Expectations shift for LPs

Issues such as ESG can no longer be dismissed, and those that neglect them could find it comes back to bite come exit time, says Katharina Lichtner at Capital Dynamics.
Despite some of the horror stories of the past few months, there are still those funds that have succeeded in raising money relatively easily, even if the bulk of GPs see themselves as inhabiting a tough and busy marketplace.

And while not quite the shake-out that many anticipated, the number of fund managers is already dwindling. The long-anticipated consolidation in private equity has coincided with a desire for limited partners to place their GPs under greater scrutiny.

Indeed, many of these fund managers might now be wishing they had treated their LPs better when things were going well, says Katharina Lichtner, managing director and co-head of investment management at asset manager Capital Dynamics. And any issues or concerns look set to become amplified in a crucible-like fundraising environment.

“2009 was a lost year for fundraising. And while it picked up in 2010 and last year, a lot of managers have postponed fundraising,” she says. “Investments and realisations are slower, so a lot of managers that would have been back under normal circumstances have delayed returning to the market. We have almost missed a cycle, with many managers coming back in 2012.”

No rush to re-up

From a capital availability point of view, Lichtner insists there is still capacity to invest, though many LPs are mindful they need to maintain a vintage year diversification, and will be keen to avoid over-concentration in 2012. Re-upping relationships is simply no longer an option, she says. “Investments and realisations are slower, so a lot of managers that would have been back under normal circumstances have delayed returning to the market. We have almost missed a cycle, with many managers coming back in 2012.”

Market aberration

There is now a particular focus on the ability of fund managers to syndicate debt, in particular prior to the deal closing. Returning this is more of the classic private equity that defined the earlier days of the industry.

She adds, “What we saw from 2005 to 2008 was simply an aberration in the market. It is nice to profit from it, but it cannot be relied on. If you take a 20 to 30-year view, it is a three-year anomaly.”

The issue of management fees has been held up as an example of where the industry has broken down, but Lichtner says this should not be used as a stick to beat GPs while they are down.

“Where we have an issue is where fees are taken that disrupt the alignment of interest. In situations where transaction fees and management fees add up to the stage where carry becomes a ‘nice-to-have’, the alignment is broken.”

Unsurprisingly LPs are keener than ever for open and straightforward communications, though this is still not a given. She says, “Foremost in today’s environment we look for transparent and honest relationships. There are many portfolios with accidents caused by the crisis. Trying to fudge something is one of the biggest mistakes a GP can make with LPs nowadays.”

Issues such as ESG can no longer be dismissed, and those that neglect them could find it comes back to bite come exit time, says Katharina Lichtner at Capital Dynamics.
One positive of the financial crisis is that it has provided the catalyst for investors of all kinds to refresh their approach and their portfolio, providing some key markers within an industry that was beginning to look somewhat uniform, says Lichtner.

“The crisis was helpful to the extent that it allows us to separate the wheat from the chaff by evaluating how GPs dealt with the crisis - no-one was immune to what was happening.”

Talent drain
Perhaps the biggest theme that has emerged within the whole LP approach is that of environmental, social and governance issues (ESG). For many it remains a nebulous concept, but there is no doubt that the whole theme of ESG is gaining a higher profile and status within the fund-management process. And it is not simply another tick-box exercise on behalf of institutional investors seeking to placate their stakeholders – it is far more complex, says Lichtner.

“It is inherently tied to value creation. It is clear that a good portion of value will have to be created through operational measures, as we anticipate a shift away from debt playing a significant role.”

She adds, “Enterprise values continue to be on the high side, so multiple arbitrage opportunities will play a lesser role in creating value as well.”

In the absence of debt and arbitrage as possible value generators – and alongside only moderate growth prospects – GPs will increasingly need to rely on genuine operational improvements to generate value. At the same time, markets are beginning to see an uncomfortable shortage of talent in certain regions and need to look at how they can attract the best personnel.

Lichtner says, “The next generation coming into the workplace is not just looking for money, they look at it increasingly from a lifestyle perspective. They have a much broader view on their expectations from their employer and businesses they work with.

“In order to effect operational improvements, highly intelligent, flexible and skilled people are required. Consequently, without thinking about the ‘social’ aspect of the ESG component, companies will increasingly struggle to attract that talent. Companies that don’t get this component right will begin to struggle,” she adds.

Private equity has historically been strong on the governance side, bringing much of its value-creation ethos that characterises the industry, while the environmental aspect is also slowly insinuating its way into private equity mindsets, she says.

“The environmental aspect is another no-brainer. Increasingly, those companies that do not meet environmental standards or have poor environmental risk management will suffer, and will find it hard to achieve good exits.

“All of a sudden ESG does not feel like a vague concept any more, but becomes very tangible from the value-creation point of view, in light of the changing demographics and attitudes we are seeing, particularly in Europe. A GP that does not look at, say, the energy efficiency of its companies is making a mistake. The topic simply cannot be ignored.”

The emergence of ESG offers a timely indicator of the need for a return to the basics tenets of private equity investment, as well as reflecting the desire for investors to engage more closely with both their fund managers and underlying portfolios.

Lichtner says, “These are not questions we would have entertained five years ago, but they have become important today.”

“For us, fees are not necessarily a differentiator. If you want the best people working on complex matters they should be rewarded”