2019

Perspectives
What really matters to private equity LPs

- Co-investment stampede
- Style drift
- Gender on the agenda
- What keeps LPs awake
- And much more...
The Debevoise Private Equity Group continues to lead the field, in an industry it has helped shape for decades.

The practice includes focused groups experienced in fund formation and investment management, buyouts and other equity and debt investments, finance, securities and capital markets, tax, and management compensation and employee benefits.

More than 200 lawyers work within the Group in offices around the world, making it one of the few truly global private equity practices. Teams are lean and efficient, and are tailored to the culture, strategy and risk profile of individual clients.
Why the views of LPs matter

We live in a world in which some of the world’s biggest and most influential limited partners have made noise about being less “limited” in their approach to private equity.

Some investors reach a point at which they decide to take a mature private equity programme and start shifting it in-house: making principal investments rather than outsourcing deal-making to general partners. Others have decided to concentrate their programmes on a smaller number of external relationships, giving them – in theory – greater leverage to negotiate terms.

The rationale for both approaches has the cost of investing at its heart. An institution that invests directly off its own back is not subject to the management fee-carry combination that GPs require. It can also hold companies to the management fee-carry combination for longer – potentially reducing the administrative costs of maintaining a vast number of fund holdings.

It is not all about costs. In conversation with a large number of the world’s biggest and most influential limited partners, we heard about the need to be able to negotiate lower fees and reduce the administrative costs of managing a larger number of fund relationships. Others decided to take a mature private equity programme and start shifting it in-house: making principal investments rather than outsourcing deal-making to general partners. The view was that GPs require.

The survey shows the perception that LPs are paring back the number of relationships in their portfolio is just that: perception. Most LPs (53 percent) want to increase their number of manager relationships, 30 percent want to increase the number of external relationships, 30 percent want to maintain the same number while 11 percent want to decrease it. One-in-three LPs plans to increase its target allocation to PE in the next 12 months and most investors (92 percent) believe LP allocation will exceed its benchmark in the next 12 months.

The LP community is becoming more relevant and LP data is more needed than ever. The following pages are crammed full of data; I’d like to thank our research team for their efforts in gathering it. I believe it is a valuable benchmarking resource for anyone starting or maintaining a private equity programme. And for GPs, I hope it gives an insight into what your investor base is currently thinking.
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PRIVATE EQUITY INTERNATIONAL DECEMBER 2018/JANUARY 2019
$27 billion
raised and advised on by MVision in the last 12 months

Our team collaborates across the world advising a wide range of clients, from first-time funds to large established managers, who benefit from our long-established investor relationships and in-depth industry knowledge.

We are proud of what we have achieved this year, and are excited for the next.

Look ahead. Share our vision.
Seven LP perspectives that matter

Private Equity International’s Perspectives is one of the most comprehensive surveys of the private equity investor universe. Here are the charts that tell us what LPs think of today’s major talking points.
By Toby Mitchenall
HIGH FEES ARE A TOUGH SELL

A 10-year bull run in public markets is a mixed blessing for private equity. Yes, rising valuations make for an exciting market to sell businesses into, but the relative performance of the wider stock market – which is easily accessed through low cost trackers – can make private equity seem like a needlessly expensive option for an asset allocator. Earlier this year, Pennsylvania state treasurer Joe Torsella claimed the two state pension systems had “wasted” up to $5.5 billion in investment expenses and would have been better served by low-cost passive funds. This simple comparison of the last 10 years ignores some important factors, most notably the relative outperformance of private equity over the full market cycle.

Even so, our survey suggests Torsella is not alone in his late-cycle misgivings: 61 percent of limited partners said they either agree or strongly agree with the statement that “the fees charged by private equity funds are difficult to justify internally”.

RESTRICTURING COSTS DISPUTED

Our survey reports that most LPs (57 percent) have had a fund restructuring – where assets are moved from an existing vehicle to a new one with new terms – proposed by at least one of their GPs. In the last two years a number of storied firms have run such processes on their funds, such as Nordic Capital, InvestIndustrial and – ongoing as this publication goes to press – TH Lee. These are complex transactions and often divide opinion among an investor base. Per our survey, more than a third of LPs who have been involved in such a proposal said they did not have sufficient time to make a decision, while a similar proportion said they had insufficient information.

While this may seem alarming, it
Which of the following best describes your assessment of GP investment behaviour in the last 12 months?

<table>
<thead>
<tr>
<th>Option</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>I see occasional examples of “style drift” among my GPs</td>
<td>8.3%</td>
</tr>
<tr>
<td>GPs are remaining disciplined and sticking to their investment thesis</td>
<td>1.2%</td>
</tr>
<tr>
<td>I see widespread examples of “style drift” among my GPs</td>
<td>35.7%</td>
</tr>
<tr>
<td>Other</td>
<td>54.8%</td>
</tr>
</tbody>
</table>

Source: Private Equity International

I see style drift

Two words no one in private equity wants to hear: “style drift”. It can take many different forms: investing in an unknown sector, a new geography, moving from majority to minority stakes, buying public stocks; or buying larger (or smaller) companies. It tends to be a topic of conversation at the height of a market, when competition for assets pushes managers to get creative: 55 percent of LPs report seeing “occasional examples of style drift” among their GPs, while 8 percent reported seeing “widespread examples”. Just over a third said GPs were “remaining disciplined and sticking to their investment theses”.

Should we be alarmed by this finding? Other data suggest GPs are slowing their investment pace, rather than drifting beyond their remit. In August 2018, PEI reported distributions have outpaced capital calls for five years, and the gap between the two was widening. “If managers are keeping an eye on pricing relative to public markets and other M&A transactions, and decide to slow down on this basis, then I am more comfortable with a slower investment pace,” Angela Willetts, co-head of private equity at Capital Dynamics, told PEI in August.

Gender as agenda item

Diversity and inclusion is an emerging factor among limited partners when selecting a manager. While the “staples” of due diligence – track record, team size and investment thesis – remain the central tenets of nearly all LPs’ due diligence, a portion – 43 percent – are including gender pay disparity at the GP as part of their due diligence process. We fully expect this percentage to increase in the coming years. Lobby group ILPA is now including gender and ethnic diversity in its due diligence template. Said Andrea Auerbach, head of private markets at LP advisor Cambridge Associates: “If [some of our clients] don’t see sufficient levels of diversity and inclusion, or well-intentioned and meaningful efforts...”
PRIVATE EQUITY INTERNATIONAL
AWARDS 2016
Secondaries advisor of the year in North America

PRIVATE EQUITY INTERNATIONAL
AWARDS 2017
Secondaries advisor of the year in the Americas
Thinking of your fundraises in the last 12 months that you expressed interest in, which of the following describes your experience?

- We have consistently received our full requested allocation in our chosen funds: 59.8%
- We have had our allocation scaled back in most of our chosen funds due to excess demand: 28.0%
- We have had our allocation scaled back in some of our chosen funds: 3.7%
- We have been unable to secure allocations in most of our chosen funds: 3.7%
- Have not made any new commitments in the last 12 months: 2.4%
- Other: 2.4%

Source: Private Equity International

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

- Yes: 65.1%
- No: 23.3%
- Unsure: 11.6%

Source: Private Equity International

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

- Asia-Pacific: 84.1%
- Central/Eastern Europe: 39.0%
- Latin America: 31.7%
- Middle East and North Africa: 17.1%
- Sub-Saharan Africa: 13.4%

Source: Private Equity International

CO-INVESTMENT STAMPEDE

It is a popular way to cut fees when investing in private equity, which is why, according to our survey, 65 percent of limited partners intend to deploy capital through co-investments in the next 12 months. Widespread co-investment is a relatively new feature of private equity investing “I don’t think we’ve been through a whole cycle yet with co-investments and there are certainly some challenges there,” said Per Olofsson, head of alternatives at AP7.

GP POWER

The received wisdom in private equity is that rampant demand from LPs has put GPs in a position of firm negotiating power in fundraising; take our terms or we will easily replace you in our investor base. One data point from our survey suggests the situation may be more balanced. Most LPs (60 percent) told us they have consistently received the full allocation in their chosen funds, whereas only 28 percent had seen their allocations scaled back in some of their chosen funds. Rather than pare LPs commitments back, it is likely GPs are simply raising bigger – or additional – funds.

ASIA ON MY MIND

Asian PE has come of age and global investors are arriving in droves. The region’s GDP growth and rising middle classes, combined with the growth of “institutional-grade” general partners is proving a draw; a number of US public pensions are growing their exposure.

“In the past five years, nearly 40 percent of our global private equity commitments have been to managers focused on the Asian region,” said Art Wang, managing director, private markets at San Francisco Employees’ Retirement System.
MATURE FUNDS - MAXIMIZE VALUE, MINIMIZE COSTS

Do you manage a mature PE fund or a PE fund of funds with illiquid or distressed stub positions? Is the management of mature funds becoming a distraction to active management of younger funds or capital raising? Has the ratio of the fund’s expenses to NAV increased significantly, and are your investors growing impatient?

If you answer Yes to any of these questions, now is the time to start talking to a mature fund specialist. Start a wind-down strategy to allow the fund to reduce or avoid many annual expenses and deliver a liquidity solution for your investors.

**BRG Asset Management & Fiduciary Services can help:**

- We act as a fiduciary and align with investor interests to minimize operational expenses.

- We specialize in implementing effective and timely strategies to improve performance and maximize recovery of investor value.

- We are independent and approach situations with fresh thinking unburdened by prior investment decisions.

- We have broad experience across all major fund types and asset classes.

- We have deep fund management experience acting in COO and CFO capacities and a team of industry-specific experts and trading and valuation professionals.

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BRG provides registered investment advisor services through its wholly owned affiliate, BRG Fund Management Services, LLC.
How we conducted our LP survey

Now in its seventh year, the LP Perspectives Survey is Private Equity International’s annual study of institutional investors’ approach to alternative asset classes. It 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.

Perspectives 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 question set for Perspectives is reviewed annually, with the objective of reflecting market developments and shifts in sentiment.

For the 2019 study, PEI’s Research & Analytics team surveyed 101 institutional investors across private equity, private real estate, infrastructure and private debt. Fieldwork was carried out from August to October 2018. Participation in Perspectives is anonymous, with the findings amalgamated and presented in this supplement.

In which region is your institution headquartered?

<table>
<thead>
<tr>
<th>Region</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Western Europe</td>
<td>45%</td>
</tr>
<tr>
<td>North America</td>
<td>19%</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>14.5%</td>
</tr>
<tr>
<td>Middle East/Africa</td>
<td>14.5%</td>
</tr>
<tr>
<td>Latin America</td>
<td>14.5%</td>
</tr>
<tr>
<td>Central/Eastern Europe</td>
<td>1%</td>
</tr>
</tbody>
</table>

What is your average fund commitment size for the following asset classes?

- **Private real estate**: $100.15m
- **Private equity**: $67.02m
- **Infrastructure**: $73.31m
- **Private debt**: $65.75m

What type of institution are you?

<table>
<thead>
<tr>
<th>Type</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public pension fund</td>
<td>19.3%</td>
</tr>
<tr>
<td>Fund of funds</td>
<td>14.5%</td>
</tr>
<tr>
<td>Private pension fund</td>
<td>14.5%</td>
</tr>
<tr>
<td>Bank/financial services</td>
<td>14.5%</td>
</tr>
<tr>
<td>Family office or high-net-worth individual</td>
<td>13.3%</td>
</tr>
<tr>
<td>Insurance company</td>
<td>10.8%</td>
</tr>
<tr>
<td>Corporate</td>
<td>4.8%</td>
</tr>
<tr>
<td>Consultant</td>
<td>2.4%</td>
</tr>
<tr>
<td>Sovereign wealth fund</td>
<td>2.4%</td>
</tr>
<tr>
<td>Endowment or foundation</td>
<td>1.2%</td>
</tr>
<tr>
<td>Other</td>
<td>2.4%</td>
</tr>
</tbody>
</table>

Source: Private Equity International
STOP WITH THE GUESSING GAMES

START PLAYING WITH AUTHENTIC DATA AND GET GENUINE INSIGHTS.

Private equity professionals need a solution capable of streamlining and centralizing their entire investment cycle, optimizing their processes while enhancing their data and reporting, in order to excel in an increasingly competitive and technologically evolving market.

The eFront Solution Suite gives alternative investment professionals the data and insights they need to make fact-based decisions in order to mitigate risks and maximize the performance of their direct and indirect portfolios.

The go-to solution suite for alternative investment professionals.

www.efront.com
Why ‘contrarian’ South Dakota is bearish on PE

The $14.8bn pension manager is slowing its deployment to private equity and other equity-like assets to cut risk, writes Alex Lynn

South Dakota Investment Council is, by its own admission, unlike any other US public pension. At a time when many institutional investors are piling capital into private equity, the Sioux Falls-based fund is doing the opposite.

SDIC manages $14.8 billion in assets across six funds, including the $12.2 billion South Dakota Retirement System and the $1.2 billion South Dakota Cash Flow Fund.

The pension has as much as 9 percent exposure to private equity but is slowing its deployment to the asset class and other equity-like assets as part of its “contrarian” investment strategy, state investment officer Matt Clark tells Private Equity International.

“It was around 7 percent a decade or so ago and then it went up after the crisis because there were a lot of opportunities,” he says. “And that’s been slowly working its way back down.”

Silver Lake, Blackstone and Cinven accounted for the largest pools of assets within SDRS’s $782 million private equity portfolio as of June 2017, according to its latest annual report. The portfolio also includes commitments to KKR, Carlyle Group and CVC Capital Partners, each of which has raised a mega-fund over the past two years.

The Federal Reserve and other monetary authorities around the world are creating these bubbles to push things to bigger extremes on the overvalued side than we’ve historically seen

Matt Clark

“The wall of commitments out there is competition for underlying deals, and the more money in private equity chasing a given number of deals, the more bid up the prices get and the less the return prospects are,” Clark says.

“When those conditions suggest poor prospects for a time, well then we pull back. If we’re right then there’ll be disappointment experienced by those involved, and then opportunities will re-emerge and we’ll be back.”

RISKY BUSINESS

Clark’s bearishness is not based on gut instinct; the loss of appetite comes from a formula SDIC uses to assess investments. It gauges the fair value of potential assets by estimating future cashflows of these investments and comparing that to the price.

In a neutral risk environment around 70 percent of SDIC’s portfolio would be held in what it considers to be risky assets, such as stocks, private equity or real estate, with the remainder in bonds, Clark says.

If prices are well above its appraised fair value measures then it cuts risk to around 50 percent, with the remainder going into either investment-grade bonds or cash.
We are pleased to announce the final closing of

LANDMARK EQUITY PARTNERS XVI
together with its secondary co-investment affiliates

US$7.0 Billion

September 28, 2018

Landmark Equity Partners XVI has been formed to acquire interests in established private equity funds through secondary market transactions.

South Dakota is unlikely to remain a bit-part player in private equity forever.

“The Federal Reserve and other monetary authorities around the world are creating these bubbles to push things to bigger extremes on the overvalued side than we’ve historically seen,” Clark adds. “That then leads to some kind of bubble that ultimately gets pricked and creates a crisis where it overshoots on the other side, [which] just creates huge opportunities.”

And while the heady fundraising environment has left some LPs struggling to secure their desired commitment size, or in some cases even a place in the vehicle, Clark is not concerned about losing out in future as a result of neglecting important GP relationships.

“I would think that partners of ours would appreciate the fact that we show up when they need us most, which is when things are bad and others are making excuses and they’re struggling to have much of a fund,” he says.

SDRS AT A GLANCE

PE accounted for only a small proportion of SDRS’s $11.6bn portfolio as of 30 June 2017

Though the strategy provides some protection from market headwinds, it can also mute short-term performance. SDRS – the largest of SDIC’s funds – had an estimated 1.1 percent net return for the fiscal year-to-date as of 31 July.

The long-term rewards, however, are clear: South Dakota had the third-lowest pension liabilities shortfall of any US state as of December, behind only Vermont and North Dakota, according to research from the American Legislative Exchange Council.

“Right now as minimum risk exposure in the markets keeps going up we’ll be suffering on a relative performance basis, and that pain will discourage imitators especially when they haven’t tasted the rewards in the past,” Clark notes.

“It’s kind of a chicken and the egg thing on that. It’s hard to start off being a contrarian if you think you’re going to get fired after the first wrong call. Therefore you never take that first bold step and you never build up a track record.”

Source: SDIC
‘LPs are asking more about operational value creation’

For private equity firms, one of the most gratifying aspects of the PEI LP Perspectives Survey is just how supportive investors are of the way that GPs are investing their funds. Of the LPs surveyed, 69 percent say they think that GPs have allocated capital at an “appropriate rate” in the last 12 months, and when asked about “style drift”, more than one-third of LPs say GPs are remaining disciplined and sticking to their investment thesis, and, of the rest, 55 percent saw just occasional style drift.

Either way, LPs are more focused than ever on how GPs can add real and measurable “alpha” to their portfolios, and as a result, are increasingly focused on how GPs drive operational success, say Scott Dahnke, global co-chief executive officer at L Catterton, and Karen Gordon, managing partner of portfolio operations at L Catterton.

Q What do LPs want to know about operational value creation and how do you address the topic with investors?
Scott Dahnke: In today’s environment, with record levels of dry powder and significant access to relatively inexpensive financial leverage, LPs are increasingly seeking to understand the drivers of performance that will be consistent over time, regardless of the prevailing economic conditions.

We’re seeing LPs engaging more with GPs and portfolio companies, and asking for more data to understand the sources of the returns. Increasingly, LPs are looking for specific drivers of operational value creation in addition to how much of that return is being driven by earnings growth vs. multiple expansion and/or debt paydown. As an operationally focused GP, we love it when LPs are asking more about value creation from an operational perspective.

We tend not to use as much financial leverage as most others in the space, which means that our equity has to work harder. Better operating performance is therefore key to our ability to drive high risk-adjusted returns. Historically, roughly 80 percent of our value creation has been of an operational nature.

Karen Gordon: Our operating approach is highly replicable deal after deal, fund after fund, and we’re very proud of what we have built. We do our research and assess the value with respect to the execution risk. Our operational team brings relevant expertise in specialised operating disciplines, such as digital marketing, procurement and Six Sigma. The fact that the economy has been strong means there is more pressure on operating returns and more focus by LPs on operating returns. That is all good from our perspective.

Q Could you describe your operational value creation process?
SD: We’re category-first investors. We identify categories to target for investment based on identifiable consumer trends and then develop an investment thesis in those categories based on how we see competitive dynamics, consumer trends, and other forces playing out. We then partner with management and deploy our own resources to help the company execute that plan.

KG: This helps us to identify specific companies, and once we build a relationship with them we can jointly develop a value-creation thesis that’s right for that business,
LPs are increasingly seeking to understand the drivers of performance that will be consistent over time

Scott Dahnke
Can you describe the methodology you use once you’ve made an investment?
KG: We believe we have a particularly powerful framework. We have a consistent approach to collaboration, to issue identification, to prioritisation, and a philosophy for how and where we deploy resources to drive higher levels of value creation.

The first step is to develop a value creation thesis very early in the diligence process. This ensures our team is aligned with management from the outset. Immediately upon deal closing, and sometimes earlier, we work together to get very specific about the initiatives that we want to drive, how those initiatives translate into value creation, what resources are required, and what milestones we should measure our progress against. We have a disciplined approach to creating KPIs that gives us visibility into the performance of the business overall.

This also allows us to project performance so we can respond to what is happening, predict what will happen, and plan for it proactively. At times, we will also dedicate our own internal team resources to drive certain initiatives and support their delivery.

SD: We’re investing in growth businesses across the consumer sector. At a high level, the drivers of value creation are similar across many of these companies, however the approach required to achieve the value is always bespoke. From that perspective, metaphorically, we are not walking around with a hammer looking for a nail – we have developed a broad tool kit that enables us to deploy the right tools for the job, in partnership with portfolio company leadership.

How much does being a sector-focused fund help you with operational value add?
SD: CEOs, boards, and even investment bankers are increasingly aware of our operational success in the consumer arena, and that proprietary edge helps us source deals that fit our skills. Given the competitive dynamic in the private equity space, founders and CEOs are increasingly asking what an investor offers beyond capital. Having the ability to bring case studies and relevant value creation examples to bear is powerful in winning investment opportunities. Further, our sector-specific expertise has helped cultivate a well-developed global network of industry relationships. There are myriad benefits from being a sector-focused fund and from having been a sector-focused fund for 30 years. We can’t imagine it any other way.

What do you expect in 2019 for the economy and private equity and can you explain how that may impact your investment thesis?
SD: We’re now 10 years into a five- to seven-year economic cycle, so every investment we make today is one in which we forecast a recession within the hold period of that investment. That doesn’t mean that we necessarily think a recession will happen in 2019 or in any specific time frame, but we would forecast some sort of pullback in the next few years. This impacts our underwriting, our capital structures, and our value creation plans.

We really do our homework and that’s a differentiator for us. Many of us including Karen and me have backgrounds at places such as McKinsey, BCG and Bain and know the value of data and research. As it relates to our investment focus, we are targeting areas where consumers are likely to continue to spend and prioritise. These are driven by secular and demographic trends, technological trends, geographic trends and socio-economic trends. While we expect that there may be some slowdown, we’re confident that if we pick a well-positioned company in an attractive and on-trend category and apply our unique capabilities, the investment will still do well.
The Dutch asset manager is planning to increase its private equity exposure, but is taking nothing for granted, writes Carmela Mendoza

The Dutch asset manager is planning to increase its private equity exposure to 5 percent of its total portfolio in the next few years.

“We are in the build-up phase, the group is light in private equity exposure and we are building up the programme,” senior portfolio manager Jos van Gisbergen tells Private Equity International. “It’s challenging to time the market, so if there’s not any good offering or any great fund that fits our criteria, we won’t do it. Quality and alignment goes first since private equity is a long-term asset category.”

Achmea’s strategic target allocation to the asset class is 60-80 percent in funds, 10-20 percent in co-investments and 10-20 percent in secondaries, he adds.

Along with investing in high-quality managers, van Gisbergen also notes the firm is “keen on backing European spin-outs because they know how the system and processes work and have a good network”.

The investor has backed funds managed by LeapFrog Investments and Life Sciences Partners, according to PEI data.

Achmea serves as asset manager for 35 pension funds and insurance companies in the Netherlands and manages more than €130 billion in assets, according to its website.

The firm’s private equity exposure stands at less than 1 percent or about €1 billion, including outstanding commitments, van Gisbergen says. The private equity investments are highly diversified in terms of sector, geographical region and type of investment such as buyouts, growth and special opportunities. The US makes up about 45 percent of its portfolio; EU, 45 percent; and the rest of the world, 10 percent.

Its portfolio of alternative assets also includes hedge funds, infrastructure, real estate and commodities. The value of this portfolio as of August 2018 is approximately €13 billion. The share of alternative investments in the overall portfolio has, however, decreased due to reductions in its positions in commodities and infrastructure, Achmea notes in its latest annual report.

What goes up...

Van Gisbergen says private equity investors expect returns to inevitably come down because the fundamentals of the market are changing.

“We already see the first signs of trouble coming – a rising interest environment combined with high leverage, will make it more difficult to make good returns. It’s also a highly competitive market where people are buying at crazy multiples, at 10-12x EBITDA whereas the average historic has been around 8x. It’s almost impossible to make great returns as we saw in the past. At expectations of 5 percent for public equity and 3 percent for illiquidity premium, one should expect returns of between 8 percent and 12 percent as being more realistic.”

Van Gisbergen also warns of private equity’s "massive inventory pool", which he explains as GPs circulating assets among themselves instead of selling to strategic investors or listing in the public markets.

“There’s too much money for too few deals. On the surface the returns are fantastic, but if the underlying companies are not growing, people will realise that’s just lot of air in it.”
Investors want greater private equity exposure in their portfolios.

One in five respondents to the PEI LP Perspectives Survey 2019 indicated they are underallocated to the asset class, and there are several contributing factors. Strong performance in recent years has driven investors to gradually ratchet up their allocations, leading to a perpetual state of “catching up” with their own targets.

Added to this, private equity distributions have outweighed capital calls for the past five years, according to data from private equity software provider eFront. In fact, in the last quarter of 2017, LPs had an average of 1.2 percent of their committed capital to a given fund called, versus distributions of 3.5 percent.

“Distributions back to investors have continued to be incredibly robust, and as a result, investors are having to turn right around and put money back to work,” says Andrea Auerbach, global head of private investments at Cambridge Associates. This “indigestion of success” is a challenge for many LPs.

This is compounded by strong performance of public equities portfolios leading to a “reverse denominator effect” – a bloated equities component squeezing the same dollar-value of private equity investments into a smaller proportion of the overall investment portfolio.

Private equity has been performing well for our survey respondents; more than half of investors indicated private equity had outperformed their benchmark for the asset class, while just 9 percent said the asset class fell below their benchmark.
Regarding private equity, how do you plan on allocating to the following strategies over the next 12 months?

And they have high expectations for the next 12 months, with 41 percent expecting the asset class will exceed the benchmark and 50 percent that it will meet the benchmark. Investors are most optimistic about private equity’s ability to exceed the benchmark versus other asset classes.

Over a three-year period, the Cambridge Associates Private Equity Index delivered a 14 percent return, versus a 12 percent return and an 11 percent return for the S&P 500 and the Russell 2000, respectively.

“Not that you can buy the market in private equity, but even if you did buy the market, you would still be outperforming your public market options,” Auerbach says. “The return dispersion in private equity is immense. It’s about choosing the right asset class, sector, geography, and timing. The winners will be those who are disciplined in their investment approach.”
markets is immense, so if you’ve done a decent job of manager selection you should be significantly outperforming those public market benchmarks.”

Thanks to this strong performance, around a third of respondents intend to increase their target allocations to private equity in the next 12 months, more than the other asset classes; just 3 percent expect to decrease their allocation. The most out-of-favour asset class appears to be private real estate, with 21 percent expecting to decrease their allocation over the next 12 months.

Within the private equity bucket, LPs are most excited about growth strategies; 29 percent are looking to increase their target allocation. And investors could be on to a winner here: analysis by Cambridge Associates found that half of companies that grew revenue 20 percent or more while under ownership were sold for a 3x multiple or better.

“Growth is scarce. In any market environment, companies will pay for growth,” Auerbach says.

In terms of emerging markets, nearly 85 percent of respondents are considering Asia-Pacific for investment in the next 12 months. Excitement for the region has been palpable over the last few years, with prominent LPs such as the California State Teachers’ Retirement System affirming their intentions to commit more capital there.

Underlying reasons for the increased appetite include the region’s GDP growth rates of at least 6 percent, its rising middle class, and the growth opportunities and investment themes around disruption that are expected to generate outsized returns, LP sources told Private Equity International in September.

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

Which of the following best describes the rate of capital deployment by your GPs over the past 12 months?
Enthusiasm for private equity is, of course, tempered by a healthy dose of concern. Respondents indicated that extreme market valuations are likely to have the greatest impact on performance over the next 12 months.

Private equity sponsors paid on average 14x EBITDA for US assets and 11x in Europe last year, according to data from S&P Global Market Intelligence, and 14.1x in Asia-Pacific, according to Bain & Co.

“The biggest [concern we’ve heard from LPs] is how you respond to the excess supply of buyout capital pushing up prices for assets; that’s the bit the LPs are working hardest to understand,” says Christian Marriott, head of investor relations at European buyout firm Equistone, which closed its sixth flagship fund on €2.8 billion in March.

“In particular, they’re trying to get comfortable with many GPs using higher leverage on the basis that it’s being provided on very sponsor-friendly terms, in terms of covenant headroom and equity cure rights.”

Another indicator we are late in the cycle for private equity are instances of “style drift” among LPs; 55 percent of respondents said they see occasional examples of this among their LPs, and a further 8 percent consider it widespread.

“We’re nine or 10 years into the cycle, so you have a lot of investment professionals trying to put capital to work that haven’t necessarily experienced volatility. Their awareness of the risks they’re taking may be dulled,” says Auerbach.

This emboldens managers to extend their strategies into different sectors, market segments and geographies.

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“Style-drift tends to occur right now,” Auerbach adds. “It doesn’t occur when you’re in a trough.”

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### Which of the following emerging market geographies will you consider for investment over the next 12 months in the following alternative asset classes? Please select all that apply.

- **Asia-Pacific**: 84.1%
- **Central/Eastern Europe**: 39.0%
- **Latin America**: 31.7%
- **Middle East and North Africa**: 17.1%
- **Sub-Saharan Africa**: 13.4%

Source: Private Equity International

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

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Average Number of Fund Opportunities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private equity</td>
<td>86.5%</td>
</tr>
<tr>
<td>Private real estate</td>
<td>38.1%</td>
</tr>
<tr>
<td>Private debt</td>
<td>34.3%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>25.4%</td>
</tr>
</tbody>
</table>

Source: Private Equity International

---

### Of those fund opportunities, what percentage reach the due diligence stage? (%)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Percentage of Funds Reaching Due Diligence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private equity</td>
<td>16.6%</td>
</tr>
<tr>
<td>Private debt</td>
<td>16.1%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>14.9%</td>
</tr>
<tr>
<td>Private real estate</td>
<td>14.0%</td>
</tr>
</tbody>
</table>

Source: Private Equity International
LPs demand a more customised approach

Investment solutions tailored to an investor’s needs are gaining in popularity, say Ardian’s Martin Kessi and Krista Oertle

Customised mandates, separate managed accounts, funds of one — investment solutions tailored to an investor’s needs have many names and come in different forms, but one thing is certain — their popularity continues to increase.

Ardian is well-known for its secondary business, having made a number of landmark transactions over the past years. Less in the headlines but growing just as strong is its mandate business. Martin Kessi, managing director in the fund of funds team, and Krista Oertle, head of mandate solutions in Ardian’s Zurich office, tell us more.

Q Are mandates a new business area for Ardian?
No, tailored mandates are not a new business for us. We have been doing this for over 20 years. Especially since the spinout of Ardian from AXA Group in 2013, we have broadened our offering and added a number of new mandate clients. On the one hand, the overall investor demand in the market for customised portfolio solutions has grown significantly over the past years, visible also in our growth rates. On the other hand, mandates are one of the strategic focus areas of Ardian and as such, the results of our continuous efforts to improve our services are yielding results.

Q Where is demand coming from?
We have long investor relationships with many pension funds, insurance companies and family offices so part of the demand is coming through these existing relationships. At the same time, new pension funds, insurers and family offices continue to enter the market and often prefer to partner with an established manager such as Ardian, who can deliver a complete investment solution. We are also talking to investors, who traditionally have not been the main target segment for mandates. Private banks, for instance, are increasingly interested in finding solutions for their high-net-worth individuals and how they can access an asset class that has been geared towards institutional investors up to now.

Geographically, much of the demand is coming from our traditional investor regions, meaning Europe, North America and Asia. However, the landscape is broadening. For instance, we just closed our first Latin American mandate a little while ago, so it is becoming global for us.

Q What are investors looking for in mandates?
Lower fees are often thought to be the main reason for choosing a mandate over a fund of funds commitment. While this is a very important aspect of the mandate offering, in our experience, other aspects matter just as much. What investors generally seem to look for is flexibility and something that meets their needs. This comes in various forms and can be fully delivered through a tailored mandate solution.

At Ardian, we tailor a mandate around each client’s organisation, investment needs and preferred ways of collaboration. We combine funds across private market strategies, segments and regions. For this, the large fund of funds platform that we have today is key, with around $5 billion on average invested in primaries and secondaries an on annual basis. We offer discretionary and non-discretionary mandates, giving
investors the choice to decide how much they want to be involved in their mandate. Our investors define what is their investment horizon and targets and when those targets change, the mandate solution adapts. And on top of this our investors get the operational and reporting services they need.

Do investors want to be involved in their mandates?

Some, yes, to a varying degree.

If you as an investor know you do not have the resources to be involved in the investment process and portfolio planning and are looking for a reputable, trusted partner to outsource your private market allocation, you probably will opt for a discretionary, hands-off solution.

But we do have mandate investors who want to participate in the decisions on where the assets are being invested, want to read the investment memos and have the final say and we can accommodate that.

All in all, the needs from the investor side are complex and a mandate manager today needs to be able to understand and adapt to those needs.

What is the role of secondaries in your mandates?

We have mandates that do not have any secondaries and we have mandates in which secondaries are a key allocation type. It really depends on the investment targets of the investor.

Often if we put together a comprehensive portfolio solution for a client, particularly if the investor is new to private equity, and secondaries have a significant role in ramping up exposure, in addition to the diversification benefits that they bring to a portfolio. You might see higher allocations to secondaries in the first one or two years. Naturally, this allocation tends to change over time, particularly when we are talking about mandates that invest over 10, 15 or 20 years.
When does a mandate not make sense?

We can recommend a mandate solution to all clients who want an individualised private market investment programme tailored to their needs. Due to the initial effort at the beginning of such a programme, mainly with legal and operational setups, a mandate is generally worthwhile only from a certain volume. The cost savings in relation to management fee must compensate for these initial fixed costs.

What matters when investors select a mandate manager?

Fees and performance are the most typical reoccurring themes, of course. But at the same time, the differences between managers can be very small on these two aspects.

A private market mandate is often longer in term and larger in size than a single fund of funds commitment and the investor’s relationship with the manager tends to be closer. When choosing a manager, it often comes down to soft factors; it is like choosing a partner: how comfortable do you as the investor feel with the manager, how well can you communicate with them, how much do you trust them, how well can they adapt to your needs?

A mandate solution provider today needs to have the right service package, in addition to offering attractive fees and being able to demonstrate a good track record, just to make a difference between you as a manager and your competitors.

Do you see the growth in private infrastructure in mandates?

Infrastructure is becoming more and more important for our investors. We already have mandates which are focused on infrastructure. And we have mandates which invest across private market strategies, infrastructure being one of the target investment segments. Looking at the mandate proposals we have already made for 2018, infrastructure – even if in absolute terms still behind private equity – has grown the fastest. Going forward, we would expect to see more mandate opportunities on the infrastructure side.

What do you expect to see in 2019?

We expect the growth to continue. Current investors aim at maintaining or increasing their exposure to the private market. We continue to see many new investors entering the market and new investor segments getting interested. And with this overall growth in interest for the private market, the demand for customised mandates will continue.
PORTFOLIO CONSTRUCTION

LPs play the field with relationships

Investors are looking to expand their GP portfolios as access to funds becomes increasingly competitive, writes Alex Lynn

Received wisdom is that limited partners are cutting down on their general partner relationships.

This is certainly true of some. Much has been made about California Public Employees' Retirement System's efforts to do so; the $362 billion public pension had in recent years attempted to cut its portfolio back to 30 “core” managers to reduce complexity and the cost of managing the portfolio.

But more than half (53 percent) of limited partners intend to increase their fund manager relationships over the next 12 months, according to PEI LP Perspectives Survey 2019. An additional 30 percent will opt to maintain their current number of relationships, while just 11 percent will actively reduce them.

“It’s a cycle; there are periods when LPs retrench the number of GP relationships that they have and then gradually increase them again if some of the existing managers don’t perform and need to be replaced,” Brad Young, head of global

Thinking of your current fund manager relationships, do you plan to make fresh commitments to these managers over the next 12 months?

Thinking of your current fund manager relationships, would you like to increase, maintain, or decrease the number of relationships?
advisory services at Pavilion Corporation, tells Private Equity International.

“A few years ago I’d say all of them were in some form of consolidation of their GP relationships, and if a group retrenched they might now need to expand or increase their PE allocation.”

Trimming the fat has its advantages. Resources are a precious commodity for most LPs, making the ability to commit to multiple strategies and asset classes through fewer relationships invaluable for certain institutions, Sweta Chattopadhyay, director, private markets at LP advisory firm Bfinance, says.

“It’s actually very hard to prune the relationships back,” Jim Strang, head of EMEA at Hamilton Lane, says. “There’s more transparency in private equity today, which makes it easier to identify winners. It’s quite difficult to access the most attractive funds because of the dynamics of supply and demand, so trying to increase your aggregate exposure while focusing on fewer managers is a challenging game to square.”

CalPERS is a case in point. The pension plan’s investment advisor Meketa said last year that the Core 30 plan had failed to deliver its intended improvements due in part to a difficulty in deploying larger amounts of capital with fewer managers.

Capital is flooding into private equity. Firms raised $266 billion in the first three quarters of 2018, having collected a mammoth $464 billion last year, according to PEI data. Distributions have also significantly outpaced private equity capital calls since 2013, according to eFront data, making it a struggle to put enough capital to work.

Competition for commitments is an unfortunate side effect of this insatiable appetite for the asset class. More than one-quarter (28 percent) of LPs have had their allocation scaled back in most of their chosen funds due to excess demand and a small minority (4 percent) have been unable
What is your primary source of fund opportunities, for the following alternative asset classes?

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Direct with fund managers</th>
<th>Existing GP relationships</th>
<th>Investment Consultants</th>
<th>Placement agency</th>
<th>Third-party fund databases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private real estate</td>
<td>39.6%</td>
<td>32.1%</td>
<td>18.9%</td>
<td>7.5%</td>
<td></td>
</tr>
<tr>
<td>Infrastructure</td>
<td>41.3%</td>
<td>32.6%</td>
<td>19.6%</td>
<td>6.5%</td>
<td></td>
</tr>
<tr>
<td>Private debt</td>
<td>40.8%</td>
<td>28.6%</td>
<td>16.3%</td>
<td>12.2%</td>
<td></td>
</tr>
<tr>
<td>Private equity</td>
<td>44.2%</td>
<td>42.9%</td>
<td>7.8%</td>
<td>5.2%</td>
<td></td>
</tr>
</tbody>
</table>

How confident are you that your GPs’ deals have been structured sensibly enough to withstand a downturn?

<table>
<thead>
<tr>
<th>Alternative Asset Class</th>
<th>Very confident</th>
<th>Somewhat confident</th>
<th>Neutral</th>
<th>Somewhat not confident</th>
<th>Very not confident</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private equity</td>
<td>6.2%</td>
<td>39.5%</td>
<td>48.1%</td>
<td>4.9%</td>
<td></td>
</tr>
<tr>
<td>Private real estate</td>
<td>8.5%</td>
<td>54.9%</td>
<td>31.0%</td>
<td>4.2%</td>
<td></td>
</tr>
<tr>
<td>Infrastructure</td>
<td>4.7%</td>
<td>62.0%</td>
<td>28.2%</td>
<td>4.2%</td>
<td></td>
</tr>
<tr>
<td>Private debt</td>
<td>15.5%</td>
<td>54.9%</td>
<td>28.2%</td>
<td>28.2%</td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Due Diligence Factor</th>
<th>Percentage of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>GP performance track record</td>
<td>97.6%</td>
</tr>
<tr>
<td>GP team size and investment capacity</td>
<td>91.6%</td>
</tr>
<tr>
<td>Investment thesis and style drift</td>
<td>89.0%</td>
</tr>
<tr>
<td>Firm “culture” at the GP level</td>
<td>61.0%</td>
</tr>
<tr>
<td>Fund structural review</td>
<td>60.2%</td>
</tr>
<tr>
<td>Succession planning and retention plans at the GP level</td>
<td>57.8%</td>
</tr>
<tr>
<td>Fee validation</td>
<td>52.4%</td>
</tr>
<tr>
<td>GP balance sheet/financial strength</td>
<td>19.3%</td>
</tr>
<tr>
<td>Gender pay gap at GP level</td>
<td>38.6%</td>
</tr>
</tbody>
</table>

LPs must also contend with managers that are looking to cultivate their investor base, Strang notes. “What’s happened on the GP side is they’ve become a lot more thoughtful about the kind of investors they want. If their strategy map for the investor base has got some combination of investor-type and geography, it means there’s going to be some crowding out.”

Forms a major part of the process
Forms a minor part of the process
Not covered in due diligence
High prices for assets and a lack of differentiation among GP business models is making private equity less appealing, Future Fund’s head of private equity Steve Byrom tells Adam Le

High prices for assets and a lack of differentiation among general partners’ business models are making private equity less attractive, according to the head of the asset class at Australia’s A$148.8 billion ($105.6 billion; €92.6 billion) sovereign wealth fund.

“I’m concerned at the prices being paid for beta today, the cost of beta exposure and the ability to continue generating upside at the prices being paid,” Future Fund’s Steve Byrom tells Private Equity International in an interview at the investor’s Melbourne headquarters.

The high cost of assets implies private equity is a “far more efficient market than it’s supposed to be”, says Byrom.

Private equity sponsors paid on average 14x EBITDA for US assets and 11x in Europe last year, according to S&P Global Market Intelligence, and 14.1x in Asia-Pacific, according to Bain & Co.

“At a big picture level, this asset class is becoming less attractive,” says Byrom. “Business models aren’t sufficiently differentiated because of the number of GPs in the ecosystem and the amount of capital competing for a reasonably small number of bidders. Those kinds of competitive dynamics worry me.”

Future Fund’s private equity portfolio grew by 3 percentage points to 14.8 percent of its total portfolio compared with a year earlier, according to its latest quarterly update as of 30 September. The growth came amid a drop in its cash exposure to 14.4 percent from 18.9 percent, while debt securities also fell to 8.8 percent from 9.9 percent of its total portfolio.

“Inflationary pressures are gradually building in the US and markets continue to respond to rising interest rates,” Peter Costello, chairman of the Future Fund Board of Guardians, noted in the update. “While the short-term economic outlook remains reasonably positive, we remain cautious about the longer term outlook, the impact of geopolitical and trade tensions and the potential for shocks to markets.”

CHINA AND SECONDARIES

Future Fund is particularly excited about opportunities in the Chinese market, where local GPs are becoming more sophisticated and are doing “more than just multiple arbitrage”, according to Byrom.

“We’re starting to see opportunities to put capital to work where we feel very comfortable with the GPs we’re working with,” he says. The fund counts Hong Kong-based Citic Capital and CDH Investments, as well as Beijing-based Hillhouse Capital Group among its China-focused private equity managers, according to its website.

The fund has also been using secondaries to manage its private equity exposure. In 2016 Future Fund sold a portfolio worth around $1 billion to Canada Pension Plan Investment Board, as sister publication
Future Fund’s PE portfolio has grown by 3 percentage points over the past year

**A$148.8bn total portfolio**

<table>
<thead>
<tr>
<th>%</th>
<th>Australian equities</th>
<th>Global equities</th>
<th>Private equity</th>
<th>Property</th>
<th>Infrastructure &amp; timberland</th>
<th>Debt securities</th>
<th>Alternative assets*</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.5</td>
<td>25.3</td>
<td>14.8</td>
<td>7.0</td>
<td>8.2</td>
<td>8.8</td>
<td>15.0</td>
<td>14.4</td>
<td></td>
</tr>
</tbody>
</table>

*Definition can be found here: www.futurefund.gov.au/investment/how-we-invest/investment-managers

Source: Future Fund as of 30 September 2018

**Secondaries Investor** reported, and the sovereign investor would consider using the secondaries market again to rebalance its portfolio, Byrom says. Using secondaries is far better than scaling commitments up or down, he adds.

“Some people seem to think that scaling commitments is a lever to pull to try to get the portfolio moving. It’s just far too slow moving to have an impact within three or four years.”

While some firms such as BlackRock and KKR have launched products like long-term funds to hold assets for longer, Future Fund is not the type of investor to commit to such strategies, Byrom says.

“There are pools of capital where that’s quite appropriate and it works, and there are other pools of capital where it doesn’t make sense to do,” he adds. “We’d probably put ourselves in the latter camp.”

When it comes to how the SWF incorporates environmental, social and governance issues among GPs into its day-to-day portfolio management, Future Fund is particularly looking at social diversity, according to Byrom.

“Our hot topic would be diversity of thought, ie, a GP made up of classmates from, say, Princeton. It’s not just gender, it’s also experiences and different ways of looking at things that they bring to the table – upbringing, education, background, different societal norms.”

Future Fund was established in 2006 to strengthen the Australian government’s long-term financial position. The sovereign wealth fund invests five funds: Future Fund, DisabilityCare Australia Fund, Medical Research Future Fund, Building Australia Fund and Education Investment Fund.
Reinventing LP-GP data exchanges and analytics

Investors want more information about where their money is going and that is putting a strain on fund managers. GPs can gain a competitive advantage from managing these requests effectively, says eFront CEO Tarek Chouman.

The data revolution may have made enormous amounts of information available to GPs and LPs, but it remains a burden to manage. *Private Equity International* sat down with Tarek Chouman, the CEO of eFront, to find out how technology can lighten the load and what it means for the alternative asset industry when all this data isn’t just accessible, but also understood.

There’s no world where today’s investors start asking for less data, or stop making additional requests beyond that last quarterly report. And by the very nature of the business, as any GP matures, they will grow in size, which means more portfolio companies and more data to manage and report.

That’s where today’s technology platforms step in and automate as much of this data exchange as possible. Software solutions provider eFront has long been on the cutting edge, understanding that managing alternative assets is very much about managing data. Chouman knows the gap between LP expectations and GP capabilities, but believes that technology can make the most of the data that’s already available today to make better decisions.

But that thirst for information is putting a strain on GPs. They can’t provide data in different formats and different ways for each and every LP. So they find themselves either serving their biggest LPs, say the top 10 or 20 percent of their investors, which can immediately frustrate the other 80 or 90 percent, who are not getting the data the way they want.

And this is precisely where we come into the picture. Because we are able to provide the tools that are going to allow them to automate, optimise and streamline this data exchange, even as the amount of data for any GP to manage grows steadily. And I’d argue that any GP’s ability to manage their data can become a competitive advantage. This isn’t just about investor reporting per se, it’s about securing the commitments to the new fund.

**Q** We have heard that LPs value fast, accurate reporting. Is that the advantage?

It’s more fundamental than that. Data can serve as a reality check, and can help differentiate one manager from another. This isn’t about better service, though that’s important. It’s about LPs using more robust data to select managers through sophisticated analysis powered by the latest technologies.

How can investors chose a manager when the managers are all telling the same story? When they refer to themselves as top quartile, what is that based on? Data can substantiate these claims, and our latest offering Insight can help LPs see where a GP sits and where its true source of value creation lies. Granular data that used to sit buried in a manager’s Excel spreadsheet...
is now accessible to LPs, more than ever before. Investors often have to pay steep fees to advisors to get this kind of intel, and now it’s readily available. And given that most LPs are constrained in terms of resources, these platforms can make a massive difference.

Q Has there been any pushback from GPs on making that information, once hidden in Excel, more available to LPs?

We sit between GPs and LPs, so we’re clearly sensitive to the needs and priorities of fund managers. But we believe that today’s private market players have nothing to hide, and nothing to be shy about. On the contrary, disclosing that track record is going to draw more attention, and win more fans, which naturally means more commitments. Unless a manager is failing, we see no threat from transparency. On the contrary, we believe open books can mean full coffers.

Because data isn’t just a tool for LPs looking to vet managers. It can help a GP stand out from their peers, by backing up their track record. That smaller manager in China might be able to catch the attention of a large pension fund in California by a data-rich testament to their own performance. The level of data out there today is a reality check, but if a manager is an actual contender, it can make them look better, and rightfully so.

Q How does a firm like eFront balance the appetite for so much data, with the need to ensure that data is secure?

We operate on a trust-based relationship with our clients, so data security is one of our highest priorities. We leveraged our 20 years of experience when designing our system, with penetration tests, strict governance over access rights, and secure hosting capabilities with the right level of confidentiality every step of the way. It’s vital to our business to protect a client’s data and their relationships.

Q LPs are keen to get to the bottom of the true sources of value creation of their managers

Digitalising and enhancing data exchanges between LPs and GPs is not the endgame. The main purpose is to enable superior, more sophisticated analysis that will bring some more factual reasoning into the alternative investment decision-making process. The mere benchmarking of performance through skewed industry benchmarks will soon be insufficient for an LP to measure performance. LPs are keen to get to the bottom of the true sources of value creation of their managers, down to asset and individual partner level. To achieve that level of sophistication, they need to combine multiple and granular data sets into a powerful analytical tool. This is precisely what we offer with our recently launched eFront Insight solution. GPs are as interested as LPs in accessing this level of analytical capabilities to perform some self-assessment. We are proposing the same analytical platform to our GPs who contribute their data – and they are genuinely learning so much about themselves.

Q Where do you see the industry going from here?

In the last 15 years, the pace of change has been staggering. Just three years ago, we started our eFront Data Intelligence offering dedicated to facilitating the exchange of data between LPs and GPs before anyone was talking about that. However, as much as we invest in our future, LPs are going to drive the next generation of innovations. They’re beginning to see the potential for not just more data, but data they can process at an accelerated pace to make better decisions. They can pool their data requests through a platform like ours and get what they need to improve their manager selection, no matter the size of their commitment. In that respect, initiatives such as those driven by ILPA to harmonise data requirements from LPs are positive catalysts.

Although, this isn’t just about making LPs savvier. The enhanced ability to measure risk and performance and factually assess investment opportunities is going to make more investors willing to invest in private markets, which are still a very small part of the financial industry in terms of AUM. Better transparency has the potential to grow private markets in the future, and that’s what excites us about our business.
It’s full steam ahead for the secondaries market. As of late November the top 10 largest secondaries funds were seeking a combined $51 billion, according to *PEI* data. This includes the latest vehicles from Ardian and Lexington Partners, both seeking $12 billion – the largest amount ever sought for the strategy.

It will be of comfort to these large firms that LP appetite for the strategy remains strong. According to the *PEI* LP Perspectives Survey 2019, at nearly half of LPs plan to commit to secondaries funds over the next 12 months, a sign that high pricing for second-hand fund stakes and falling returns for the strategy have not deterred LPs just yet.

“It looks like the strategy is firmly anchored in LPs’ investment agendas and is here to stay,” says Bernhard Engelien, a managing director at advisor Greenhill.

LP portfolios or “plain vanilla” transactions comprised the bulk of deal volume in the first half of this year. Looking into 2019 secondaries buyers can rest easy in this part of the market: according to the survey, just under half of LPs plan to be active in the private equity secondaries market either as a buyer, a seller or both.

The picture is less rosy in other asset classes, with around 20 percent of LPs in real estate and infrastructure and around 7 percent in private debt saying they plan to buy or sell interests.

“It has become much more a part of normal business for LPs to manage their portfolios in private equity but other strategies are lagging behind,” Engelien says. While the survey results for real estate are surprising, most infrastructure investors are pension funds and life insurers that are typically underallocated to the asset class, and therefore selling has “not really been a topic” for them, Engelien says. Private debt, meanwhile, is too young an asset class to see meaningful deal volume, although Greenhill is seeking second-hand stakes in some senior lending funds coming to market, he adds.

But when it comes to GP-led transactions...
GPs are increasingly instigating restructuring processes on old funds in order to move assets into a new vehicle. In these circumstances, do you believe:

You have sufficient information to decide whether to roll over or cash out?

- Yes: 42.4%
- No: 22.4%
- Have not been party to a restructuring: 35.3%

Source: Private Equity International

You have sufficient time to decide whether to roll over or cash out?

- Yes: 44.6%
- No: 22.9%
- Have not been party to a restructuring: 32.5%

Source: Private Equity International

The costs of the process was fairly divided between the GP and the fund?

- Yes: 42.7%
- No: 22.0%
- Have not been party to a restructuring: 35.4%

Source: Private Equity International

Do you plan on committing capital to secondaries funds in private equity over the next 12 months?

- Yes: 47.1%
- No: 41.4%
- Unsure: 11.5%

Source: Private Equity International

— secondaries processes such as fund restructurings or stapled tender offers which are initiated by a manager — many LPs remain sceptical, with more than one-third feeling the costs were unfairly divided between the GP and the fund, according to the survey.

With the Securities and Exchange Commission’s fining of buyout firm Veronis Suhler Stevenson in September in relation to a GP-led secondaries deal, and the Institutional Limited Partners Association set to issue guidance next year on such transactions, there will be increased pressure on GPs over the next 12-18 months to provide greater transparency.

“There will certainly be greater emphasis on having LPs’ interests being better represented in these types of transactions,” Engelien says.
A bigger, more nuanced market

Armed with the most recent data, Nigel Dawn, senior managing director at Evercore, reflects on the growth of the secondary market, what has surprised him the most in its evolution and where he sees it heading in the next decade.

Q Can you illustrate the growth of the secondary market over the last 15 years?
The 10 top secondary funds raised in 2004 aggregated to $13 billion. Fast forward to 2018 and the total rises to around $77 billion, again for the top 10 funds. That’s greater than five times growth and also a significant amount of capital. This growth is being driven by very strong investment results and, worth noting from an IRR perspective, secondary returns are surprisingly close to what has been achieved in the primary buyout market.

In 2004, there was a relatively small group of secondary investors. In 2018, as an advisor, we’ve sold assets to over 100 investors. That’s a dramatic change in the number of secondary investors compared with 2004.

Finally in 2004, there wasn’t a single secondary fund in the top 10 private equity funds raised. In 2018, five of the top 10 funds are secondary funds. This provides clear evidence of the significant increase in the importance and scale of the secondary market.

Q What do you think has remained stable in the secondary market?
The amount of dry powder in the market is still very concentrated in a few hands. Fourteen buyers represent 80 percent of the dry powder. Even though there are many more secondary investors, the capital that’s available to be deployed in the market is still highly concentrated.

Also, if one compares the top 10 secondary funds raised in 2004 with 2018, it is essentially the same group: nine of the 10 are the same firms. One has left, Paul Capital, and one investor has joined, AlpInvest. The remainder are the same. The order of the top 10 has changed as some groups have become more prominent.

A lot of capital has been raised by secondary investors. However, a significant amount of capital has also been raised in the overall private equity market. Therefore, on a relative basis, secondary sales volume as a percentage of all private equity assets has remained stable. The secondary market volume is roughly between 1 and 1.5 percent of the outstanding NAV.

Q What are some of the big changes?
The sellers have changed. This is a market that used to be driven by financial institutions. Banks and other financial institutions accounted for 35 to 45 percent of the market, followed by pension funds and asset managers.

If you compare 2014 and 2017, GP liquidity solutions has risen to become almost 25 percent of the market. Also, asset managers and primary fund of funds selling have generated a large tertiary market for secondary funds to participate in. This development is natural given the “bubble vintages” were from 2004 to 2008. During these years, funds of funds raised their largest funds. Therefore, it’s not surprising that vehicles that are 10 years or older are now being sold.

Public and private pensions continue to be very important, but the key change is GP liquidity solutions and asset managers as key sellers. In the first half of 2018, GP solutions and direct transactions accounted for 37 percent of the market, up from 19 percent in 2014. This year, we would expect GP liquidity solutions to take 35 to 40 percent of the total. That’s a huge increase over four years – one I just wouldn’t have imagined.

The other big change from 2004 is specialisation. In 2004, the transactions were all fairly vanilla: sales of portfolios of LP interests, that were highly mature. If you look at investors now, some specialise in early secondary positions or structured transactions, some use leverage, others will focus on staple transactions. There’s a big variety, even within LP positions. Some firms also specialise in GP-driven transactions. There is also the emergence of the preferred equity market which has developed in the last few years.

Specialisation within the secondary market is not surprising. As industries develop, the largest groups get larger and the smaller groups tend to be more specialised. It’s the groups in the middle that get squeezed.
What does this mean for return expectations?

I think there’s an expectation that the more complex the secondary transaction and the more concentrated the assets being purchased, the higher the expected returns should be. There’s probably more bifurcation in terms of returns for the sub-strategies. Most secondary groups invest across GP transactions and LP transactions. The relative mix of those strategies will determine the returns.

Is risk-taking going up in the secondary market?

The risks are very calibrated. In the more traditional businesses, LP portfolios are diversified across many companies. Perhaps the biggest single change is the common use of leverage as part of the capital structure. The risk is higher when investing in more concentrated portfolios or direct companies, such as in GP-led transactions, so one would expect returns to be higher for these transactions.

Where do you see the secondary market in 10 years?

The market will continue to grow. Market volume in 2018 should be between $65 billion and $70 billion. That compares with $8 billion in 2004. Within the next few years, I’d expect annual volumes to rise to $100 billion. Differentiation among secondary funds will also continue. There will be much more nuance among investors.

I would expect the GP-driven part of the market to reach 50 percent of volume in the next few years. This is a huge change. This is partially driven by GPs considering the secondary market as an exit option for individual companies. The market for single-asset secondaries is here to stay.

I spoke to a GP the other day about his plan for a company and he said: “We’re thinking about a trade sale, an IPO or a secondary.” One would have not heard that 18 months ago. It’s a fairly dramatic change in terms of the importance and profile of the secondary market.

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Rattner: Credit quality deterioration ‘well underway’

Steve Rattner, the chairman and chief executive of Willett Advisors which manages the personal and philanthropic investment assets of Michael Bloomberg, shared his thoughts on the US economy at the PDI New York Forum in September.

Rattner on ... how the global financial crisis came about
It was a combination of factors that include, in no particular order: poor regulatory oversight from the federal government in terms of really understanding what was going on in the financial system and in curbing things that we later knew to be excesses; and poor risk management on the part of a lot of banks and other financial institutions, who were buying things that they either didn’t understand or overpaid for or got out in front of them.

I remember in the summer of 2007 I was helping Mayor Bloomberg buy back part of the interests in his company that Merrill Lynch owned at the time. I sat down and tried to read Merrill Lynch’s financials and I couldn’t understand any of it – it was so complicated, there was so much off-balance sheet stuff, there were so many what we used to call the SIVs and the conduits and all this stuff. I remember thinking, ‘This is a very unusual way to run an institution’ and of course it didn’t really work out very well.

It all came together in this perfect storm where you had over-leveraged banks – Bear Stearns first and then Lehman Brothers – and then this cascading effect into Fannie and Freddie [Mac], into Citi and [Bank of America], AIG and so on. And then of course the financial effects spilled over into the real economy and that caused a recession.

...where we are today
Hank Paulson, Tim Geithner and Ben Bernanke have been doing a number of sessions [at forums]. [They] deserve a lot of credit for what they did. This could have been 1929, this could have been the Great Depression, it could have been a financial Armageddon, and we’re really very fortunate that those three guys and a lot of other people really did save us. There’s no doubt about that.

The second message they’ve been conveying, which I agree with, is we are actually in some ways better prepared for the next crisis and in some ways worse. Essentially the Federal Reserve and the federal government did what it could to put us back on a growth trajectory, so when you look at how fast the economy turned, how fast the stock market turned, it really is quite remarkable. We’ve now had a long period of sustained growth, low inflation, low interest rates. We are now in the longest post-war expansion in history, we’ve had 124 months, and things are going pretty well. The biggest concern I have is that growth has been somewhat slower than normal and productivity growth – very, very importantly – has also been slower than normal, and that does tend to cause slow GDP growth.

...when the next downturn might hit
There was a study done not too long ago by The Economist which found that over a 15-year period, of 220 instances in which a member’s economy contracted in the year-ahead, not once did the IMF forecast the downturn.

So before any of us say ‘We’re going to have a recession next year’, I think we have to be humble about it.

Economists like to say that recoveries don’t die of old age, but they kind of do.
I really think that power — and that was a political decision — would have been better vested in the Fed.

...on what keeps him up at night

I do worry about the trade war; tariffs are a tax, taxes slow the economy, trade is good for an economy, I think that’s been well proven, and if we get into a trade war and the amount of trade drops off, that’s also bad for economic growth.

The second thing is this build-up of inflationary pressures that one can vaguely see. I think it is a potential worry and something we should really keep a close eye on. I think the recent moves in 10- and 20-year treasuries may be signalling something, we’ll see, but we should be watching those unemployment numbers and the wage numbers and the consumer price index numbers and the personal consumption expenditures numbers very, very carefully.

The third thing I worry about is that, on paper, what’s happening in the Howard Marks world of ‘too much money chasing too few deals’, is visible. You can see that spreads between high yields and investment grade loans are not all the way back to where they were right before the global financial crisis, but they’re pretty darn close. And there are other measures, like the share of deals being done through covenant-lite structures, that also tell you things are scary. And you can also look at the debt ratios that are going into private equity deals — the Fed had a policy that they didn’t want more than six times debt to leverage in private equity deals, that has sort of been nudged up a little bit.

There are indicators in every direction that while most of the really crazy financing structures that existed at the time of the great financial crisis have been taken off the table, the more conventional, simple act of credit quality deteriorating in a bull market is obviously well underway and is a scary situation.

...on regulatory weapons to fight a downturn

In reaction to the so-called bailouts of the banks and financial rescues, which were unbelievably unpopular among the people and still are to this very day, as part of Dodd-Frank, Congress took away from the Fed and the Treasury a fair amount of their power to provide emergency lending assistance to failing institutions. And that is a very scary situation. Because while you can hate the bailouts, or believe, as I might, that there are some things that could have been done differently, that would have created less popular resistance to them, it was the ability of the Fed and the Treasury to move in that really saved us from Armageddon.

There’s a second thing in Dodd-Frank that I don’t like. They have set up a better mechanism — and this is a plus — for winding down failing large banks. The Federal Deposit Insurance Corporation has always been able to deal with failing little banks, but wasn’t in a position to deal with failing large banks; they’re just so complicated.

They gave to the FDIC the authority to make sure the subordinated lenders and the equity holders in those banks take haircuts, which didn’t happen last time because it just couldn’t be done structurally. While very good at saving little banks, the FDIC doesn’t know anything about saving big banks. And
In an environment where limited partners are trying to maximise returns and lower their fees, co-investments have become an ordinary component of the private equity landscape and of relationships between LPs and general partners.

Nearly two-thirds of LPs plan to invest in co-investment opportunities, according to the PEI LP Perspectives Survey 2019.

“In the last five years, co-investments went from being pretty common to ubiquitous,” says Brian Gallagher, a partner and co-founder at Twin Bridge Capital Partners, which often co-invests alongside its GPs. “It’s gone from a topic at most fundraising meetings, to a topic at every fundraising meeting.”

But no two co-investment situations are the same and specific arrangements between managers and co-investors in the same deal often vary greatly.

Initially, GPs offer co-investment opportunities to their LPs in different ways.

“I’m seeing some sponsors forming specific co-invest funds ahead of time, anticipating that they’re going to need additional capital for specific investments that their main fund will make,” says Babak Nikravesh, a partner with Hogan Lovells and the co-head of the firm’s sovereign investor practice.

“But most people actually do it on an à la carte basis. They realise they need more money for a particular investment, maybe because they’re up against their percentage cap on how much they can invest per company and they have to go out and raise money from other institutional investors. Typically they will reach out to the people in their main fund, often preferred LPs who they hope will re-up in another fund and which they believe can provide capital promptly. Or they may reach out to other potential partners outside their main fund.”

Co-investments also differ in terms of the structure GPs adopt once they are about to make a specific investment.

The majority of general partners offering co-investments structure these transactions as a separate entity as opposed to direct investments in a portfolio company.

Gallagher believes it’s always better to be in the same vehicle as the sponsor of the deal, but adds that “as long as we have the right protection and rights, it’s form over substance”.

John Guinee, managing partner and co-founder of Constitution Capital Partners, also a frequent co-investor, thinks the type of structure varies depending on the size of the GP and that the creation of a limited partnership with co-investors is typically
With so much money flowing into private equity funds and such a great interest among LPs for co-investments, the negotiating power has tended to swing into the hands of fund managers recently as opposed to co-investors.

“For savvier GPs, they’re recognising that co-invests are a hot commodity, and they may have the ability to command some form of management fee and/or carry depending upon the deal and LPs in question,” says Nikravesh.

Co-investment arrangements also differ based on the types of fees and expenses being charged. One of the main drivers behind institutional investors wanting more co-investments is the ability to avoid paying management fees and carried interest on such deals.

The fee structure depends on how close the links are between the LP and the GP.

“If it’s a true co-investment that you’re offering to LPs in an existing fund, a no fee, no carry arrangement is pretty typical, but there’s a lot of variation,” says Nikravesh.

Gallagher notes that overall, whether a co-investor pays management fee and carried interest depends on if it is also an LP in the main fund. As co-investment transactions become larger, if interest among LPs from the main fund is not sufficient, GPs tend to reach out to investors who have not invested in the main vehicle.

“If you are not an LP in the fund, I think it’s totally reasonable to be charged a management fee and carry,” he says, adding that Twin Bridge only co-invests with existing managers.

Guinee agrees co-investments for existing LPs should be no fee/no carry. “Organisational and set up fee is all we ever see and that’s the only one we pay,” says Guinee. “All the other fees – management fees and carried interest, that’s more indicative of bigger funds,” he adds.

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This is especially true for strong performing money managers. But for first-time funds or managers starting a co-investment programme, co-investors can still have the upper hand.

It remains to be seen whether a downturn in the economy will modify co-investment appetite among LPs and as a result will impact LPs’ and GPs’ negotiating power.
CO-INVESTMENTS

Sharing isn’t always easy

Today almost every GP is obliged to provide at least some co-investment deals to investors. Debevoise & Plimpton’s Katherine Ashton outlines the issues at stake.

With so much demand for co-investment on the part of investors, and so many promises of opportunities from fundraising sponsors, there is a growing sophistication in execution. Here, Katherine Ashton, partner at the law firm Debevoise & Plimpton in London, tells Private Equity International what she is seeing in terms of issues and resolutions.

Why are co-investments now happening with greater frequency?

Firstly, club deals, where PE firms band together sharing governance as well as money, are on the wane. There have been a lot of not particularly successful deals, and it is time consuming and difficult to negotiate the governance around who makes the decisions. That means sponsors that want to invest in large deals are increasingly likely to favour relatively passive co-investors.

Second, we have reached a point where the co-investment rights that LPs have been demanding as a price for coming into primary funds are coming to fruition. In recent years, those became a standard request, and today almost every GP has some obligation to show co-investment deals to some investors. For LPs, these deals represent a way to diversify and show some great returns.

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Q What are sponsors’ motives in bringing in co-investors? And are pre-closing or post-closing opportunities more common?

The question is whether the sponsor is offering the opportunity just because they promised they would or because they genuinely want to lay off part of the expense and the risk. Both motivations are common, but they affect the dynamic and the process.

Sometimes there are a number of co-investors who all want more of the deal than they are getting. In those cases, the LPs that do well are the ones who work well with the sponsor and make the effort to understand the dynamics and the timetable of the underlying transaction. Other times there is one LP with a significant piece of a large deal.

Ten years ago, sponsors would do deals and then afterward look to lay off part of the risk by bringing in co-investors and syndicating out pieces. That still happens, but now it’s much more common for LPs to be brought in earlier by the sponsor, before the deal has closed. Then there is a lot more time pressure, but there’s also more opportunity to potentially influence the structure.

Q Do co-investments work better for specific types of LPs? Are there new entrants coming into the market?

Not all the LPs doing deals are traditional private equity players. We see sovereign wealth funds, and new entrants including institutional investors from other parts of the world, who may be interested in the direct dealflow and exposure that co-investments offer but are not always set up to make decisions as quickly as sponsors need them to.

On the other hand, a sovereign wealth fund may have so much money and so much potential influence with the sponsor that it can participate in a very meaningful way and materially impact transactions. It’s all about relationships – there aren’t a lot of structural barriers to coming in and doing co-investments; it is whether you can persuade the sponsor to give you a piece of the action. Sponsors are wary not only of the
There’s an eagerness to have more direct exposure to the magic value that a really good sponsor can bring.

How do LPs react to sponsor contacts undertaking co-investments with other (potentially rival) LPs?

I have not come across that as a major issue. Yes, there is competition, because LPs are quite often scaled back and get less of the deal than they want. But everyone acknowledges sponsors have numerous demands and LPs need to distinguish themselves by being easy to work with.

Co-investments are significant transactions and need to be taken seriously. But they are a different kind of negotiation because it’s not winner takes it all in the way it is when negotiating M&A. Instead, these deals are driven by long-term relationships – the parties already do business together in lots of different ways and want to do business together again.

What structuring aspects of a co-investment spark the most debate between LPs and GPs?

If you’re going into a deal pre-closing, then an important issue is what happens if the deal doesn’t close – how do you split up expenses, for example, and also what ability does the sponsor have to force the co-investor’s hand if the terms change a little.

Once you get through the deal, the most important thing is the governance and structuring arrangements by which the co-investor is brought in. When representing an LP, you have to look carefully to make sure the interests of the LP continue to be aligned with the interests of the sponsor, so the sponsor cannot dilute the LP by putting more money in, for example. If the sponsor decides to sell, the co-investor should be able to go along.

If you’re an LP, you want to go into a deal with the understanding that you will make or lose money to the extent that the sponsor does, so you want to make sure the legal structure allows for that and that will continue to be the case down the road.

To what extent are major institutional investors turning to co-investment opportunities instead of commitments to more traditional fund vehicles? Could the co-investment model overtake traditional funds?

In our experience of the market today, there are a lot of people with a lot of money to invest, and it is not a zero-sum game of one or the other. For most major investors working with fund sponsors that they trust and have done well by, there’s an eagerness to have more direct exposure to the magic value that a really good sponsor can bring.

It is about diversifying and coming up with a bespoke solution. If you are an LP investor with a really great sponsor and you need more exposure to, say, Southern Europe, then co-investment is a great way to pick and choose and construct a portfolio more attuned to your assessment of the market.

What are the risks of co-investments?

As an LP, you are piggy-backing on a sponsor. So, although you may have some opportunity to do due diligence and structuring, in essence you are trusting the sponsor not only to identify a good opportunity, but also to get the right price and manage that investment through to a good exit and a good return. The co-investor gets to tailor its portfolio, but it may end up very exposed to one manager.

Some co-investors may not have the background and resources to adequately appraise an opportunity – the best ones don’t just work very well with GPs, but are also rigorous in their analysis and know when to say no.

From the sponsor point of view, the risk is that you bring other people into your situation, and if something goes wrong they complain. Plus, there is the execution risk of bringing them in, and, in theory, the highly unlikely but terrible scenario where a sponsor may have committed to pay X, the co-investor agrees to pay Y, and then the co-investor defaults and the deal collapses.

Sponsors today are moving toward standardising their co-investment documentation as much as they can because nobody wants to be dealing with the same issues over and over again when bringing in more parties to a deal. The bigger sponsors are increasingly working to make it more cookie-cutter deal-to-deal, and I think that standardisation will continue as the co-investment market continues to mature.
On the minds of top LPs

From dealing with stressed portfolios to handling ESG issues in portfolio companies, investors tell us the issues that keep them awake at night

**KEY QUESTIONS**

**What are the most promising regions and strategies in 2019 and why?**

**What issues keep you awake at night?**

**Marc Lau:** Risk in all its forms could be attractive in 2019 if safety is prized. Patient capital remains uniquely positioned to take advantage of mispricing and has the long-term orientation to wait for mean-reversion.

**Marcus Simpson:** North America, Asia-Pacific, and Europe – with a preference for venture, growth and smaller buy-outs – remain attractive: We like the gains made by investing well into businesses, growing them with talent and capital and positioning them for the next shareholders.

**Daniel Winther:** For me, a one-year perspective does not mean much. Over time, specialisation will continue to deliver the most attractive returns regardless of region and asset class.

**ML:** The increasing encroachment of politics into business.

**MS:** Private equity stops outperforming public markets by an attractive margin; industry perception; and ESG issues in portfolio companies.

**DW:** Many GPs are scaling (too) quickly – how do we separate the winners from losers?

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**Many GPs are scaling (too) quickly – how do we separate the winners from losers?**

Daniel Winther
What’s the biggest challenge in 2019?

**ML:** To have the courage of your convictions if sentiment diverges significantly from fundamentals.

**MS:** Balancing investing in attractive businesses (that we still find at this point in the cycle) with keeping powder dry for opportunistic investments if/when there is a future downturn.

**DW:** Keeping up realisations with investments.

What surprised you most in 2018?

**ML:** While not surprising to individual users who value individual convenience, data privacy concerns have not seemed to alter user behaviour as much as the press or stock market attention it has generated.

**MS:** US economy growing by more than 4.0 percent real in a quarter.

**DW:** The persistent appetite for mega-funds makes no sense.

What's your one piece of advice for GPs?

**ML:** The principles for success in PE rarely change – stick to what you know, focus on carry and have strong alignment of interests with investors and investees.

**MS:** Combine your good work on outperforming public markets with an increased focus on ESG, especially diversity and transparency.

**DW:** Make sure the ratio between number of portfolio companies and investment professionals is not at max. If the portfolio is put to stress, a few bad deals can take up a disproportionate amount of your time.

**OUR INVESTOR PANEL**

Marc Lau, managing partner, Axiom Asia Private Capital

Marcus Simpson, head of global private capital, QIC

Daniel Winther, head of private equity and infrastructure, Skandia
FUNDRAISING

Why mega-funds are on a roll

MVision’s CEO Mounir Guen talks huge fundraises, new pools of capital and the value opportunities from Brexit

Q Looking big picture, what has been the key theme of 2018?

This year was really all about mega-funds and that trend will continue. Investors have been highly focused on the US market and still are. If they are investing in 10 GPs, they are easily investing in eight in the US, as the returns have been very prominent. And that is why US GPs are able to get bigger and bigger. Many are doubling their fund size and they are still having allocation stress.

There’s rising demand for European GPs because investors are significantly underweight in Europe and can’t ignore a market of half a billion people with the rule of law, bankruptcy laws, financial and capital markets infrastructure and a lot of noise. There’s a lot of inefficiency and opportunity to capture value partly caused by Brexit, and other government changes.

Q Can funds continue to grow?

Yes. Managers will grow in terms of business structure, the number of alternative vehicles they manage and assets under management. Individual fund sizes are capped by a strategy, so GPs will keep raising different types of funds and maximise their businesses.

Q Bigger funds means increasing competition for assets. How are LPs responding to rising prices?

Are investors a little nervous about investing at higher multiples? Of course they are. Do they want to dig in a bit more into the operational and risk profiles of private equity firms? Yes they do. Are the regulators doing that also? Yes they are. Investors manage their portfolios very carefully. Right now, with the equity markets so high and when we’re approaching the end of the cycle, the question is: should an investor be more cautious or continue to invest a regular amount of capital consistently? I believe they should do the latter and the reason is that private equity firms, particularly at the larger end, are buying great companies. If they are expensive that’s fine. At the end of the day, these companies are well positioned with strong operational infrastructure and excellent management and are likely to continue to perform. They are not commodity orientated or cyclical.

Q With the US and European markets so bullish, are LPs still looking at other geographies?

The interest in new markets like Latin America or Africa and even parts of Asia is extremely limited. Not because of lack of opportunity or experience, but due to local currency volatility relative to the US dollar and the net dollar returns. For local LPs it is fine to invest and currency returns are attractive. A lot of local investors are now becoming more international which is reducing the potential volume of capital available domestically for GPs. Over the next few years, GP headcount in those markets will be inhibited because it’s very difficult to finance them.

One of the few markets breaking that mould is China: the local headcount of private equity firms financed exclusively by Chinese capital is really high. It is also seen in the South Korean and Japanese mid-markets but not at the same scale as China.
But the volume of domestic capital invested locally is particularly pronounced in China. As a GP, you have to be very focused on making investments that will generate cash and put you within a range of your global peers, as well as demonstrate your strategy, internal governance and discipline. The benchmark is a challenge for the emerging managers right now.

**Q** Can international GPs also access these pools of capital?
Absolutely. GPs are targeting these markets. In the next five years we are going to see a lot of new capital specifically from northern Asia, Japan in particular – Japanese pension funds are all between $1 trillion-$3 trillion in size and they are allocating 2-3 percent to alternatives, which is going to move to 5-6 percent – and also markets such as Taiwan and South Korea will be more prominent. There’s a good volume of capital coming from these countries and a lot more to come. When the Chinese pension and insurance companies become more international, there will be a huge amount of capital moving into the global market place from pension funds and insurance companies.

One of the things you need to decide as a GP is whether you’re going to open an office for investor relations in the region or not. Also, LPs have opened up offices in London and New York to address access. The GPs can reach them in these offices, but they still need to be very conscious of local regulations.

In a market where there is a significant local investor community, as a local GP my decision is how much non-local money to accept if any. A domestic GP in Japan, for example, might as well get financed 100 percent by Japanese investors. They are dealing in local currency, with investors that understand the local market.

**Q** If I’m a new LP, from Asia say, how do I compete for allocations?

For GPs in demand it is complicated. Imagine 80 percent of LPs want to re-up with an incredibly popular manager and increase their allocation by 1.5 times in aggregate. The space for new capital becomes very limited. Even more so with European funds that only scale up by 30-50 percent. You have to introduce an LP early – one or two years before a fundraising. US public pensions have a short list of firms they will review in two years’ time. Also, most investors have decided to have fewer GP relationships: 40-60. When I first started it was more than double that. All these dynamics can create huge access issues for investors.

**Q** What do you do if you can’t get in?

The appetite for co- and direct investing is increasing substantially. It’s become part of portfolio construction. The largest Asian investors are very sensitive to the construction of their J-curve, so they will use secondaries and a combination of primaries and directs to manage it. This new capital has a significantly steeper J-curve than I’ve ever seen in my career. They are in the money in very short times. When I first started in the business, it would take 12-15 years for people to work through the J-curve and arrive at a good place. As a result, historically, US capital is so prominent because those LPs have been through multiple J-curves. The Japanese investors in particular have caught up super-fast. They can see what everyone else has done. Investors are all hiring the same consultants and lawyers and they face similar regulatory conditions. That’s why a lot of the investment programmes convert to a mean.

**Q** Are direct and co-investors at risk come a downturn?

Mega-investors can’t put enough money to work in third-party vehicles and they have to find solutions.

Over the past few years there has been a discussion about investors not having the infrastructure to match a GP. But they are now hiring people from GPs all the time. Remember, direct investments from investors are quite conservative – reputational risk is a very big focus for them. Also they are becoming more specialist. They have huge amounts of capital with a lot of discipline and experience, governance and infrastructure and are able to weather a turn in the cycle with their long-term horizons.

**Q** Does the focus on going direct dampen LP interest in first time funds?

In the US, LPs have been very good at creating “emerging manager” programmes and allocating funds to first time funds. Their favourites are spin-out teams. If they can access a team from one of the big firms who are launching a fund and going down the investment ladder to go up again, investors love that, especially from popular funds. But outside of the US there is limited support for first time funds or infrastructure for it. At the other end of the spectrum, the more remote your market is, the more likely it is the government will kick in or development finance institutions. In between, it’s quite difficult. For European first-time funds, for instance, it’s more challenging and most support comes from the US investors.
MANAGEMENT FEES

Picking up the tab

Fees remain a bone of contention for limited partners, as fund sizes continue to grow, writes Claire Coe Smith

Management fees remain the biggest bone of contention for investors during due diligence with managers, according to PEI’s Perspectives Survey 2019, and are rising up the agenda as fund sizes grow.

In all, 45 percent of respondents pointed to management fees as the most contentious terms raised during negotiations on the limited partnership agreement, and advisors say this is not surprising.

“Fee negotiations tend to follow a well-trodden path,” says Jason Glover, investment funds partner with law firm Simpson Thacher & Bartlett. Management fees are typically expressed as a percentage annual levy on funds committed. “First-time funds are usually at 2 percent, and then thereafter tend to find an equilibrium at about 1.5 percent, especially for the mega-funds,” says Glover.

“The area of contention arises when you are looking at increasing the size of the fund, with some investors querying why doubling the size of the fund means the total amount of management fee should also double, when the manager is not necessarily doubling headcount.”

Nearly two-thirds of the investors surveyed (65 percent) have asked their GPs for greater fee transparency and disclosure in the last 12 months, with 63 percent agreeing that the fees charged by private equity funds are now difficult to justify.

Mounir Guen, chief executive of Source: Private Equity International

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

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<thead>
<tr>
<th>Term</th>
<th>Percentage of respondents</th>
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<tr>
<td>Management fees</td>
<td>45.2</td>
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<tr>
<td>Unsatisfactory/no key man clause</td>
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<td>Performance fees</td>
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<td>GP commitment</td>
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<td>Structure of carry distribution waterfall</td>
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<td>Lack of clawback provision</td>
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<td>Set up costs</td>
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<td>Board representation policy</td>
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Source: Private Equity International
placement firm MVision, says: “For me, the debate isn’t so much on the quantities when it comes to fees, but on the visibility of the underlying cashflows, and how they are categorised relative to expenses, fees and other costs of investment.

“Where GPs spend a lot of time in discussions with investors is on fund size, and what the fund size means for the positioning of the strategy. There’s then a fairly interesting discussion to be had around resourcing relative to that positioning, and it is worth noting that US private equity teams are typically much smaller relative to the quantities they are investing than their European counterparts.”

Nick Benson, investment funds partner with Latham & Watkins, says there are also frequent bilateral conversations to be had around fees: “Often big investors will feel they should get a particular deal given their size and strategic importance.”

Second to fees, investors pointed to unsatisfactory or non-existent key-person clauses as a hot topic in LPA discussions, with 44 percent saying these were a recurring issue. Glover says: “Key person is always an issue, and it becomes an increasing focal point in the market as investors become more keen to back institutional brands, which tends to drive a much broader key-person test than might previously have been the case. Investors now often want to see a broader bunch of people named, and then there is negotiation around trigger events, remedy periods and so on.”

A third of the LPs pointed to the GP commitment as an issue, with investors focused on general partners having ‘skin in the game’ by committing their own money to a fundraising. Again, this becomes more of an issue as fund sizes grow; with GPs typically asset rich but cash poor, and therefore constrained in their ability to commit.

Guen says: “The investors would typically like the GPs to be at 2 percent of total committed capital, but not all managers can meet that — some funds can do a lot more. That’s an area where there are sensitivities.”
KEYNOTE INTERVIEW: BRG

MATURE FUNDS

Extracting liquidity from tail-end assets

The secondaries market is an efficient way to restructure maturing funds, but managers and LPs may need to consider other options, say Finbarr O’Connor and Gavin Farrell of BRG’s Alternative Investment Advisory group.

What are the alternatives to liquidity for mature funds that are struggling to access the secondaries market? Finbarr O’Connor, leader of BRG’s Alternative Investment Advisory, which specialises in the management and resolution of tail-end fund interests, and Gavin Farrell, its director of business development, discuss the options available.

Q What are your views on the current state of the private equity market, particularly as it relates to maturing funds? Finbarr O’Connor: The wave of capital that was raised by PE funds between 2003 and 2008 has been maturing Currently it is estimated that approximately 25 percent of the PE fund universe has reached maturity.

As these funds mature, GPs need to assess the available options and which of these are in the best interests of their LPs. A significant portion of the mature fund market will go through a restructuring process, facilitated by the strong appetite and creativity within the secondary market, and deliver LPs with liquidity or subsequent investment options.

However, this is not always feasible or indeed may not be the best option for LPs. Some maturing funds, particularly those with distressed, out of favour or small remnant positions may be unable to attract decent bids from the secondaries market or the GPs may be struggling to raise capital for a continuation fund, so LPs are left with the status quo – ie, a GP with no incentive and an investment with no end in sight.

Q Why haven’t these smaller maturing funds been able to take advantage of the secondaries market? FO: A theme we encounter is the existence of some form of structural issue either at the portfolio level or at the GP level that may prevent many smaller funds from executing a restructuring or outright secondary sale. For example, we have dealt with situations where the GP is out of the carry and lacks any real incentive to lead a restructuring, or where the portfolio assets are distressed and only deemed attractive to deep discount buyers. We’ve also had mature situations where there are consent issues or legacy litigation preventing transfers on residual assets.

Today, we’re dealing with some older funds facing a range of these sorts of issues. Some have assets that require time for us to work through asset level changes or restructuring and exit plans. But there’s often a reason mature fund assets haven’t been exited — those assets are either unattractive or need attention. For the potential buyers of such assets, it comes down to a balance of the ability and attention required to resolve the structural issues, a pathway to liquidity and also pricing. So, smaller tail-end funds and assets tend not to be attractive to a wide community of buyers in the secondaries’ market. LPs of those funds can be left with limited options. If I’m an LP in that situation I am looking for a plan to deliver liquidity with someone who will be focused and drive execution.

Q What should these fund managers and their LPs do in the current environment ahead of a possible downturn? FO: If I am the private equity owner or asset manager, I would be beginning to think in terms of stress tests at the asset level. What happens if prime goes above 6 percent (where the Fed seems to be headed within 12 months), and what does that do to portfolio company performance and cashflow alongside a dip in sales or activity, or if something happens to global trade or in the Middle East? I think understanding how those, or similar assets, performed in prior downturns, as well as assessing the impact of any leverage constraints, should form part of the investor’s cushion analysis.

Gavin Farrell: We believe the private equity market is approaching an inflection point, if it’s not already there. There are decisions that are going to present themselves to LPs in terms of liquidity or the rolling over of mature funds. There will be a portion of that mature fund market that may not be either possible to roll over or restructure in a traditional way. Or it may not be in their best interests that a traditional approach be followed. Not many GPs, or LPAs for that matter, contemplated end of life scenarios when the funds were being established and there are now alternatives to a secondary sale, but that alternative doesn’t necessarily mean accepting the status quo. As Finbarr mentioned, some GPs aren’t in a position to complete an orderly wind down. Others may be very good GPs with a very solid business, but the time and effort required to focus on winding down a late-stage fund may not be the best use of their talents when they could be raising a new fund or managing existing portfolio assets on behalf of their LPs.
FO: We see ourselves as complementary to other participants in the secondaries market. We do this in two main ways. In the past we have worked alongside secondary buyers to assist with the management and optimisation of troubled assets that have been acquired as part of a secondary deal. Secondly, as a replacement manager, we are an alternative to a secondaries transaction where we take on the fiduciary responsibility for management of an orderly run-off and wind-down process and distribute capital back. LPs and GPs introduce us when they are looking for a plan to deliver liquidity and someone to who will be focused and drive execution. We devise a plan for each remaining portfolio asset to optimise value and drive the process to deliver liquidity to the LPs. As our compensation is linked to the value of returned capital, the approach is completely aligned with the interests of LPs.

Q: How does BRG fit within the secondaries market?

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Q: Can you describe different paths to liquidity?

FO: Liquidity can come in the form of a fund restructuring, a secondaries asset sale, a secondaries fund transaction or a collection of asset sales, and then a distribution to investors. Of the mature funds we’re managing currently, we are working through a fund restructuring on one, while the other funds are at various stages in the secondaries market or in direct asset sales. The largest fund we manage is a hedge fund with illiquid private equity style assets where we’re working through to a deliberate asset-by-asset exit process returning capital as we close transactions.

Q: How can you ensure such transactions are LP friendly?

FO: As I mentioned, we are economically aligned with LPs, but in addition to that we operate with complete transparency and communicate openly and regularly with LPs to ensure that they are fully informed at all times. We see this as a key pillar of our fiduciary duty to LPs. Good stewardship begets more stewardship and, as a result we have repeat institutional clients that view us as a practical solution to work through their tail-end interests.

One of the things that is, of course, a hot point with both the SEC and LPs when it comes to fund restructurings is what are the exchange terms and how to avoid any conflicts of interest. The SEC has rightly scrutinised these transactions in the past few years. Likewise, the Institutional Limited Partners Association has promised to issue guidance to its members on the topic in 2019. In any exchange of value, there’s a potential for conflict and a potential for a breakdown in trust. It can be an extremely complex process to provide liquidity optionality to LPs that will also satisfy the LPs that want to stay invested. Five years ago, fund restructurings were almost unheard of. Therefore, as a relatively new form of transaction, a success factor is that the process be well documented and communicated to LPs.

GF: In a GP-led restructuring, you are transferring assets from one fund to another that is being partially funded by a new set of LPs. There is no actual realisation event, therefore you’re determining the value of a portfolio and transferring a portion of that value to the second fund and providing liquidity to some initial investors with the other. It’s critical that there’s an independent opinion of value provided to confirm the fair value of that portfolio of assets, and that this is well communicated to the LPs.

Furthermore, among the LPs, there’s a real sensitivity around the reset of carry. LPs rarely object to sharing the upside with GPs when they get paid. But when there’s a restructuring they will be likely to pay close attention to fee terms and when transparency is lacking, suspicions and concerns can grow. At all times, there must be a clear alignment of interests and full transparency to avoid any conflicts of interest.
For Texas Municipal Retirement System’s director of private equity Christopher Schelling, identifying the good managers is the easy part – the challenge comes in securing consistent access at scale. By Isobel Markham

**Q** How has your private equity portfolio performed?

We have had a good run the last couple of years, it’s exceeding our expectations over every metric and over every period. Our three-year performance is 17 percent and our one-year is 35 percent. A lot of that is just the fact we’re in a strong equity market in general and we’ve gotten some strong performance from a couple of funds, so it’s early yet I think for TMRS, but we’re definitely pleased with the performance so far.

**Q** How is your portfolio split?

We’re around 90 percent US, 10 percent international. By what we consider market exposure – NAV plus unfunded commitments – we’re 50-55 percent buyout, 20-25 percent growth and venture, but most of that is in growth equity, and then we’ve got another 20-25 percent in special situations, which is basically mezzanine and distressed.

**Q** Is the impending market correction affecting your investment decisions?

We’re looking at sector specialists – we try to be bottom-up in building this portfolio. If someone comes to market who’s the best at what they do and we can invest, we would invest there, we would not make a tactical sector call. But at the margins, we’re trying to find exposure to managers that do things that are less cyclical and should have more stability in their top line, and we’re also thinking about how managers performed during the last downturn. We want to avoid really beta-heavy funds that maybe had a great fund before, a great fund after, and did terrible during the downturn. We would prefer someone who maybe over time doesn’t have the highest numbers but did well before, preserved during and has continued to do well after. We’re thinking about distressed because that is an area to deploy capital when the rest of the world blows up. But as far as tactical bets, we don’t make them, and we’re not changing our pacing model, we’re trying to be consistent. If we want to do $500 million and we find great managers who complement our portfolio, meet all our hurdles, we will put $500 million out. If we don’t, we will under-pace.

**Q** Will private equity continue to hold up when the market turns?

Because of how the asset class is priced, it will absolutely hold up better, at least initially, it just won’t get marked down as fast. I understand that is merely an accounting factor, but as far as its portfolio impact, the vast majority of public plans and endowments will actually get benefit from being there. Now, there are areas that I think might have bigger drawdowns than others, and there are areas where there will be opportunity to deploy capital, so we’re trying to figure out ‘what happens if’ rather than make predictions. I think the most overheated market segments are the ones that are going to hit the hardest, that’s not a stretch to say.

**Q** Given the current strength of the fundraising market, are you seeing managers return to market earlier than expected?

We’re seeing several funds come back a lot sooner than we thought, and that impacts pacing. It also means your capital’s going to be put to work less quickly, which is an issue when you’re trying to get to target, so that does concern us, although we understand the reasons for it: investing is lumpy, and all of our funds go through a little dry spell and then at some point most funds will have three or four deals close in a very short period of time. If the general partner is saying, “We need to have capital available so we can continue our franchise because we’ve got two or three deals that are going to close,” it’s not my job to tell them they’re wrong.

Schelling: plenty of opportunities to go round
We’re seeing several funds come back a lot sooner than we thought, and that impacts pacing. The number of opportunities is going up because there are more and more private companies and fewer and fewer public companies, so you can have more managers. I think we’re still a long way from the private market being anywhere near as efficient as the public market, at least in some parts. You’ve got 15,000 mutual funds, you’ve got hundreds of thousands of traders and investors, you’ve got 10,000 hedge funds, and you’ve only got 3,500 publicly traded companies, so that’s super-efficient. You’ve got 400,000 private companies that have EBITDA between zero and $50 million-$100 million, so that’s a deep pool. Is 10,000 too many? I don’t know, but I think for private equity, there are plenty of opportunities and how many dollars behind that.

The number of opportunities is going up because there are more and more private companies and fewer and fewer public companies, so you can have more managers. I think we’re still a long way from the private market being anywhere near as efficient as the public market, at least in some parts. You’ve got 15,000 mutual funds, you’ve got hundreds of thousands of traders and investors, you’ve got 10,000 hedge funds, and you’ve only got here in America 3,500 publicly traded companies, so that’s super-efficient. You’ve got 400,000 private companies that have EBITDA between zero and $50 million-$100 million, so that’s a deep pool. Is 10,000 too many? I don’t know, but I think for private equity, there’s plenty of opportunities to go around.

What we want to see in that situation if we’re going to commit is that they don’t turn on the fees until the other fund is done. There are ways you can make that less of a conflict. If you’re only 45 percent in the ground and you still have two years left of your commitment window for the prior fund, you do not get to turn on fees on committed until the other one is done, period. That would be non-negotiable. But we would still commit if they would structure it appropriately.

Access is an issue. In private equity I don’t think identifying good managers is tough, really, at all. Getting access to the best consistently and in scale to move the needle for a large portfolio, that’s more of a challenge.

For large public pensions, all of us have a ton of capital to put to work, we have people who source, we have consultants who work for us, we see a lot, so I don’t think any public pension team that’s got a $2 billion private equity portfolio will tell you it’s so hard to identify good managers. But the problem with putting out so much money is getting enough in the ground relative to your resources to monitor that portfolio.

We’re seeing a lot of spin-outs. Is there still space in the market for new managers?

I think there is still space. We also see some spin-outs from shops where there is not going to be a subsequent fund, so it’s not adding to the number of managers in the space. I think there will only be an increasing number of managers, and at some point there will be too many. My concern then isn’t necessarily the number of managers, it’s really the efficiency of the market – how many people chasing how many opportunities and how many dollars behind that.

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Making an impact

Impact investment is on the rise, with the increased involvement of more mainstream players in this part of the market. Partners Group’s Kevin Lu discusses how their entry is changing the market.

Responsible investment practices have come a long way in the last decade as investors increasingly seek ways of creating value and mitigating risk through an environmental, social and governance lens. Yet many are also looking for ways of making a positive impact through their investments across a variety of measures, from promoting gender equality and reducing poverty through to mitigating climate change and protecting human rights. For many, this has been made easier by the creation in 2015 of the United Nations’ Sustainable Development Goals, an articulation of 17 goals for sustainable development, as they provide a framework around which investors can focus their impact investment efforts.

The growth of impact investing is clear. In its 2018 annual survey of impact investors, the Global Impact Investing Network says that the latest “best available floor” for the size of the impact investing market is $228 billion, a marked increase on the 2017 figure of $114 billion, with respondents expecting to increase the amount of capital they invest by 8 percent over the coming year. Private equity, given its concentrated shareholder model and corporate governance features, is one of the main beneficiaries of this move and it’s therefore no surprise that some of the industry’s biggest players have now raised impact funds.

Earlier this year, Partners Group established a specific impact strategy, PG LIFE, which aims to achieve market-rate financial returns as well as positive social and environmental impact by investing in line with the UN’s SDGs. We caught up with Partners Group’s Kevin Lu, partner and chair of PG LIFE’s impact committee, to explore the growth of impact investing and what effect the entry of mainstream investors will have on this part of the market.

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**Q** What’s your view on the difference between ESG and impact investing?

I see this as a spectrum rather than binary, so you have a continuum of ESG, investing according to the SDGs and impact investing. This spectrum is simply a reflection of the genuinely different ways for investors to monitor the impact of their investments. You have to consider that there are different types of investors and fund managers – you have smaller, niche impact investors that focus on a very specific geographic or thematic area and then there are more mainstream investors that cast the net much more widely and invest much larger amounts of capital. Overall, I see responsible investment as the umbrella term that covers this spectrum and it’s a space that has evolved – and continues to evolve – from, for example, the broad set of principles set out in the UN Principles for Responsible Investment through to more specific ways of achieving impact.

So, for example, we monitor ESG factors for all our investments, we involve our ESG and sustainability team and implement ESG initiatives in all our lead and joint-lead investments and we have our PG LIFE strategy that has a specific impact mandate and focuses on investments whose products and services directly support the SDGs.

**Q** It can be a bit like alphabet soup for the uninitiated – to what extent do you think there’s still confusion around some of these terms?

I don’t think there’s confusion about the outcome, whether that is simply improving ESG performance or achieving deep impact, but there is still definitely some confusion around what people are talking about and that’s a function of the space still evolving. People label what they’re doing...
differently and there is no standardised definition of each of these terms.

However, I’m not concerned about the lack of a standard definition because the bigger question is whether we are now reaching an inflexion point for ESG and impact investing. The fact that more mainstream players are developing products and offering investors a means of accessing impact investments has to be a positive development. The fact that people are generally more responsible investment-minded suggests that the direction of travel is good, it’s just that different players are trying different ways of developing ESG and impact.

Q How do you see the impact investment market developing in the future?
I see an evolution of the niche, thematic players as they grow. These are highly targeted strategies and you have a lot of philanthropic capital directed at this space. At the other end of the scale, you’ll see more large, commercial players emerge to meet investor demand for impact investment at scale. This makes sense from a capital deployment perspective – if you’re a large LP and you have an impact objective for part of your portfolio, you need larger vehicles in which to invest. You also need the comfort that you are investing with an institutional platform with well-defined processes, rather than with a few people with a lot of passion. And once these larger players develop a track record, I think you’ll see more LPs allocate to impact investment programmes. I guess the question of how the market will evolve remains in the middle part of the market – it’s difficult to know whether these players will gain any traction in the impact space.

Q What’s driving more mainstream impact strategies?
It’s a natural evolution: 10 years ago, impact was a nice-to-have. It was niche. Yet over the last few years, it has started to enter into the collective mindset of LPs and these days, if you don’t think about impact, you are an outlier. For its part, the industry has been innovative in offering LPs impact products. For example, we’ve seen impact funds being raised by some of the largest private equity firms over the last two years and this has enabled LPs to access products that help them meet their impact as well as return objectives.

There’s also an element of larger managers realising that they have made such investments in the past, just without the intentionality of making them “impact investments” per se. These products reflect increased deliberateness in how to evaluate, measure and own these same companies with impact goals in mind.

And then there are the generational...
If you’re a large LP and you have an impact objective for part of your portfolio, you need larger vehicles in which to invest

» differences – if you’re an LP, your constituencies are changing. There is far more focus on impact among younger generations and so LPs investing on behalf of these generations have to take this into account. These differences also affect investors from a staff perspective. When I’m hiring millennials, for example, it’s clear that they think very differently about their careers than junior employees did just 15 years ago. It’s no longer about how to maximise earning potential; it’s much more about what their career means to them.

What would you say to those that suggest the entry of more mainstream players will dilute impact investing? There will always be those who equate an industry reaching new levels of scale with dilution, but, in the impact investing space, I think the reverse is true. The vision of most impact-minded investors is to see the concepts and values of impact investing reach scale. This cannot happen without leading investment managers carrying across these concepts and values to larger, more mainstream assets, and doing so with the governance rights to deliver meaningful impact.

And if you want to achieve impact at scale, there also have to be platforms that can be commercial and that achieve the financial returns that investors are looking for – you can’t ask them to sacrifice returns or they will look elsewhere. Mainstream investors have access to large amounts of dealflow and that allows them to be highly selective. Our strategy, for example, is to invest through our impact programme only if a transaction has also met the criteria for our private equity, real estate or other programmes.

You have to consider that a big part of an impact methodology is to introduce forward-looking monitoring. You put in place KPIs for management based on what you want to achieve from an impact point of view, so if you’re building a solar park, for example, you have to think both about how it will reduce greenhouse gas emissions, but also how the business will responsibly dispose of batteries and protect local biodiversity, among other things. If you inject this type of forward-looking mindset into companies and you define impact objectives effectively, there is a multiplier effect. If you own the largest renewable platform in a country, its practices will affect other renewable platforms in that market and perhaps even beyond. This is the promise of impact at scale; the potential to have a systemic impact on the “mainstream” economy.

To what extent can LPs assess and compare impact methodologies and measurement, given the lack of standardisation?

If you’re looking at the financial aspect of whether the strategy makes money, that’s quantifiable and therefore easily compared. When it comes to measuring impact, there is no standard way of reporting, despite a number of initiatives. For example, the IFC’s Operating Principles for Impact Management, which are an attempt to prevent dilution of impact investment and offer some clarity on what it is, are still conceptual. That’s not a criticism, it’s a statement of fact – Partners Group was involved in the initiative. And I don’t think it’s a problem because moving towards standardisation for the sake of standardisation can actually be counterproductive as it can give a false sense of objectivity. You have to make too many assumptions if you try and quantify impact in IRR or multiple terms.

However, this places the onus on LPs to understand what separates a robust impact methodology from a superficial one. This should start with simple questions: what is the manager’s definition of impact? How do they screen and evaluate investments for impact? Beyond monitoring and reporting outputs, what processes are in place to truly manage for impact?

Proper LP vetting will certainly help assess impact strategies, but I think many managers will be wary of entering the impact investing space without a robust methodology. The potential cost to brand and reputation is too great if they get it wrong.

Private markets are in some ways a natural home for impact investment, but to what extent do you think there is scope for growth in the public markets space?

Yes, private markets have a big advantage in impact investing because their models allow for much greater control of the transaction throughout its lifecycle – private equity firms can own and influence a portfolio company’s strategy. Public markets are, by their nature, much more indirect – the same goes for fixed income. I’d ask the question of whether there is a way of having a minority shareholding but still a big say in corporate governance. Public company governance tends to be more inefficient, so if there was a means of injecting the tighter, more direct governance seen in private markets, that would be a huge boost to the impact investment industry. The public and fixed income markets are so large that if this issue could be resolved, it could be transformative.
ENVIRONMENTAL, SOCIAL AND GOVERNANCE

Taking the responsible road

Only one-third of LPs describe ESG as a major consideration, but that doesn’t tell the full story, pension funds say. By Victoria Robson

For managers feeling the pressure from LPs to deploy more time and resources in the pursuit of environmental, social and governance policies, the rather muted LP interest in ESG captured by PEI’s LP Perspectives Survey may come as a surprise.

For about a third of LPs, ESG is a “major consideration” in fund due diligence, with the remainder reporting ESG issues were of minor or no concern at all, while two-thirds believe GP investments reflect their ESG policies only “somewhat”. Just 19 percent report their ESG outlook was strongly aligned with manager practices.

However, David Russell, head of responsible investment at the UK’s largest pension scheme by assets, USS Investment Management, described this reading of the results as “perhaps a little too simplistic”.

“What this means is that the majority [of LPs] will put some emphasis on ESG in fund due diligence and that would seem to be a positive step forward compared to the past. There is obviously still some way to go, but there is a definite growth in the number of LPs assessing ESG risks in their private equity investment,” he says.

USS has developed a responsible investing questionnaire that it sends to all potential GPs and scrutinises new GPs’ track records on ESG issues. It is critical, however, that LPs continue to monitor ESG activities post-investment to gain assurance policies are being implemented but also to signal that the LP takes this issue seriously, Russell says.

The definition of ESG continues to stretch. “What LPs are demanding of GPs [in terms of ESG] continues to grow”, says David Jeffrey, partner and head of StepStone Global’s European business. “It really matters to us because it matters to our end investors.”

However, one impediment is the absence of tangible data on the contribution of ESG to returns. “We’re still on a journey within the world of private markets to be able to provide the empirical data that is required to show responsible investment can add value,” Jeffrey says, noting that it falls to the LP community as a whole to standardise due diligence so managers can prove that they are good corporate citizens.

To what extent do you believe your GPs’ investments reflect your ESG policies?

GPs’ investments strongly reflect my ESG policies: 5.3%
GPs’ investments somewhat reflect my ESG policies: 18.7%
GPs’ investments hardly reflect my ESG policies: 8.0%
GPs’ investments do not reflect my ESG policies at all: 68.0%

Source: Private Equity International

How much emphasis do you place on environmental, social, and governance issues throughout fund due diligence for private equity?

ESG is a major consideration: 15.2%
ESG is a minor consideration: 45.6%
ESG is not a consideration: 39.2%

Source: Private Equity International
CONSOLIDATION

Who gains from the fund admin M&A boom?

Given the wave of takeover activity among fund administrators, we sat down with Jason Bingham of SANNE to discuss what it means for GPs shopping for service providers and the future of his industry.

Nothing makes a fund administrator happier than an overwhelmed CFO looking to get something off their desk, and given the increasing demands from LPs and regulators, plenty of service providers are probably giddy. It’s also created a boom in the industry and that’s translated into major M&A activity. Apex and SS&C alone acquired three companies each by August of this year already, and major private equity firms, including The Carlyle Group, have added fund administrators to their own portfolios.

But what does this mean for the quality of service? When a service provider merges with a peer or acquires another business, does it always mean clients get more bang for their buck? Or does it mean there will be hiccups, as the service provider hunts for those synergies? And how can a GP tell the service provider will be there when the boom ends?

We spoke with Jason Bingham, the managing director of product development at SANNE, a FTSE 250 fund administrator listed on the London Stock Exchange, to get some answers. And what he suggests is that GPs should pay attention to the ownership structure of their administrators. As service providers merge, acquire or find themselves with new owners, there will be an impact to their service capabilities, both positive and negative. But the current landscape suggests that in a few years, this industry could consolidate into a handful of larger, elite professional firms, which may end up a net positive for their clients.

How should GPs look at the wave of M&A activity in the fund administration business?

They should understand that a service provider’s ownership structure matters. M&A in our industry dates back to 2006, when Bank of New York merged with Mellon Financial in a deal worth $16.5 billion. Fund administration offerings of big banking institutions are a complementary addition to their other core services. And it makes a certain amount of sense that a bank that’s already offering lines of credit and other banking products would offer fund administration as part of their one-stop shop solution to access GPs.

But having worked in that large bank environment, the reality is that their offering comes with a fairly rigid service model that isn’t necessarily conducive to small to medium-sized fund managers. Some banks may have minimum criteria requirements that can be hard for them to meet, and if the GP needs something beyond their standard service offering, they’ll be a price to pay for that.

The credibility of a big banking name for LPs can be attractive to GPs, but that brand and that big balance sheet can come with limitations, in terms of service offering. And some banks don’t have the risk appetite for some of the fiduciary requirements that are part of servicing private equity firms.

At the other end of the spectrum are the smaller local players that have real limits to the jurisdictions they serve and size of funds they can handle. Investment in technology and managing their own growth can prove challenging, which makes them prime targets for acquisition.

Then there are offshore law firms that offer a fund administration component as a complementary service. Such work provides steady annuity income and sticky relationships that only strengthen their legal operations. But at some point, the size and complexity of that business can often exceed their appetite for investment in more people.
This industry could consolidate into a handful of larger, elite professional firms, which may end up a net positive for their clients.

What about the fund administrators that are owned by private equity firms? GPs seem bullish on the space, at least as portfolio companies. They are, and I believe they see an attractive market, where a buy-and-build strategy is able to generate value and increase their returns. But from a fund manager perspective, there's the inevitable exit strategy. And that means making decisions based on a finite timeline and ways to drive performance in the near term. That may well mean reducing costs, which can result in a leaner organisation or less investment in new technology, which may reduce the overall quality of service.

The desired ownership structure for us is the listed one, which we are. We went public on the LSE in April 2015 and I have to admit, I had my doubts about competing with privately owned firms. Our competitors would know a lot more about us due to the transparency requirements that come with being a public company but that transparency has actually given our customers greater insight into our business, which is a good thing.

It provides comfort and credibility to LPs and GPs. In terms of governance, the standards for a listed company are very high, which is certainly an advantage to us. It's a badge of honour to be on the LSE, and challenges our unlisted peers to find ways to match that. The access to capital markets also makes it easier to manage growth. We're able to attract more talent and have the capital to invest in our service offering.

Say a GP's service provider gets scooped up by a larger peer. What should they know about that transaction to understand if, and how, their service may change?

They need to understand the rationale for that transaction. Our acquisitions are around giving us a new jurisdictional presence, or a new product. For example, we acquired a hedge fund administration business in 2016, because we never had the capability in that area. However, if an administrator is acquiring a competitor in something more akin to a merger, that's a different story. The commercial rationale for a merger involves the presumption of synergies, which can often mean lengthy integrations that potentially take the focus away from client service or require adaptation to a new system. And GPs rarely enjoy doing either.

Here's a way to look at M&A activity in our space. Is the transaction driven by the priorities of the administrator's owner, or by the demands of clients? All our acquisitions are driven by what our clients need, which is high visibility in multiple jurisdictions, across several complementary product lines. And that means we've acquired businesses in new places or that cater to new products – this adds real value to clients.

There will always be smaller niche providers, but the global players will be better placed to meet the increasing demands of an international client base.

How do you see the M&A landscape in your industry in five to 10 years? What does the future look like?

We are of the view that in a few years there may be a situation similar to the ‘Big Four’ accounting firms, where the industry consolidates into a handful of key elite professional players. There will always be smaller niche providers, but the global players will be better placed to meet the increasing demands of an international client base. Only the most innovative and customer led organisations will survive. All those PE firms will be looking to exit these investments in our industry, and that means a potential IPO or selling to a strategic buyer, which ends up feeding that consolidation trend.

But the upside is that clients will enjoy that competitive environment, as we’ll be competing with each other to provide them with cutting edge technology, high standards of governance and solid, reliable relationships.
THE OPERATING PARTNER IN PRIVATE EQUITY
Volume 2

Advanced strategies for value creators

CONTENT HIGHLIGHTS:

• Dan Colbert discusses how The Riverside Company built and refined its operating approach with key lessons for achieving success.

• Scott Glickman, Dan Soroka and Sara Boyd of Graham Partners outline a programme for proactively identifying and reducing business model risks.

• Mark Gillett of Silver Lake Partners and David Moss, an independent adviser, provide a framework for assessing and implementing transformational versus incremental change.

• Sandy Ogg of The Blackstone Group, proposes three action points for ensuring the portfolio company CEO search and selection process is successful.

• Matt Sondag of West Monroe Partners provides useful tips for how to select and optimise the emerging role of the IT operating partner...plus much more

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DIVERSITY

Gender inequality in the crosshairs

Under-representation of women can have serious consequences in private equity, writes Alex Lynn

Finance has long had an embarrassing diversity problem, and private equity is no exception.

Women account for just 14 percent of partners at UK private equity firms, hedge funds and other financial services partnerships, according to Financial Conduct Authority data analysed by law firm Fox & Partners in September. Progress is being made, but the pace is glacial; the figure stood at 13 percent five years ago.

Diversity is front of mind for a growing number of investors – a trend underscored by the Institutional Limited Partners Association expanding its due diligence questionnaire to include general partner-level diversity issues and giving guidance to GPs on the establishment of codes of conduct for “defining, reporting, investigating and disciplining harassment, discrimination and violence in the workplace”.

The changes to the DDQ include a template for GP firms to measure and report the gender and ethnic diversity of their teams by seniority and role, as well as a new section that aims to enhance a limited partner’s understanding of a GP’s policies and procedures in areas such as hiring, promotions, family leave, mentoring, harassment and discrimination.

“[Diversity] is a question that we are asking GPs all the time given the under-representation of women and minorities in the private equity realm,” Andrea Auerbach, head of private markets at LP advisor Cambridge Associates, told Private Equity International in September, noting that some LPs will take a step back if not enough has been done to tackle the issue.

“If [some of our clients] don’t see sufficient levels of diversity and inclusion, or well-intentioned and meaningful efforts to build towards a team and organisation that has more diversity of personnel, they will make an investment decision fully incorporating that information.”

A deficit in workplace diversity contributed to heavyweight managers Blackstone Group and Brookfield Asset Management being passed up for a $50 million infrastructure allocation by the $10.8 billion Chicago Teachers’ Pension Fund in June, sister publication Infrastructure Investor reported.

“Blackstone and Brookfield are still challenged with some diversity issues. And while they’re working on it, they’re just not there yet,” CIO Angela Miller-May told II.

“We want to make sure we make the right decision that’s going to protect the assets of the pensioners and at the same time we want to be responsible with our investing, making sure we’re investing with diverse and inclusive managers.”

New UK legislation requiring businesses with more than 250 employees to report on pay differentials between men and women provides an – albeit limited – glance at the state of play.

Blackstone’s UK business paid male staff bonuses that were on average 75.4 percent more than those received by female colleagues for the 12-month period to April 2017. Men earned 30 percent more than women on an hourly basis, compared with the UK national average hourly pay gap of 9.1 percent recorded by the Office for National Statistics.

The firm explained the gap by pointing to the fact close to three-quarters of its male employees are investment professionals, and these roles typically attract higher rewards than non-investment roles. It said less than a fifth of its female employees are investment professionals.

But Blackstone is something of an exception: it’s unlikely that many, if any, other UK private equity houses will have enough staff to qualify for the reporting legislation. ILPA’s questions should help, but for now, gauging progress, or a lack thereof, on diversity is likely to remain a challenge.
Whether it was on how to prepare for a downturn or on the challenge facing mega-funds, LPs had plenty to say in 2018

“Having 5 percent to 7 percent to alternatives is meaningless because of the fees… I don’t have a magic number but it’s not worth dipping a toe in”
Sandra Robertson, CIO of Oxford University Endowment Management

“The superior results of Yale and a number of peers strongly suggest that active management can be a powerful tool for institutions that commit the resources to achieve superior, risk adjusted investment results”
Yale hits back at Warren Buffett’s suggestion that endowments should adopt a passive indexing strategy

“We need to take advantage of the most attractive timing to invest, and we cannot do this if we are too scared, or we lose the courage to continue investing”
Katsunori Sago, CIO at Japan Post Bank, on keeping up the pace of investment

“It is imperative the council be able to analyse exactly what we are paying for those investments and to ensure that those costs are accurate and appropriate from a risk/return perspective”
New Mexico State Investment Council on why it hired a fund services firm to validate the fees it pays GPs

“Private equity is a very heterogenous asset class and if you can’t access world-class managers you shouldn’t do it, you’re better in the public markets”
A spokesman for Church Commissioners

“Selling a company out of one fund and buying it in another, even when a third party leads the transaction to establish the value, is simply a huge conflict for GPs who have broad discretion”
Christopher Schelling, director of PE at Texas Municipal Retirement System, on a “concerning” new trend

“The sheer bite-size to come in and actually move the needle for these funds is going to be a very interesting challenge”
Christopher Ailman, COO at CalSTRS, on the challenge of deploying giant funds

“If we’re right then there’ll be disappointment experienced by those involved, and then opportunities will re-emerge and we’ll be back”
Matt Clark of South Dakota Investment Council on why they are pulling back from PE

“We are trying to do now is really to batten down operations of our portfolio companies”
Olivia Ouyang, director of funds and co-investments at Ontario Teachers’ Pension Plan, prepares for the next downturn

“If the market was to naturally evolve, I think it probably would have happened already”
David Enriquez, interim co-head of private equity at New York City Employees’ Retirement System, on how the 10-year limited partnership is here to stay

“Sounding of LPs”

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“Sounding of LPs”

INSIDE THE FUND MANAGEMENT FIRM
How to build and deliver operational excellence

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