Private equity managers regain the upper hand

Top general partners imposing tough terms on investors again

BY **ARLEEN JACOBIUS** | **MAY 2, 2016**

David Fann said public funds are being hurt most by the contract terms of new funds.

Private equity investors are getting a dose of the new normal as the hottest fund managers again demand general partner-friendly terms and fees that investors have not seen since the pre-crisis go-go fundraising days.

Some managers are again charging “premium carry” similar to 2007 vintage funds and are eliminating terms from their current funds that are designed to protect limited partners, such as preferred returns, also called hurdle rates, and clawbacks.

Hurdle rate clauses provide that general partners can't take their share of the profits until investors earn a specified return. Clawbacks, meanwhile, award investors some of the general partners' share of profits if the fund's losses on later investments mean the manager retained too large a portion of the carried interest.

Public pension fund investors are feeling the pinch the most. Sovereign wealth funds, endowments, foundations and high-net-worth investors are generally less sensitive to terms and transparency issues and are becoming the preferred investors, said David Fann, the New York-based president and CEO of private equity consulting firm in the New York office of TorreyCove Capital Partners LLC, San Diego.

When Advent International Corp. closed its eighth private equity fund in March at its $13 billion hard cap, the oversubscribed fund's terms had no investment hurdle, according to a memo to the system's board by Thomas Moutes, general manager of the $14 billion Los Angeles City Employees' Retirement System.

Sources said that was the first time in Advent's history it did not offer a preferred return.

Vista Equity Partners is charging investors in its latest two funds graduated carried interest. The two funds are an $8 billion target and no hard cap to invest in larger companies and a $2 billion target for smaller companies. Depending on distributions, carried interest starts at the typical 20% and moves up to 30%, according to sources and agenda materials of the $14.4 billion Arkansas Teacher Retirement System, Little Rock.

A few investors are walking away from these funds, but not many.

Some 90% of the Advent fund's committed capital came from investors in prior Advent International funds, firm executives said.

Most investors are “term takers,” said Jonathan Grabel, chief investment officer of the $13.3 billion New Mexico Public Employees Retirement Association, Santa Fe. “There's a supply-demand imbalance,” Mr. Grabel said. “There is greater demand for allocations to these funds than there is supply … and the demand by LPs is voracious.”

In the last six months, New Mexico PERA officials have walked away from some alternative investment funds because of the terms. And it is not always economic terms that are the deal breakers, he said.

Changing terms

Some managers are changing terms such as key man provisions and fund extensions.

“I would be more comfortable if GPs were putting more capital at risk, but not when GPs are decreasing their commitments to the funds and are also ratcheting up unfriendly terms,” Mr. Grabel said. “It leaves a bad taste in my mouth and hopefully, other LPs.'”

Limited partners fear that if they complain, the private equity manager will at best cut back their commitments or, at worst, bar them from their highly sought-after funds.

For GPs, this is a golden age of private equity and GPs can get these terms due to the supply-demand imbalance, Mr. Grabel said. This is the case, even though not all the highly-sought after funds are “the best or ones with the brightest prospects,” he said.

Rather than agreeing to terms and fees that they cannot stomach, New Mexico PERA officials are straying from the hot list of GPs for general partner relationships, Mr. Grabel said. They are investing in niche strategies in separate accounts and in smaller funds “where it is less about an historical franchise and preferred terms and more about making money in the future,” he said.

Limited partners say the situation negatively affects the general partner-limited partner alignment of interests, making the relationship more antagonistic.

“Some GPs are trying to win every single battle and trying to make each term slightly more GP friendly,” Mr. Grabel said.

This comes at a time when asset owners are pouring more money into private equity in search of higher returns.

“There is so much capital chasing top funds now that in terms of fee and expense negotiations, the best general partners have the upper hand,” said John D. Skjervem, chief investment officer of the Tigard-based Oregon Investment Council, which runs the $68.1 billion Oregon Public Employees Retirement Fund.

"Persistently low stock and bond returns are pushing investors into ever-higher private equity allocations," he said.

Even the largest investors can no longer dictate terms.

Michael Moy, a managing director and member of the board of directors in the Mission Viejo, Calif., office of alternative investment consulting firm Pension Consulting Alliance Inc., said one limited partner cannot force a private equity manager to change its fund terms.

"I don't care how big it (the limited partner) is," said Mr. Moy, speaking at the Pension Bridge Conference in San Francisco in April.

"Short of collusion, I don't know that you can amass that muscle," Mr. Moy said.

TorreyCove's Mr. Fann says it's simply a broken supply-demand equation. The vast majority of investment funds have hard caps, so whether they want to or not, limited partners are competing for the prized spaces in these hot funds. "The very best funds on the market are reverting back to premium terms and conditions a la 2007. Most LPs are frenemies. As a result, public pension LPs are forced to choose between holding the line on economic, structural terms, or transparency issues in a high-demand fund and risk being tossed out, or simply being acquiescent," he said.

"If investors (pension funds) want to compete with endowments and foundations, they have to accept the terms," Mr. Fann added.

At the same time, lawyers working for some of the hot managers are using a divide and conquer approach with limited partners.

While there are private equity firms attempting to ensure a level playing field, many are playing hard ball, said Mary T. Hornby, managing director and general counsel at New York-based private equity fund-of-funds firm Abbott Capital Management LLC.

Playing hardball

Some general partners "go out with terms that clearly are just an attempt to start with the best terms the GP can get and they figure they will make the LP ask" for concessions, she said. "It is more of the legal adversarial approach like in a courtroom."

And discounts are fading away for investors who make commitments by the fund's first close, as has been standard since 2008.

It's very much case-by-case but "truly strong performing GPs have a much better chance of raising their desired capital base on terms which may not include fee discounts for either size of LP commitment or other considerations such as first closing timing," said Jonathan D. Roth, president of Abbott Capital.

There are fewer first-close incentives for investors, agreed Lori D. Campana, partner in the Boston office of alternative investment placement agent Monument Group Inc.

Still, Ms. Campana maintains "the balance of power didn't shift, it became an even playing field."

General partners that wanted larger funds with a stable investor base realized the "market was setting the terms for them," she said.

There are fewer first-close incentives not because it is easier to raise capital, she said. "There are fewer first close incentives because if existing investors have been happy they will commit prior to the first close."