ALTERNATIVES

Views from the LPAC

BARINGS INSIGHTS

Over our 25+ years investing across private markets, Barings has had the opportunity to hold hundreds of Limited Partner Advisory Committee (LPAC) seats—helping mitigate conflicts of interest, and making suggestions to General Partners (GPs) and Limited Partners (LPs) on best practices. As the landscape has evolved, we've had the ability to identify several trends throughout the space—and it is from this vantage point that we offer the following insights.

1. Sell-Off of Equity Stakes

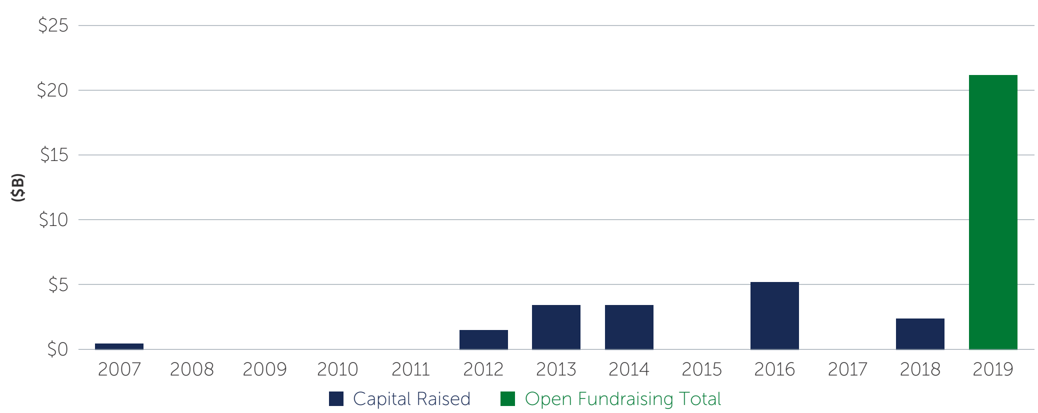
The Current Trend

In recent years, there's been a rising number of GPs looking to sell off pieces of equity in their firms. According to data from PitchBook, the trend has accelerated materially this year **(FIGURE 1)**, with the three largest investors in the space currently seeking a combined $17 billion—more than has been raised in the overall strategy in the last decade.[1] The motivations for this vary: GPs might be looking to generate cash flow to support additional fundraising or operational activities; they might use the capital to expand into different strategies and set up the structures necessary to execute them; or they might see the benefit in gaining third party expertise. In 2018, for example, GPs cited that equity capital was primarily used to launch initiatives in new sectors and geographies, increase commitment to a fund, and seed new strategies.[2] That said, these situations often generate more questions than answers: Will the future strategy stray from the original fund strategy? How will the current talent be retained for succession planning? Who is the incoming investor, and how will their goals and incentives as a new owner make an impact?

Our View

We encourage LPs to take a thoughtful, long-term approach to the partnership—and above all, to proactively communicate with the GP and other LPs to understand the unique dynamics of the transaction. When presented with a decision around a GP stake, LPs should dig deep into the genesis of the transaction; strive to understand the rationale driving the sale and the intended use of the proceeds; and ask whether or not the entity has proper alignment of interests with their own organizations.

FIGURE 1: GP Stakes Fundraising Value—Including Open Funds



SOURCE: Pitchbook. As of May 24, 2019.

2. Increased ESG Discussions

The Current Trend

Environmental, Social and Governance (ESG) integration into an investment process is steadily becoming a best practice of managers. However, ESG adoption can vary depending on geography and manager. Whereas European GPs tend to have a more mature approach relative to other geographies—with ESG factored into the investment process and discussed with investors at least annually—within North America, the landscape is still developing.

1. Source: Pitchbook. As of June 12, 2019.
2. Source: *How GP Stakes Investing is Becoming Less Rare*, Pitchbook. As of August 2018.

As this has become more important to institutional investors, North American GPs and LPs are having more advanced dialogue around ESG documentation and measurement today. While these conversations often have more of a focus on the "S" and the "G" components, there's a growing need for a comprehensive risk approach—and they are beginning to assume a heightened awareness for environmental issues as well. Additionally, due to the growing demand by LPs for transparency, GPs are incorporating better ESG monitoring and reporting as a standard practice.

Our View

The GP should have an established ESG policy and strive to provide all LPs with an annual report on ESG-related fund details, which allows them to hold the manager accountable. In the event that a portfolio company generates headlines, the GP and LPs should have transparent dialogue within the LPAC environment to discuss both the risks and opportunities that it presents. We believe GPs can make investments that are in the best interest of LPs, and still generate competitive returns without sacrificing a sound ESG infrastructure. As an example, Barings has made the integration of ESG criteria a core tenet of our research and investment process, which incorporates a rating and monitoring system. Similarly, GPs that have an ESG integration framework benefit from a more holistic understanding of the complex issues, risks and value drivers that may impact the portfolio over time. We suggest that LPs conduct thorough independent research on the framework, and ask thoughtful questions about all ESG-related aspects of the portfolio before investing.

3. Extended Fund Life and Fees

The Current Trend

When a fund comes to the end of its legal life and assets remain in the portfolio, GPs are increasingly seeking an extension of the fund duration to avoid a forced sale of the remaining holdings. In some instances, these extensions also include payment of the management fees beyond a timeframe that was originally contemplated or budgeted by investors. Typically, the long-term nature of the partnership entails a minimum of 10 years, often 12 with the stated extension period. For LPs, ideally all assets will be liquidated by the end of the fund's life, and the cash returned will be a multiple of their original investment—or in the event that the fund goes beyond 12 years, they will only be paying very nominal management and administrative fees. But this is not always the case, and it increasingly results in LPs allocating more time to investment oversight, and paying higher direct or indirect costs.

Our View

When the subject of charging management fees outside of the fund term and extensions arises, we urge LPs to discuss the rationale with the GP and LPAC members, in order to understand whether the proposed management fees are consistent with the resources and value-add activities of the GP. In regard to other fund administration and accounting expenses—sometimes stemming from external services—the LPAC members should ensure that the GP keeps them minimal. We also encourage LPs to conduct detailed due diligence to ensure they are comfortable with the terms outlined in the Limited Partnership Agreement (LPA) for the entire duration of their fund commitment. Particularly, they should be aware of the costs and timing of future value creation initiatives, and the exit horizon for the remaining assets—which should include a specific milestone-driven timeline to exit any unrealized investments. Additionally, LPs should work to negotiate management fees that are as low as possible, without hindering the GP's ability to make the most of its underlying assets. The LPAC can often provide guidance on fee preferences.

While each situation will be different—in all cases, post-extension period discussions between the LPs and GP are beneficial in establishing expectations and creating accountability. In many instances, negotiating lower management fees or eliminating post-extension period management fees will be in the best interest of LPs—and we encourage LPs to actively engage with the GP in these situations. LPs should not necessarily aim to avoid management fees altogether—since it could limit the ability of the GP to do its job in certain situations—but rather they should push for transparency, and ensure that any management fees beyond the extension period are reasonable and being effectively utilized.

4. Extended Capital Call Facilities

The Current Trend

It is gradually becoming commonplace for GPs to request the extension of capital call facilities to one year, or potentially longer—straying from the 30-to 90-day window typical of the past. This is largely to alleviate the administrative burden and cost of issuing several rounds of capital calls, and to streamline the process. However, it raises concern over longer-term ramifications, mainly in terms of how it will affect future return attribution. In some instances, aggressive use of these facilities has resulted in a boost to overall IRR of as much as 300 basis points, typically with the greatest impact earlier in the life of the fund.

LP sentiment on this topic tends to vary widely. Some favor the use of longer duration facilities in an effort to maximize IRRs—particularly when the impact to Multiple on Invested Capital (MOIC) is minimal, due to the low costs and interest rates of these facilities today. Others, which tend to be larger LPs, often prefer limited use of these facilities—with capital called in smaller increments—as they can better manage their own cash flows, with an equal or lower cost of borrowing than the underlying fund.

Our View

Going forward, we urge LPs to be cognizant of how these facilities are being used when underwriting a track record, and request detailed performance attribution at both the deal and fund level. They should also have their risk management team conduct full back office and accounting due diligence to ensure that the manager is using these facilities in a prudent manner—not only to bridge the gap between when an investment is funded and when called capital is received, but also to reduce manager costs—rather than taking advantage of them to bolster short-term returns. When LPs see an aggressive use of these facilities that can significantly enhance IRR, they should calculate the attribution associated with the facility—versus that of traditional value-add activities—in order to get a true "apples to apples" comparison of relative fund performance within the same vintage year. In all cases, we believe LPs deserve greater ongoing transparency around facility expenses, interest rates, and the impact to net returns. Although the extended use of these facilities is common today, the long-term continuation of this trend will require a low interest rate environment and sufficient supply of liquidity providers.

5. Accommodation of Bigger Checks

The Current Trend

Over the years, GPs have increasingly come back to LPACs at the end of a fundraising period with a request to raise the fund's hard cap. In many instances, this action is driven by an LP who has a structural preference to write a larger check due to its overall AUM size. But raising the fund's hard cap above its original target can also move the needle on where a manager identifies investment opportunities—for example, straying into larger investments. A significant increase in fund size can introduce problematic style drift, whereby the GP targets larger and larger deals, or stretches the team to take on more deals than originally considered. It's true that LPs often see value in diversifying the investment base—but only to the extent that it does not distract the GP or significantly alter the investment objective of the fund.

Our View

As a best practice when conducting their due diligence process, LPs should work to understand the GP management team's ability and capacity to invest the fund within the stated strategy and time frame—including an analysis of capital deployed per annum, deals per partner, board seat capacity, and capital reserve usage policies. Importantly, LPs should understand that their goals are not always aligned with a manager's request to raise hard caps—and we suggest that they be mindful of the GP's actions. Specifically, LPs should remain attentive that the manager doesn't: (1) deviate from its deal size targets, (2) increase the number of portfolio companies managed, or require unmanageable tuck-in M&A execution, (3) lose the ability to execute and manage a larger fund, including the professional bandwidth to invest, operate and monitor its investments, or (4) dilute the other LPs, especially if there are existing deals already funded with the original capital commitments.

6. Inclusion of GP-Friendly LPA Terms

The Current Trend

As partnerships have become progressively sophisticated over time, the LPA terms have gotten more granular and nuanced—and there's been a noticeable shift toward agreements that incorporate more favorable terms for the GP. Specifically, there are a few areas where these "off market" LPA terms are GP-friendly and particularly impactful:

- Inclusion of direct GP costs, formation costs and maintenance costs in fund expenses
- Removal of parameters around formation and operation of co-investment vehicles, leading to conflicts of interest between fund LPs and co-investors
- Variance of key investment terms, including all investment restrictions and the investment period length, with only LPAC consent

While this tip in the GP-LP balance raises concerns—it is really an issue that depends which side of the table you're sitting on. Many GPs believe that LPA terms have moved in the direction of becoming too LP-friendly, whereas many LPs have become frustrated with GP terms that they believe are too aggressive.

Our View

We urge LPs to evaluate the GP's actions, and ensure that they are investing with a trustworthy, reasonable and transparent manager that views current LPA terms in the context of a long-term partnership with LPs. Additionally, with LPAC support on its behalf, LPs should strive to negotiate the best possible terms, and ensure that those terms are in line with the market. In the event that they believe the LPA terms are weighted too heavily toward the GP, they should work with the LPAC to make revisions and weave in more LP-friendly terms—with the input of both internal and external counsel. We encourage LPs to push for transparency from the GP, and collaborate on mutually important issues. Additionally, we emphasize the importance for LPs to begin legal reviews earlier in the due diligence process, in order to address any issues that can be detected up front.

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Elizabeth Weindruch is a member of Barings Alternative Investments, a global real estate, private equity and real assets platform. Elizabeth is a part of the Funds & Co-Investments team and is responsible for originating and underwriting funds and co-investments in North America and Latin America. Prior to joining the firm in 2015, she was with the Wells Fargo Investment Institute where she led the strategy, due diligence, implementation and support efforts for private equity and private real estate products across the alternative investments platform. She also held various private equity roles at Citi Private Bank, Brooke Private Equity Associates and Investor Group Services. Elizabeth holds a B.A. in Political Science from Davidson College.

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