Practical Implications of a Limited Partner

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ISSUES FACING LPs IN PRIVATE EQUITY FUNDS:

PRACTICAL IMPLICATIONS OF A LIMITED PARTNER

Introduction

Investors should exercise caution when building portfolios and as the search for the best managers intensifies, there is more at stake and more to lose. In an increasingly competitive market, when access to the best funds is restricted, how can investors navigate this complex environment to find the best private equity managers and gain access to their funds?

Investors remain positive on private equity

It is an interesting time for private equity: with an estimated $1tn of dry power to invest (globally at the end of 2018) [1] many have expressed fears of overheating as private equity managers battle to find assets in an environment of rising prices and readily available debt. In fact, the outlook for private equity is positive: not only is dry powder (uninvested but committed and available capital) skewed by a handful of mega funds but private equity investment opportunities (a “dry opportunity”, as I call it) is robust – with deal size increasing 12% globally in Q2 2018 to $118bn [2] compared to the same period in 2017. Investors continue to divert capital from shrinking public markets and with private equity still representing less than 1% of global GDP, there is significant room for further expansion in private markets as investors search for exposure to smaller and mid-market higher growth companies and sectors with limited representation in the public markets.

Programme Preparation

When building a private equity programme the list of considerations and potential pit-falls are many: from programme set-up issues such as structure and appointment of an administrator; to programme design covering size, diversification requirements, sourcing of investment opportunities and on-going monitoring and reporting. It is important for investors to appoint industry advisers to help navigate the complex legal, tax and regulatory frameworks to secure the best terms. Of paramount importance is seeking specialist industry advice to access the best private equity managers and to build a long-term diverse and risk-adjusted portfolio.

Portfolio construction

When building out an existing portfolio or starting from scratch, consideration of how a private equity allocation will fit into an investors’ overall portfolio across asset classes is fundamental. Once the investor’s appetite for risk, liquidity and weighting of the strategy is understood, it is possible to work with them to assess which segments of the private equity market should be in focus.

As a first step in designing a private equity portfolio, initial investment objectives should be set, including: programme size, targeted private equity AUM, investment period, commitment pacing and capital return/ cash flow profile objectives. Once investment goals are established, investors should look to refine these by setting diversification targets across: geographies, sectors, stage, size and vintage years before looking to specific funds. Although an over-commitment strategy may seem daunting to new entrants to the asset class, this may be an important step to reach desired private equity NAV investment goals.

Maintaining a rolling commitment model

Building a model to show how the private equity portfolio builds over time is not only a useful portfolio construction tool; but a hugely beneficial planning tool, to map future private equity commitments necessary to maintain a target private equity allocation.

Indeed the cash flow profile of different private equity funds vary greatly depending on their investment focus, stage (venture capital, growth or buy-out) and geographic focus. Further complexity can be added through building secondaries into the portfolio, which in addition to adding vintage year diversification and IRR up-lift, provide liquidity early in the life of the portfolio. Further complexity is introduced by modelling secondaries with varying cash flow profiles, for example, direct secondaries vs. tail end portfolios vs. GP restructurings. Co-investments may further help to see capital efficiently deployed (lower fees and carry are paid) and reduce overall portfolio fees but again impact the overall cash flow profile of the portfolio and should be factored into any portfolio modelling exercise.

Fund selection and sourcing

Once allocation has been planned, navigating the universe of funds within each segment is daunting: at any one time, around 3000 funds are on the road targeting around $1 trillion of capital commitments.

With so many funds in the market at one time it is a challenge for new investors to identify the consistent performers, which should form the core of any private equity portfolio. Further, identifying specialised strategies, which make-up an increasing part of investor private equity portfolios, is an additional skill-set for investors, as these managers continue to deliver outsized returns [3].

Reaching the best managers often means the harder-to-access managers and largely depends on the power of the investor's network and forward-looking pipeline: meticulous coverage of funds coming to market across strategies, sectors and geographies on a rolling basis is key to identify managers which should be targeted, avoided and which managers may prove difficult to access. Access comes down to knowing the teams through meeting regularly and presenting yourself as an investor, and a future partner.

Building in-depth market knowledge, keeping it up-to-date and ultimately investing consistently through cycles is a challenge for smaller private equity investors. Often cherry-picking funds on an ad-hoc, un-structured basis can leave investors burnt and with patchy and volatile returns as they latch on to passing trends or commit to managers which shout the loudest.

Ultimately a key determinant of successful private equity portfolios is vintage year diversification and investing consistently through cycles. Achieving this often comes down to access to a team of private equity specialists with in-depth working knowledge of the private equity market.

Fees

The industry has evolved considerably in response to LP's cries for greater transparency from GPs.

As an industry, fees have come down overall [4]; but indeed, the numbers are again skewed by the mega funds. These funds, raising funds of $5bn each and more, feel they can charge discounts to attract investors.

That being said, traditional fee structures have remained relatively resilient with over 85% of GPs surveyed by MJ Hudson in a recent survey continuing to use the 2% management fee and 20% carried interest model.

The industry still has some way to go here but with returns continuing to out-perform other asset classes, managers must still justify their fees to an increasingly outspoken community of investors.

Monitoring and reporting

Monitoring the portfolio is the next portfolio management tool that we come to. Indeed, consistency amongst managers in measuring returns and the reporting of this has come some way in recent years with most firms following the ILPA template. The IRR prevails as industry standard for but as LPs look to incorporate elements of ESG into their reporting; so too do they look for ways of capturing the broader impact of their investments in their returns assessment.

Time Partners have worked with industry partners to develop the ERR, which aims to create a platform where companies, investors and third parties can comprehensively and transparently report their activities across a range of parameters encompassing a company, its suppliers, customers, the society in which it operates and the environment. Much like ESG adoption patterns amongst investors where we see the Nordics leading the charge, the same patterns emerge in terms of ESG reporting amongst GPs and we have indeed seen some firms e.g. Summa Private Equity adopting the ERR formally into their reporting framework.

The GP-LP relationship has evolved

As investors have become more sophisticated, so indeed have GPs and competition for access to the best managers has never been more intense. Having a reputation as a proactive, helpful investor carries huge swaying power in convincing harder-to-access managers for allocation; and for consideration as potential co-investment partner - a topic which continues to rank highly on investors lists of must-haves.

LPs need to bring something more to the table, over and above the fund commitment to be considered for these opportunities. There is increasing frustration from investors who are promised co-investments by GPs during the fundraising; but 5 years into the fund's lifetime, co-investments have not materialised, or have only been shared with a select, small group of investors.

Although size is a factor here, GPs consider many other features of an LP when selecting them as a co-investment partner: speed of execution, as deals will have short timeframes; the investors fit with, or knowledge of, a particular sector; and ultimately a good relationship with the GP.

Conclusion

Private assets continue to expand as investors are attracted to superior returns and diversification benefits enjoyed by the asset class. Securing allocation to managers and maintaining these relationships has never been more competitive, with advisers being central to navigating investors through the ever-expanding universe of GPs to build risk-adjusted, long-term portfolios and at the best terms. Whilst fundraising remains at record levels and the music plays, GPs must continue to evolve to an ever sophisticated and proactive community of investors.

References

[1] M. Mittelman, "Why Private Equity Has $963 Billion in Dry Powder," *Bloomberg Businessweek*, p. 1, 1 September 2017.

[2] Preqin, "PRIVATE EQUITY & VENTURE CAPITAL Q2 2018," *PREQIN QUARTERLY UPDATE*, p. 9, 2018.

[3] A. Auerbach, "CA Answers: Are Private Equity Returns Doomed?," January 2017. [Online]. Available: https://www.cambridgeassociates.com/research/ca-answers-are-private-equity-returns-doomed/.

[4] C. K. a. E. Peghini, "Fee Structures in Private Equity," *Bocconi Students Private Equity Club* , 2018.