2019

GP Trends

Investec

Corporate & Investment Banking

Solutions. Capital. Empowered people.

We are a solutions-led corporate and investment banking business who provide capital and innovative ideas to growth-orientated Companies, Private Equity and Institutional Investors across markets and sectors.

Foreword

A clear sense of optimism pervades the 2019 GP Trends report, our ninth annual survey of private equity sentiment across the globe, with the majority of General Partners (GPs) expecting to raise significantly larger funds next time around.

But, with scale, come challenges. Uncertainty surrounding Brexit, coupled with the prospect of an economic slowdown and retrenchment of asset-level debt, mean that deploying increasing sums of dry powder will require GPs to be both flexible and agile. This is where innovative fund finance and risk management solutions, structured to provide cost-effective support in any deployment environment, can give savvy firms the edge they need to win deals.

Escalating fund sizes also mean that GPs' personal commitment requirements are growing. Alignment of interest is paramount to limited partners (LPs) – almost half of GPs have experienced LPs seeking lower management fees in return for a greater emphasis on carried interest – and average GP commitments to funds now sit at 2.9% or $17m.

Senior leadership will be funding these commitments from existing wealth. But LPs want this crucial incentivisation mechanism to be effective across the board. With almost a quarter of private equity professionals, below partner level, unsure how they will fund their share, it is vital that managing partners explore all avenues to support their more junior colleagues.

Relying on carried interest, as 39% plan to do, is precarious. At Investec, we can advance the GP commitment against management fee income. As fund sizes continue to climb, having a clear strategy to finance skin in the game is becoming increasingly important.

GPs are also having to think harder – and longer – about how they add value to portfolio companies. A massive 83% expect to make follow-on investments after the initial investment period has expired. Finance secured against the underlying NAV of the entire portfolio, or hybrid facilities secured against a mix of NAV and undrawn commitments, can help GPs support portfolio companies later on in a fund's life, maximising value creation and driving returns.

We hope that you find the report insightful and thought-provoking. We appreciate that the market you operate in is evolving and we are continually innovating to help meet the challenges that you face. We would be delighted to discuss your fund finance and risk management requirements.

Please drop us an email at fundfinance@investec.co.uk.

Simon Hamilton
Global Head of Fund Finance
Investec Corporate and
Investment Banking

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Peak performance?

Depending on who you are, fundraising could be a marathon, or it could be a sprint.

Whilst some GPs are dipping at the line for a medal, there are many others just hoping to finish the race. But there are enough lining up on the starting blocks to suggest that the confidence we reported in last year's GP Trends survey has not evaporated: far from it.

The confident noises cannot, however, drown out the increasing number of individuals asking the question: why are there not more women working in private equity? This ninth edition of the Investec GP Trends survey is the second to specifically include a cohort of 50 female private equity professionals amongst respondents.

Moreover, it comes at a time when increasing pressure from Limited Partners is forcing any GPs not already looking to address issues of gender imbalance to move this up the list of corporate priorities.

Naturally, there are other issues giving cause for serious thought. Rapidly rising fund sizes and a more aggressive stance from some GPs on fund terms are raising concerns around returns and alignment.

Anecdotal evidence suggests that a large number of funds plan to make investments post investment period, in order to support their portfolio, raising questions as to how such investments will be funded.

Finally, questions around succession, ownership and franchise expansion are proving fertile ground for those whose political convictions encourage them to look for ways to portray the industry in a less than perfect light.

In this year's report, we will look at each of these issues and more. However, before we get into that, let us look at something more fundamental to the health of the private equity industry – the people working there.

1

Private equity – a “people” business

1

Private equity – a "people" business

Working in private equity is an attractive proposition to many, with high remuneration coupled with the opportunity to work with and influence the performance of dynamic businesses.

But how does this experience stack up against these high expectations? Does the industry do enough to keep the talent it attracts, for the long term?

And what is the industry looking for in the first place, from those that wish to start their careers in private equity?

For most respondents, the career path for those on the investment side of the industry has broadly remained unchanged in the last ten years. Nonetheless, and as noted by Rohan Maxwell, COO of Investindustrial, the growth of the industry has led to increased opportunities.

"Career paths have accelerated. People can be promoted and have greater responsibility, faster."

For finance and IR teams, the situation has evolved considerably. As Richard Howell, Partner and Head of IR at pan European buyout house, PAI, states:

"We all know that pre-crisis, IR was often, more or less, a small admin function. Those firms that do it correctly now see it as a cornerstone function of the whole firm. There is a real career for IR professionals in private equity, now."

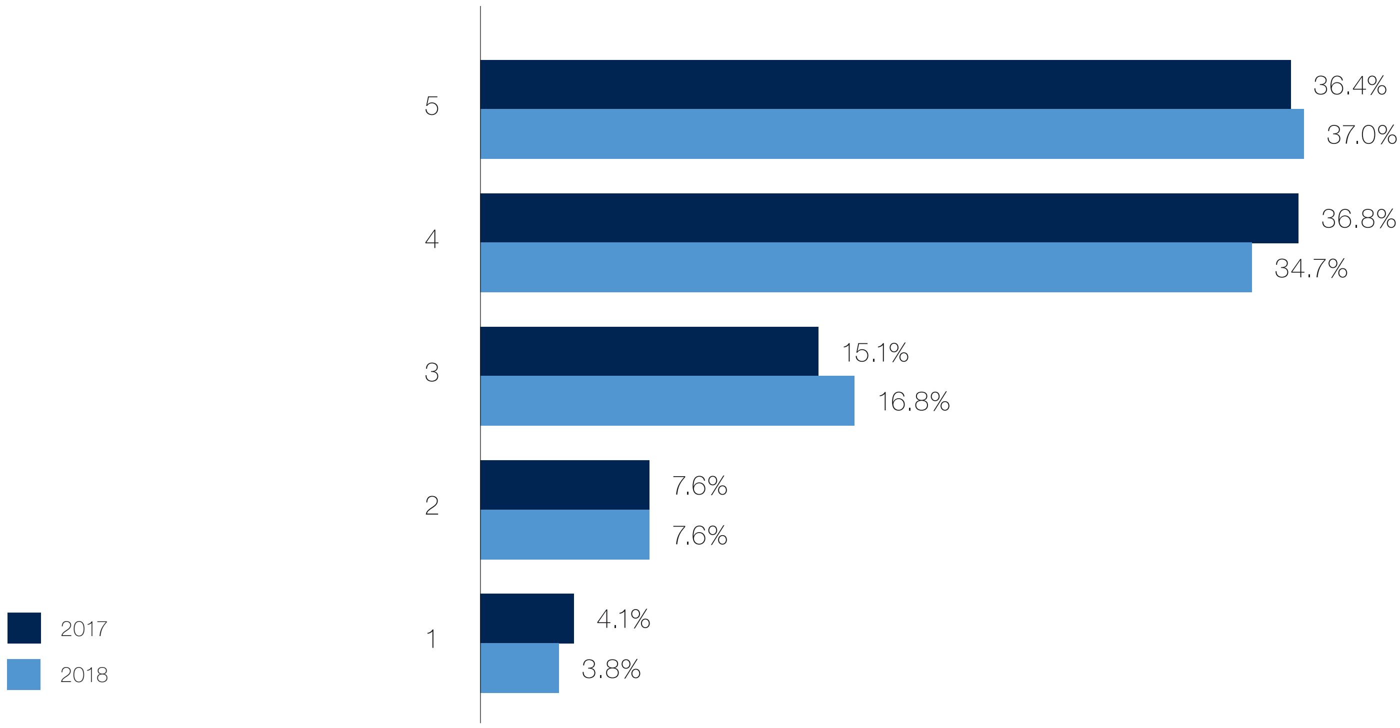
Rohan Maxwell
COO
Investindustrial

"Career paths have accelerated. People can be promoted and have greater responsibility, faster."

Therefore, one would assume that the prospects for those joining the industry, now, must be better than ever and amongst those in the industry, confidence in their long-term career prospects remains high, as this comparison with the same question, last year, demonstrates:

5 – Very confident
1 – Not confident

On a scale of 1 – 5, (where 5 is very confident), how confident are you in your long-term career prospects at your current firm?



Sherri Croasdale, CFO at Resource Capital Funds, explained that the career path has changed on the finance side, too:

"There are more demands on finance teams, but that also means that there are more opportunities – and that creates more career paths, now."

However, these results are buoyed by the perhaps unsurprising confidence of those already at the top of the tree.

19%

Managing Partners in our sample score their confidence in their long-term career prospects at a five out of five in 77% of cases. For those respondents below Partner level, this fell to a significantly lower 19%.

27%

It is clear that there is some level of uncertainty for junior team members and, in fact, 27% of those below Partner level told us that they were considering leaving their current firm within the next 12 months. This is not good news for the industry.

35%

Even though almost two-thirds of junior staff said that, if they did leave their firm, they would either move to a peer or start their own private equity firm, that leaves 35% that would rather leave the industry, altogether (with more than two-thirds of these anticipating a move out of the finance sector, entirely).

Clearly, the significant wealth creation that private equity carried interest has demonstrably provided to its veterans is not a sufficient draw, to all – or does it perhaps just seem a little too far away?

Certainly, it makes a difference how carry is apportioned and how the distribution waterfall works. In North American funds that may provide for deal-by-deal carry; this is not quite the issue that it can be in the whole-of-fund carry structures that are the norm in Europe.

Primary Capital's Neil Wallace, the firm's Managing Partner, counsels retaining some flexibility in the way that carry is distributed. As he points out:

"The framework for carry distribution is typically set up at the beginning of the fund, which can be a long time before it is realised and a lot can happen in that time, particularly for junior staff, who may become more senior members of the team, in that time."

And firms have other ways to incentivise their staff, beyond the carry. The industry is well-known for compensating its professionals well for their intense workloads.

For example, Wallace also stressed the importance of bonuses as a shorter-term incentive, with others agreeing that this can be a useful way to raise the remuneration of those high-performers in the lower ranks of the organisation.

Despite the issue of longer-term incentivisation through carry, particularly for more junior team members, it does seem that those in the industry are, overall, content.

Only 15% said that they were somewhat (11%) or much (4%) less satisfied than 12 months ago. This compares to 17% that were much more satisfied and a further 30% that were somewhat more satisfied than last year.

The picture is a little more complex, of course, particularly when viewed through the filter of gender, as we shall see.

2

A tale of two equities

2 A tale of two equities

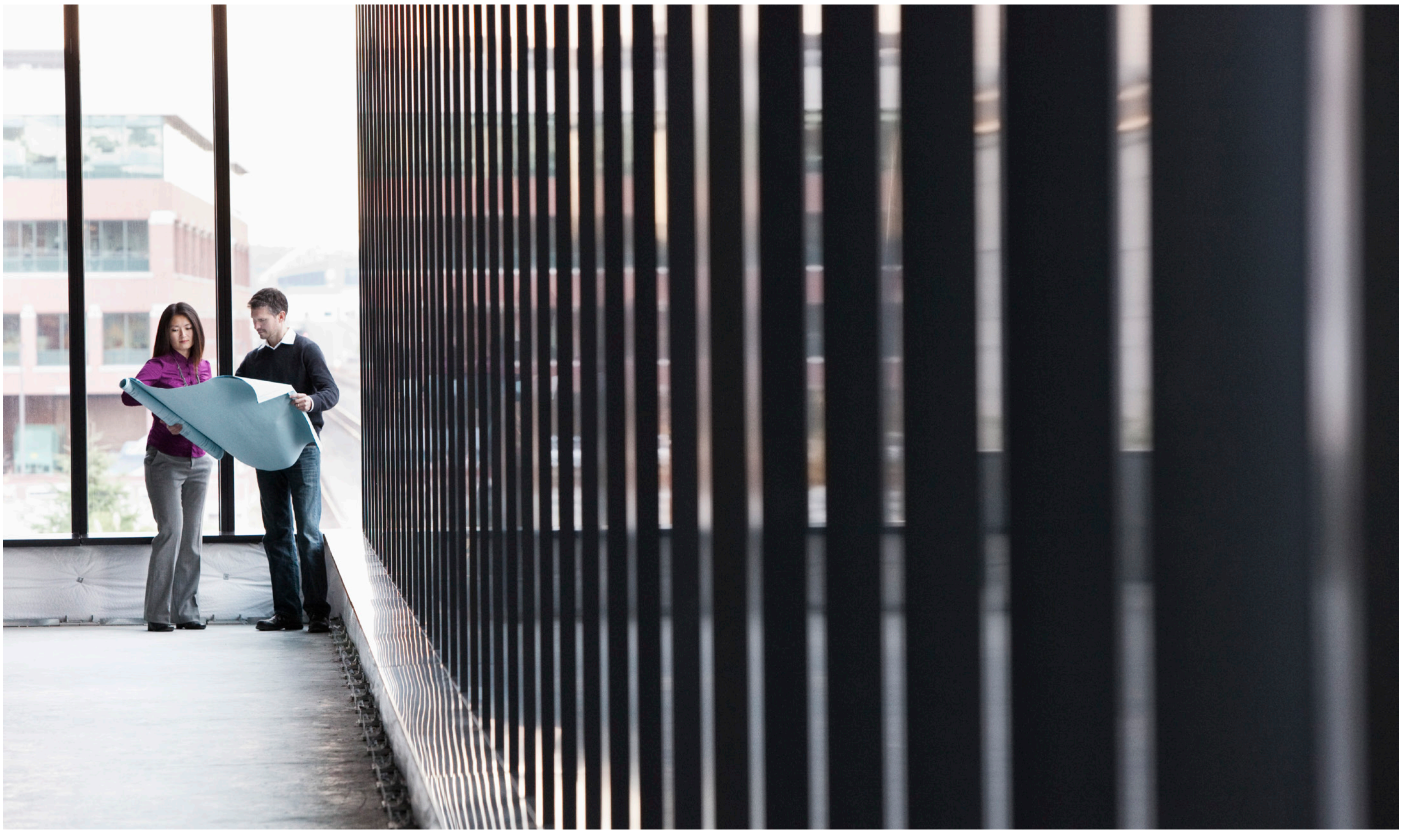
Primarily, for those working in our industry, the word "equity" defines the ownership stake we take in private (or soon-to-be-private) companies.

What has become rather less of a private matter for the industry, however, relates to another meaning of "equity": the quality of being fair and balanced in the treatment of different groups.

Specifically, we are talking about the issue of gender equality and, when it comes to private equity, the stakes are high, and rising.

Whilst LPs are far from homogenous in their views on this topic (as on all topics), one thing is certain: many LPs care about and are becoming increasingly vocal on issues of gender equality and diversity. Jennifer Choi, Managing Director for Industry Affairs at ILPA, the Institutional Limited Partner Association, explained what she has heard from the organisation's membership:

"Interest in gender equality is not driven by the desire to see hard quotas set and met: LPs want to understand to what extent the stated corporate values are reflected in reality and they are keen to see how GPs are working to improve inclusion, rather than just diversity[...]. They [LPs]... appreciate the value in a diverse decision-making base."



And when it comes to any potential issues (discrimination or harassment, for example), beyond the moral imperative to behave appropriately, LPs additional interests are in ensuring that there are no surprises.

As Choi puts it: “LPs also want to know what would happen if there was an incident, such as a harassment case. How does the GP plan to handle that? Are there HR policies in place? How would the GP bring the LPs up to date? How would the GP deal with it? It can have an economic impact for an LP, too.”

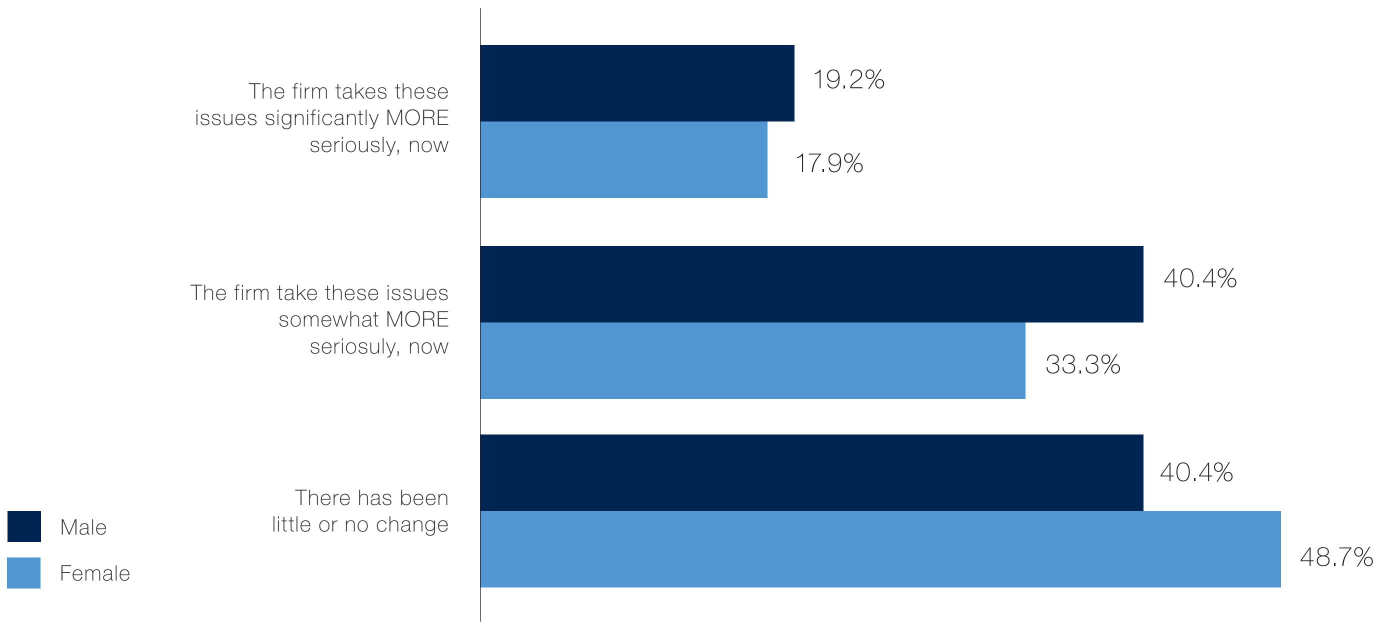
In an environment where investors clearly care about what is happening (or not happening), it stands to reason that even the slowest moving firms would understand the importance of addressing the issue, and making changes, where necessary.

We asked our survey respondents how the felt their firms’ attitudes towards diversity and equal opportunities had changed in the last two years.

Whilst the majority of both men and women felt that their firms take diversity and equal opportunities issues more seriously, almost half of the female participants in our study, and one-in-four men, said that they felt that there had been little or no change.

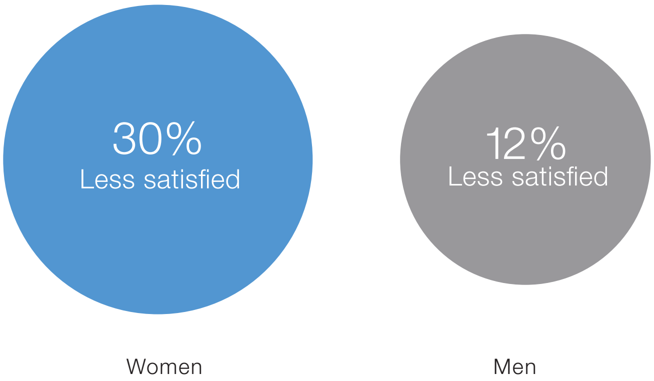
How do you feel your firm’s attitude towards diversity and equal opportunities has changed in the last two years?

Gender comparison:

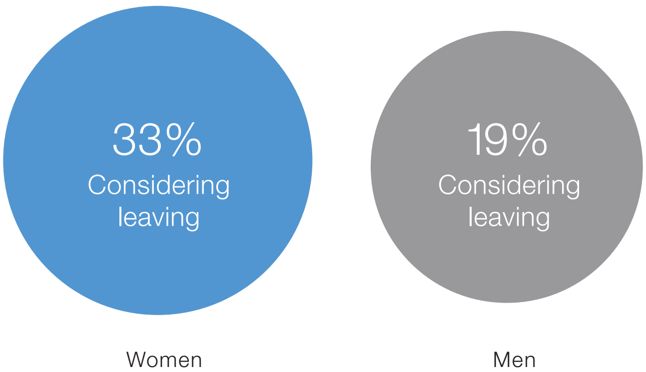


Despite the progress that has been made, there is still a marked difference between how women and men evaluate their prospects in the industry.

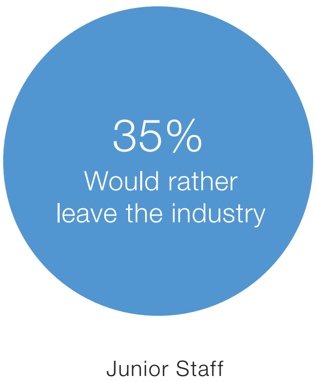
Career satisfaction



When asked to compare their career satisfaction with 12 months ago, 30% of women said they were less satisfied. This could be down to many reasons, of course, but men responded similarly in only 12% of cases.



In addition, women tended to score their long-term career prospects lower than their male peers and one-third of female participants said that they were considering leaving their firm in the next 12 months (compare this to 19% of male respondents to our survey).



Even though almost two-thirds of junior staff said that, if they did leave their firm, they would either move to a peer or start their own private equity firm, that leaves 35% that would rather leave the industry, altogether (with more than two-thirds of these anticipating a move out of the finance sector, entirely).

One key issue for the industry is the clear gender imbalance at the top of the industry, with numerous causes cited for it.

There is now, however, a growing feeling among many that, fully cognisant of the long road ahead, the first steps are finally being taken.

As ESO Capital's Richard Butler points out:

"There are fewer women in the industry, but we are moving in the right direction and we now have female managing partners and other senior roles held by excellent women."

Sasha Jensen of alternative assets recruiter Jensen Partners sees light at the end of the tunnel:

"The growing emphasis on diversity across the financial services industry has created an opportunity for more and more women to enter and to advance within the private equity industry. I believe we are about to see a huge spike in the percentage of women in senior roles."

Richard Butler
ESO Capital

"There are fewer women in the industry, but we are moving in the right direction."

3

From equal opportunities to missed opportunities…

3

From equal opportunities to missed opportunities…

Private equity firms are renowned for their ability to squeeze value from seemingly barren terrain, yet not all of them are taking advantage of the opportunities to protect or create value through active FX management.

Whilst GPs are more likely to employ strategies to actively manage foreign exchange when participating in cross border transactions, 66% were not doing this (although some may not be participating in cross border deals, at all, of course).

And when it comes to managing FX on the investor side of the equation, despite most GPs accepting investors from a wide variety of regions, only 11% of GPs in the sample said that they actively manage currency risk with regards to investor-related issues. With feeder funds and multiple share class structures increasingly prevalent, it seems likely that GP attention will turn to managing these risks, soon – hopefully before someone gets burnt.

4

Fund sizes hit record highs

4 Fund sizes hit record highs

Despite the issues discussed previously, the uncertain outcome of unfolding political events and concern around the growing amount of dry powder in the market (will this drive up entry multiples and leverage to unsupportable valuations?), there has been no cooling of the industry's ability to secure fund commitments.

In the last two years, there have been numerous "personal bests" (as firms have raised their largest ever funds) and the European and world records have fallen, too, with Europe-based CVC raising €16 billion and Apollo Global Management raising an astonishing $24.6 billion.

GPs in our survey expect the benign fundraising market to continue and are just as bullish as they were last year, with regards to the amount of capital commitments they will be able to secure for their next funds.

George Brown
Investec Economics

> "The US looks set to expand by respectable 2.4% this year in spite of the fading boost from last year's tax reform."

Expectations that 2018 would see the world economy step up a gear were ultimately dashed, with global growth now expected to have moderated slightly to 3.7% last year from 3.8% in 2017. The subsequent outlook faces a number of potentially destabilising threats including a rise in protectionism, a disorderly Brexit and a 'hard landing' in China. Even if such risks fail to materialise, growth still looks set to slip further to 3.5% in 2019.

But even in the face of this challenging global backdrop, GPs remain confident in their ability to secure the necessary funding for the upcoming year. This may partly reflect that, for all the prevailing uncertainty, economic fundamentals remain robust in key geographies.

The US looks set to expand by respectable 2.4% this year in spite of the fading boost from last year's tax reform. Meanwhile, activity in the Eurozone and the UK is likely to pick-up in the latter part of 2019 once the disruption caused by onerous new car emissions tests and (we hope) Brexit passes. Additionally, sizable fiscal stimulus by Beijing should serve to cushion the Chinese slowdown and secure above 6% growth this year.

At the same time various central banks look set to rein in the pace of monetary policy tightening. The US Federal Reserve has signalled it will be "patient" in its approach to setting policy, while the European Central Bank is expressing caution amid the various risks to growth. Liquidity should consequently remain ample when set against the modest rise in interest rates and supportive of equity raising conditions.

Source: Global Economic Overview, Investec, 23 January 2019

Raising larger funds typically means picking up larger management fees in aggregate, which can raise questions of alignment with some LPs.

One way to counter this issue is for GPs to provide LPs with options, paying more carry in exchange for a lower management fee or, conversely, paying a higher management fee in order to reduce the carry paid to the GP.

Whilst just over half of GPs surveyed (53%) said that they had not observed LPs looking for either of these options, 47% said they had experienced LPs looking to reduce management fees and being willing to give up more of their returns to a carried interest vehicle.

Depending on the LP, of course, just more than a quarter of GPs that participated in this wave of the survey (28%) said that they had met with LPs that were willing to pay higher management fees in exchange for paying less carry – this is a pretty strong endorsement from an LP, of course!

Another consequence of larger fund sizes, beyond the increased fee income, is an increase in the quantum that has to be committed by the GP into the fund. Whilst the ability to raise larger funds is certainly music to the ears of GPs, it also creates a problem, particularly if fund sizes increase rapidly, from one generation to the next. If it was considerably smaller than the target for a current fundraising, a fund two or three generations ago may not throw off enough carry to cover a GP commitment, comfortably.

Let us take a closer look…

5

A question of commitment...

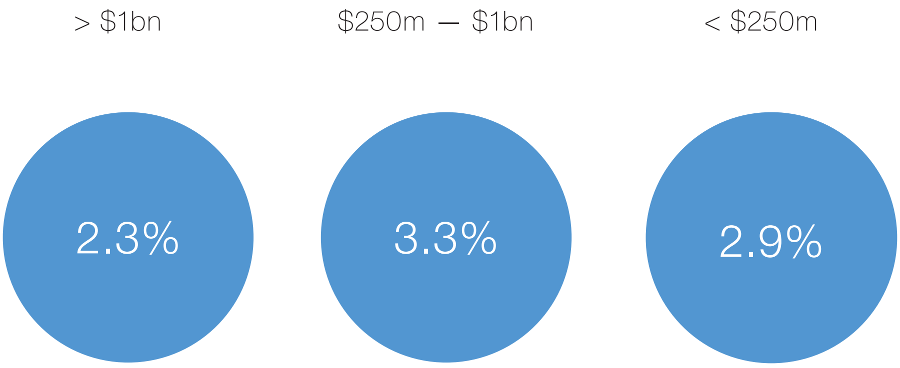
5 A question of commitment…

As with previous years, we found that the amount GPs will commit to their own funds varies significantly. As such, using a single number to describe the market cannot tell the whole story.

Trimming the outliers from our sample leaves a modified average expected GP commitment of 2.9%, down slightly from the 3.3% we recorded last year.

However, pressure from LPs for GPs to increase their commitments to their own funds further is unlikely to cease anytime soon, as the amount of “skin in the game” is seen as a key indicator of GP/LP alignment.

Focussed average comparison by size of fund



Average % of next fund to be committed by the GP, by size of fund

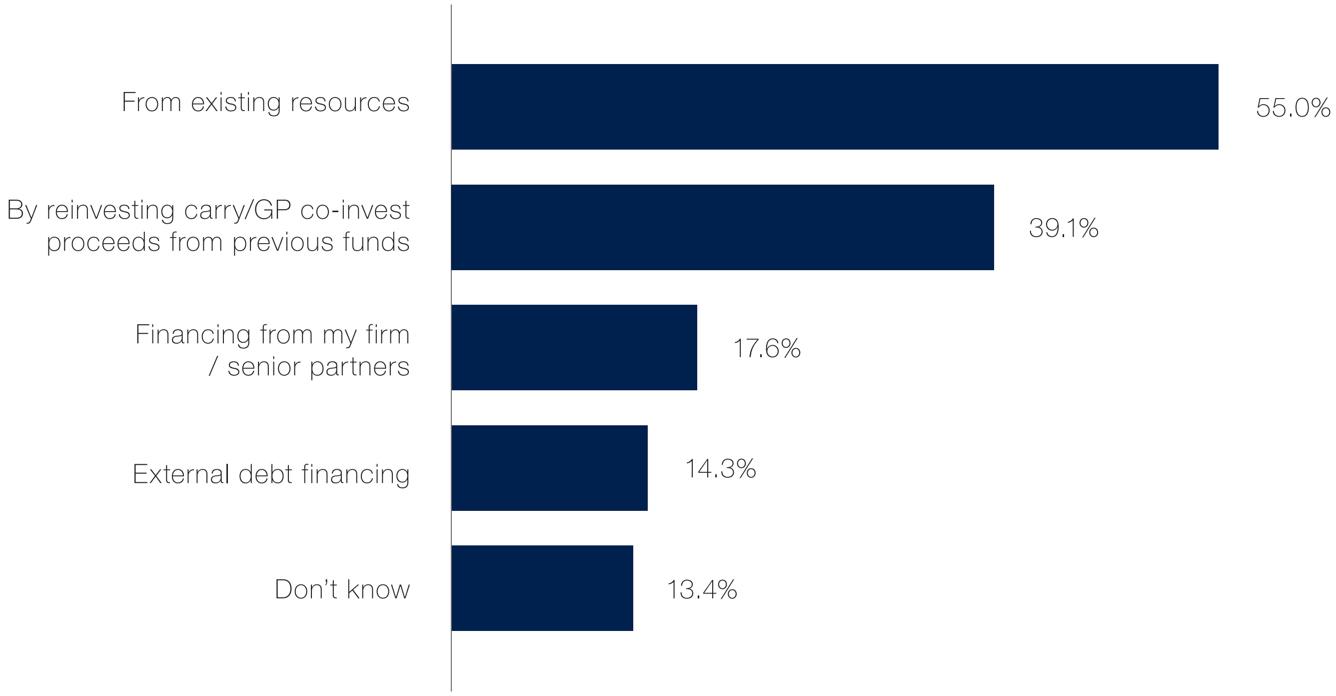
It is clear that GPs need to find a substantial amount of capital to satisfy the expectations of their LPs, with regards to the GP commitment.

Although our data confirms that the relative size of fund commitments tends to shrink as funds cross the $1bn size, 2.3% of a $1bn+ fund is a significant amount of cash.

This gives rise to the obvious question as to how the GP commitment is to be funded. As we noted earlier, carry from earlier funds may not be sufficient to fund the increased GP commitment on a much larger fund. And in any event, will be of little use to newer members of a team who were not around for the earlier fund(s).

In this year's study, 13% of respondents said that they did not know how they would fund their portion of the GP commitment. For staff below Partner level, this increased to 23%.

How will you personally fund your portion?



One mechanism a GP can utilise to fund the GP commitment is a management fee waiver. However, LPs are not always happy with this approach.

As Jennifer Choi, Managing Director for Industry Affairs at the Institutional Limited Partner Association (ILPA) explains:

"Next generation leadership may not have accumulated the wealth to commit the right amount to the GP commitment. If the alternative is a fee waiver, LPs are open to the conversation – but not if the established leadership in a GP is doing it for other reasons."

Note that it is not just LPs that want to see participation in the fund from a GP's entire team. Whilst being cognisant of the challenges on junior team members in finding the capital needed to fund their individual share of a GP commitment, those running private equity firms see the opportunity for junior members to participate as a key motivator.

Simon Hamilton, Global Head of Fund Finance for Investec Corporate and Investment Banking, sums up the issues and provides salient advice to GPs:

"It is important for LPs to see that the GP commitment to a fund comes from the entire investment team – it is a key alignment mechanism. The fact that so few team members below Partner level know how they will fund this is an issue. There are a number of financing options for these kinds of situations and it is important that GP leadership teams investigate them fully – if not for themselves, then for their more junior colleagues."

Whilst the more senior members of the GP team are much more likely to have identified how they will fund their carry commitments, fund raising is not the only scenario where the GP team may need to find significant amounts of cash. For example, when a Managing Partner looks to retire, they will need to be bought out in some way. Succession, and how it is planned, is our "next chapter".

Jennifer Choi
Manging Director
Institutional Limited
Partner Association

"Next generation leadership may not have accumulated the wealth to commit the right amount to the GP commitment."

Simon Hamilton
Global Head of Fund Finance
Investec Corporate and
Investment Banking

"It is important for LPs to see that the GP commitment to a fund comes from the entire investment team – it is a key alignment mechanism."

6

The next chapter

6 The next chapter

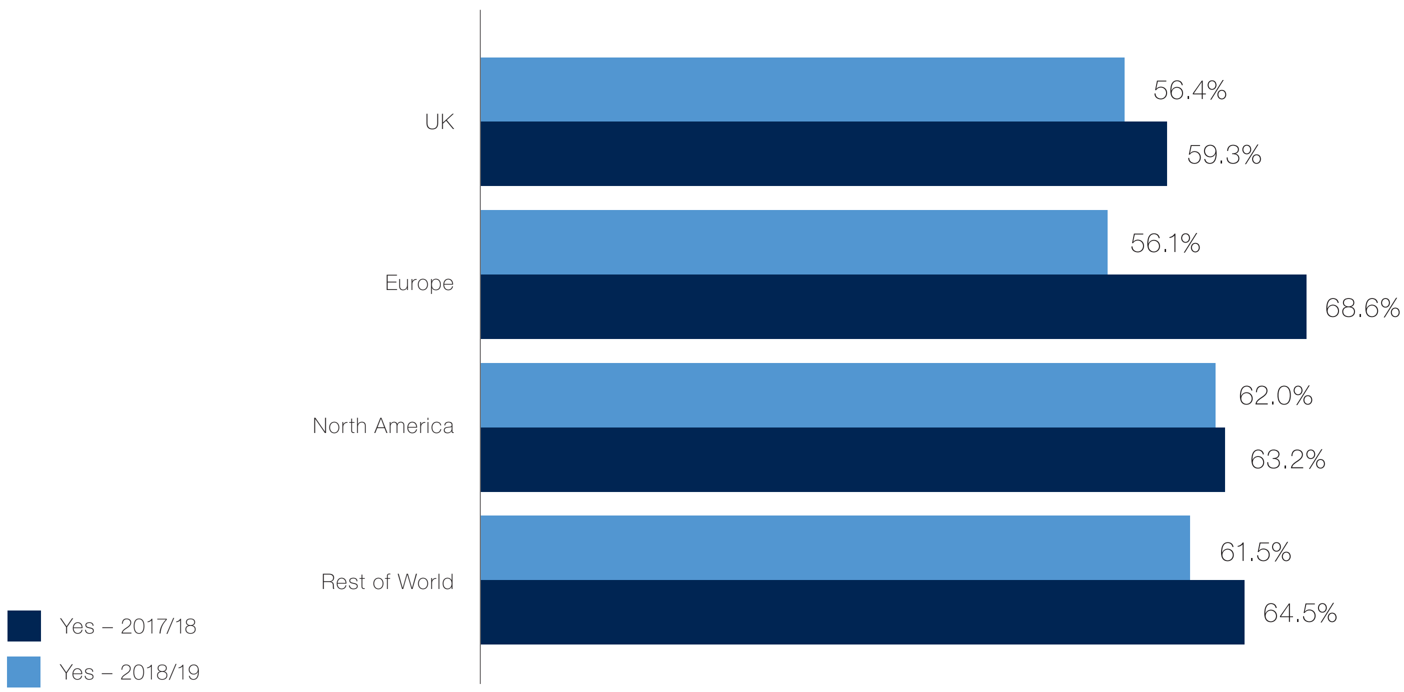
Succession is often a discussed topic in private equity, with the industry sometimes said to have a succession problem. Certainly, it is a topic that can exercise LPs.

Firms can expect to be asked about their succession planning when out on the road raising their next fund.

While 58% of respondents to this year's survey felt that their firm had an adequate succession plan in place, this was a reduction on the 64% in last year's survey.

Whilst a smaller proportion of respondents from all geographies felt their firm had an adequate succession plan in place than in 2017/18, the reduction was most notable in UK-based (from 59% to 56%) and, especially, European-based firms (from 69% to only 56%).

Do you think your firm has an adequate succession plan in place?



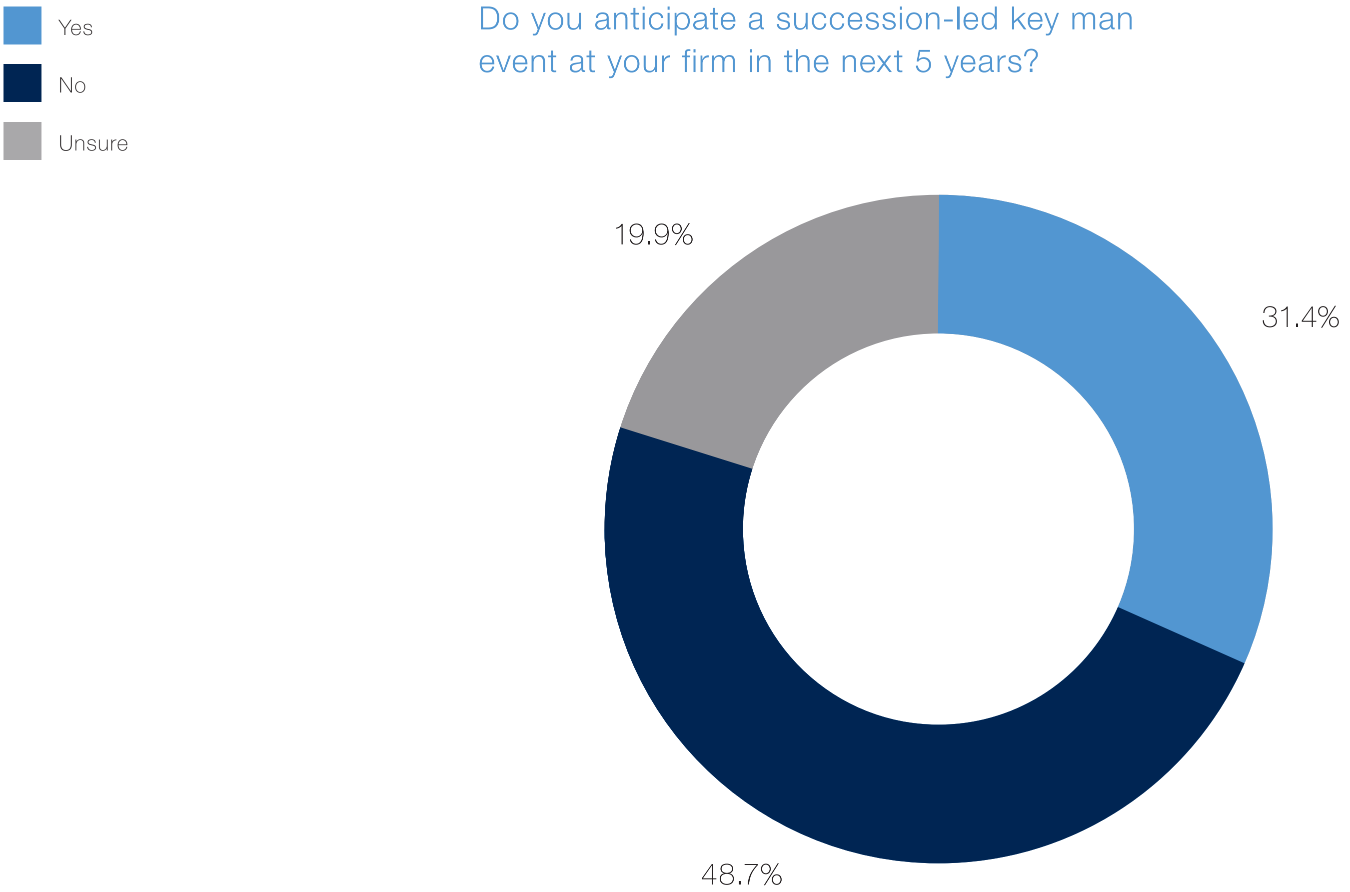
The seniority of respondent had a significant bearing on whether he or she felt their firm had a handle on succession.

Respondents at Managing Partner or equivalent level were the most likely to feel their firm had an adequate succession plan in place, with 72% answering the question in the affirmative.

This is perhaps to be expected, given Managing Partners or their equivalent are the current leadership of their firms. For respondents below Partner level, the proportion was only 51%.

Perhaps surprisingly, nearly one-third of respondents (31%) anticipate a succession-led key man event at their firm in the next five years, indicating that there are many firms out there that need to be giving thought to succession planning, now.

Do you anticipate a succession-led key man event at your firm in the next 5 years?



Neil Wallace of Primary Capital, took the reins himself, following a smooth transition from the previous Managing Partner. He explains the importance of transparency and bringing LPs and the team with you in order to effect a successful succession plan.

"I believe our transition was successful because we provided absolute transparency to investors and internal stakeholders. We gave them time to get comfortable with the idea and to adapt to it. We were also sure to get the buy-in internally, first. That was key - trying to foist something on the team can be dangerous."

7

New structures

7 New structures

There are other ways in which private equity fund managers are looking to evolve their businesses and the structures of their fund vehicles, beyond the typical ten-year fund with optional two year extensions and a five-year investment period.

This desire may be driven by the investment focus of the fund, with a view that adjacent asset classes such as infrastructure and energy require longer-dated funds.

In fact, 31% of respondents to this year's survey said that they were considering launching a product with a longer duration than the typical 10+2 or 10+1+1 fund.

Appetite amongst GPs was lowest in the UK (25%) and highest in the regions outside of the UK, Mainland Europe and North America – 48% of GPs based in the rest of the world said that this was something they were investigating.

The most senior individuals in a GP were also most likely to state an interest in this evolved structure, suggesting it may be more visible in the next few years.

Whilst only 25% of team members below Partner level said that their firm was considering a longer duration fund, one-third of Managing Partners said that this was, in fact, under consideration. According to ILPA's Jennifer Choi, investors have become accustomed to the idea that even supposed 10-year funds may, in reality, be more likely to run to 12 or 15 years (or even longer, in some cases). In her view, this has created an issue that needs to be addressed:

"There is an issue that the fund documents need to catch up with reality. Many LPAs are silent on some of the events that can occur, when a fund's duration is significantly extended. Most do not treat this in sufficient detail."

It is not just the length of the fund as a whole that has seen some evolution. Anecdotal evidence suggests that a large number of funds plan to make investments post investment period, in order to support their portfolio.

Indeed, 83% of GPs in our survey said that they would want to make bolt-on or follow-on investments in their portfolios, after the investment period has closed.

Only one in ten Managing Partners said that they would not look to do this, suggesting that the significance of the "investment period" in private equity funds (beyond its relevance to calculating management fees) is waning.

This poses the question as to how such investment activity will be funded. Undrawn commitments will have been largely utilised in many cases and, even where funds have capital reserved, it may prove insufficient.

GPs are increasingly willing to utilise innovative financing models, such as lending to NAV, to provide follow-on investment into their portfolios without the need to either raise the capital directly from LPs or find a co-invest partner.

83%

of GPs in our survey said that they would want to make bolt-on or follow-on investments in their portfolios, after the investment period has closed.

8

A word of thanks

8 A word of thanks

We are very grateful to the 289 private equity professionals who participated in this edition of the GP Trends survey.

Thank you to the individuals listed below, who participated in longer conversations, during which they provided additional insights on the results and the market, in more general terms. We appreciate your considerable contribution.

Aldo Beolchini
Founder & CFO, Next Energy Capital

Richard Butler
Founding Partner & COO, ESO Capital Partners UK LLP

Jennifer Choi
Managing Director, Industry Affairs, ILPA

Sherri Croasdale
Partner, CFO, Resource Capital Funds

Richard Howell
Partner, PAI

Marc Immerman
Principal, Metier

Sasha Jensen
Founder & CEO, Context Jensen Partners

Rohan Maxwell
COO, Investindustrial

David Till
Senior Partner & Co-Founder, Oakley Capital

Neil Wallace
Managing Partner, Primary Capital Partners LLP

9

A final word

9 A final word

The need for specialist financing in private equity funds

I hope you have found this, the ninth edition of the Investec Fund Finance GP Trends survey, as interesting as we have. This year we have seen fundraising confidence continue, unabated, and average GP commitments to these larger funds remain around the 3% level, much higher than the 1% that used to be the norm.

A slightly larger proportion of GPs (39%, this year, compared with 36%, last year) told us at that they plan to fund their personal commitments to their funds from carry payments that they expect from their current funds. In other words, they do not have the cash available, now.

We hope that this optimism is well founded, but it makes sense for GPs to explore the options available to finance these commitments. This is particularly true for GPs where individuals below Partner level are expected to commit meaningful sums. These individuals, from which future generations of firm leaders will emerge, may still be some years away from any carry payments.

Of course, some GPs (17%) provide their own financing to assist junior team members with these commitments – but these programmes are far from ubiquitous and, in this year's survey, 16% of respondents below Partner level told us that they simply did not know how they are going to finance their portion. This is troubling.

Investec can help provide certainty around GP commitment financing, allowing staff to focus on what they do best – investing and generating returns for their investors.

In fact, we have a range of innovative financing solutions that can assist GPs in any number of scenarios. Whether the desire is to reduce inefficiencies for LPs through subscription line financing or to fund the strategic changes in the ownership of a fund or management company, Investec can help – and in many other cases, too.

Simon Hamilton

Global Head of Fund Finance
Investec Corporate and
Investment Banking

About the Investec Funds Team

Together, Investec Fund Finance and Investec Fund Solutions provide strategic financing and risk management solutions to funds and fund management teams globally.

This unique set of capabilities offers flexibility and strategic solutions at each stage of the fund cycle, as well as to the GP itself. Our aim is to help you enhance returns, maximise the efficiency of your fund's equity and increase your competitiveness in an aggressive market environment.

Innovation is at the heart of our thinking and our global team has the vision and the resources to create unique financing structures and bespoke hedging solutions to match your requirements.

About the research

Research for this edition of the GP Trends report was conducted in conjunction with MJ Hudson, a leading provider of research and other services to the private equity industry.

289 GPs from across the globe took part in the project, this year, and an additional 10 individuals contributed further insights via longer conversations.

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