

GP RELATIONSHIPS (P. 37)

FEES & TERMS (P. 34)

RETURNS EXPECTATIONS (P. 38)

NO TAIL-ENDS (P. 40)

NON-FUND INVESTMENTS (P. 39)





LP of the future

Fund managers are not the only ones who will need to remodel the house to take on future investment challenges. Over the next decade sophisticated limited partners will be ratcheting up the home improvements in a bid to generate the best returns. By *Isobel Markham, Alex Lynn and Rod James*

What will a typical private equity limited partner look like in 10 years' time? Will closed-ended fund investments still play a prominent role in its portfolio, or will co-investments, direct investments and separately managed accounts take the lion's share? Will it still be willing to pay management fees to GPs? Will it have finally broken down the transparency and disclosure barriers it has been chipping away at since the global financial crisis? Will 'limited partner' even be the correct way to describe it?

Over the past decade we've seen a shift in the way investors act. The industry's most sophisticated investors began it as 'limited partners', with the emphasis on 'limited', accessing the asset class almost exclusively through commitments to primary vehicles or funds of funds and whose relationship with GPs is restricted to writing a cheque. Now the emphasis is

on 'partners' as they team up with fund managers on more of a level footing. They position themselves as strategically valuable, bringing sector expertise, industry contacts and even, on occasion, a viable exit route. It's not a stretch to imagine that in the next decade the 'limited' might disappear altogether.

The rapidly evolving needs of investors are evident in the increasingly creative solutions being put forward by fund managers: innovative management fee and carry structures, long-dated funds and funds of firms, to name a few.

At the heart of these changes is the need to generate consistently strong returns in an increasingly challenging investment environment. From surface improvements to full-scale renovations, over the next few pages we walk through the transformations limited partners have in store. GPs, take note.

FEES & TERMS

What we do in the shadows

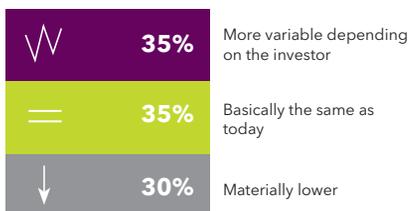
A trend away from high fees has already started to take its toll on some parts of the market. Funds of funds have declined in popularity in recent years, with capital raised for this strategy dropping to a 10-year low of \$11.4 billion in 2017, according to PEI data.

The desire for LPs to cut costs and thus boost returns has sparked a shift towards more customisable fund models, or ‘shadow capital’. A particular favourite of the LP market is separately managed accounts, with Paris-headquartered Ardian among those reporting increased appetite from its investors.

“If you look at the phrases ‘limited partner’ and

INTO THE FUTURE

In five years, fees for PE structures will be:



Source: Hamilton Lane Private Markets Survey Class of 2016

‘general partner’, those will become not fit for purpose in the future,” says Eamon Devlin, managing partner at fund lawyer MJ Hudson. “It presupposes that your relationship is in a fund, and there’ll be a lot more shadow capital in the next 10 years, which is not a GP/LP structure.”

This movement will be further bolstered by increasing consolidation of LPs, Devlin adds. In the UK, 89 local government pension schemes have already been grouped into eight pools of assets to improve transparency, boost returns and bring down administration costs. With greater assets comes the need to put more money to work, meaning some funds will not be able to provide the commitment sizes required by superfunds. “Pension funds are consolidating, family offices are consolidating, those are all trends leading into bigger pools of money, which will in turn lead to investors having separate account mandates with GPs,” says Devlin ■



51%



Share of LPs citing management and performance fees as the top area of disagreement when conducting due diligence

18%



Share of LPs who regard the structure of the carry distribution waterfall as the biggest source of disagreement

Source: PEI annual LP survey

REMUNERATION

Eyes on the same prize

Future LPs will incorporate performance-based incentives into their investment professionals' compensation packages.

Data from the latest Collier Capital *Global Private Equity Barometer* show LPs whose remuneration is tied to private equity performance are almost three times more likely to deliver annual returns in excess of 16 percent than their peers.

Corporate pension funds and banks or asset managers are the most likely to include an element of performance-based compensation, at 80 percent and 77 percent respectively, according to the report. Just 41 percent of public or other pension funds or insurance companies do the same.

A GP-like compensation package has worked well for Ontario Municipal Employees' Retirement System, which almost exclusively makes direct PE investments.

"OMERS wanted to build a direct-drive private equity business, and we understood that if we wanted to do that, we would have to be competitive" with GPs on compensation, says the pension's global head of private equity Mark Redman, adding that compensation at the pension "tends to be more analogous to mid-market players" rather than the amounts on offer at large-cap and multi-strategy managers.

"To attract and retain top talent, you have to be sufficiently competitive that people feel fairly compensated."

Mirja Lehmler-Brown, managing director in the private equity funds investment team at Hayfin, highlights the necessity of "alignment in a positive sense" to produce the best outcomes. But she stresses the

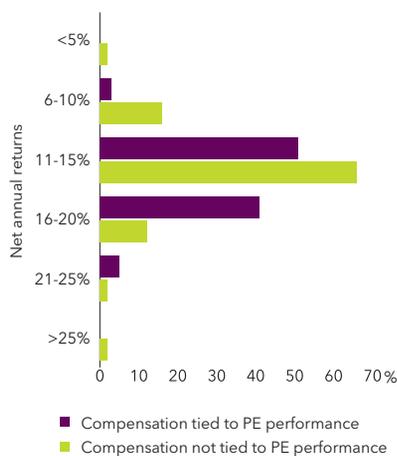
need for that alignment to go beyond the individual.

"You do need to structure remuneration levels to incentivise teams, not just individuals, to perform together."

Edi Truell, co-founder of private equity firm Disruptive Capital and a key figure behind the UK's public pension consolidation, sees low salaries as a significant impediment to UK pensions' success in private equity. Low pay deters the best investment professionals, and in his view is to blame for the lukewarm relationship between most of the country's public pensions and the private equity industry.

MONEY TALKS

LPs whose remuneration is tied to private equity performance are almost three times more likely to deliver annual returns in excess of 16% than their peers



Source: Collier Capital

"You have to be lucky to get a bunch of experienced people pro bono," Truell told *Private Equity International* in April. "You've got to be prepared to pay proper money to attract the talent to take on private asset managers on equal terms."

But performance-based remuneration is not without challenges. For starters, how do you structure an annual compensation scheme to take into account J-curves and other issues specific to long-term asset classes? It can also sway investment decisions – and not necessarily for the better.

"It could cause some decisions to be made that could enhance performance, [such as] if you're an LP compensated on short-term performance, wouldn't you want to invest in private equity firms that aggressively use subscription lines of credit, because that mitigates against the J-curve and in some cases it enhances the performance," says David Fann, president and chief executive at TorreyCove.

This underscores the need for alignment to be pursued "mindfully," as Lehmler-Brown says. Working at an LP requires fundamentally different mindset to working at a GP.

"It can't be only money-driven." ■

PORTFOLIO STRUCTURE

Going with the flow

There's a good chance the LP of the future will take a much more fluid approach to how it structures its investment portfolio, including private equity.

Hayfin's Mirja Lehmler-Brown points out that, in more mature public equity markets, portfolios that used to be divided into geographies are often structured globally.

"That's one vertical that's already gone from separate buckets to one big bucket."

It's not a stretch to imagine alternatives portfolios following the same trajectory, providing LPs with a broad pool which they allocate to managers on a global basis – and perhaps even eventually to different alternative asset classes and strategies – based on their risk-return profiles, she says.

"We see directionally two schools of thought potentially capturing the imagination of some chief investment officers and investment programmes," says TorreyCove's David Fann.

The first is to combine private equity with public equity, viewing this bucket as all equity risk. The other is to split the portfolio into liquid and illiquid strategies, which would put private equity into a broad private markets bucket with private credit, private infrastructure and some real assets investing. The preference for one over the other is a philosophical one, based on how the investor perceives risk.

Last year the California Public Employees' Retirement System announced it was considering a merger of its private equity and global equity allocations, placing the asset class in a "growth bucket". The idea behind the change is that the private equity team would no longer be under pressure to reach a certain target allocation; instead it would focus solely on committing to the best managers. ■



GP RELATIONSHIPS

An LP by any other name

Private equity is busier than ever. General partners are raising bigger funds more frequently, presenting limited partners with a seemingly endless string of re-up opportunities.

It is therefore little surprise that some have taken to cutting back their GP relationships to focus on a select number of multi-strategy managers they know and trust, while also lessening fees. California Public Employees' Retirement System was an early adopter, having launched a 'Core 30' plan in 2011 to reduce its portfolio to 30 managers.

Such activity has placed the onus on blue-chip firms to expand their range of assets, with private debt, real estate and infrastructure among the most common expansion routes for private equity houses. What's more, GPs are insuring themselves against the possible loss of LPs by tapping directly into retail and high-net-worth investors – thus bypassing the asset managers that historically would have committed

to their funds. “The line between LPs and GPs is going to be increasingly blurred,” says Wilf Wilkinson, managing partner at placement agent Acanthus.

“You’re going to get your traditional household mega-buyout names that increasingly look like LPs, because they’re just providing one-stop shop alternative asset solutions for the end capital providers.”

Increasing parity between brand name GPs and LPs will instead create greater demand for specialist asset managers that can tap into niche segments, Wilkinson adds. Future LP portfolios may comprise a larger proportion of these funds, rather than those who have evolved into competitors. “You’re going to see specialist private equity asset managers continue to have a place in the market to hunt out specialist teams that are genuinely able to offer unique risk-return profiles on the basis of a particular skew of knowledge, experience or a niche approach.” ■

Are LPs that have cut back on the number of GPs they invest with happy?



Source: Palico Key Trends Winter, February 2018

Half of LPs intend to increase the number of PE managers they invest with in 2018



Source: Palico Key Trends Winter, February 2018

RETURNS EXPECTATIONS

It's all relative

The LP of the future will still be expecting outperformance from its private equity portfolio to justify the associated fees and expenses. But rather than sticking an absolute number on those expectations, it is likely to judge performance in relation to other investment options.

"It's shifting away from an absolute to a relative standard," says TorreyCove's David Fann. "The expectation that you're going to achieve 20 percent rates of returns is shifting to a perspective of generating to 200-400 basis points over a public equity index or some other benchmark."

The asset class's eroding performance is already evident. In the American Investment Council's 2016 Pension Fund Analysis, private equity investments by US public pensions outperformed all other asset classes, yielding a

median 10-year annualised return of 11.4 percent. This compares favourably with public equity's 7.6 percent, real estate's 6.3 percent and fixed income's 5.2 percent.

This year, the numbers are less impressive. In the 2018 report, private equity yielded a median 10-year annualised return of 8.6 percent, against 6.1 percent for public equity, 4.7 percent for real estate and 5.3 percent for fixed income.

The best performing pension fund – Massachusetts Pension Reserves Investment Trust – earned a 10-year annualised return of 13.37 percent; the top-performing fund in 2016, the Teacher Retirement System of Texas, posted 15.40 percent that year.

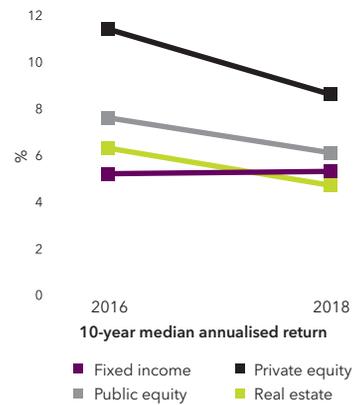
"It's a secular trend. There's just more competition for private assets," says Fann.

"Returns are much higher in an environment where there are 200 firms operating internationally, returns were typically 30-40 percent 20 years ago. Today, getting high-teens rates of returns would be impressive. You're operating in an environment where there might be thousands of firms that are trying to transact. Almost everything is being sold in an auction today."

Private equity is still performing well relative to other asset classes. Almost 70 percent of LPs and GPs surveyed by Palico for its latest *Key Trends* report expect private equity to outperform other forms of investment despite historically high prices, and 62 percent believe investors lose less money in private

COMMANDING PERFORMANCE

Private equity returns are slipping but are still much higher than other asset classes



Source: AIC Public Pension

equity than in the stock market. Increasingly challenging investment conditions will put the onus on future LPs to select funds, co-investments and direct investments carefully to target top performers. "With the amount of capital coming in, on average if you look at funds' base cases, it has come down," says Hayfin's Mirja Lehmler-Brown. "However, there remain pockets of the market capable of delivering strong returns in line with historic expectations."

Of course, private equity doesn't exist in a vacuum; how both the public markets and the financing markets behave have a significant effect, which could turn negative when the next downturn hits. "If there is a correction in the overall capital markets, that could pose challenges for those that have bought assets in the last five years,"

Fann says. "There could be downwards pressure on rates of returns in all markets, including private equity." ■



NON-FUND INVESTMENTS

Taking control

The LP of the future will look a lot more like a GP. Instead of relying on the discretion of fund managers in blind-pool vehicles, the LP will have much more control over its investment exposure – and much lower fees – thanks to an increased proportion of co-investments, direct investments and customised mandates.

The trend for investing outside the confines of a commingled fund has taken hold since the financial crisis. According to Collier Capital's 2017 *Global Private Equity Barometer*, the percentage of LPs co-investing alongside general partners shot up from 26 percent in summer 2006 to 55 percent in the winter of 2017-18. The proportion making direct investments jumped from 17 percent to 31 percent over the same period.

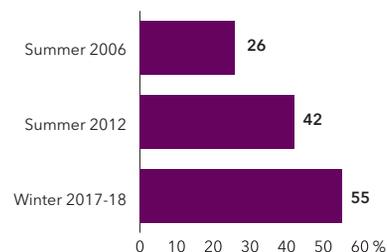
The benefits to LPs suggest the enthusiasm for these opportunities will remain. Dave Smith, co-head of co-investments at Capital Dynamics, believes they will account for a “substantially increased proportion, driven by a combination of co-investment having come of age and limited partners’ demands for a lower cost of access to an expensive asset class”.

Innovation should iron out some creases. In the traditional fund model, LPs are often unable to respond quickly enough to GPs’ calls for co-investment capital. To address this, we are likely to see more investment company-type structures, perhaps with LPs on their board, which can help reduce the pressure, according to Shawn D’Aguiar and Ajay Pathak, fund formation partners at law firm Goodwin.

It’s also possible that growing numbers of LPs will enter funds primarily with the aim of doing direct or co-investing. Arrangements with the GP would be tailored – lower fees for investment recommendations, cashflow projections and monitoring, higher fees for anything more specialised.

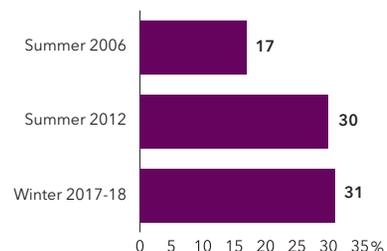
While the move towards acquiring minority stakes in GPs has increased in recent years, few *PEI* spoke to expect it to become widespread. Some sounded a hint of caution around the risk of conflicts of interest. Still, around a third of LPs already are, or are considering, making such investments, according to Collier Capital data. ■

PROPORTION OF LPS CO-INVESTING ALONGSIDE GPs



Source: Collier Capital

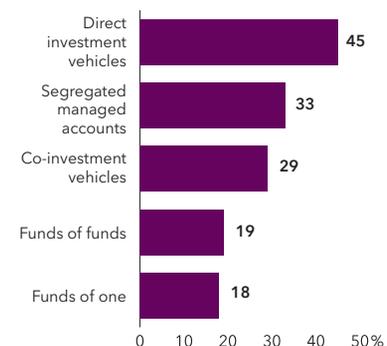
PROPORTION OF LPS MAKING DIRECT INVESTMENTS IN PRIVATE COMPANIES



Source: Collier Capital

DIRECTOR’S CHOICE

LPs state their preferred investment method in 2018-19, other than commingled funds



Source: Intralinks 2018 LP Report



TAIL-ENDS

The end of the tail-end

24%



Percentage of PE funds aged 15 years or older, compared with 16% in December 2013

\$1.6trn



Unrealised value in private equity funds worldwide

Source: NYPPEX Private Markets

The LP of the future will have no unwanted funds that have outlived their 10-year life. Portfolios will be devoid of zombies. Assets will have been rolled into new structures or a pre-agreed liquidity process will have been triggered and LPs would have opted to cash out with the help of the buoyant secondaries market.

According to Goodwin fund formation partners Shawn D'Aguiar and Ajay Pathak, GP-led liquidity options are likely to feature regularly in fund documents, whether in the form of a promise by fund managers to hold a tender offer at a certain point in a fund's lifespan or a less binding agreement that the GP will help an LP seek a secondaries buyer if it wants to

exit. These innovations won't mean the death of the tail-end secondaries market. Thanks to the sheer weight of primary fundraising the acquisition of funds near the end of their 10-year life is bound to be a much bigger market in 10 years' time. John Carter, founder and chief executive of Hollyport Capital, believes the market will be dominated by perhaps four specialist secondaries buyers. GPs are increasingly insisting buyers of stakes in their funds are managers with which they have an existing relationship.

Also contributing to a tidier portfolio will be innovation in longer life funds, taking a cue from the real assets world. The Goodwin lawyers point to a recent high-profile example – Core Equity Holdings' 15-year, €1 billion debut fund last year – on which they advised.

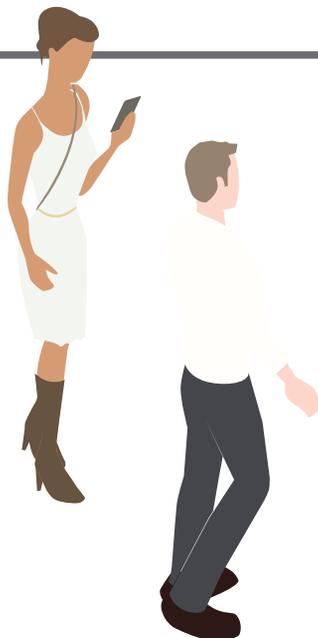
Savvy use of the secondaries market will also allow a chief investment officer to increase or decrease certain investment exposures on a much more frequent basis, providing some liquidity in a long-term asset class.

"The transaction and friction costs right now are too high for that, it requires GP approvals and usually involves a process, but I would imagine over time, the secondaries market could become far more liquid and with less friction from a transaction perspective," says TorreyCove's David Fann.

"This approach works well if it's highly liquid, where you can actually buy and sell secondaries in an exchange-like fashion. In a 10-20-year time frame, it's not too difficult to see that possibly happening."

We are also likely to see more investment company-type structures, as GPs relieve themselves of the pressure of having to invest within the constraints of a fund. ■





TRANSPARENCY & DISCLOSURE

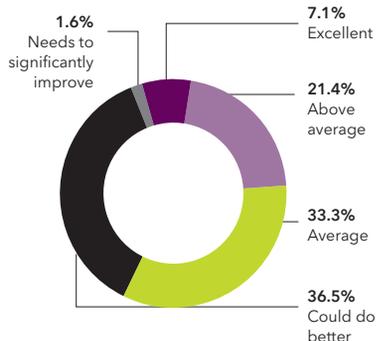
Loud and clear

In 10 years' time there will be no single piece of information an LP cannot access about a manager it invests with and a fund it commits to. There will be a completely clear channel between LPs and GPs through which information will flow freely back and forth. If a manager is not willing to open itself up to this degree, there's a high chance investors will take their capital elsewhere.

Transparency and disclosure between GPs and the limited partners that commit to their funds is an area of top priority for investors and regulators alike. Industry insiders agree progress has been made over

OPEN SESAME

Most LPs believe their GPs could be more transparent



Source: Intralinks 2018 LP Survey Report

the last few years, but there's still work to be done to address the perceived "double standard" between private equity and other forms of investing, says TorreyCove's David Fann.

"All other forms of investment have high degrees of transparency, except for hedge funds and private equity," he says.

"If you invest in a mutual fund or an ETF, fee disclosure is extremely explicit; you know what you're paying in management fees, you know all the performance fees and under what circumstances they'll be paid. Right now in private equity there are certain managers that are still a bit opaque."

Fann notes it can often be in the GP's best interest to maintain some opaqueness, and a segment of private equity and hedge fund managers like to operate in secrecy. However, the trend towards greater transparency is only moving in one direction, and it's likely

the LP of the future will have much greater access to information than is available today.

In an April letter to the Securities and Exchange Commission, the Institutional Limited Partners Association called on the regulator to update its rules around marketing and fee disclosure and to enhance other reporting and disclosure requirements in the name of investor protection.

"Private equity is institutionalising to a point now where it's a multi-trillion-dollar industry, and investors have plenty of choices in the marketplace," Fann says. "They are going to continue to expect greater transparency from those that they've invested with."

And LPs won't be getting off lightly either; they are likely to face increasing calls for greater transparency too. California law AB-2833, which was enacted in 2016, requires all California-based public pensions to disclose private equity-related fees and expenses. It's likely other states will follow suit, with Kentucky, New Jersey, Washington and Illinois all discussing similar rules. ■



TECHNOLOGY

Making tracks

The recent controversy over Abraaj's commingling of corporate and investor capital is a timely reminder of the potential for distributed ledger technology in bolstering governance.

Distributed ledgers are a list of transactions replicated across a number of computers rather than stored on a central server. The technology carries significant potential in every sector, as deals of any kind can be recorded with increased security and transparency.

Enter private equity. Distributed ledgers could keep track of where money is moving, thus providing general partners and limited partners with greater awareness of how their capital is being deployed. This assurance would be especially beneficial in emerging markets with lower governance, or complex greenfield infrastructure funds.

“What we’ve been seeing is a lot of green funds coming to us and saying in the past they’ve had a huge amount of problems, having backed projects in emerging markets where a lot of the money’s gone missing and it hasn’t actually been spent on the original investment they thought it was going to be spent on,” says Oliver Oram, chief executive of Chainvine, which creates blockchain platforms.

“Essentially what they’re looking to do is track and trace that investment.”

Private equity houses are already exploring this technology. Geneva-based Unigestion utilises a blockchain platform built as a collaboration between fund administrator Northern Trust and technology company IBM. The blockchain is deployed on a high-security cloud, with each stakeholder – including investors, fund managers and administrators – accessing the information via secured means.

The ability to provide an instantaneous audit would have served Abraaj’s investors well. Expect to see LPs push for greater adoption of this technology in the near future. ■

ALLOCATIONS

On the up and up

PEI's Research & Analytics team keeps a keen eye on institutional investors around the globe as they make commitments or adjust their exposure to the asset class. Luckily for GPs, strong returns are keeping most LPs coming back for more

CHURCH COMMISSIONERS

The Church of England's investment manager, with £8.3 billion (\$11.2 billion; €9.4 billion) in assets under management, is raising its target allocation to private equity. It had a 4.7 percent allocation to the asset class as of 31 December, up from 3.9 percent the previous year. Church Commissioners decided to target more direct relationships and focus on a select group of the strongest performing private equity and venture capital managers last year.

THAILAND GPF

The Thailand Government Pension Fund said last summer it expected to raise its exposure to private equity over the next three years to balance the Thai-bond-heavy portfolio. It aims to increase its long-term allocation to private equity to 3 percent by 2020, from 2.6 percent. Once Thailand's finance ministry relaxes the offshore investment limit, GPF expects to extend that target allocation to 4 percent.



JAPAN POST BANK

Japan Post Bank is aiming to ramp up its alternatives allocation to ¥8.5 trillion (\$76.3 billion; €65.1 billion) by the end of Q3 2021. The investor is making the move to reduce the reliance on interest income from Japanese government bonds. It currently allocates around ¥1.6 trillion to strategic investments, comprising private equity, real estate funds, direct lending funds and others.

MASSMUTUAL LIFE JAPAN

MassMutual Life Japan said in summer 2017 it was gearing up to raise its private equity allocation. Its preference is for funds, but it will also consider direct investments and co-investments. The insurer will focus on buyout opportunities, but also pursue growth and venture capital. It will target a diverse range of sectors, predominantly in the US and Europe, but also in Japan and across Asia.

KIC

Korea Investment Corporation plans to increase its exposure to alternative assets by 5 percent over the course of two years, bringing its total exposure to 19 percent, in an attempt to achieve higher risk-adjusted returns with low correlation to public markets. The fund is aiming to increase its assets under management from \$134.1 billion to more than \$200 billion within three years.

CPPIB

The Canadian Pension Plan Investment Board reported a 65 percent rise in emerging markets private equity assets from its previous financial year. The C\$356.1 billion (\$278.1 billion; €235.6 billion) pension had C\$9.6 billion invested in emerging markets private equity as of 31 March, representing 2.7 percent of its total investment portfolio, according to its 2018 annual report. This compares with C\$5.8 billion, or 1.8 percent of its portfolio, the previous year.



CHICAGO PABF

In October, Chicago Policemen's Annuity & Benefits Fund said it is replacing its private equity portfolio and shifting focus to private debt, because the fund is "severely underfunded". The pension is looking for more cashflow to support benefit payments from private debt.

ADIA

In 2017 the Abu Dhabi Investment Authority, the world's third-largest sovereign wealth fund, reduced its reliance on external fund managers as it continued to bolster its in-house investment team. According to its 2017 annual report, 55 percent of its assets under management were overseen by external fund managers, down from 60 percent in 2016. Last year ADIA restructured its private equities department as part of a strategy to increase direct investments, moving from a product-focused approach to regional teams with expertise in five key industries: healthcare, financial services, industrials, technology and consumer.

NCRS

North Carolina Retirement System did not make any new commitments to alternatives during 2017. Its external managers, however, continued to make investments into alternatives through unfunded commitments of approximately \$9 billion. Future investments will depend on the Treasurer.

