2018
WHAT REALLY MATTERS TO PRIVATE EQUITY LPs
EBRD: How to be cool in a crisis
CalPERS rethinks core approach
What keep LPs awake at night
Betting big on India
Fund terms: Finding the right balance
Why ESG is a growing concern
And much more...

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Apex Fund Services
Debevoise & Plimpton
Graphite Capital
MVision
Pantheon
Pomona Capital
Schulte Roth & Zabel
"We got a better outcome in our transaction as a result of working with them."

The Debevoise Private Equity Group continues to lead the field, in an industry it has helped shape for decades. With consistently high rankings from Chambers Global, The Legal 500 and PEI year after year, the group has been a recognized leader for more than 35 years.

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

Chambers UK lauds the team’s ability to “guide clients through regulatory, tax, investment and fund-raising matters with aplomb,” and quotes one client as stating, “we got a better outcome in our transaction as a result of working with them.”

Debevoise.com
The great debate

Surprise, what surprise? When LPs look back on 2017 it will be as much about what didn’t happen, as what did. Or as Christian Kallen, managing director in the fund investment team at Hamilton Lane, puts it on p. 18 of Perspectives 2018: “The biggest surprise was probably that there were no real surprises. From a private market perspective, 2017 has been a steady continuation of 2016.”

So far, so stable, but there is a strong sense that emerges in our sixth end-of-year poll of LP sentiment that this is an uneasy calm. Worries persist: notably over high valuations and leverage levels. Concern is mounting over the impact of rising interest rates. The fact distressed debt is the strategy LPs are targeting in 2018 is a telling indication of the growth opportunities as we head into the new year.

On the plus side, LPs remain committed to private equity with 46 percent of respondents intending to recommit to existing managers in the next 12 months, and 36 percent planning on forming new fund relationships. And they are broadly satisfied with performance: 32 percent saw performance better than internal benchmarks, while 52 percent received returns that were better than expected.

But less than a fifth of LPs believe returns will improve in 2018, suggesting clouds are building on the horizon. That could bode well for the secondaries market: “Disruption will create opportunities, but we will need to have a lot of conviction before jumping into it,” says Michael Granoff, founder of secondaries firm Pomona Capital (p. 35).

There are clear regional differences, too, with North American LPs the most likely to decrease their allocations over the next 12 months, and the least likely to consider ESG issues, although this is starting to change (p. 46).

The keynote interviews include Pantheon partners Dennis McCrary and Jeff Miller on co-investment opportunities (p. 7); Graphite Capital’s Markus Golser and James Markham on why operational improvements matter more than ever to investors (p. 16) and MVision CEO Mounir Guen on fundraising (p. 44). Apex Fund Services look at outsourcing trends (p. 27), Schulte Roth & Zabel considers whether it’s time to revise your LPA (p. 48) and Debevoise & Plimpton explains the implications of the OECD’s flagship tax avoidance project BEPS for investor relations (p. 20).

The sheer range of material covered in this issue from compliance and crisis management to geopolitical issues and climate change show just how the debate between LPs and GPs has matured in the last decade. Our LP Perspectives Survey suggests there’s plenty to talk about in 2018.

Enjoy the supplement.

Graeme Kerr

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LPs are increasing their appetite for co-investment, but with growing competition they will need to focus on the value they can bring to a partnership with a GP, say Pantheon partners Dennis McCrery and Jeff Miller.

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Look ahead. Share our vision.

MVision is a pre-eminent alternative assets fundraising advisory firm, experienced in raising significant amounts of capital for our GP clients. Our long established investor relationships and in-depth industry knowledge means the advice we offer is relevant, targeted and efficient.
Historically high prices remain a big investor concern as we head into 2018, writes Sam McMurray

Dutch Tulips in the 17th century, the internet-heavy Nasdaq of the 90s and the US MBS market in the late 2000s. All distinctive, yet characterised by one major trait – historically high prices. What goes up, most certainly in these cases, comes down. It is reasonable enough, therefore, that investors rank extreme market valuations as their largest macro cause for concern in the private equity space.

Our PEI LP Perspectives 2018 Survey finds that record high valuations is the issue at the forefront of investors’ minds, followed by increasing availability of leverage and the impact of rising interest rates.

Valuations in US private equity transactions as a multiple of EBITDA reached new highs in the first six months of 2017 at 13.7x, as debt markets remained fluid, according to a report from valuations firm Murray Devine.

As one concern remains constant, another changes direction. In last year’s LP poll, investors were concerned about the low interest rate environment. Now, the worry is the impact that tightening monetary policy and rising interest rates may have on portfolios. The increasing availability of leverage is a new concern on the list. Many investors are fearful of extending loan periods.

LPs remain committed to private equity, with 46 percent of respondents intending to recommit to existing managers in the next 12 months, and 36 percent planning on forming new fund relationships.

Distressed debt is the strategy of most interest, with 20 percent looking to increase their allocation to the space. Twelve distressed debt funds have held a final close so far this year, raising an aggregate $39.34 billion, according to PEI Q3 2017 fundraising research.

The average commitment size varied widely among respondents, leading to differing results about their ability and willingness to access the asset class in various
DO YOU PLAN TO INVEST IN FIRST-TIME FUNDS?
- Much more confident
- More confident
- About the same
- Less confident
- Much less confident

HOW DO YOU PREDICT INVESTMENTS WILL PERFORM OVER THE NEXT 12 MONTHS?
- Much more confident
- More confident
- About the same
- Less confident
- Much less confident

DO YOU PLAN TO MAKE FRESH COMMITMENTS TO EXISTING MANAGERS OVER THE NEXT YEAR?
- We plan on recommitting funds to existing managers
- We will opportunistically invest in funds being raised by existing managers
- We will not recommit to existing managers

WILL YOU COMMIT TO NEW FUND MANAGERS OVER THE NEXT YEAR?
- We plan on committing capital to new managers
- We will opportunistically invest capital in funds raised by new managers
- We will not commit capital to new managers

HOW DO YOU PLAN ON ALLOCATING TO THE FOLLOWING STRATEGIES OVER THE NEXT 12 MONTHS? (%)

WHAT ARE YOUR TOP MACROECONOMIC CONCERNS?

Source: Private Equity International

* figures may not add up to 100% due to rounding
ways. For instance, 18 percent of the LPs surveyed had an average commitment size of over $100 million, which correlates with the 14 percent that have a defined allocation to invest directly. Investors are more likely to have a defined direct investment allocation across private real estate, infrastructure and private debt than private equity.

Some 40 percent of respondents were underweight in their target allocation to private equity, a consequence perhaps of the 31 percent that have found it harder to source investable opportunities over the past 12 months. That may seem like a high percentage, but is lower than the percentage that said they had struggled to find real estate and infrastructure openings.

PEI Perspectives 2018 suggests investors have been satisfied with private equity performance over the last 12 months. Thirty-two percent saw performance better than internal benchmarks, while 52 percent received returns in line with expectations.

As to whether this performance will continue, 29 percent are less confident in performance over the coming 12 months, compared with 19 percent who believe returns will improve.

### WHICH OF THESE STRUCTURES DO YOU PLAN TO INVEST IN OVER THE NEXT 12 MONTHS?
- We have a defined allocation to invest in these funds
- We may opportunistically invest in these funds
- We do not invest in these funds

![Bar chart showing the percentage of respondents planning to invest in different structures over the next 12 months](chart1)

Source: Private Equity International

### WHICH OF THE FOLLOWING GEOGRAPHIES WILL YOU CONSIDER FOR INVESTMENT OVER THE NEXT 12 MONTHS? (%)

<table>
<thead>
<tr>
<th>Geographies</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>84</td>
</tr>
<tr>
<td>Latin America</td>
<td>27</td>
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<tr>
<td>MENA</td>
<td>15</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>12</td>
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<td>Western Europe</td>
<td>84</td>
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<tr>
<td>Eastern Europe</td>
<td>22</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>63</td>
</tr>
</tbody>
</table>

![Bar chart showing the percentage of respondents considering different geographies for investment over the next 12 months](chart2)

Source: Private Equity International

### HOW EASY HAS IT BEEN TO SOURCE INVESTMENT OPPORTUNITIES OVER THE PAST 12 MONTHS?
- Far easier than the previous 12 months
- Easier than the previous 12 months
- The same as the previous 12 months
- Harder than the previous 12 months
- Far harder than the previous 12 months

### WHAT IS YOUR PRIMARY SOURCE OF FUND OPPORTUNITIES?
- Investment consultants
- Existing GP relationships
- Placement agency
- Direct fund manager interaction
- Third party fund database
- Conferences and events

### HOW EASY HAS IT BEEN TO SOURCE INVESTMENT OPPORTUNITIES IN THE FOLLOWING STRATEGIES? (%)

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Far easier than the previous 12 months</th>
<th>Easier than the previous 12 months</th>
<th>The same as the previous 12 months</th>
<th>Harder than the previous 12 months</th>
<th>Far harder than the previous 12 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyout</td>
<td>28</td>
<td>6</td>
<td>11</td>
<td>4</td>
<td>24</td>
</tr>
<tr>
<td>Distressed</td>
<td>49</td>
<td>58</td>
<td>55</td>
<td>56</td>
<td>51</td>
</tr>
<tr>
<td>Fund of Funds</td>
<td>12</td>
<td>6</td>
<td>22</td>
<td>19</td>
<td>18</td>
</tr>
<tr>
<td>Growth</td>
<td>6</td>
<td>3</td>
<td>6</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Secondaries</td>
<td>11</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>12</td>
</tr>
<tr>
<td>Venture</td>
<td>18</td>
<td>2</td>
<td></td>
<td></td>
<td>2</td>
</tr>
</tbody>
</table>
As co-investment grows in popularity among limited partners and competition for deals increases, it is more important than ever that LPs are able to differentiate themselves as a worthwhile partner for fund managers, say Pantheon partners Dennis McCrary and Jeff Miller.

**Q** How has the co-investment market evolved over the last decade?

**Jeff Miller:** While LP demand for co-investment has certainly increased, we believe there has been a greater supply of co-investment opportunities available in the market. More GPs are aware of the relationship benefits with LPs of offering co-investment and are doing less partnering with other PE firms on deals than they may have done 10 or 15 years ago. GPs have also become increasingly comfortable and confident that they can syndicate co-investments successfully with their LP base. They might not have had that same confidence 10 or 15 years ago. We believe the net effect of both of these factors has driven greater co-investment supply.

**Q** Has the perception of risk around co-investment changed?

**Dennis McCrary:** In the past, investors were saying ‘co-investments – aren’t they really risky?’ Well, they’re the same underlying operating companies you are exposed to if you are an LP in a direct private equity fund or a fund of funds. However, you have more control with regard to deal selection, allowing you to optimise portfolio construction, and you are paying a lower fee. People have become more comfortable with co-investments as returns have proven to be quite solid over the last 10 years and it’s become easier to see multi-year track records. Co-investing can, of course, be riskier if concentrated in just a few deals.

**Q** How do GPs manage the competition for co-investment among their LP base?

**JM:** Most GPs are managing co-investment syndication in a thoughtful way to enhance their LP relationships and not disappoint LPs. However, there are varying approaches that can be driven by the nature and capability of the LP base and the dynamics of the transaction. Some GPs will look to syndicate deals more broadly across their LP base. They may effectively rotate the deals around, so each LP may not see every deal but they’ll get their fair share. Or they may syndicate each deal more broadly and LPs may get a lower allocation than desired as a result. Occasionally, the nature or speed of the transaction necessitates the GP to go to the LPs they have the most confidence in, because ultimately they need to get their deal done and not disrupt their own deal process.

**Q** Besides reduced fees, what are some of the benefits of co-investment for LPs?

**JM:** Benefits include more investor control over the deployment and pacing of their capital as well as where and how that capital is invested. Other advantages include being able to build out diversified portfolios to help fill in certain sectors.
**KEYNOTE INTERVIEW: PANTHEON**

LPs can also concentrate their capital with their preferred private equity GPs. They will likely have a fund investment, but then they can deploy additional capital with that particular GP. This is increasingly relevant today as many LPs are looking to concentrate their GP relationships and reduce the number of managers in their fund portfolio.

**DM:** What level of due diligence do you need to do and what capabilities does an LP need to have?

**JM:** Co-investors will get access to a fair amount of diligence. GPs typically provide their investment memo, third-party consultant reports, industry research, comparables valuations and their base model that you can sensitise. There are other things co-investors can do to help augment information provided by the GP. One is to look at the track record of deals in their own portfolio, whether it’s through primaries, co-investments or secondaries, and understand how that sector has traded historically, prices buyers have paid and returns these buyers have generated investing in the sector. Co-investors also may be able to talk to other GPs they have relationships with that have experience in the space. Also, it is quite important to analyse the deal and the fit with the manager. Is this a type of investment where the manager can deliver and has in the past delivered differentiated value?

**Q** Can an LP to have too much co-investment in its portfolio?

**DM:** I don’t think in theory you can have too much co-investment. The idea is to build a portfolio with the best PE managers you can find and access, and in whom you have great confidence; where you have the geographic, sector and vintage diversification and exposure that you think builds a good portfolio. Whether you do that through co-investment or through a direct fund investment, the ultimate portfolio of underlying operating companies is most important. I should note that not all PE firms offer co-investment, or offer very little. So to obtain exposure to certain excellent managers will generally require investing in their fund directly or through a fund of funds or managed account.

**JM:** Some LPs would say there’s a natural minimum they want to have because co-investing requires different resourcing, so they want to make that meaningful within their portfolio. Then there’s probably a natural ceiling on how much co-investment you can have, because you need to still maintain meaningful fund relationships and investments in funds to be able to drive the co-investment flow.

**DM:** LPs need to continue to evolve the value they bring to GPs. The more competitive the market becomes, the more the LPs need to differentiate themselves. The engagement has to be professional, it has to be responsive in terms of time frame, and all those fundamentals, but there are other things like helping to underwrite and bringing diligence insight where it becomes more of a partnership than just, ‘hey, can I buy a piece of this deal?’ I think you’ll see that evolution continue.

**Q** What will be the big trends in co-investment in 2018?

**DM:** I think in theory you can have too much co-investment. The idea is to build a portfolio with the best PE managers you can find and access, and in whom you have great confidence; where you have the geographic, sector and vintage diversification and exposure that you think builds a good portfolio. Whether you do that through co-investment or through a direct fund investment, the ultimate portfolio of underlying operating companies is most important. I should note that not all PE firms offer co-investment, or offer very little. So to obtain exposure to certain excellent managers will generally require investing in their fund directly or through a fund of funds or managed account.

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**DM:** The desire to be a good co-investment partner hamper an LP when it comes to negotiating terms on a primary fund?

**DM:** It’s a delicate balance. You need to make sure upfront that the fund investment is properly structured and then from that will hopefully come a good relationship. Even if you’re negotiating hard, you do it in a way that the GP still finds it attractive to work with you in a co-investment context. As it relates specifically to co-investments, there is always a balance between rigorous due diligence, which is of course required, and being a good partner, being user friendly. Leveraging off the GP’s diligence, and supplementing that with our own has worked well.

**Q** Is adverse selection – the GP offering their LPs the less attractive deals as co-investment opportunities – an issue?

**JM:** Intuitively we’ve felt there’s less risk of adverse selection for a couple of reasons. First, these LP relationships are very important to the GP in terms of raising their next fund, so we can’t see a GP potentially disadvantaging their LPs by showing them a co-investment that might be less attractive than what they would normally do. And this assumes they know upfront the relative

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performance of the deal, which is unlikely. And second, these deals are going into the GP’s fund and they’re going to be important drivers of performance, because co-investments tend to be larger than the average deal in the fund, which is part of the reason they need the co-investment. These larger deals will be very big drivers of performance but also will be scrutinised by LPs in future fund diligence, whether they did the co-invest or not, because they represent a meaningful part of the fund.

Q Do you tend to see more co-investment at the beginning or the end of a fund’s life?
DM: We see co-investments offered throughout the life of a fund for a variety of reasons. Certain GPs may offer opportunities at the beginning of a fund’s life if they are still fundraising and use co-investments to entice LPs to make a primary investment into their fund. Also they don’t know how large their fund will be. Let’s say a GP wants to raise a $500 million fund, and they’ve raised $250 million and they’re starting to close deals into that fund. Even though at $500 million they might be able to flex up to say a $75 million equity cheque, when they’ve only raised $250 million they can’t take that concentration risk, so they do a smaller equity cheque and then syndicate the remainder.

At the back end of a fund’s investment period co-investment may be influenced by investable capital remaining, the number of deals the GP would like to fit into that fund, and the timing of those deals and the next fund raise. For example, if the normal bite-size is $50 million and there is $70 million remaining in the fund for new transactions, the GP may choose to do two more $50 million deals, investing $35 million in each, and invite LPs to fill out the deals with $15 million of co-invest in each deal.

Q Now co-investment has become a more established part of the private equity landscape, are investors becoming more creative in how they approach this strategy?
JM: Traditional LP syndications certainly represent the majority of what we see, but co-investors have been considering broader sets of opportunities and have been more creative in what they’ll do.

This can include warehousing deals, where an LP might speak up for a larger cheque size to give the GP deal certainty, and then allow the GP to syndicate a piece of it out to smaller investors later in the process or post-close. The other area warehousing could be applicable is if the GP is raising a new fund and hasn’t had a close yet, but they want to do a deal. An LP could underwrite the equity and allow that GP to claw a piece back for the fund once they’ve had a first close.

There are cases where LPs are effectively co-bidding alongside the sponsor, and because of that they’re willing to underwrite a large cheque, get involved earlier, but also underwrite their share of the broken deal expenses if a deal doesn’t close.

Q Have you seen fundless sponsors tapping into co-investment capital?
JM: Groups that have spun out of larger firms and want to raise a fund but maybe they’re not able to quite yet, and who want to demonstrate some track record working together, may seek equity from the co-investment market, tapping into traditional co-investment sources and family offices.

For a co-investor, that could come with additional risk, but they may get access to smaller deals and companies that have the potential to generate outsized returns. An LP may not see those deals through their traditional manager relationships given the smaller size. We occasionally see fundless sponsors where the principals have significant experience working at larger, well-established firms and have gained valuable experience that they can now apply to smaller companies and that can be attractive.

DM: It takes a more experienced set of skills and deal professionals to be effective in the fundless sponsor area, and it’s a bigger time commitment too, depending on how the deal unfolds, who the sponsor is and what their goal is. We don’t do very many of them but we do see a lot, and they can be attractive. The economics tend to be a little different so you’ve got to make sure you’ve got a deal that’s providing a good return.
Ahead of the game

European LPs have been happy with their PE performance, but take nothing for granted, writes Sam McMurray

In terms of investor satisfaction, European LPs top the global rankings for private equity, according to the PEI LP Perspectives Survey 2018. Private equity portfolios outperformed investor benchmarks for 40 percent of the European LPs surveyed, with only 9 percent saying that performance fell below expectations.

This was notably higher than in North America, where 29 percent had benchmark beating returns or Asia-Pacific where the figure was 30 percent. Investors in Europe are also more confident than North American LPs about the next 12 months, with only a quarter of respondents expecting a dip in performance, compared with 36 percent across the Atlantic.

When it comes to target allocations to private equity strategies, European LPs – like their counterparts in North America – are most likely to increase capital available to distressed opportunities: 22 percent plan to do so. But they are far less likely than Asia-Pacific or North American investors to reduce target allocations to funds of funds.

Venture capital strategies are less popular than elsewhere with 12 percent of European investors planning to decrease their exposure.

European LPs share the same top three macro concerns as their North American peers – extreme market valuations, rising interest rates and the increased availability of leverage.

On the latter point, LPs may be taking some comfort from the increasing prevalence of cov-lite and cov-loose loans, which would potentially allow sponsors greater flexibility to remain in control of investments during periods of stress.

Waymond Harris, investment director at Blue Cross Blue Shield of Michigan, told sister publication Private Debt Investor the increase in risk-taking and leverage in recent years is still not comparable with pre-crisis levels. He added it is normal to have an increased awareness of downside risk.

LP SURVEY

WHAT IS YOUR CURRENT PE ALLOCATION?

Under allocated
At target allocation
Over allocated
Have no target allocation and invest opportunistically
Have no allocation

WHAT IS YOUR AVERAGE COMMITMENT SIZE?

Up to $20 million
$21 million to $50 million
$51 million to $100 million
$100 million to $250 million
Over $250 million

HOW DID INVESTMENTS PERFORM AGAINST BENCHMARKS OVER THE PAST YEAR?

Better than expected
As expected
Short of expectation

ALL RESPONDENTS

WHICH ASSET CLASSES DO YOU PLAN TO MAINTAIN OR INCREASE ALLOCATION TO OVER THE NEXT YEAR? (%)

Private equity 91
Private real estate 96
Infrastructure 97
Private debt 90

Source: Private Equity International
DO YOU PLAN TO INVEST IN FIRST-TIME FUNDS?

- Much more confident
- More confident
- About the same
- Less confident
- Much less confident

HOW DO YOU PLAN TO MAKE FRESH COMMITMENTS TO EXISTING MANAGERS OVER THE NEXT YEAR?

- We plan on recommitting funds to existing managers
- We will opportunistically invest in funds being raised by existing managers
- We will not recommit to existing managers

WILL YOU COMMIT TO NEW FUND MANAGERS OVER THE NEXT YEAR?

- We plan on committing capital to new managers
- We will opportunistically invest capital in funds raised by new managers
- We will not commit capital to new managers

HOW DO YOU PLAN ON ALLOCATING TO THE FOLLOWING STRATEGIES OVER THE NEXT 12 MONTHS? (%)

- Increase target allocation
- Keep target allocation the same
- Decrease target allocation
- Invest opportunistically

WHAT ARE YOUR TOP MACROECONOMIC CONCERNS?

- Extreme market valuations
- Impact of rising interest rates
- Increasing availability of leverage in alternative investment markets
- Impact of the UK’s exit from the EU
- Western political instability
- Terrorism
- Commodity price volatility

Source: Private Equity International

* figures may not add up to 100% due to rounding
risk at this stage in the cycle. Our survey found that Western European investors are less likely to be under allocated to private equity than their North American and Asia-Pacific peers, with 26 percent considering themselves below target. In line with the global average, 31 percent of European investors felt it had been harder to source investable private equity opportunities over the past 12 months.

Co-investments are more popular in Europe: 32 percent of LPs have a defined allocation of capital for co-investment – higher than in Asia-Pacific (27 percent) or North America (17 percent). A further 45 percent would enter co-investments opportunistically. At the recent PEI Co-Investment Roundtable, Debevoise & Plimpton partner Kate Ashton noted that a growing number of European sovereign wealth funds are demanding such opportunities.

Only 11 percent of European investors have a defined allocation to direct investment, which is lower than the global average. Of European respondents, 27 percent found venture capital opportunities easier to source over the past 12 months and just 5 percent more difficult.

This contrasts with North America where 45 percent of LPs found venture funds harder to come by.
How to be cool in a crisis

The EBRD’s private equity head Anne Fossemalle tells Rod James about the lessons learned from the 2008 crash and how it taught GPs to listen to their investors.

“We’re an LP that gives a signal to the market. We have explored selling some funds on the secondaries market but it hasn’t really happened.”

Fossemalle: crisis taught EBRD a lot about nature of GP-LP relations

The European Bank for Reconstruction and Development was born in 1991 out of one of the biggest political and economic ruptures of the last century – the collapse of the Soviet Union – amid an underrun of volatility.

In the past decade, the bank has had to deal with an array of financial crises and geopolitical ructions such as the conflict between Russia and Ukraine and the Arab Spring, as it goes about its mission: to drive the development of market economies through investment in financial institutions, businesses and infrastructure projects.

Initially focused on the countries of the former Soviet Union, the bank’s remit now spans parts of North Africa, Turkey, Jordan and the West Bank.

Given its emerging markets focus, the bank’s private equity team and its general partners were better prepared than most when the financial crisis struck in 2008. Still, the crisis taught them a lot about the nature of GP-LP relations, the importance of counter-cyclical investing and how hard it can be to keep private money flowing when an emerging market encounters trouble. Anne Fossemalle, the EBRD’s director of equity funds, spoke to PEI, about the challenges it has faced.

Q Can you remember when you became aware of how serious the crisis was?
In our private equity portfolio it was immediately evident just before the financial crisis that funds had been investing in a market that was overly optimistic: everyone made assumptions of incredible growth prospects. With the financial crisis it quickly became obvious that this was not going to happen. It had an effect on the entire chain: investors investing in the region, the existing portfolio and a huge impact on the exit pace of funds that were already invested.

Q You moved to the private equity brief in 2009. What was the top priority in those first few months?
By 2009, it was clear that the fundraising environment had become extremely challenging. There had been a peak in fundraising in the CEE in 2007 due both to growth in the region and because of the natural fundraising cycle. The market isn’t sufficiently deep that you can have many funds raising all the time and in 2006-7 you had Baring Vostok, Mid-Europa and Enterprise all raising funds.

These GPs had jumped in terms of the size of the funds they were managing and suddenly there was a financial crisis. Those investments that they had completed in 2006-07 were much harder to exit and these companies no longer benefitted.
from the growth prospects of the economy. The role of development financial institutions again became very important.

Before the financial crisis the EBRD was in discussions to gradually scale back activity in certain markets, so we were a smaller investor in some of these funds. Our role is to mobilise private capital, to have a participation in the fund that’s as large as is necessary to act as a catalyst, but small enough not to displace private capital.

The US money withdrew completely, so there was more investment from the DFIs and a much longer time-lag to fundraise. There was a transition phase from when GPs were used to just going like this [she clicks her fingers] for funds and then investing the money. Suddenly, teams had to be more involved in the fundraising and spend a lot more time explaining their track records. The fundraising became much harder and our role became even more critical.

Q And this would have had repercussions all the way down the chain? The funds that had been raising money pre-crisis had assets for which they’d paid quite a lot of money and suddenly they weren’t able to sell them for the same multiples. They found themselves having to change their model, becoming even more operational and hands-on than they were before. They had to work on these companies to make sure that the value-add was going to come through. The funds which invested prior to the crisis had much longer holding periods, so there are a whole cluster of funds in our portfolio that have had a much harder time exiting. You don’t just hope the economy will grow and your company will grow with it.

Q In terms of weathering crises, have you seen GPs invest in a more defensive or counter-cyclical way? Now they all do that definitely, but those that were more successful were also able to deal with their existing investments.

Some successful GPs are now having quicker fundraises than they had immediately post-crisis partly because they have learned to execute counter-cyclical investments; taking care of the currency aspect and focusing on sectors that are recession proof. Everyone has had to
change slightly their strategy and business models.

At the same time, we work in emerging markets that have had their fair share of problems.

Our GPs investing money in Turkey and Russia ask themselves questions about potential valuations as a matter of course. They are more used to it than British fund managers were after Brexit with the fall of the currency.

Q Longer hold periods have led to an increase in the number of proposed GP-led secondaries processes. As an LP, do you ever participate? 
We aren’t in a hurry to sell anything – for us the returns are the most important thing. Plus we’re an LP that gives a signal to the market. We have explored selling some funds on the secondaries market but it hasn’t really happened.

Q How do you feel about the situation today? 
In our portfolio the crisis investments are being worked out and exited. That next vintage is actually doing quite well, so hopefully it will continue.

Also, through that financial crisis GPs learned to fundraise better and to take into account their LPs. They don’t take it for granted that the money is going to fly in but understand the importance of listening to what they have to say. They also don’t get too excited by a successful fund. You are only as good as your last fund – indeed after the crisis some GPs left the market altogether.

Q What keeps you awake at night? 
What’s going to be the next geopolitical crisis in the countries where I work. I work in areas like Central Asia, the Caucasus, Mongolia, Greece, Turkey and North Africa, which is a younger portfolio for us, so geopolitical matters are at the forefront. I want to see the markets where we work becoming very attractive for LPs again and I can see that even though the returns are good and it’s a good time to invest, because of geopolitical issues investors aren’t going to be flying in.

You have market situations that you can still exploit. There is a lack of health services and education services. In Poland, industry entrepreneurs who created their companies 25 years ago are now ready to exit. There are great opportunities for PE to invest. An investment officer looking at making an investment in Turkey might be really keen on a deal, but their colleagues on an investment committee headquartered in the US less so. There’s always that gut reaction when you are sitting on an investment committee. Is this an environment that’s conducive to successful investments?
OPERATIONS

Redrawing the growth map

Graphite Capital’s Markus Golser and James Markham describe how operational effectiveness sits at the core of value creation

With the focus of LPs squarely on a GP’s proven ability to create value – almost three-quarters of respondents to the PEI’s LP Perspectives survey report they conduct due diligence on performance track record – the ability to deliver operational improvement at the portfolio company level is ever more important. Graphite Capital senior partner Markus Golser and portfolio management partner James Markham explain why.

Q How important is operational effectiveness to overall value creation?

Markus Golser: It’s fundamental. In a more challenging environment the focus on organic growth has risen. It’s also a reflection of what businesses expect private equity owners to contribute. Quite often with the size of businesses we buy, which tends to be between £50 million and £150 million in value, the company is evolving fast and its operations need to evolve too to support the growth plan. We want to create a scalable platform that will continue growing beyond our period of ownership.

Q At what stage in the investment process does Graphite start to think about the potential for operational improvement?

MG: If we can get access during the sale process and there’s time, we’ll undertake operational investigations. Post-deal, we put a lot of effort into understanding the operational capability of the business. Alongside management, we’ll start to hone in on areas of weakness that need to be tackled.

James Markham: One of the things we assess early on is organisational design. If the business is currently generating a few million pounds of EBITDA but we want to take it to £20 million, for example, does it have the right business functions to deliver that? Sometimes we help management establish functions from scratch, or the existing functions might need considerable enhancement and professionalisation.

Q What are your key areas of focus?

JM: We will tackle any area if it is key to unlocking value. We always start with a diagnostic phase during which we assess the quality of management information, the robustness of internal processes and the extent to which the management team really understands where the business is making its profit. Upgrades to the quality of management information, in turn, will often lead to improvements in a project team to stabilise that situation. We implemented a completely new stock forecasting and planning system, reinforced pricing controls and hired someone to focus exclusively on pricing.

We also changed the way the business purchased tyres from its Far Eastern suppliers. This challenging phase was at the heart of making the business more robust. Margins recovered strongly and the business began to report record profits, which grew from £9 million to £24 million under our ownership. We sold it in early 2017 for £215 million to a large Japanese tyre manufacturer, making 3.7x our money on the deal.

TAKING STOCK

Markus Golser tracks how Graphite helped Micheldever overcome major inventory management issues

Q Talk us through an operational challenge and how you overcame it.

Micheldever Tyre Services was a large and growing distributor of car tyres in the UK, which also operated a chain of retail outlets. We invested in 2006 and about halfway through our ownership period, due to a change in demand for tyres in the UK, the business encountered difficulties related to its IT infrastructure and stock ordering and forecasting. These resulted in too much stock arriving in their warehouses from suppliers mainly in the Far East on long lead times. Pricing controls proved insufficient to manage that stock effectively. That led to a fall in margins and the business underperforming.

We stepped in very quickly and created what was effectively a project team to stabilise that situation. We implemented a completely new stock forecasting and planning system, reinforced pricing controls and hired someone to focus exclusively on pricing.

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MANPOWER

James Markham highlights the importance of operational transformation to multiple enhancement

Q Can you share an example of operational transformation and its impact on the value of the business?

In 2007, when we bought the global leader in recruitment process outsourcing, Alexander Mann Solutions, it had been very successful, but then was affected by the financial crisis. We undertook our own diagnostic and a number of issues came to light.

One key area was the inefficient utilisation of internal resources on contracts. The business serviced large contracts, sometimes with 80 dedicated personnel, but the profile of the staff assigned was not optimal. Working with external consultants on an 18-month project, we adjusted how staff managed their time and ensured central control over the allocation of staff on contracts. We attended weekly project steering committee meetings throughout.

The business wasn’t sufficiently aware of where it made profit. We also spent a lot of time analysing and improving management information and amending key terms within contracts. We hired a new finance director with the right level of focus on cost control and margins, who is still in the business working alongside the founder.

It was very much a partnership, the management team and ourselves working together to transform the operational efficiency of the whole company. The direct result of our work was a profit improvement north of £4 million and a doubling of the operating margin – which was very influential in improving the multiple. The business grew its EBITDA from £5 million to over £20 million and was eventually sold in 2013 for £260 million, generating a 3.6x money multiple for our fund.

Q What challenges can arise implementing the plan?

MG: It is important to communicate and agree common objectives with the management team. With businesses that are preoccupied with running their day-to-day operations and are relatively small, there are constraints around how much resource people can allocate to change projects. We can supplement that from our internal resources. Having invested in the mid-market for almost 30 years now and in around 100 companies in that time, our team has developed a broad range of skills. We can also tap the advisory network that we’ve built up over many years.

IT infrastructure, in systems and processes and, of course, in the finance function as a whole. We look very closely at the cost base of the business to understand where there are either areas for potential savings or areas for investment required to support the growth plan.

There are also commercial considerations. Businesses may not have evolved their planning or sales and marketing functions in line with the intended direction of revenue growth. Very often we work with businesses to put in place, for example, key account management, as well as examine the effectiveness of the sales force, the efficacy of their digital marketing strategy and if they need to invest in any new products or channels. And, although we invest in UK businesses, we have helped many of them expand internationally.

Q Practically, how do you help businesses implement operational change?

MG: Our involvement could be limited to a specific issue such as strategy, funding, profit improvement initiatives, IT systems, business development, or span across many of them. For example, Alexander Mann Solutions (see box) was a very comprehensive exercise.

JM: As a firm, we’ve been focusing actively on operational improvement for some time. We have had a dedicated portfolio management team since 2005 and, in addition, now have a colleague in the US, which is our key focus territory for international growth.

Opportunities and challenges come at any time. We constantly assess the ability of the company to deliver and the extent to which we are involved will depend on how ambitious the growth plan is, whether there are any market headwinds, and the bandwidth and experience of the management team.
KEY QUESTIONS

On the minds of top LPs

From valuations to geopolitical issues, investors tell us the issues that keep them awake at night

What issues keep you awake at night?

What surprised you most in 2017?

Pitichai Yungtawesak: High valuations/price driven up by so much dry powder. I’m sceptical on where we are in the private market cycle.

Christian Kallen: The market is overly focused on top quartile net IRR performance, without considering GPs’ level of risk. As LPs are rewarding GPs that take higher risk, the industry as a whole is motivated to maximise returns by moving up the risk curve.

Dong Hun Jang: Because of high valuations, can we accomplish our expected target return?

Joncarlo Mark: Leverage and pricing in the US middle market are at an all-time high.

JM: The buoyancy of the market and the comeback of Europe in spite of it all.

PY: Not much in 2017 indeed, but a spill-over surprise from 2016: UBER’s successful Series G fundraising.

DHJ: Can the huge amounts of dry powder be deployed successfully?

CK: The biggest surprise was probably that there were no real surprises. From a private market perspective, 2017 has been a steady continuation of 2016.

OUR INVESTOR PANEL

Dong Hun Jang, chief investment officer of South Korea’s Public Officials Benefit Association

Christian Kallen, managing director in the fund investment team, Hamilton Lane

Joncarlo Mark, founder of the Upwelling Capital Group and a former senior portfolio manager at the California Public Employees’ Retirement System

Pitichai Yungtawesak, director, private equities, Government Pension Fund of Thailand

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DHJ: Can the huge amounts of dry powder be deployed successfully?

CK: The biggest surprise was probably that there were no real surprises. From a private market perspective, 2017 has been a steady continuation of 2016.
What's the biggest challenge this year?

**CK:** To be sure, it’s the lack of technology in the private markets. GPs and LPs have to be investing more in their own infrastructure to better harvest and analyse data on a fund and portfolio level.

**JM:** Emerging markets PE, particularly LATAM, which has not had the same comeback as the rest of the PE market.

**DHJ:** The RFP process is getting more competitive as too many GPs are participating.

**PY:** Geopolitics globally.

What are the most promising regions and strategies and why?

**PY:** Aside from the North Korea threats, Japan especially in the mid-market seems to be a bright prospect given its market condition improvement. I’m also foreseeing a structural shift toward more accessible dealflows.

**DHJ:** European mezzanine and debt strategy. There’s a higher Sharpe ratio because of tougher bank regulation.

**JM:** Fundless sponsors and family offices who have no need to aggressively invest, continue to see value in Mexico and India and southern Europe.

**CK:** Across the board, we continue to favour buyout strategies globally, as well as private credit. We’re recommending that LPs maintain their commitment pacing for 2018 and opt for safety and value where possible. Lastly, invest in infrastructure and people – a dollar, a euro, a yuan spent here will be better spent than one in another fund, CI or secondary opportunity.

**JM:** Slow down – give money back to LPs

**DHJ:** The hurdle rate is too low. There needs to be more co-investment opportunities.

**CK:** Similar to having a succession plan, GPs need a strategy around diversity and inclusion. If you don’t have one, work to implement one in the coming year.

**PY:** Stay disciplined and focus on your expertise.
CROSS-BORDER TAXATION

BEPS: LPs react to new tax environment

Investors are asking general partners some tough questions about the OECD’s flagship tax avoidance project. Funds need to know how to address these worries, say partners Matthew Saronson and Richard Ward and associate Matthew Pincus of Debevoise & Plimpton

Big changes to the taxation of cross-border investment activity by private equity funds are coming into view. The Organisation for Economic Cooperation and Development and its member countries are reaching the conclusion of their base erosion and profit shifting initiative, known as BEPS, which seeks to address perceived methods of tax avoidance.

On the basis of the recommendations developed during the BEPS initiative, over 100 countries (including the members of the European Union) are collaborating on the implementation of a new international tax framework that fundamentally alters how transnational business operations and investment are taxed. While the US has signalled that, with a few exceptions, it does not intend to make legal changes in response to BEPS, substantial changes to its international taxation system are possible as part of the tax reform package currently working its way through the US Congress.

Even though the precise contours of the new tax regimes have yet to be fully delineated, investors are increasingly concerned as to how funds will adapt to the changing international tax environment. Investors and their tax advisors frequently raise questions in the due diligence process as to whether a fund’s investment strategy and holding structures are vulnerable to challenge by tax authorities or may need to be altered on the basis of changes to international tax regimes. Sponsors need to stay up to date on how international taxation is evolving in order to respond to these concerns.

PUTTING BEPS INTO ACTION

BEPS seeks to address flaws in how tax regimes worldwide fit together that enable multinational companies and other international investors to either avoid tax or unfairly reduce their overall tax burden. The OECD argues the gaps and mismatches between the laws of different countries allow businesses that operate across borders to gain a competitive advantage over enterprises that have solely domestic operations. Furthermore, the OECD claims that allowing multinationals to reduce their tax liability by exploiting such gaps undermines voluntary compliance by taxpayers that do not operate internationally.

The aim of the BEPS project is to harmonise the tax rules between participating countries in order to ensure that income taxes are paid in the jurisdictions where the economic activities generating such income occur. To this end, the OECD has published a list of 15 Actions that encompass changes both to the domestic tax law of individual countries and to the tax treaties the participating countries have agreed with each other. These changes are currently being implemented by participating countries, even while the OECD is still finalising some of the fine details of its proposals.

Bringing these action points into force will impact many areas of tax law important to the structuring of fund investments, including the deductibility of interest, transfer pricing and permanent establishment status. Action 2 which concerns neutralising the effects of so-called “hybrid mismatch arrangements”, is of particular importance for fund sponsors, since it directly challenges one strategy that funds often use to structure international investments in a tax-efficient manner.

A “hybrid mismatch” arises when entities or financial instruments are treated differently under the tax laws of different jurisdictions. For instance, a “preferred equity certificate” (a “PEC”) issued by a Luxembourg
A company may be treated as debt for Luxembourg tax purposes while simultaneously being treated as equity for tax purposes in other jurisdictions. The proposed rules are designed to prevent such mismatches from being used by related taxpayers to claim a deduction from taxable income in one country (e.g., an interest deduction by a PEC issuer for an interest payment on a PEC) without claiming a corresponding income inclusion in another country (as may be possible for a corporation that holds the PEC, since corporations are often able to exclude dividends from their taxable income).

Some jurisdictions, including the UK, have already enacted legislation implementing Action 2, adding significant complexity to the already challenging task of returning proceeds from international investments to fund investors in a tax-efficient manner.

Countries participating in BEPS are also in the process of altering the terms of the tax treaties that they have agreed. Tax treaties are agreements between nations as to how they will tax the income of each other’s residents, and generally are integrated into – or supersede – domestic law. Treaty planning is an important aspect of structuring fund investments, as tax treaties can help preserve tax neutrality for fund investors who would often be entitled to treaty benefits if they directly invest in the fund investments.

Action 6, which tries to prevent the granting of treaty benefits in “inappropriate circumstances,” addresses the practise of “treaty shopping” – whereby a non-resident attempts to obtain the benefits of a country’s tax treaty – by recommending that participating nations should revise their tax treaties to ensure that the benefits are not abused. Incorporating such provisions into treaties may result in the denial of tax treaty benefits for certain fund structures, impacting the tax costs of exits and distributions. Already, more than 60 countries have formally entered into an agreement known as the “multilateral instrument” whereby they have agreed to implement the treaty-based recommendations of the BEPS initiative, including the recommendations of Action 6.

Action 2 and Action 6 are only two facets of BEPS, which is wide-ranging and encompasses many other areas of law as well. Since large portions of BEPS are not yet fully incorporated into law, there is still significant uncertainty as to the full impact of BEPS on investment structures.

**US OVERHAUL**

Adding to the environment of uncertainty is the prospect of significant changes to the US system of international taxation. For the most part the US has not proposed changes to its tax treaties or domestic law in reaction to BEPS, primarily because the government takes the position that the concerns that the OECD is seeking to address are already reflected in its regulations. But even as we write, the US Congress, in concert with President Trump, is engaged in a high-speed effort to overhaul US tax law. Given the political environment in the US, it is not clear how extensively, if at all, this will affect investment structures. However, several changes that have been discussed – such as altering how interest expenses are deducted – could challenge strategies that are used widely for efficiently structuring the US investments of non-US residents.

Given this environment of uncertainty, investors are increasingly seeking assurances from general partners that they are scrutinising how international tax law is developing and that they are considering how to adjust their investment structures to address any changes in the law. Some investors are also asking that fund documentation include covenants to give due consideration to BEPS in investment structures.

In general, general partners ought to resist agreeing to such provisions where the precise compliance requirements are not yet clear. General partners can often address investors concerns by being able to speak knowledgeably about BEPS and other developments in tax law that are relevant to their investment strategies. Being able to do so, however, requires continual and dedicated monitoring of the legal environment.
North American LPs are pessimistic about private equity returns heading into 2018, writes Sam McMurray

There is a distinct sense of unease among North American investors in the PEI LP Perspectives 2018 Survey: 39 percent are less confident about private equity returns in the coming 12 months. And just 8 percent feel more confident, considerably below the global average of 19 percent.

A sizeable 32 percent of North American respondents are planning to decrease their target allocation to funds of funds over the next 12 months – compared with the global average of 24 percent. This could well be a reflection of a more mature institutional investor landscape, with a greater number of LPs having built up the necessary internal resource to select funds and manage their portfolios.

Distressed fund strategies are experiencing the greatest rise in allocations over the next 12 months, with 23 percent of North American investors planning to increase their exposure to this strategy. This is reflected by the fundraising environment.

Certainly one contributing factor to the fundraising success experienced by Apollo Global Management, which this year closed the largest private equity fund ever on $24.7 billion, was the firm’s perceived ability to “flex” between benign economic conditions and periods of distress. The firm has told investors that up to a quarter of the new mega fund will likely be invested in distressed opportunities.

Over the past 18 months, Cerberus, KKR and Bain Capital have raised $3 billion-plus vehicles with at least a partial focus on distressed companies.

The PEI Perspectives 2018 data show that 33 percent of investors found it harder to source distressed opportunities over the past 12 months. In fact, it was only fund of fund opportunities that North American LPs found easier to come by, with investable venture, growth, buyout and secondaries funds all considered more difficult to source. For secondaries, only 9 percent of North American LPs said they

**ALL RESPONDENTS**

<table>
<thead>
<tr>
<th>WHICH ASSET CLASSES DO YOU PLAN TO MAINTAIN OR INCREASE ALLOCATION TO OVER THE NEXT YEAR? (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private equity</td>
</tr>
<tr>
<td>Private real estate</td>
</tr>
<tr>
<td>Infrastructure</td>
</tr>
<tr>
<td>Private debt</td>
</tr>
</tbody>
</table>

*Source: Private Equity International*

<table>
<thead>
<tr>
<th>WHAT IS YOUR CURRENT PE ALLOCATION?</th>
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<tbody>
<tr>
<td>Under allocated</td>
</tr>
<tr>
<td>At target allocation</td>
</tr>
<tr>
<td>Over allocated</td>
</tr>
<tr>
<td>Have no target allocation and invest opportunistically</td>
</tr>
<tr>
<td>Have no allocation</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>WHAT IS YOUR AVERAGE COMMITMENT SIZE?</th>
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</thead>
<tbody>
<tr>
<td>Up to $20 million</td>
</tr>
<tr>
<td>$21 million to $50 million</td>
</tr>
<tr>
<td>$51 million to $100 million</td>
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<tr>
<td>$100 million to $250 million</td>
</tr>
<tr>
<td>Over $250 million</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>HOW DID INVESTMENTS PERFORM AGAINST BENCHMARKS OVER THE PAST YEAR?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Better than expected</td>
</tr>
<tr>
<td>As expected</td>
</tr>
<tr>
<td>Short of expectation</td>
</tr>
</tbody>
</table>
**WHAT ARE YOUR TOP MACROECONOMIC CONCERNS?**

- Extreme market valuations
- Increasing availability of leverage in alternative investment markets
- Impact of rising interest rates
- Western political instability
- Commodity price volatility
- Impact of the UK’s exit from the EU
- Terrorism

Source: Private Equity International

*figures may not add up to 100% due to rounding

**HOW DO YOU PLAN ON ALLOCATING TO THE FOLLOWING STRATEGIES OVER THE NEXT 12 MONTHS? (%)**

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Increase target allocation</th>
<th>Keep target allocation the same</th>
<th>Decrease target allocation</th>
<th>Invest opportunistically</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyout</td>
<td>15</td>
<td>8</td>
<td>65</td>
<td>27</td>
</tr>
<tr>
<td>Distressed</td>
<td>27</td>
<td>6</td>
<td>44</td>
<td>23</td>
</tr>
<tr>
<td>Fund of funds</td>
<td>18</td>
<td>32</td>
<td>50</td>
<td>16</td>
</tr>
<tr>
<td>Growth</td>
<td>28</td>
<td>5</td>
<td>52</td>
<td>57</td>
</tr>
<tr>
<td>Venture capital</td>
<td>22</td>
<td>11</td>
<td>57</td>
<td>11</td>
</tr>
</tbody>
</table>

Source: Private Equity International

**HOW DO YOU PREDICT THEY WILL PERFORM OVER THE NEXT 12 MONTHS?**

- Much more confident
- More confident
- About the same
- Less confident
- Much less confident

**DO YOU PLAN TO MAKE FRESH COMMITMENTS TO EXISTING MANAGERS OVER THE NEXT YEAR?**

- We plan on recommitting funds to existing managers
- We will opportunistically invest in funds being raised by existing managers
- We will not recommit to existing managers

**WILL YOU COMMIT TO NEW FUND MANAGERS OVER THE NEXT YEAR?**

- We plan on committing capital to new managers
- We will opportunistically invest capital in funds raised by new managers
- We will not commit capital to new managers

**DO YOU PLAN TO INVEST IN FIRST-TIME FUNDS?**

- Yes, we have a defined allocation
- Yes, we invest opportunistically
- No, but we plan to invest in the future
- No, we do not invest
have a defined allocation in the next 12 months versus 72 percent who will invest on an opportunistic basis.

One deterrent is prices, with secondary stakes sitting close to all-time highs at an average of 96 percent of NAV, dampening potential returns.

In September, Brady Hyde, then private equity portfolio manager for the UPS Group Trust, told PEI the pension was seeing heightened competition among secondaries buyers – exacerbated by more widespread use of leverage – that had pushed up prices. This had put it off from buying stakes recently, but, said Hyde, “we still view secondaries as strategic in our portfolio in terms of mitigating the J-curve and getting some unique exposure”.

The impact of rising interest rates is one of the top three issues for investors in the region, with 34 percent viewing the tightening of monetary policy as a big concern.

They may take some comfort from the installation of a private equity insider in the form of former Carlyle exec Jerome “Jay” Powell as chair of the Federal Reserve. Powell is viewed as a continuity candidate following on from Janet Yellen who has largely taken a dovish approach to monetary policy.

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**WHICH OF THESE STRUCTURES DO YOU PLAN TO INVEST IN OVER THE NEXT 12 MONTHS?**

- We have a defined allocation to invest in these funds
- We may opportunistically invest in these funds
- We do not invest in these funds

**WHICH OF THE FOLLOWING GEOGRAPHIES WILL YOU CONSIDER FOR INVESTMENT OVER THE NEXT 12 MONTHS? (%)**

<table>
<thead>
<tr>
<th>Geography</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>97</td>
</tr>
<tr>
<td>Latin America</td>
<td>30</td>
</tr>
<tr>
<td>MENA</td>
<td>15</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>12</td>
</tr>
<tr>
<td>Western Europe</td>
<td>90</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>30</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>78</td>
</tr>
</tbody>
</table>

**HOW EASY HAS IT BEEN TO SOURCE INVESTMENT OPPORTUNITIES OVER THE PAST 12 MONTHS?**

- Far easier than the previous 12 months
- Easier than the previous 12 months
- The same as the previous 12 months
- Harder than the previous 12 months
- Far harder than the previous 12 months

**WHAT IS YOUR PRIMARY SOURCE OF FUND OPPORTUNITIES?**

- Investment consultants
- Existing GP relationships
- Placement agency
- Direct fund manager interaction
- Third party fund database
- Conferences and events

**HOW EASY HAS IT BEEN TO SOURCE INVESTMENT OPPORTUNITIES IN THE FOLLOWING STRATEGIES? (%)**

<table>
<thead>
<tr>
<th>Strategy</th>
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<tbody>
<tr>
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<td>33</td>
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<td>Fund of Funds</td>
<td>47</td>
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<tr>
<td>Growth</td>
<td>56</td>
</tr>
<tr>
<td>Secondaries</td>
<td>57</td>
</tr>
<tr>
<td>Venture</td>
<td>42</td>
</tr>
</tbody>
</table>

Source: Private Equity International
INVESTING IN THE GP

Why Alaska has warmed to GP interests

The sovereign wealth fund has committed more than $1.2bn to the strategy of taking stakes in managers over the past three years. By Alex Lynn

It is safe to say Alaska Permanent Fund is a fan of private equity.

The $62 billion sovereign wealth fund is a relative newcomer to the asset class, having only invested through two separately managed accounts prior to the appointment of Stephen Moseley as head of private equity in 2014. As of 30 June, its commitments to the asset class stood at more than $8 billion.

It is also one of the largest participants in private equity’s latest trend: funds that take ownership stakes in general partners. Alaska is a major supporter of the two biggest so-called funds of firms that have closed, having agreed a $550 million commitment to the $5.3 billion Dyal Capital Partners III and $500 million to the $3.3 billion Blackstone Strategic Capital Holdings.

It is understood the commitments were accompanied by revenue sharing arrangements with both funds.

“We think this is a juicy strategy,” Moseley tells Private Equity International. “The purchase by LPs of GP stakes has been around for a long time, but with the advent of funds targeting this strategy, the institutional floodgates have opened.”

Credit Suisse, AlpInvest Partners and Goldman Sachs Asset Management are among those taking advantage of this influx.

Such is its appeal that Dyal has already secured around $1 billion of commitments for its fourth fund, for which it is targeting up to $6 billion, as PEI reported in October.

Acquiring a stake can entitle funds to a share of management fees and carry across all the target GP’s vehicles. It can also provide the target’s founders with much-needed liquidity without having to list.

LPs hoping to pursue this strategy are not constrained to funds of firms. One option is the direct-seed model in which LPs back a first-time manager with a cornerstone or foundation commitment that eliminates the need for fundraising. These deals can result in a revenue-sharing arrangement of as much as 20 percent with the target.

Alaska has made five such arrangements in the past four years. The fund has also invested approximately $225 million directly into the management companies of GPs.

The Juneau-headquartered investor has been rewarded well for its confidence. As of 30 June, the fund had generated a 37.5 percent one-year net internal rate of return across its direct GP interests and 24.2 percent when combined with commitments to funds targeting a stake strategy, Moseley notes.

“Our intent was to benefit in some part of our portfolio from a buoyant fundraising environment and from general market froth,” Moseley adds. “I guess you could say it was a hedge, since heated fundraising tends otherwise to be dilutive to LP returns.”

And while the fund does not expect to significantly increase its exposure to GP interests at this point in the cycle, interest in the segment is far from slowing down.

“Seed and stake deals can make great sense but the due diligence and execution is complex and labour intensive, so we’re also exploring ways to institutionalise this activity through the formation of a joint venture with two other large LPs,” Moseley says, adding the parties are aiming to close the deal within the next month.
GP RELATIONSHIPS

CalPERS rethinks core approach

The pension plan’s strategy to reduce GP relationships to a core group has not delivered the benefits it expected, writes Marine Cole

The California Public Employees’ Retirement System’s 2011 plan to reduce the list of its core private equity managers has failed to deliver intended improvements, according to an investment committee meeting in November.

CalPERS’ so-called ‘core 30’ is the pension plan’s list of private equity managers that was formed as part of a five-year strategic programme to reduce complexity and the cost of managing the portfolio. It was intended to allow CalPERS to take advantage of a broad range of investment opportunities such as co-investments and customised accounts.

However, some of these goals have not materialised, prompting questions around the future of the core 30 from CalPERS’ PE consultant Meketa Investment Group and some of its board members.

Meketa noted in its annual review that portfolio complexity and monitoring intensity as measured by the number of capital transactions and amendment requests has not diminished. It also pointed out CalPERS “has not benefited from meaningful fee reductions that were not available to similarly situated limited partners”.

In addition, CalPERS has not been pursuing co-investment opportunities and discussions about separate accounts have not led to commitments. It has also struggled to deploy larger amounts of capital with fewer managers as planned.

“We’re not seeing the kind of partnership opportunities where there’s co-investments and separate accounts that can be taken advantage of,” Steven Hartt, a principal with Meketa, told the CalPERS’ board members during the meeting.

“In some cases, it might be a little of how a number of these large managers tend to want to do their partnership activities. What I mean is there can be groups like Blackstone or Carlyle that look to do partnership activities across a number of asset classes as opposed to just private equity and working with CalPERS to do those kinds of activities across multiple asset classes can be a little complex.”

Meketa’s mixed review of CalPERS’ core 30 prompted several questions from board members.

Betty Yee, California’s state controller, asked whether the concept should be dropped or whether CalPERS could expand the list.

Hartt replied that the investment staff has a process to alter the list and has considered other managers. “From what I’ve heard from staff more recently is that they would look to have some more than just 30 managers on their list,” he said. “I don’t think there’s been a decision as to exactly how many, but I know that other plans do have a larger set.”

Priya Mathur, a board member, asked Hartt what he considers the right level of concentration versus diversification in the PE portfolio of very large and smaller buyout funds. “Do you have a sense of what that sweet spot might be for an organisation of our size?” she asked.

Hartt said that Meketa and the investment staff need to do some more research to come up with an answer, but he also said commitments to small buyout firms wouldn’t move the needle much unless there were hundreds done.

If CalPERS decides to take advantage of co-investments, it should ensure its private equity underwriting team gains experience in the field, Hartt added.

“In terms of staffing to be able to execute that, what I have seen now is that there are just a few members of the team, the underwriting team, that have experience in doing co-investments,” he said.

“I would think that in order to do more co-investments that more staff should be able to have experience in doing that, whether that is a training and mentorship programme within CalPERS, whether it’s going out to other groups, lots of different ways to do that.”

The board asked Meketa and CalPERS’ investment staff to study possibilities to refine its core 30 list and assess its ideal size.

CalPERS’ net asset value for its private equity portfolio was $25.9 billion as of 30 June.
As the private equity asset class has grown, so has the need to outsource the fund administration function. Sri Kumar T.E. of Apex Fund Services considers what’s in store for this growing industry amid increased reporting requirements from LPs.

Much like the private equity industry itself, the fund administrators that serve it are in clear growth mode. Where once, the majority of private equity firms kept all their operations in-house, a recent survey of private equity CFOs conducted by EY and PEI found that 61 percent of firms now outsource their fund accounting functions, with more planning to do so in the future. And while middle office outsourcing rates remain low, the survey highlighted a clear trend towards further use of third parties for areas such as portfolio company analytics.

We spoke to Sri Kumar T.E., deputy CEO of Apex Fund Services, to gain his perspective on some of the key changes—past, present and future—to the industry and to discuss why regional nuances count when it comes to providing outsourced services.

Q Outsourced private equity fund administration services have long been a feature of the market, so why are firms now looking beyond their in-house teams?

My perspective is that much of this has to do with the make-up of the fund administration business. Until recently, many players were geared largely towards hedge funds—outourcing rates have historically been much higher there because of the nature of their investments and the need for custody services. As a result, there were very few specialist private equity administrators who had the skills and technology to service the unique characteristics of a private equity fund.

The landscape has changed, with more services now tailored specifically towards private equity, so there’s a pull factor. Yet there are also a couple of major push factors. One of the biggest drivers is the increased reporting requirements of limited partners today. They need more detailed information in specific formats and they are seeking the comfort of a layer of independence in reporting. Regulatory change is also pushing firms towards outsourcing as items such as FATCA and CRS compliance require upgraded IT, which can be expensive to build and maintain.

Q Where are you seeing most demand?

There is clearly a greater percentage of smaller and medium-sized houses looking to outsource, although demand is actually across the board. Some larger houses are also looking at this because, even if they do have the firepower to build big, in-house teams and invest in IT, they are facing continued pressure on fees, which can make the need for constant technology updates prohibitively expensive.

With the smaller and medium-sized players, there’s a move to outsource all fund administration services, while at the larger end, many firms are choosing from a menu of options and will often have in-house teams and infrastructure plus external providers and these act as a buffer for each other.

Q So what are the reporting requirements of LPs now? In what ways are their needs changing?

They are seeking more granular information from their GPs. So, that might be deal-by-deal IRR, transparency in allocation of fees or more information on investment holding structures. The point is they need it in a timely fashion and in a format that they can use. This means that GPs are having to report according to ILPA templates, in some instances, or according to whatever other format an LP may require. That takes either much more sophisticated technology than many GPs have access to or it...
requirements and the need for regulatory compliance are increasing the need for powerful solutions. The rise of automation is enabling GPs to produce data according to many different templates and to synchronise data at increasingly granular levels, while also consolidating information at a higher level. Yet it’s not just automation that’s proving powerful. Technology is starting to emerge that will enable increased customisation so that individual GP and LP information needs can be met.

The next big development will be on asset valuations. Most GPs still conduct these in-house, but there is now scope for them to outsource this to a fund administrator via a platform that can not only update asset valuations efficiently, but also provide LPs with greater transparency – they can understand better which valuation models are being used and tell from which stage the reports they are receiving have been drawn.

While GPs can source many of these technology solutions and run them in-house, the need for constant upgrades (not to mention the initial implementation) makes this an expensive undertaking. At the same time, while the technology is already here, the skills and talent required to test these solutions is in short supply – many GPs are weighing up whether they can recruit the right people and whether they really want additional staff to manage.

**THE TECHNOLOGY DIMENSION**

New software is providing LPs with greater transparency on valuations, says Srikumar T.E.

With these greater demands are you seeing private equity GPs increase the requirements they have for fund administrators?

Absolutely. And that’s where private equity specialist knowledge really comes in. Fund administration in PE is fundamentally different from what is needed by hedge funds. You can’t take a cookie-cutter approach. There needs to be a level of flexibility in the way you service private equity clients – it’s not a commoditised business where you have, say, 5,000 people based in India or China doing the work. You need to be capable of producing bespoke reporting across a variety of private equity fund strategies to offer a real value proposition for private equity. You also need to take account of the different regional nuances if you are to build a business of scale.

What do you mean by regional nuances?

The private equity market is not uniform globally. Different regional markets have different dynamics, characteristics and investment preferences. In the Middle East, for example, there is a high affinity to investing in real estate through private equity funds and, more recently, REITs that have launched over the last 12 months.

There is complexity in the level of detail and granularity that needs to be recorded in this type of investment. It requires collecting data and reporting it right down to the property level, including rent collection. Firms based in the Middle East have traditionally therefore been open to the idea of outsourcing. They also value the independence a fund administrator can bring as this provides a level of comfort and
reassurance to their global investor base. Asian GPs have historically also been very open to outsourcing, although for slightly different reasons.

Q So what are the nuances with Asian GPs?
The Asian private equity market is different. A lot of capital has flowed there from local LPs, unlike with open-ended funds and hedge funds in Asia, and so it’s not necessarily the comfort factor that comes into play here. However, many of these firms run small funds, yet make investments across a number of different jurisdictions with different tax regimes and local compliance requirements. This makes administration complex.

There are also a lot of new GPs in Asia – and it’s often the case that newer fund managers tend to opt for outsourcing so they can hit the ground running Singapore and China, for example, have many new GPs, including large numbers of venture capital funds as well as buyout houses.

Q So if both of these markets have been very open to outsourcing, what are you seeing in some of the more traditional private equity markets?
We’re seeing a big uptick in outsourcing in the Americas, a region that has been slower to use third-party services. Canadian investors, for example, have largely concentrated on local real estate, but that is now changing as they are looking internationally. In the US, many mid-market houses are now outsourcing to upgrade their operating environment through improved technology. They want to ensure they are adhering to best practices, managing their internal teams effectively and are more nimble.

European managers, meanwhile, are the most regulated of all with the implementation of the AIFMD. This has had some taxation implications because of the substance requirements in the jurisdictions in which their funds operate. Many firms are now trying to outsource as much as is legally possible and, as a result, the European Union is where we see the greatest trend of larger private equity houses moving towards third-party administration.

Q Given all these nuances, how can fund administrators service the different needs of private equity clients globally?
First, you really need on the ground presence to appreciate the nuances locally. Yet the fact is that private equity is also a global industry today, with investors committing from different regions and investments being made across different jurisdictions, so it’s hard to be a single-region fund administration player. At Apex we have a network of offices worldwide to service clients’ needs seamlessly – you have to be able to follow a fund that may be established in one jurisdiction, with investors in a different jurisdiction and the assets in yet another.

Q What do you think will be the most significant trends in private equity fund administration in the coming few years?
Private equity has had a dream run over the last few years. The industry has performed well and this has resulted in increased allocations from pension funds, endowments and other institutions. At the same time, many new investors have emerged over the last 10 to 20 years in regions such as Asia. There is $327 billion of money set to come towards the industry over the next few years from Greater China alone. The pace of change in the industry may well be much faster in the years to come.

Yet the flip side to this success is that regulatory pressure is likely to increase significantly, too. Unlike hedge funds, private equity has largely been left to its own devices in markets outside the US and Europe. The fact is that the industry is now much more dispersed than it used to be as it has reached all the corners of the globe, so it’s inevitable that compliance will upgrade too.

Q Where do you think increased regulation is likely to bite most?
I think we’ll see moves to engender greater accountability from the private equity industry worldwide, but particularly in emerging and newer markets where there are currently fewer rules and guidelines than in more established markets such as North America and Europe. The capital call default process has never been tested in the Chinese market, for example, so there is no legal precedent set there. Regulations will inevitably develop and tighten and the industry will need to grapple with these, coupled with more data protection issues, greater calls for transparency as well as more frequent valuations that are independently conducted.

Srikumar T.E. has over 18 years of experience of the global financial services industry. At Apex (see www.apexfundservices.com), he is responsible for overseeing various Apex offices globally as well as leading Apex’s specialised private equity service solution. He is member of Apex’s global executive committee, risk committee and operations committee.
Western political instability is one of the top worries for Asia-Pacific investors, writes Sam McMurray

After extreme market valuations, the second biggest macroeconomic concern for Asia-Pacific investors over the coming 12 months is western political instability, according to our PEI LP Perspectives Survey 2018. Another key concern, the impact of the UK’s exit from the European Union, is also more of a worry for Asia-Pacific LPs compared with the global average. This hasn’t dampened investor appetite for these regions; 69 percent of Asia-Pacific LPs see North America as an investable region over the next 12 months; 62 percent said the same about Western Europe.

We are seeing anecdotal evidence of increased appetite among Asian LPs for exposure to their domestic private equity markets. In India, for example, “more domestic capital is being mobilised into private equity funds”, Nupur Garg, regional lead for South Asia, Private Equity & Venture Capital Funds at the International Finance Coporation told PEI.

“There are a lot of domestic financial institutions that have large programmes backing funds.”

Meanwhile recent data from the Australian Private Equity and Venture Capital Association show that domestic investors, in particular the country’s super funds, are re-emerging as a prominent component of the Australian private equity fundraising landscape.

“Over the past three years we’ve seen a steady increase in overseas funding and now it’s a welcome change to see the re-emergence of domestic funding sources,” Yasser El-Ansary, AVCAL chief executive said in the report.

Nearly one in three Asia-Pacific LPs – 30 percent – reported that private equity returns outperformed their internal benchmarks, which compares favourably with private debt and infrastructure returns, where 13 percent and 20 percent outperformed respectively. No respondents

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<th>WHICH ASSET CLASSES DO YOU PLAN TO MAINTAIN OR INCREASE ALLOCATION TO OVER THE NEXT YEAR? (%)</th>
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<th>HOW DID INVESTMENTS PERFORM AGAINST BENCHMARKS OVER THE PAST YEAR?</th>
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DO YOU PLAN TO INVEST IN FIRST-TIME FUNDS?
- Much more confident
- More confident
- About the same
- Less confident
- Much less confident

HOW DO YOU PREDICT THEY WILL PERFORM OVER THE NEXT 12 MONTHS?
- Much more confident
- More confident
- About the same
- Less confident
- Much less confident

DO YOU PLAN TO MAKE FRESH COMMITMENTS TO EXISTING MANAGERS OVER THE NEXT YEAR?
- We plan on recommitting funds to existing managers
- We will opportunistically invest in funds being raised by existing managers
- We will not recommit to existing managers

WILL YOU COMMIT TO NEW FUND MANAGERS OVER THE NEXT YEAR?
- We plan on committing capital to new managers
- We will opportunistically invest capital in funds raised by new managers
- We will not commit capital to new managers

HOW DO YOU PLAN ON ALLOCATING TO THE FOLLOWING STRATEGIES OVER THE NEXT 12 MONTHS? (%)
- Increase target allocation
- Keep target allocation the same
- Decrease target allocation
- Invest opportunistically

WHAT ARE YOUR TOP MACROECONOMIC CONCERNS?
- Extreme market valuations
- Western political instability
- Impact of rising interest rates
- Increasing availability of leverage in alternative investment markets
- Impact of the UK’s exit from the EU
- Terrorism
- Commodity price volatility

Source: Private Equity International
saw their private equity portfolios fall short of expectations over the past 12 months, compared with a global average of 16 percent. A total of 38 percent of Asia-Pacific LPs surveyed were under allocated to private equity, in line with the global figure of 40 percent.

There was an even split over how easy it was to source investment opportunities: 18 percent of respondents found it easier to access opportunities; the same proportion found it harder. The latter figure compares favourably with the global average, where 31 percent of respondents found it difficult to source suitable investments.

LPs in the region are more likely than their Western European counterparts to source opportunities via an investment consultant: 14 percent said it was the primary route to fund introductions. Asia-Pacific investors also view conferences and events as a more active avenue than North American and European LPs.

Only 11 percent of LPs in the region have a defined allocation to private equity secondaries over the next 12 months. But Asia-Pacific LPs are more likely to have a defined allocation to co-investment opportunities (27 percent) and direct opportunities (18 percent) than their global counterparts.
India, a priority country for the International Finance Corporation, has attracted $11.3 billion of private equity capital from global and domestic investors in the first half of the year, a more than 50 percent increase from the previous year, data from Venture Intelligence show.

IFC, the private investment arm of the World Bank Group, has a total India exposure of $6.5 billion or more than a tenth of its $55 billion portfolio. Since 1958, the investor has been mobilising private capital to reshape the country’s infrastructure, financial services, healthcare, consumer and renewable energy sectors through direct investments, fund commitments and advisory services.

India now ranks as the most attractive emerging market for general partner investment in 2017, followed by South-East Asia and Latin America, according to an EMPEA report. The government’s attempt to improve its investment climate through the implementation of the goods and services tax, cleaning up of banks’ balance sheet and easing of foreign direct investment rules appears to be paying off. The country ranked 40th out of 137 countries on the World Economic Forum’s 2017 global competitiveness ranking – its highest-ever score in WEF’s methodology – brought about by improved market efficiency, business sophistication and innovation.

“Currently we are investing about $2 billion per year in India and we are working towards quickening this pace because of the investment opportunities available,” Jun Zhang, country manager for India at IFC, tells Private Equity International. “Doing $2 billion a year means we’ve invested in about 55 projects. We are looking on a longer-term basis at a double-digit increase in investment value,” he adds.

Zhang says that everyone wants to come to India to invest because the macroeconomic picture is stable, demand is strong and its growth potential is huge. “Recent reforms from the government are also positive news and I believe the corporate governance and regulatory environment will improve through time.”

**UNLOCKING DOMESTIC CAPITAL**

Foreign investors like IFC formed the lion’s share of private equity investments in the country in the past decade but that is changing as domestic institutional investors become more relevant in the Indian market.

Nupur Garg, regional lead for South Asia, private equity & venture capital funds at IFC, tells PEI the investor appetite for...
India has changed, with more domestic capital being mobilised into private equity funds.

What’s noticeable is that a lot of domestic financial institutions are establishing large programmes backing funds, Garg points out. One example is the government’s 100 billion rupee ($1.5 billion; €1.3 billion) fund of funds managed by Small Industries Development Bank of India (SIDBI). As of end-April this year, SIDBI had backed 88 funds with venture capital strategies including those managed by ICICI Venture, Paragon Partners and Multiples Alternate Asset Management, it said on its website.

Garg also observes that strategic and corporate investors have taken an active interest in backing India-focused funds, a clear sign LPs are more willing to put their money to work. US, European and Asian family offices have similarly started experimenting with funds before getting into direct investing.

The shift in the investor base, however, has not diminished big participation from large global pensions and sovereign wealth funds especially in direct investments. Data from Deloitte showed Canadian pension funds are the most active in India deal flow, deploying up to $5 billion in the last two years. Others such as Singapore’s GIC, Abu Dhabi Investment Authority and Malaysia’s Khazanah Nasional Berhad were also active dealmakers in 2016.

LONG-TERM DRAW

New investors into the asset class is an emerging sign of market maturity but historical performance remains a concern.

“Similar to other limited partners, the India portfolio has not really performed up to expectations,” Garg says. “We’ve seen a combination of currency depreciation of up to 60 percent, macro headwinds like the global financial crisis and resulting slowdown has led to a slow capex cycle and high leverage.

Added to that India private equity is extremely young: “Through the years the private equity industry has seen a lot of challenges — contractions, consolidation and corrections have taken place. It has matured and at the same time remains very nascent because of the size of the industry and the number of players in comparison with the massive Indian economy, the opportunity and the need for private capital – I think the industry has a lot of growth ahead.”

Weak performance and exit environments have deterred investing in India but latest figures show that is slowly changing. The industry witnessed the highest value of exits in 2016 in the past five years; private equity and venture firms clocked exits worth $6.8 billion across 239 exits in 2016, according to data from Deloitte. While there was a 19.5 percent decline in the number of deals as compared to last year, overall deal value saw an increase of 17.2 percent, an indication that exits are getting bigger.

“I think LPs need to take a step back and introspect on their decision-making instead of penalising the India private equity market because of its underperformance,” she says. “India private equity is still extremely young and has seen just two fundraising cycles and one full investment cycle. We need to look at the long-term potential of this market, recognise that it’s a long-term market, and that we can’t expect results to come by in three years.”

Most investors targeting emerging markets do so because they expect strong long-term economic growth there and India is no exception. “India is a market that holds great potential and we at IFC really want to be making a difference in the country in the way we have done for its microfinance and energy sectors,” Zhang says.

“However, if you are a short-term investor, India is not the place you want to go. Fund managers need to be patient to see the results.”
KEYNOTE INTERVIEW: POMONA CAPITAL

STATE OF THE MARKET

Staying nimble in secondaries

Pomona Capital’s chief executive officer, Michael Granoff, reflects on the evolution of the secondaries market, today’s environment and what 2018 has in store

Since Michael Granoff founded secondaries firm Pomona Capital nearly a quarter of a century ago, the market has grown significantly. With some funds expanding in size, Pomona has strategically and deliberately kept its fund sizes modest, with the most recent closed vehicle, Pomona Capital VIII, being $1.75 billion.

Typically buying only 1 to 3 percent of the dealflow it sees each year, Pomona believes in the importance of being disciplined and selective. Pomona tends to focus on niche, mid-size transactions where it can take advantage of inefficiencies, capitalise on its edge and steer away from buying a slice of the generic secondaries market.

In a recent interview, Granoff explains what makes Pomona different, his views on GP-led transactions, the state of the secondaries market and opportunities from retail investors.

Q What differentiates Pomona in this market?

In today’s market there is no shortage of dealflow. Increased volume brings with it increased variability in transaction size, asset type and quality, and liquidity profile. What differentiates Pomona is our ability to seek opportunities where we believe we have an edge and not compromise on asset quality or price.

Our modest-sized funds provide us with the ability to be deliberate in our investment decisions without the pressure to deploy capital and sacrifice our strategy and risk/return objectives. Typically, our sweet spots are transactions $100 million in size, but our flexibility keeps us focused on selectively buying quality assets at good prices. If you look at our last secondaries fund, Pomona Capital VIII, the largest transaction was over $400 million and the smallest was about $10 million. Being able to be that nimble is a real benefit to us. If we could only buy tiny little pieces of things, I think we’d be really limited in what we would see. If we could only buy the largest transactions, we would end up in the more efficient side of the market and have to compromise on quality or price.

Q What type of transactions do you pursue?

Pomona focuses on uncovering opportunities where we believe we have or can create a competitive advantage. We seek transactions where we have the ability to capitalise on an informational advantage through existing relationships and in-depth knowledge of particular assets and/or funds or leverage our status as approved buyer on a general partner’s restrictive list.

We invest mostly in LP stakes and take a targeted approach focused on acquiring high-quality and mature assets that have identifiable near-term liquidity and downside protection. We maintain a disciplined pricing approach in our efforts to provide a margin of safety on the downside and to enhance returns on the upside. We actively seek ways to enhance liquidity for our investors while also achieving a lower risk profile by targeting mature assets that are typically five-to-seven years old and funds that are 70-90 percent called. Often assets in these portfolios have substantially de-levered, are demonstrating positive operational performance and are preparing for liquidity events.

Q Do you invest in GP-led secondaries transactions?

I haven’t seen too many good funds that needed to be restructured, so the barrier for our participation is high. We have been sellers in many more cases than we have been buyers. Pricing is generally high and close to NAV. There is usually not much growth.
left in the assets. If you told me I could take my money off the table today and lock-in returns for our limited partners, or wait years for the same amount of money, I would rather take the money now, especially in the current environment.

**Q** How important is primary investing to secondaries?

Our relationships with GPs are important. Primary investing is one element of the multidimensional relationship we seek with GPs. We’ve built a lot of critical mass in the primary asset class over the years. Today, we manage over $3 billion in primary commitments and deploy approximately $250 million a year on the primary side. We do some co-investing as well. Over the past 23 years, we have developed relationships with over 600 GPs from around the world. As a primary investor, Pomona is able to leverage those relationships and create an informational edge that we can apply to our secondaries investing platform. This informational edge is invaluable in today’s market, where GPs tend to avoid giving insight into underlying portfolios and are becoming even more restrictive in consenting transfers to many secondaries players. In our last fund, nearly half of the transactions were in one way or another directed to us by a GP. Having that critical mass really helps.

**Q** How can a secondaries firm buy quality assets at an attractive discount?

The market is not monolithic. It’s a big market. Sellers sell for many reasons. We’re buying only 1 to 3 percent of the dealflow we see. We know the funds, we know the assets, we know the GP and we might even know things that others may not about what’s happening to the underlying companies. As a result of our targeted approach, we are able to consistently buy at a price below the market averages. For instance, Pomona Capital VIII, which we invested between 2012 and 2016, has now returned over 90 percent of drawn capital and has experienced many

Dealflow is quite robust. It may be that we are entering a period where we are going to see more dealflow because of the amount of capital that went into private equity after the financial crisis. Pricing is tight, but because we don’t need to deploy too much capital, we believe we can pick our spots and buy better than market quality assets at lower than market prices. The most probable outcome at the beginning of 2018 is a continuation of what we’ve seen in the second half of 2017.

That’s subject to some macro considerations about what other markets and the rest of the world look like, and that’s hard to predict. Europe is doing better than people thought. The US is doing fine. People were concerned about Asia and China and they seem to be doing okay. But, there are also a lot of anxieties and things percolating that could interrupt the growth. This could include what our Congress is able to do in terms of legislation, what happens to tax and healthcare reform, geopolitical concerns, and the many other unexpected events that we can’t predict.

In the next four years, it’s more likely than not that we will enter a period of distress and disruption. In this case that will create more opportunities for us because there will be more distressed sellers. However, we also need to be very careful. Disruption will create opportunities, but we will need to have a lot of conviction before jumping into it. It will take a little bit of time for us to make sure we are comfortable, but we believe our nimbleness and selective approach to secondaries investing will allow us to take advantage of opportunities as they arise. ■
realisation events. The average discount to NAV in that fund was 14 percent.

It all goes back to fund size and selectivity. Could we deploy twice as much capital in the same strategy? No, we’d be forced into where the market is more efficient and we wouldn’t be able to buy at the right prices, or where we would have to take more risk. Neither is a place we want to be for our limited partners.

Q Why would someone sell a good asset?
This is one of the seminal questions of the secondaries market going back to its roots. For the most part, institutions tend to sell not because something is happening to a fund they own, but because something is happening to them. Reasons to sell could be regulatory, organisational changes, proactive portfolio management or liquidity needs. Sellers tend to sell what may even be better assets to get a better price, rather than selling underperforming assets at a poor price. We believe we can be effective in selectively cherry picking good assets that tend to be mature, with near term liquidity events, at compelling prices.

Q What’s your view on the current state of financial markets?
We’re facing a dichotomy of extremes that I’m not sure I remember ever seeing. On the one hand, we have markets pricing assets to perfection, assuming that the world is a very benign place. On the other hand, when I wake up in the morning and read the newspaper, the world seems anything but benign. People are more anxious than I have seen in a long time, and that probably extends to how investors are feeling these days. My guess is that dichotomy won’t persist over the long term. Either markets are right and we have to get used to a noisier President or markets have significantly under priced geopolitical risk and at some point they’re going to have to adjust to the realities.

Q What is the retail opportunity in private equity and particularly secondaries?
In general, retail investors have no exposure to alternatives. There’s a reason that the world’s most sophisticated institutions have allocated large sums to private equity because it’s delivered over time. You have this huge segment of retail capital, probably larger overall than the institutional segment, that has no access to private equity. For many retail investors, it is difficult to lock up capital for extended periods and finding a product that gives frequent liquidity is difficult.

Today, you’re seeing more of the biggest players in private equity trying to provide access to retail investors. They’re doing it for a reason. Certainly there are hurdles to get there and no one has it completely figured out. Hopefully, one day it will get to a point where retail investors can easily access private equity, opening up trillions of dollars in capital not just in the US, but in Europe and Asia as well. It will be interesting to see how it plays out.

Q How has Pomona tackled the retail offering with its listed Pomona Investment Fund?
We believe that being a private equity secondaries manager brings us closer to being a good fit with the retail and retirement markets than other private equity strategies. Is it a perfect mouse trap? No, but I would argue that we have come closer than buyout or fund of fund strategies. With secondaries, investors have the ability to mitigate the J-Curve completely and instantly diversify across strategies, GPs and vintages. We are finding a way to introduce private equity investing to a new segment, and it is an ongoing exercise. The Pomona Investment Fund is an open-end fund that has been growing, and we are looking forward to the opportunities ahead.

Michael Granoff founded Pomona Capital in 1994. Granoff has previously served on the staff of the US House of Representatives Appropriations Subcommittee on Foreign Operations and was a member of the 1992 Presidential Transition Team for the Department of the Treasury.

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Limited partner appetite for secondaries funds is at an all-time high. More capital was raised for the strategy in the first six months than any other half-year period, with almost $24 billion collected for private equity secondaries vehicles alone as of the end of June, according to PEI data.

By the end of the third quarter, the amount of capital raised for buying stakes in private equity funds hit $26.9 billion, slightly surpassing that raised at the same point last year. It is clear LPs are hungry for secondaries: according to the Perspectives 2018 Survey, almost three-quarters of limited partners globally commit to private equity secondaries funds in some way, either through defined allocations or opportunistically.

Regional differences are palpable: North American LPs are much more opportunistic when it comes to the strategy, with almost 72 percent responding that they invest opportunistically versus less than half in western Europe.

“A lot of European LPs have so far not taken the time to think about the place of a secondaries GP in their portfolio,” says Sunaina Sinha, managing partner at London-based placement agent and advisory firm Cebile Capital. “They are weighing [secondaries] against their existing portfolio and saying, I don’t need to change. There’s a lot of, if it ain’t broke, don’t fix it.”

Still, more than one quarter of LPs globally do not commit to private equity secondaries funds, according to the survey. This figure isn’t surprising as LPs have a multitude of other alternatives strategies to choose from — buyout, growth, venture — which deliver higher returns, Sinha says.

While an attractive way to beat the J-curve by deploying capital faster as well as diversifying a portfolio by vintage and manager, secondaries do not appear de rigueur in an investment portfolio...for now.

A few developments this year signal that LPs are becoming increasingly savvy when it comes to the strategy. In October Singaporean state-owned investor Temasek emerged on the buyside of a portfolio of buyout stakes from British Columbia Investment Management Corporation, and State of Wisconsin Investment Board invested $231 million over the summer in acquiring stakes in eight real estate funds.

While some of these deals are sporadic, other traditional LPs are in for the long haul. In May, Public Sector Pension Investment Board, one of Canada’s largest public pensions, told sister publication Secondaries Investor it was planning on building an in-house secondaries team as early as 2019. Clearly, LPs are starting to see the benefit of being on both sides of secondaries deals.

LPs are also becoming more selective in the type of secondaries strategy they prefer. According to a survey conducted by PEI and Switzerland-based Montana Capital Partners in September, family offices that invest in secondaries are most likely to do so via direct secondaries — acquiring portfolios of direct minority stakes in companies — than any other method. The reason? “Carry and fees — nothing more complicated than that,” says Richard Clarke-Jervoise, head of private equity at Stonehage Fleming.

As the secondaries market races towards a potential record year for both fundraising and deal volume — intermediaries are predicting at more than $42 billion in closed transactions — the year ahead for the market looks promising. Giant firms including Ardian, Lexington Partners and possibly Coller Capital may be eyeing flagship fund launches in the next 12 to 18 months, and niche players focusing on strategies such as preferred equity and GP-led restructurings will no doubt hit the fundraising trail. The range of opportunities for LPs to access the strategy is more attractive than ever — secondaries firms will do well to strike while the iron is hot.
DUE DILIGENCE

Paying the price

Fees and expenses remain a top concern for LPs but carry distribution is also a worry, writes David Turner

Fees are the biggest bones of contention between limited and general partners, according to Private Equity International’s annual survey of LPs.

Fifty-one percent of limited partners cite management and performance fees as the top area of disagreement when conducting due diligence.

“The management fee is really the big area where LPs feel there isn’t adequate alignment, because the managers are collecting the management fee whether they actually perform or not,” says Howard Beber, partner and co-head of the private investment funds group at Proskauer, the law firm, in Boston.

DOWNWARD PRESSURE

The headline fees are usually expressed as an annual percentage levy on funds committed. These are typically 1.5 percent or a little below for the multibillion dollar buyout funds, and up to 2 percent for mid-market funds, says Nick Benson, partner in the funds team of Latham & Watkins, the law firm, in London. “There is a bit of downward pressure on headline fees, because limited partners would not be doing their job if they didn’t try to push them down,” says Benson. However, he notes that oversubscribed funds are able to resist this downward pressure.

Stephen Carre, head of advisory and project management at the UBS private funds group in New York, offers another perspective. “Limited partners want the overall package of terms to make sense for the platform,” he says. “If they’re looking to commit to a first or second-time fund, for example, it may not make sense to negotiate the headline management fee rate as investors appreciate the fund manager needs capital to attract the best talent to deliver on the investment proposition.”

Market observers say that rather than worrying about the headline rate, LPs are sometimes concerned about other fees, such as those charged to portfolio companies by the investment principals for giving operational advice to portfolio companies.

This is an area in which LPs have in recent years lobbied hard and successfully. When Beber of Proskauer began as a funds lawyer 20 years ago, this was rarely discussed. But over the years, LPs have raised this as a major alignment concern, he says. Gradually, the split between the manager and fund has moved more in favour of LPs – to the point where, in many cases, all of these fees offset the management fee rather than forming an additional cost for LPs.

An issue closely related to the concern about fees is limited partner concern about the structure of the distribution waterfall – the way in which capital gains from the fund are shared between limited and general partners. Eighteen percent of LPs regarded the structure of the carry distribution waterfall as the biggest source of disagreement.
Friction over fees is an issue across much of the asset management industry; however, the concern over how much of the fund managers’ own money is committed is idiosyncratic to the private equity industry. Idiosyncratic it may be, but LPs often place a fair amount of emphasis on this. Although general partner commitment is the top priority of only 4 percent of LPs, 25 percent place it as second priority, and 44 percent place it among the top three priorities – making it the third most common concern overall.

The issue of general partner commitment is more complicated than first appears. “The key from an LP’s perspective is that it is a ‘meaningful’ amount,” says Beber: enough of the general partners’ wealth to provide meaningful “skin in the game”, as he puts it. LPs’ notion of what is meaningful has, however, become fussier over the years. Twenty years ago, “it was pretty standard that the GP put in 1 percent, and that ticked everybody’s box,” says Beber. “Nowadays that doesn’t tick many boxes.” He thinks that most LPs look for a GP commitment of between 2 and 5 percent, with anything higher than that “an advantageous marketing point”.

The fourth most common priority among LPs at the due diligence stage is the key person clause. This specifies who the key people in the fund are, and suspends the fund’s investment period if these people cease to spend most or all of the time in the fund. It is put in the top three by 32 percent of them, and even placed first by 9 percent.

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The key person clause is bound up with the issue of succession planning.
WHAT MATTERS IN DUE DILIGENCE

The track record of general partner performance is a “critical” part of the due diligence process for 72 percent of LPs, a higher score than for any other issue. In second place is “investment thesis and style drift”, regarded as critical by 62 percent.

Commenting on this question, Adam Turtle of Rede Partners says LPs are looking for two qualities: “Consistency and replicability.” He adds: “Limited partners want to understand the replicable aspects of performance that will deliver outperformance over the long term.”

To what extent do you conduct due diligence on:

<table>
<thead>
<tr>
<th></th>
<th>GP performance track record</th>
<th>Investment thesis and style drift</th>
<th>GP team size and investment capacity</th>
<th>Fund structural review</th>
<th>Firm “culture” at the GP level</th>
<th>Retention plans for key staff at GP level</th>
<th>Succession planning at the GP level</th>
<th>Selection of leadership in GP’s portfolio companies</th>
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<td>It is a critical part of the process</td>
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<td>70%</td>
<td>60%</td>
<td>50%</td>
<td>40%</td>
<td>30%</td>
<td>20%</td>
<td>10%</td>
</tr>
<tr>
<td>It is an important part of the process</td>
<td>70%</td>
<td>60%</td>
<td>50%</td>
<td>40%</td>
<td>30%</td>
<td>20%</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>It forms part of the process but is a low priority</td>
<td>60%</td>
<td>50%</td>
<td>40%</td>
<td>30%</td>
<td>20%</td>
<td>10%</td>
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</tr>
<tr>
<td>It is not covered in due diligence</td>
<td>50%</td>
<td>40%</td>
<td>30%</td>
<td>20%</td>
<td>10%</td>
<td>5%</td>
<td>0%</td>
<td>0%</td>
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Source: Private Equity International

Stephen Carre of UBS concurs: “The question of investment repeatability is important: did the fund manager achieve their investment returns through their own skill and planning, or was there a big element of luck?” To make these judgements, he says, many investors carefully review investment committee memos and tap their own contacts.

What are LPs looking for, as they conduct these investigations? Turtle notes managers often have particular strategies which they implement across portfolio companies. For example, one manager may buy domestic leaders in a particular sector, which can be expanded through buying equivalent firms in other countries.

The amalgamated business is sold on at a higher price than the entry multiples paid by the general partner, since the new company is bigger, more stable and, as Turtle puts it, “more strategically interesting”. This strategy can be checked backwards – through seeing whether the general partners stuck to it with a previous fund – and forwards – by interviewing anyone at the private equity firm who is involved with the fund to check their understanding of the strategy matches everyone else’s.

Consistency and replicability are bound up with fund size, which Mounir Guen, Hong Kong-based CEO of MVision, the fund placement agent, regards as the most common single area of disagreement. LPs worry, he explains, that a larger fund can imply less exciting investment opportunities. “If you double fund size, you could lose half of your investor base, because the original investors will only put money in funds of below $1 billion,” says Guen.
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How would you characterise the current fundraising environment?
If we look at the macro patterns there are two strong trends that dominated prior years: all-time high fundraising which has been driven by large funds getting bigger. At the moment, the volume of capital coming to the asset class relative to the development of general partners is very mismatched, with money almost forced into the large funds for the lack of anywhere else to deploy.

Historically, the US market was unbelievably popular. If new investor money came to market, it went to the US first. If LPs were reviewing 10 funds, eight of them were US. There was this overwhelming US focus because of its big bench of general partners and excellent capital markets and support infrastructure. The US GPs have been outperforming globally – note the Russell 2000 Index is also at an all-time high – and if we are investing with a rear mirror perspective we should be continuing to give them money.

On the opposite side of the spectrum, we have the non-US, non-EU markets, where the bulk of capital in private equity is focused on China and the rest of Asia. About $450 billion plus of aggregate capital is raised per year, of which between 70 percent and 75 percent is US dollar-denominated investors. This meant that for these other markets, the performance was seriously lagging in USD terms when we factor in the recent currency volatility which impacted US dollar equivalent returns by GPs. We were bullish on emerging markets including Asia and expecting the Asian marketplace to have a much higher allocation in a global portfolio, but currency movements meant that it went backwards. There’s actually less capital available. Given that in Asia there is a limited pool of GPs and a concentrated selection, this means the large pan-Asia funds should naturally be oversubscribed. In fact capital is getting more scarce. Note China is still very active domestically and internationally.

What’s your view on the rise of shadow capital over traditional fundraising in Asia?
Asia is still difficult to get money into. The large investors need to consider going direct. Some are opening multiple offices as a result. They have to deploy the money and they believe in the region, but they can’t put enough money through funds. Access can be extremely difficult especially for large commitment numbers – large investors are lucky if they can put $100 million to work in a new fund and this is rare. Pension funds, sovereign wealth funds and family offices are increasingly getting savvier, boosting internal know-how and deploying capital directly under their control.

There was a time when there was quite a gap in the compensation structures between LPs and GPs – that’s disappearing quite quickly: GPs are becoming heavily regulated, carried interest in many countries is viewed as income tax, and the waterfall mechanism has moved to a more delayed access to profits. LPs now are more experienced, considering new ways to put money to work. Shadow capital is here to stay and grow. In my view this presents GPs with new opportunities to partner with LPs. For us that means trying to figure out how to create new products, reposition existing products or a GP’s business, and creating more first-time funds.

A whole new game
The investor dynamic in the next 10 years will be less of a US dollar-denominated performance-based business, says MVision chief executive Mounir Guen
Where do you see new pools of capital for the asset class?

US investors are among the most mature investors in the industry and it’s interesting to see how the country is constantly in a creation cycle with new pools of capital emerging. We see, for example, technology-related businesses and families creating new pension plans, new foundations and family offices.

When we start looking around at the underlying historical programmes that have been in the market for 25 years or more, there are two things that stand out. First, if you are a new GP it’s extremely difficult to access some of these investors because they already have around 50 to 60 core GPs so you can only displace another firm. Second is the potential for growth in the defined contribution market. In addition, savings and personal pensions are a significant multiple of the public and corporate pensions that are huge investors in private equity. It’s a dramatic pool that’s been inaccessible, but as the industry finds DC solutions and creates new fund structures to tap into broader groups, they will unlock that pool of capital. However, the question to address is: What happens to the return profile as the volume of capital in the market expands? I don’t know what the impact is but I believe that returns are being adjusted to what the capital is seeking.

New capital will also come from China, Japan, Taiwan, Korea, and Latin America also has big potential. There will be a significant demographic shift as this capital activates and the new pools of capital are no longer US dollar-denominated in their benchmarks. In the next 10 years, we will have a very different investor dynamic compared with what we’ve had throughout the whole history of the asset class when it was a US dollar-denominated performance business.

Looking at funds and fundraising, does the market currently favour LPs or GPs?

Follow my thesis that there aren’t enough GPs in the market, those GPs that are popular will be in a stronger negotiating position. However, they also have to remember that LPs have limits, and they are sensitive on net returns, fund sizes, net gross spreads, as well as succession and the depth of the bench. If a GP can’t tick these boxes, LPs can walk away.

One of the big trends is Institutional Limited Partners Association reporting and how the regulators are converging on their views about full transparency. When a GP draws capital from an investor, the ILPA reporting template and the regulators will want to record exactly what happened – how much went into different fees and expenses, how much went into the investments and whether there’s any other capital usage. There is a real openness to accountability, visibility and responsibility.

Within this is a new nuance which focuses on the uniformity of disclosure of the fees, expenses and profits of a GP. Under AB 2833, new legislation that California introduced at the beginning of this year, alternative investments must disclose more granular information and it must be made public. It’s a new world for the GPs.

What other current themes have you observed in the industry?

GP s are also encouraged to integrate ESG factors into their private equity investment activities. This means managers not only need investor relations plans but also require internal counsel to deal with regulators and all these investor policy changes that are coming to the market. It’s no longer what it was like 20 years ago when two people can get together and outsource a lot of the corporate structure, hire an external lawyer and placement advisor, and then they are in business. Today GPs need to have quite an extensive infrastructure – finance, legal, compliance, IR – and that again becomes another barrier to entry. This pushes the capital towards existing GPs and, as a consequence, some GPs are going into multi-products, an area I expect to grow.

There is one theory that the whole asset class will just converge to a dozen firms, while others believe it will keep its depth. In the ideal world, we would have vertical and horizontal activity – from the mega funds to the smaller funds whereby companies can be listed, sold to trade or to another private equity firm. There is another new trend that’s taking quite a limelight in our industry reflecting the sophistication of the secondary market. We’ve seen some very clever restructuring of GPs that involve repositioning of their older attractive investments into new structures. This is a whole new game and one that creates newer liquidity in the asset class.
There’s a definite sense that responsible investment criteria are figuring more prominently on the limited partners’ landscape in our PEI LP Perspectives Survey 2018.

Nearly half of the 115 LPs surveyed said ESG was “becoming a more regular consideration” in fund due diligence, with 22 percent saying that it was “always a consideration” and 11 percent saying they considered it “vital.”

This would appear to mark a significant strengthening in ESG sentiment since last year’s survey when “commitment to ESG” came second to bottom in the list of fund terms that LPs consider mandatory in limited partnership agreements – key-man clauses and the level of management fee were, perhaps unsurprisingly, the top concerns.

There were certainly strong indications at PEI’s Responsible Investment Forum in Berlin in September that limited partners are pushing general partners to deliver on ESG metrics. One reason is that investors are coming under increasing pressure to rate their portfolios against ESG criteria – and that is having a knock-on effect on GPs. “We are being asked to do it and expected to do it,” said David Russell, co-head of responsible investment at USS Investment Management, one of the largest UK pension funds.

Or as Anders Stromblad, head of alternative investments at AP Fonden 2, the second Swedish national pension fund, put it: “Reporting and data collection from GPs to LPs will increase over time. Prepare yourself for that. That will happen.”

Russell was also keen to stress that LPs firmly place the responsibility for ESG at a GP’s door. USS is invested in more than 2,000 portfolio companies via its private equity investments, he said: “There’s no way for us to monitor 2,000 companies. Our expectation is that the GP is managing the material risks. It’s not our job. It’s what we pay funds for.”

GLOBAL WARMING

The conference heard that new guidelines from the Financial Stability Board calling for private equity firms to disclose the risks portfolio companies face from climate change are a potential game-changer.

Speakers said proposals in June from the FSB’s Task Force on Climate-related Financial Disclosures (TCFD) will encourage LPs to increase pressure on GPs to come clean about the potential risk to their businesses from climate change.

Tatiana Bosteels, director of responsibility and head of responsible property investment at Hermes Investment Management, said the fund of funds manager, which has £4 billion ($5.4 billion; €4.6 billion) invested in private equity, has turned down potential private equity investments because it wasn’t satisfied the GP had given sufficient consideration to the risks to the business model from global warming.

“The private equity world is not doing enough to consider climate risks and we need to wake up to that, especially when you see the pressure from the FSB recommendations,” she told the forum.

Or as Anna Follér, sustainability manager at Swedish national pension fund AP6, put it: “It is part of our fiduciary duty. Climate change is affecting our investments and this is something we need to manage and that means we need GPs to manage it.”

Our Perspectives survey does, though, throw up some interesting regional variations in the emphasis that LPs put on ESG: 24 percent of North American LPs said it was “not a consideration” versus only 7.5 percent of European LPs; 22 percent of Asian and European LPs said ESG was a “vital consideration” compared with only 2 percent of North American LPs.

There are signs, though, that the big US institutional investors are starting – finally – to formalise their approach to responsible investing. In March 2017, the California Public Employees’ Retirement System, so often a bellwether for LP activity, released details of its five-year strategic plan for ESG which will scrutinise its managers’ practices more closely, using the UN PRI’s Disclosure Framework as guidance.

“Developing a strategic plan of this magnitude was no easy task,” said Henry Jones, CalPERS Investment Committee chair. “It will guide our ESG efforts in a comprehensive and integrated way across all asset classes.”

The other big North American pensions are also placing greater stress on responsible
Investment criteria. For Tanya Carmichael, head of global funds at Ontario Teachers’ Pension Plan in Toronto, ESG is a mandatory part of the pension’s due diligence agenda. “We’re not having the why conversation anymore,” Carmichael told our Responsible Investment Forum in New York in March. “Now it’s more the how conversation.”

“ESG used to be seen as a value detractor,” said Janine Guillot, director of capital markets policy and outreach at the Sustainability Accounting Standards Board, at the conference. “Now many are talking about ESG as a return driver. I think this is a very long-term game but I think it’s moving very quickly.” Her organisation sets industry standards for corporate sustainability disclosure.

The attitude towards ESG also varies widely according to the type of investor, with family offices lagging behind other investors: 61 percent of family offices would not be deterred from making an investment if there was no ESG policy in place, according to a recent family office survey conducted by PEI in association with Montana Capital Partners.

That mirrors a survey carried out by law firm MJ Hudson in 2017 which found family offices were the least likely to have ESG provisions in side letters – 77 percent didn’t have any. Only 33 percent of insurers and pensions lacked provisions: “Single family offices are rarely accountable to any third parties nor are their investment decisions a matter of public record. So, there is limited pressure to endorse ESG,” says Eamon Devlin, managing partner at MJ Hudson.

The big public pension plans are a key driving force behind ESG in Europe, Devlin says, especially those based in The Netherlands. There is, though, widespread agreement that LP attitudes are changing and ESG is rising up the agenda. As James Stacey of environmental consultancy ERM said: “LPs are asking questions and we are seeing that in the conversations we are having with GPs.”

### GROWING TREND

How much emphasis do you place on ESG investing throughout fund due diligence? (%)

<table>
<thead>
<tr>
<th></th>
<th>Overall</th>
<th>North America</th>
<th>Europe</th>
<th>Asia-Pacific</th>
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<td>ESG is not a consideration</td>
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<tr>
<td>ESG is becoming a more regular consideration</td>
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<td>ESG is a vital consideration</td>
<td>11</td>
<td>2</td>
<td>22</td>
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</table>

Source: Private Equity International

### WHY CLIMATE RISK IS TOP OF THE AGENDA

New guidelines from the Financial Stability Board calling for private-equity firms to disclose the risks portfolio companies face from climate change are a potential game-changer: “For the first time we are being asked to consider the impact on the company not the impact of the company,” said James Stacey, partner at environmental consultancy ERM, which carries out climate risk assessments for general partners.

The FSB’s Task Force on Climate-related Financial Disclosures has said the financial risk that climate change poses to companies should be disclosed as part of annual financial filings.
FUND AGREEMENTS

LPAs: finding the right balance

When raising a successor fund, an equilibrium needs to be struck between cloning the previous Limited Partnership Agreement and making wholesale revisions, write Joseph Smith, Jason Behrens and David Miller of law firm Schulte Roth & Zabel

Sponsors indulge in two very different fantasies when forming a successor fund. The first is to clone their predecessor Limited Partnership Agreement, change the date and the Roman numeral and be done with it. The second is to revise every longstanding, suboptimal provision and finally be governed under documents that say what they wished. Neither approach is practical, so it behooves general partners and fund counsel to think carefully about which changes to make and when to make them.

The first of these fantasies is compelling because it is presumed to minimise legal costs and streamline negotiations. Indeed, counsel to limited partners who are instructed to do a mere “blackline review” have light work under this scenario. But even for GPs who like their current terms and trust the integrity of their existing documents, this can be foolhardy. Changes to the regulatory environment, the evolving range of LP comments and the vicissitudes of the market compel that predecessor fund documents be reconsidered. A foresightful approach to this exercise is proven to deliver superior results.

Nonetheless, it is important to recognise that the second fantasy – an extensive rewrite in the pursuit of perfection – can also be perilous. Certainly, a sponsor with an excellent track record that is fundraising when LPs are awash in capital will have an easier time making changes, but even a successful sponsor can overplay its hand. Not only is a full-blown rewrite expensive, it is particularly so in an environment where LP commentary is likely to be extensive. Moreover, presenting a heavy blackline can raise questions about past compliance and weaken the argument that the terms have already been agreed.

These considerations beg the question of how to find the right balance. Experienced fund counsel can be invaluable in anticipating the repercussions of proposed revisions. Given today’s robust fundraising environment and – importantly – a changed but reasonably settled regulatory landscape, now is a good time to carefully take stock of an LPA.

A comprehensive study of potential revisions and best practices could fill a treatise, but we can address six points that every GP should discuss with its fund counsel today. Keep in mind that once a provision must be changed due to tax, regulatory or market dynamics, it may be easier to implement other desired changes because they are addressed in the same or closely related provisions.

1 CHANGES TO LAWS REQUIRE CHANGES TO DOCUMENTS

The most necessary and uncontroversial changes are those made in light of changes to black-letter law. For example, GPs should currently modify their LPAs due to the new partnership audit rules applying to tax returns filed for tax year 2018 onward. Under the new rules, if fund items of income or loss are adjusted in an IRS audit, the IRS will impose a tax on the fund. The fund can then either pay the tax (subject to adjustment based on the fund’s investor profile) or make an election under Code Section 6226 to push the audit adjustment out to investors who would then be directly liable for the tax.

In light of this change, a GP should ensure, among other things, that an LPA enables it to make a Section 6226 election. In addition, the LPA should deem any such

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tax paid by the fund as distributed to the investor to which it relates. This deemed distribution will permit the investors for which the fund obtained the reduction in tax to get the benefit of the reduction. Moreover, it will enable the GP to receive its carried interest unreduced by other investors’ tax. Finally, the LPA should oblige the relevant investors to cover their share of the tax if the amounts distributable to them are insufficient to do so.

Another current example of a law necessitating document changes is the new Department of Labor fiduciary regulation, effective as of 9 June 2018, expanding the definition of who is a fiduciary in the context of marketing funds to Individual Retirement Accounts and ERISA-covered pension plans. GPs should be updating their subscription agreements in light of this new regulation.

2 PRESSURE POINTS

In addition to changes of law, it is important to remember other areas of increased regulatory and investor scrutiny. Indeed, it is critical for fund counsel to be abreast not just of SEC pronouncements and enforcement actions but their press coverage, because this inevitably informs investor concerns.

3 FUND EXPENSES AND BROKEN DEALS

By now, you have undoubtedly read about how GPs are expanding the definition of “fund expenses”. Given the regulatory climate, it is important to consider not only the completeness of the list but also the manner in which cost allocation policies are implemented. For example, many LPAs now expressly provide that a potential co-investor’s allocable portion of broken-deal expenses “may” or “will” be absorbed by the lead fund.

4 CREDIT FACILITIES

The use of subscription credit facilities is another hot topic, particularly as it relates to reported IRRs. As regulators and investors increasingly focus on their use as structural leverage, the Institutional Limited Partners Association recently released guidance on their risks and parameters of use. Among other recommendations, ILPA advocates greater disclosure regarding contemplated size, duration and potential impact on reported IRRs.

This heightened scrutiny presents both a requirement and an opportunity for GPs to revisit the LPA. For example, while updating the credit facility provisions, it may be an opportunity to modernise the approach to LP estoppel letters — so called “investor acknowledgement letters”. To mitigate the effort involved, many GPs have been successful in eliminating these letters altogether while satisfying their lenders by including investor representations directly in the LPA.

5 EUROPEAN CONSIDERATIONS

Many mid-market GPs without foreign offices but seeking to raise capital in the European Union wisely consider using a “third-party ManCo” to act as an AIFM (Alternative Investment Fund Manager) for a parallel vehicle to be organised in the EU. If this is a possibility, care should be taken to draft the parallel investment vehicle provision in such a way as to facilitate allocating a proportionate share of each deal to an EU AIF (Alternative Investment Fund), even if technical portfolio management discretion will rest with a non-affiliated GP that acts as the AIFM.

6 BEST PRACTICES FOR SIDE LETTERS

Some GPs ask whether the litany of side letter provisions should be incorporated into the next fund’s LPA. As well intentioned as this may be, it is often misguided. The limited upside of having “everything in one place” does not justify the potential downside, including getting stuck with a provision when the LP who requested it does not re-up for the next fund, and the difficulty of seeking a waiver of the provision from a majority (or super-majority) of LPs rather than from particular side letter recipients.
Family offices and foundations remain a widely unreported segment of the investor community. This is due to their relative opacity compared to larger, more institutional investors. Nevertheless, they are playing an increasingly active role in private equity. They are a stable investor group and a major provider of new capital to private equity funds.

That comes out loud and clear from our fifth annual family office and foundation private equity survey, conducted with Montana Capital Partners.

The survey provides an overview of the strategies and opinions of this sophisticated investor group. In contrast to more institutional investors, family offices are often more flexible and return-driven. Their investment behaviour is also less affected by regulations and market trends.

Headline results from this year’s survey are:

- Family offices and foundations have the most positive view of private equity since PEI began surveying them five years ago, writes Sophie Colby

   Family offices have the most positive attitude to private equity since PEI began surveying them five years ago, writes Sophie Colby

- Mid-market buyouts is the most

The often entrepreneurial DNA of family offices and foundations means they have a natural affinity to the asset class
favoured strategy. While it has always been popular, the share of respondents selecting it as their top choice has increased from 58 percent in 2016 to 70 percent in this year’s survey. Real estate and infrastructure have suffered a decline in popularity this year, but secondaries is more sought after than ever with 48 percent of respondents selecting it; the highest proportion since this survey began.

- Large fund portfolio acquisitions are again the most unpopular secondaries strategy. For the first time, secondary directs has surpassed small secondaries as the preferred secondaries strategy. It will be interesting to see whether this trend continues in the coming years.

Some worries persist, of course. Amid a continued abundance of cheap capital and the prospect of increasing interest rates, a record number of respondents indicate that GPs buying into companies at too high valuations is their top concern.

That said a smaller proportion of respondents – 28 percent compared to 51 percent in 2016 – are expecting a major correction in public markets within the next 12 months. This growing optimism somewhat contradicts respondents’ concerns about high valuations.

The results prove that family offices and foundations continue to be among the most active investor groups in private equity, and are among the first investors in newer, though now established, strategies such as direct/co-investments, small/complex secondaries and smaller buyouts.

The often entrepreneurial DNA of family offices and foundations means they have a natural affinity to the asset class, making this a relationship that seems set to grow in intensity in the coming years, the survey suggests.

**PLEASE INDICATE YOUR LONG-TERM STRATEGIC PREFERENCES (SELECT ALL THAT APPLY)**

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<tr>
<th>Strategy</th>
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<td>Infrastructure</td>
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**PLEASE SELECT THE TWO STRATEGIES YOU WOULD CURRENTLY OVERWEIGHT IN YOUR STRATEGY**

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**PLEASE SELECT THE TWO GEOGRAPHIC REGIONS YOU WOULD CURRENTLY OVERWEIGHT IN YOUR STRATEGY FOR 2017**

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<td>Asia-Pacific</td>
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<td>Central &amp; Eastern Europe</td>
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<td>Latin America</td>
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<tr>
<td>Middle East &amp; Africa</td>
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<td>8%</td>
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<tr>
<td>Western Europe</td>
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From the mouths of LPs

Whether it was concern about subscription lines or worries about how to sell private equity to the Japanese, LPs had plenty on their minds in 2017.

“We’re covering more funds and we’re getting better quality information. We can know more about what we’re buying when portfolios come to market.”
Michael Woolhouse, head of secondaries and co-investments at CPPIB

“We would like to make Japanese people understand the details of our investment style and how we are investing in alternative assets. That is my priority this year.”
Norihiro Takahashi, president of Japan’s Government Pension Investment Fund

“If people are using credit facilities for a long period of time, and you are paying fees on committed capital... you could argue that is a double whammy.”
Michael Howard, head of Prudential Portfolio Management Group’s alternatives programme

“Ultimately the key to getting access to good managers is to meet them early in their fundraising process.”
Brady Hyde, former portfolio manager at UPS Group Trust

“Get away from ‘responsible’, and think of it as long-term risk”
CalSTRS CIO Christopher Ailman

“Private equity is one of those asset classes where, at the end of the day, price discipline matters most”
A spokesman for GIC

“Secondaries could end up losing money, which I don’t think anyone sees as possible”
Hamilton Lane chief executive Mario Giannini

“[With] your commitment to funds, you put the money in and then you have all your distributions; keeping that allocation on a cliff is quite challenging”
Hisham Halbouny, managing director of the Mansour Group’s family office, on why it favours direct investing

“Reporting and data collection from GPs to LPs will increase over time. Prepare yourself for that. That will happen”
Anders Stromblad, head of alternative investments at AP Fonden

“Impact investment is a new concept in Korea and it will take some time to establish our own direction”
Dong Hun Jang, chief investment officer of South Korea’s Public Officials Benefit Association

“Private equity international december 2017/january 2018”
THE DEFINITIVE GUIDE TO CARRIED INTEREST

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