as energy usage.

Meanwhile, the traditional interpretation of fiduciary duty favoured by regulators in the US can deter LPs from prioritising any factor other than financial return. Vadim Avdeychik of the law firm Paul Hastings told *PEI* in November that "there is very little specific regulation whatsoever" on ESG in the US, but guidelines for public pensions plans mandate they focus on maximising shareholder returns rather than addressing ESG policy goals. But, says

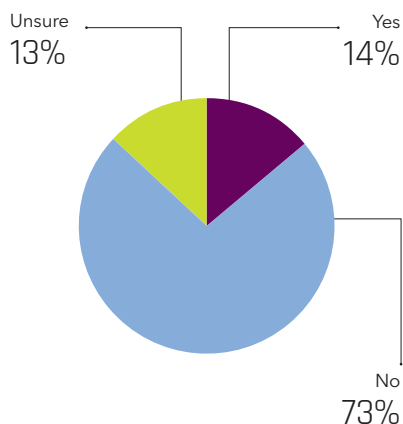
Avdeychik, "what we have seen in Europe is almost the complete opposite," with an increasing volume of regulatory proposals that would require both investors and managers to undertake greater reporting on ESG measures.

### Diversity dilemmas

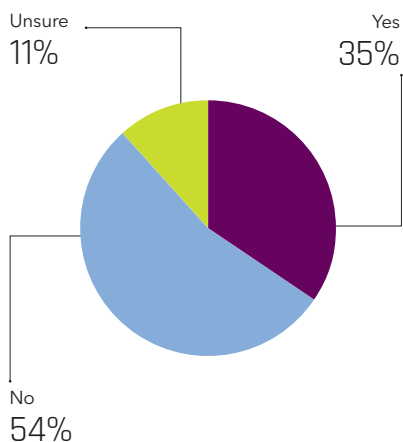
Responses on diversity are similar; it forms a major part of due diligence for only 23 percent of LPs. And for every LP placing diversity at the heart of due diligence, there is another not covering it at all. For 55 percent, it is a minor factor.

Nevertheless, 35 percent of LPs say they are actively encouraging fund managers to promote gender diversity and some, albeit still a minority, are prepared to walk away from GPs that do not reflect their values – 14 percent of respondents report they have refused an opportunity due to a lack of diversity at the fund manager level.

Has your institution ever refused an opportunity based on a lack of diversity and inclusion at the fund manager level?



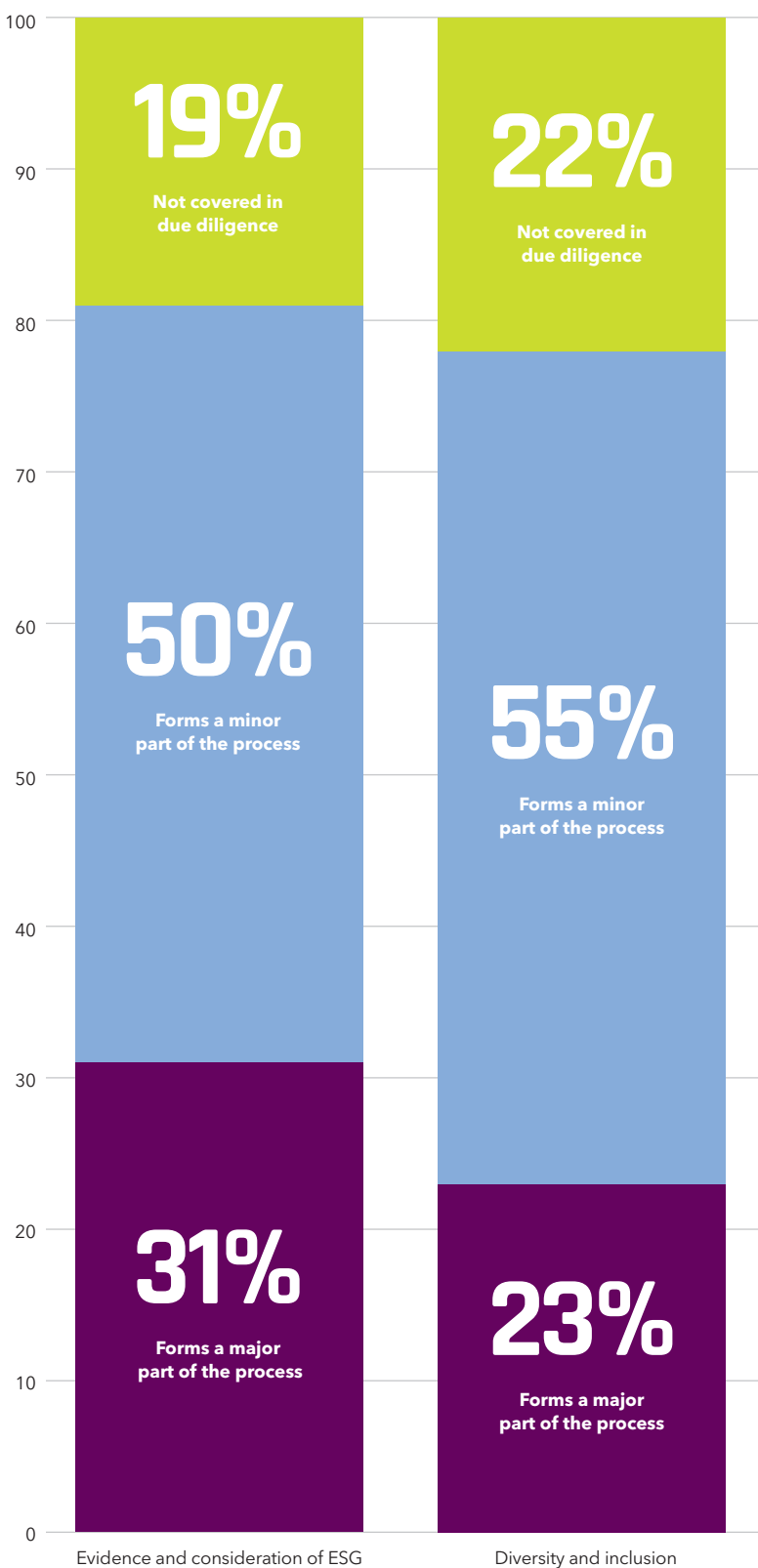
Do you actively engage your fund managers to promote gender diversity and inclusion?



At PEI's Women in Private Equity Forum in November, delegates largely agreed LPs will ask questions about diversity but are generally reluctant to pull the trigger on withholding an investment based on diversity factors. Brunel Pension Partnership, for example, considers diversity when grading managers on sustainability, but Gillian de Candole, an investment principal at the pension, told the forum that while a lack of diversity can leave a manager with a lower overall score, alone it wouldn't stop a commitment.

Anamica Broetz, head of business development and strategy at DWS Private Equity, says LPs are not doing enough to use their influence to push investment teams to become more inclusive. "The pain point is at capital. If LPs start to say 'no' to teams that are not diverse enough, I think we're going to start to see a lot of change very quickly." ■

ESG and diversity are typically secondary factors in due diligence (%)



Source: Private Equity International

## KEYNOTE INTERVIEW

# How tech can unlock private markets



*eFront's Tarek Chouman explains how data and information exchange powered by technology will open the door to increased allocations to private markets*

When challenged for detail on metrics like portfolio valuation or processes such as asset selection, to excuse the lack of information available, it is not unusual to hear managers give the time-worn response: "Well, private markets are private." eFront chief executive officer Tarek Chouman does not agree. He explains how a lack of transparency is hindering data availability, inhibiting information exchange, and ultimately squashing the potential for private markets to grow.

**Q How would you describe the current private market operating model?**

Private markets today are, without exaggeration, around 20 years behind public markets in terms of sophistication and transparency. The industry is inefficient and unstreamlined. It needs to change the way it does business, particularly in the adoption of technology to improve reporting, boost

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communication between LPs and GPs, enhance the availability of data, and generate analytics. The difference between private and public markets is like the difference between haute couture and prêt-à-porter, but even haute couture has begun to embrace innovations from ready-to-wear fashion.

**Q What are the implications for private markets of failing to apply new technology to systems and processes?**

If managers want to capture a bigger chunk of the available LP capital, they need to address the sophistication gap. Private markets are definitely growing. That's obvious when you look at the money flowing into them and the number of fundraisings and new entrants.

It's in full thrust. However, private funds still account for less than 10 percent of global AUM. LPs are not reaching their allocation targets. There's huge untapped potential and opportunity to expand. But, lack of data tools and risk management mechanisms are enormous hurdles. When you don't know where you are putting your money, you will always be somewhat reluctant to invest more. If LPs want to increase a 5 or 10 percent allocation to 20, 25 or 30 percent, they can't make a mistake. They need a clear view of the risks and rewards, and to be able to weigh them against each other.

**Q Where are the main bottlenecks constricting growth?**

First, the way GPs and LPs communicate. Most GPs still email a PDF report to their LPs every quarter. The most sophisticated may upload the same report to a portal for LPs to download. This means LPs only re-

ceive news about their holdings every quarter – and even then there is a possible time lag of around two to four weeks necessary for the GP to collect and process the information. Compare that with public markets where investors receive information in nanoseconds via digital formats. The second obstacle is access to data. An LP invested in a fund or series of funds has to really dig to obtain specific data on its private markets portfolio, let alone apply analytics to it.

### **Q What is the role of technology in bringing private markets up to public market standards?**

It can help the industry achieve more transparency, better risk management, increased automation of information exchange between LPs and GPs, and in general, enhance the ability of LPs and GPs to be more creative and sophisticated. Importantly, data is delivered on time and is therefore relevant.

At the basic level, whether an LP is investing through funds, directly or co-investing, software can facilitate the collection of diverse types of data that describe not just a portfolio company's financials, but its potential and its constraints. An LP can better monitor and compare its funds including fees and carry, GP performance, and manager benchmarks both within a GP and across multiple funds.

### **Q Where is the drive to change coming from?**

Mainly from LPs. Using the latest technology is critical for good portfolio management and obtaining enhanced returns based on smart analytics, as well as for meeting reporting obligations. GPs are also under pressure to change their practices as they seek to raise ever-bigger funds. Additionally, there is regulatory pressure from the SEC and industry bodies like the Institutional Limited Partners Association to up the volume, rigour and detail of reporting to LPs.

We observe and enable the growing level of complexity of private markets in our solutions. Take our eFront Invest platform for example, which supports LPs, GPs and asset servicers to manage fund operations and reporting. The typical number of LPs committing to a decent-sized, reputable fund used to be around 50.

Today, when we look at the new breed of funds supported by our platform, the average number of investors is closer to 300 LPs per fund. To send 300 LPs a simple call

### **Q Are more GPs hiring a chief technology or information officer?**

Depending on their maturity, many GPs are hiring a CTO or CIO. It's becoming a no-brainer for them to employ someone with a perspective on the right technology and processes that serve the business' needs. The bigger GPs are also investing in a separate position of chief information security officer to support the CIO. Together they ensure that the IT infrastructure is shielded from external threats and that the technology is up to date, reactive, scalable and fast. Those roles are privileged interlocutors for a service provider like eFront, and they appreciate the level of service and functionality we can provide.

*“Private markets today are, without exaggeration, around 20 years behind public markets in terms of sophistication and transparency”*

notice, the GP needs an automated process. A manager can't do it over a weekend using Excel. Completing such a task manually creates 300 chances to make a mistake, like sending the wrong document to the wrong LP. Similar hurdles exist on the LP side. Such a state of affairs is not sustainable.

### **Q How fast is technology evolving for LPs and GPs?**

Industry participants are already surrounded by new technology, starting from their mobile phone to their TV. They are moving at a fast pace. Failing to adopt technology is likely going to exclude those GPs, LPs and asset servicers who lag behind.

### **Q How quickly can private markets catch up with the listed space?**

The ramp-up will be faster than with public markets, simply because private markets can measure themselves against those existing benchmarks. If today we are 20 years behind, in five years we should only be 10 years behind. But remember, private markets will be growing against a moving target. eFront together with BlackRock's Aladdin technology is best positioned to drive this convergence between public and private technologies.

### **Q How do you think the back office will develop?**

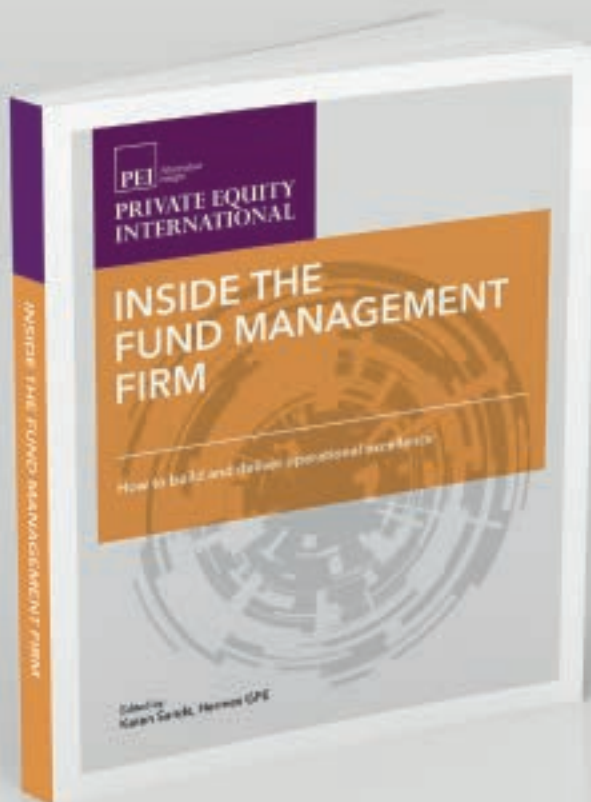
In the future, we believe, GP back-office staff will shift focus and work increasingly on the analytical side of the business and less on producing reports, sending emails, or generating financial statements. Employees will be more client-facing and involved in decision-making tasks.

### **Q What obstacles still remain?**

The challenge is to move to a new world where managers and investors are open and connected while retaining the market's uniqueness and level of returns. Some GPs are afraid of revealing their “secret sauce”. We believe transparency and openness demonstrate strength, not weakness. On balance, the value of using more sophisticated technology and automation far outweighs the costs – as we have seen with our eFront Invest and eFront Insight platforms. Technology adoption in order to enable easier information flows between investors and managers is a win-win for all, and a requirement to make alternatives less alternatives, which is eFront's mission. ■



# Inside the Fund Management Firm



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## Q&amp;A

*Jennifer Choi, managing director of industry affairs for the Institutional Limited Partners Association, shares advice for smaller LPs and thoughts on fee transparency, and discusses recent and upcoming ILPA initiatives*

**Q How do you think smaller LPs, one- to two-person shops and the like, should be navigating the investment landscape as demand for private equity exposure continues to grow?**

Based on the strategies for success that a lot of our smaller members employ, I think it's crucial to know your organisational priorities and where you will play well in the market, both in terms of getting allocation but also in erecting relationships with GPs that feature strong alignment of interests. In short, pick your spots, know yourselves, know your priorities. When our smaller LP members can be important to the GP, the relationship and the alignment are inevitably stronger. That will sometimes correspond to the size of the fund, and sometimes to the maturity of the franchise.

**Q How do you see the conversation around fees evolving over the coming year?**

We continue to see elevated interest among LPs for greater transparency and consistency of presentation of information around costs. LPs are requesting the ILPA template on fees, expenses and carried interest, and even where they're not successful, they continue making that ask. Moreover, LPs that are now receiving more consistently presented information are now contemplating how best to utilise that data, both to make better investment decisions internally as well as to achieve enhanced monitoring of their portfolio.

**Q ILPA has been busy in 2019 with the recent release of the model LPA and principles 3.0. What feedback are you getting from the market on these initiatives?**



*“It’s crucial to know your organisational priorities and where you will play well in the market”*

Industry response has been phenomenal, and very positive. We tried to be as transparent as possible about our intentions for both the Principles and the Model LPA, and had realistic expectations as to the impact on market practices. But in the last few days alone, I've heard from several of our members and some GPs that the ILPA Model LPA is entering the conversation during fund negotiations. We're delighted to hear that it's recognised as a value-added resource.

**Q What's on the horizon for the coming year? Any major initiatives that the team is working on at the moment?**

We at ILPA like to keep busy, and we have several initiatives in motion at present, which we believe will deliver value to our members and the industry. First is an aggregated set of resources for the LP community around integrating ESG into their investment processes.

When it comes to ESG, there's no one size fits all, so we set out to identify a roadmap and associated resources that could be useful for different LPs as they move along their own ESG path.

We are also drafting follow-on recommendations tied to our 2017 guidance on subscription lines of credit, specifically on standardised disclosures to LPs. We believe this will spark an even more transparent conversation about the impact that subscription lines of credit have on the presentation of fund performance.

Last but certainly not least, there is some really wonderful work taking place now around diversity and inclusion across the industry. At ILPA, a task force of our members is creating a framework for both LPs and GPs that identifies an array of specific actions and related resources to support the implementation of diversity and inclusion initiatives.

The resulting toolkit of resources will touch on recruitment, retention, culture, training, policies, and evaluation of diversity and inclusion initiatives. The framework and toolkit will be made available in early 2020, and we will build on it over time to recognise the worthy efforts taking place across the industry globally to advance diversity and inclusion. ■

# LP points of view in 2019

*“I tell everyone here, ‘You can’t name the lobsters, because if you name them you can’t cook the lobsters.’ We are maniacal about not having these biases about managers”*

**Mark Steed**, CIO at Arizona PSPRS, says investors should not be getting too close to GPs

*“I think there will be a time when the industry realises diversity is a competitive advantage and we’re going to see that become commonplace. It may take a while, but I think it’s a business issue”*

**David Enriquez**, head of private equity at New York City Retirement Systems, believes diversity leads to better decision-making

*“I can’t stress strongly enough that we are long-term investors. We make decisions based on an investment horizon that stretches across years and even decades”*

**Ben Meng**, CIO at CalPERS, stresses the importance of taking a long-term view of investing

*“It is crucial for us to understand the accurate size and risk associated with our outstanding commitments, not least in a situation where this world isn’t going to be as rosy as it has been lately”*

**Torben Vangstrup**, managing partner at ATP Private Equity Partners, explains the importance of getting granular on GP credit line use

*“I’d rather go back to the days of private equity investors just being private equity investors”*

**Gary Bruebaker**, standing down as CIO of Washington State Investment Board, is not a fan of GPs launching multiple strategies

*“It is hard to see any economic reason why GPs are willing to do co-investments; undoubtedly, a GP will choose full fee and carried interest as compared to very little returns, if any, on co-investments”*

**Allan Emkin**, managing principal at Meketa Investment Group, does not see GPs making fee-free co-investment part of their long-term plans

The background of the advertisement features a dark blue field with a pattern of light blue dots and thin, curved lines. At the bottom, there is a blurred image of a city skyline at night, with lights from buildings and streets visible.

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