THE MATURATION OF PRIVATE EQUITY

JANE PEARCE, OF VISTRA, REFLECTS ON THE EMERGENT CHANGES TO PRIVATE EQUITY GOVERNANCE AND BEST PRACTICE IN LIEU OF GREATER INVESTOR SOPHISTICATION

Jane Pearce joined Vistra as the managing director of the Jersey office in June 2015. She currently leads the corporate, fund administration and private client trust business on the island. Pearce has worked in the corporate and funds industry for over 20 years and has extensive experience of administering and accounting for complex investment structures.

HFMWeek (HFM): What are the key reasons for the shift in the private equity sector towards co-investing and limited partnerships?

Jane Pearce (JP): I've been working in private equity (PE) and funds for many years, and it seems to me that co-investment has become more popular because investors have grown a lot more sophisticated over the last 15 years and are much more comfortable with the asset classes; they understand them, and with this greater degree of familiarity and marketplace comprehension, investors are therefore less reliant on the knowledge and origination of the private equity managers than when they originally invested into blind pools at a much earlier point in time.

Also a lot of corporates now have their own investment teams capable of doing this work, as opposed to going through a blind pool, and this serves to drive diversification away from only investing in blind pools while helping to maximise returns. With a co-invest you have a choice of what assets you invest into. Conflicts of interest have likely also played some part in the appetite for co-investment alongside more traditional investment into limited partnerships.

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HFM: The influence of investors in the private equity sector has grown increasingly important. How do you expect the role of LPACs to evolve?

JP: If we take a broad look at the industry, asset classes and what they're doing, managers are looking always to fund raise, invest and divest – it's the classic private equity cycle. In the old days you would have had to stay in until the assets were all realised or sell your investment as a secondary.

Due to the increase in investor influence and where a fund has gone beyond its intended life, and there is value in the portfolio, albeit value which is not readily realisable, some investors will want out of the fund and new investors will want to come in because they recognise the value of available assets. Additionally, in some cases we have seen the use of dividend recapitalisations that have benefitted both PE managers and investors.

Due to these factors, the role of the advisory committees is even more important to ensure that all investors (new and old) are treated fairly and appropriately.

The drive from the limited partners (LPs) is to be involved and they want greater transparency, especially around performance, fees and running costs. The more access LPs have to information and the more involved they are with the investment process, the greater their awareness of the risks and opportunities within the market. LPs are more likely to invest (or continue to invest) with a PE manager if information flow on performance is good.

Advisory committees were traditionally set up to advise on difficult matters including conflicts of interest and other elements such as valuation methodology and specific consent of the limited partnership. Even the composition itself of the limited advisory committee is something that is hotly debated as to who does or doesn't have a seat. Side letter provisions often contain a reference to a place on the LPAC.

Those are some examples of where investors have grown more influential, although there is some suggestion within the industry that these committees are increasingly moving towards a more corporate form of reference. However, there is a very careful balance to be achieved between ensuring investors are happier with more difficult issues you wish to consult them on and ensuring their protection as limited partners and not inadvertently involving them in management

HFM: Which matters around transparency are currently most critical? Why?

JP: There is continuing debate between LPs and general partners (GPs) over the amount of information LPs really need or actually have time to consider. Many PE managers go to great lengths to produce elegant reporting packs, and they will often still get emails requesting information which is included within the standard packs. The volume and detail of information really does vary by investor and it is difficult to get an overall consensus. Also

there is the ever present tension around management fees, performance fees and a greater push for transparency around co-invest vehicles. In recent years, the SEC in the US has placed greater emphasis on transparency – the most enthusiastic are the LP's in the public pension funds sector. External managers that are hired by pension funds (private equity and others) are seen, in effect, as their sub-contractors. GPs that embrace the drive for more transparency are likelier to be successful with pension funds and similar institutional allocators than those that are uncomfortable with it.

HFM: What are the benefits of outsourcing personnel for PE funds?

JP: Outsourcing is great for certain segments of the market. If you are a small player and require infrastructure and operational support, then outsourcing is good because investors like to see that there's an independent third-party administrator who is regulated to provide these services. They get a certain level of assurance from this set-up. Outsourcing is also a good idea in many circumstances as setting up IT systems, recruitment, management, legal and tax compliance is likely not economically viable for smaller or medium sized PE managers.

For PE managers to keep up with the tsunami of legal/regulatory changes as well as progress their IT, HR and operational environments while running a busy portfolio is difficult. Most managers' specialisation is in originating deals, managing investments and making sure they diversify at the best possible time to maximise returns to the investors. This is where their concentration lies, and outsourcing helps to reduce the burden of additional personnel responsibilities – which can be very time consuming and difficult. Even if you are a large player you may still wish to outsource. This is appealing for many PE managers as they just view it as not being core and can achieve a better operational model by outsourcing.

Outsourcing is also a good choice for those undertaking cross-border deals. If you engage with an international firm who can offer services through their international network, you will often have a single point of contact with your relationship manager rather than having to manage the transaction and all the different in-country parties.

HFM: How do you foresee governance within the private equity sector evolving in the years to come?

JP: To answer this question it's relevant to look at the wider funds industry, Ucits and the AIFMD. Investors, particularly those based in Asia, enjoy a Ucits style product because they know exactly what they're getting. There is likely to be convergence between Ucits and the alternatives industry in the future.

Governance will play an increasing role because the ability for private equity to raise funds is going to grow as people chase yield. There's a proven appetite within the professional investor market for an increase in allocation to private equity, too, and if you're beginning to expand your investor base and the types of investor you're working with, both of those will require an uptick in governance. The PE industry is moving forward, and there will be a good mix of co-investment and blind pools. Increased governance will become inevitable. ■