In a recent blog post, we traced this decade's historic shift in the balance of power between private equity investors (commonly referred to as limited partners, or "LPs") and the operators of the funds that put the LPs' money to work (General Partners, or "GPs").

In this content piece, we are returning to expand on the topic, as shifts in this relationship hold deep implications for all entities in the private equity marketplace, particularly fund operators who already face a crowded, competitive landscape and significant upward pricing pressure on deals.

A "Wild West" History

Early iterations of private equity boom-bust cycles tended to generate big headlines and captivating storylines that resulted from the sort of no-holds-barred, "Wild West" investing atmosphere that was inherently unattractive to conservative institutional investors.

- The 1980s saw a series of increasingly large LBOs of well-known companies and brands, often characterized in the media as "hostile takeovers", transactions that were fueled by easy access to high-yield debt in the form of junk bonds
- Large corporate takeovers went out of fashion after the collapse of the high-yield debt market in the early 1990s, but the emergence of the Internet as a consumer entity at that point spurred a venture capital boom and the IPO-driven Internet Bubble of 1995-2000

It was only in the so-called "third private equity boom" of the 2000s that the asset class began to evolve and mature and the sector became attractive to institutional investors. Regulations passed in the wake of a series of corporate scandals at publicly traded U.S. companies in the early 2000s made private ownership more attractive for many companies while decreasing interest rates and loosening lending standards after 2001 further spurred the PE boom.

Those years saw institutional investors begin experimenting with allocations to private capital vehicles operating across the VC, middle market and large-cap sectors. Generally speaking though, commitment checks were relatively small and GPs were in control; in this era, they did not negotiate terms or offer LP reporting beyond high-level quarterly or even semi-annual overviews that rarely offered anything more than a top-level balance sheet perspective on activity.

The Industry Matures: 2010 to Present

We're now nearly eight years into the current private equity cycle, which began in 2010 in the wake of the 2007-08 credit crunch and subsequent Great Recession, and the landscape of LP-GP relations is radically different from any previous time in the history of private equity.

The Wild West days are over. In this new, more institutionalized private equity world, LPs' requests for greater transparency and detail about how their capital is being used are backed by larger checks and standardized reporting regimes that have the backing of key industry associations like the Institutional Limited Partners Association ("ILPA").

At TresVista, we're proud to provide support services to both GPs and LPs to meet the demands of this new world and allow GPs to focus on investing, relationship building, and adding value to portfolio investments.

Institutional Investors Depend on PE's Returns

One key to the shifting landscape this decade has been the fact that private equity emerged relatively blameless from the financial shocks that rocked the U.S. and world economy in 2007-08. The real estate-driven crisis tipped the U.S. economy into its most severe downturn since the Great Depression and scarred institutional investors, who watched entire livelihoods and retirement nest eggs in their care evaporate nearly overnight.

The nation's largest public pension fund, the California Public Employees' Retirement System, took a $100 billion loss in early 2009, losing nearly 40% of its value in the process. This came after years of chasing gains in the real estate market; CalPERS reported a 1 year loss of 48.8% on its real estate portfolio in mid-2009.

In the aftermath of the 2008 meltdown, CDOs and CLOs became four-letter words for investors. And while private equity portfolios and fund formation were negatively affected in 2008-10, the low-interest rate environment that has prevailed in the years since has been a boon for LBO activity. For institutional investors, it is now conventional wisdom that significant private equity commitments are a necessity to generate fund returns in excess of the market benchmark.

No entity better exemplifies that new approach than CalPERS, now valued at $361.5 billion (up from $200 billion eight years ago).

"Private equity is the only asset class projected to provide more than 7% return over the next 10 years," CalPERS Chief Investment Officer Theodore Eliopoulos told the fund's investment committee in June. In fact, final figures for the fiscal year that ended June 30 showed the system's private equity program with a return of 16.1% for the year.

Eliopoulos has discussed moving the system's target for private equity allocations from its current 8% of the portfolio to 10%. As part of the growing allocation, management has proposed establishing a separate direct investment arm without which they believe the target allocation would likely shrink to half the long-term target level due to competition from other institutional investors, and cost nearly $15 to $20 billion in investment earnings over the next two decades.

That makes private equity a cornerstone of the system's quest for annual returns in excess of 7% -- the return needed for the 71%-funded pension to meet its obligations to public retirees and their families in the nation's most populous state.

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In the 2000s and even the early years of the current cycle, CalPERS private equity checks were often in the $100 million to $250 million range. But as the current cycle has heated up, the size and number of those checks has increased, peaking most recently in 2014, when the system committed more than $3.9 billion in capital, including five fund commitments of $400 million or more. In 2018, the system aims to put $6 billion to work in private equity.

Similar trends can be seen at the other end of the country, where between the 2012 and 2017 fiscal years, the public employee New York State and Local Retirement System (NYSLRS) boosted alternative investment committed capital by nearly 40%, from about $31 billion to $43.2 billion.

Like CalPERS, NYSLRS noted in its 2017 annual report that it counts on it PE portfolio "to generate long-term returns that exceed those of public equities." As of March 31, 2017, the program was generating 1, 3 and 10 year returns of 7.8%, 11.0% and 8.8%, respectively.

New Demands for GPs

That being said, the scars of 2008 are still felt in the LP world, with LPs now much more vocal in their demands for portfolio transparency, selective co-investment opportunities and clawback provisions that offer an opportunity for oversight.

Studies over the years have noted the remarkable persistence of the traditional "2 and 20" compensation structure for private equity GPs (who generally take for themselves a 2% management fee plus 20% "carried interest," the return on investments that out-perform the preferred return promised to LPs). Though "2 and 20" remains the standard, recent years have seen LPs start to demand more creative fee structures, including features like clawback provisions that cover LPs' downside, reporting requirements that promote transparency and co-investment opportunities that give LPs additional upside exposure.

Let's take a look at the major areas where LPs have succeeded in winning gains over the last decade:

Transparency & Reporting

- In the old days, a private equity fund's reporting might have been a simple, twice-yearly statement listing the starting capital balance, called capital for the period, P&L, expenses, investment balance and outstanding capital. There was essentially no visibility into the operating status of portfolio companies, let alone the prospects for the eventual realization of gains or losses on those investments
- Since 2011, the Washington, DC-based ILPA has promulgated a series of standards for private equity reporting designed to promote "transparency and alignment of interests between private equity investors (LPs) and the managers with whom they invest (GPs)." Initiatives have included the development of a set of guiding principles, a template for notifications regarding capital calls and distributions, a set of quarterly reporting standards and, in the last two years, a standardized template for the quarterly reporting of GP fees and expenses
- The existence of ILPA standards and, more recently, the reporting template, has greatly strengthened the hand of LPs seeking greater insight into how their capital is being put to work and what they are paying for that privilege. For funds, adherence to the standards ensures they speak a "common language" that can be understood across their array of institutional investors. TresVista is an active endorser of the ILPA reporting templates as part of their services
- Additional ILPA initiatives have included the creation of a standard subscription agreement template, a standardized due diligence questionnaire for LPs to use in researching funds and best practices for GPs in their use of subscription lines of credit to smooth cash flows, which can exert downward pressure on LPs returns

Clawback Provisions

- In recent years, more LPs have insisted on the inclusion of clawback provisions in their investment agreements. Because of the relatively long lifespan of most funds (7 to 10 years), GPs generally like to be paid the carried interest on big "wins" that occur early in the life of a fund rather than wait another 3 or 5 years for their payout. But that can create a bind for LPs: What if later investments incur losses and the overall fund ends up falling short of the preferred return that they were promised? Clawback provisions are written to give LPs the ability to recoup "excess" carried interest distributions made early in the life of a fund that falls short of expectations, to normalize returns for all parties across the life of the fund

Family Office & Infrastructure-Heavy Approaches

- One key lesson of 2008 for institutional investors, particularly at the larger end of the market, was the need to professionalize investment procedures. A number of firms have taken substantial steps this decade to build the back office, adding the staffing and policy infrastructure necessary to know where their money is going and how it is being used
- Once you have all this professional knowhow in-house and on the payroll, the logical next step is to put those research capabilities and investment prowess to work in the form of direct investments. Those can take the form of family office-style direct investments, co-investments alongside GPs or even investing funds on behalf of peers

Co-investments

- The attraction of co-investment for an institutional investor is obvious. It often gives the investor better economics on a given transaction, a governance role in a company and an up-close view of operations at the portfolio company level – not to mention the ability to observe the GP in action. Large funds like CalPERS, the Teacher Retirement System of Texas and others specifically cite co-investments as a key part of their PE investment strategy. The California system made 22 co-investments totaling $290 million alongside PE funds in fiscal 2017, up from 11 co-investments totaling $190 million in the prior year

Responsible & Impact Investing

- Political gridlock in Washington and the relatively slow-moving legal system has given rise to increasing pressure on all corporate entities, public and private, to behave and invest in a "socially responsible" manner. The ILPA's due diligence guidelines include a lengthy section of Environmental, Social & Governance questions that encourage funds to create and maintain a "responsible investment policy" and ESG-type concerns continue to gain traction and push the industry in the direction of greater transparency

Acceptance of Secondary Deals

- The current cycle also has seen growth and acceptance of a broad market for secondary private equity interests (that is, LPs selling or otherwise transferring private equity commitments to so-called "secondary" buyers). In the past, such deals were often seen as a negative signal on the part of the LP, but by early 2018, the Financial Times was reporting $40 billion in secondary transaction volume for just the second half of 2017, up from about $40 billion in deal volume for all of 2014. The secondary market is now viewed as a generally acceptable tool for restructuring or rebalancing LP portfolios, while some GPs have even turned to secondary transactions as a way to restructure their fund infrastructures

Fee Structures

- We are slowly seeing a shift away from the long standing "2 and 20" fee structure. As firms rethink fee structures, they're devising out-of-the-box ideas such as early-bird discounts or providing LPs with a hand in fund governance. We have witnessed this within our client base and have further delved into this industry trend in a recent blog post

ILPA Leadership

The Institutional Limited Partners Association traces its roots to informal networking meetings among LPs that began in the 1990s; it wasn't until 2002 that the group formally incorporated as a not-for-profit trade association for private equity investors and appointed a board of directors.

It is only in the current cycle that ILPA has begun to exercise true leverage in the industry, a reflection of the group's growth and the maturing and institutionalization of the private equity marketplace.

ILPA membership increased by double-digit percentages in 2015, 2016 and 2017; as of early this year, the group's 450-plus members represented more than $2 trillion in private equity assets. CalPERS, the Canada Pension Plan Investment Board, the Employees Retirement System of Texas, the Washington State Investment Board and the Alaska Permanent Fund are among the major LP investors active in the group.

Introduced in early 2016, ILPA's fee reporting template was an immediate hit with LPs looking for greater insight into the costs of their private equity relationships. Fifteen months into the effort, ILPA reported that more than 160 fund managers had submitted information using the template, among them big names such as Apollo Global Management, Ares Management, Bridgepoint, Carlyle Group, KKR & Co. and Oaktree Capital Management.

As noted above, the group followed the success of the reporting template with additional templates for standardized subscription agreements and due diligence questionnaires. And it continues to evolve and respond, with an updated set of due diligence questions expected this fall in response to corporate sexual harassment scandals and the #MeToo movement.

The Road Ahead

Going forward, most observers expect no rollback of this decade's move toward greater private equity transparency. If GPs, having won over institutions, are to expand their universe of potential investors to high net worth individuals and single-family offices and, ultimately, the mass retail market (which would require an SEC change to the current rule that only accredited investors may invest in PE), increased transparency will have to be a permanent reality. The ILPA seems well positioned to continue as a leader in that effort.

In the meantime, institutional investors, having gotten a taste of direct investing and having built out their own infrastructure for monitoring their investments, seem unlikely to retreat. Co-investments should continue to rise, along with direct investments by LPs into GP management companies. Both approaches allow institutional investors to participate alongside GPs rather than as purely fund investors (and to avoid the fees associated with fund investment).

Also seeing increased popularity are Separately Managed Account structures in which a third party manages a bucket of capital that is more focused on niche opportunities than a traditional fund of funds structure and that might also include co-investments. An SMA structure allows institutional investors to put private equity money to work on their time horizon – which usually is a longer-term view than the traditional 5- to 7-year window of most PE funds.

Of course, international regulatory scrutiny of private equity funds has stepped up considerably this decade. The 2010 U.S. Dodd Frank legislation that first required PE funds to register with the SEC has been followed by FATCA (the Foreign Account Tax Compliance Act) which requires funds to report U.S. investor and account holder details to the IRS); GDPR (the European Union's new data protection regime); and MifID II (another set of EU regulations aimed at increasing transparency across European financial markets).

And while the current administration has raised the prospect of mass deregulation in the U.S., particularly in financial markets (beginning with the tax overhaul), the approach so far to legislation and regulatory change has been anything but predictable.

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Conclusion

The decade since the U.S. credit crisis has brought meaningful regulatory changes to private equity, along with increased competition and opportunity as well as new demands for transparency and flexibility. The "Wild West" days of the 1980s and 1990s are long gone, and in this case, greater responsibility has resulted in greater power in that private equity influence over the economy and within the investment community is at an all-time high.

We see two primary possible pathways for the evolution of the LP-GP relationship over the next 5-10 years. Path One assumes no significant changes in overall market dynamics and returns from private equity investing. In this scenario, the current "war of attrition" between LPs and GPs continues where LPs try to nibble away at the margins of GP control, scrutinize manager selection more closely, negotiate preferential investment terms and fee structures that are more aligned with performance, and continue to push, via the ILPA, for structural changes in the overall direction of greater transparency and accountability by GPs. This path will continue to see LPs gaining more clarity and control over their investments and GPs bringing to the table greater transparency and reporting standards.

Path Two assumes the increasing relative attraction of private equity as an asset class along with superior returns that might gradually tip the scales of power and influence back toward the GP community. We don't necessarily expect reduced transparency in conducting business, given the continued blurring of lines between LPs and GPs, although economics in this scenario could certainly favor the GPs through favorable fee and carry structures. We have already started to see some of the larger PE firms move in this direction, as witnessed by economics on recent fundraises.

At TresVista, we are positioned to serve the needs of GPs and LPs regardless of market conditions. Our teams of Wall Street-caliber professionals integrate with your operating strategies, adhere to industry best practices and deliver best-in-class outsourced support across the functional areas of your organization including deal diligence, business development, investors relations, portfolio management and CFO office support. By lowering costs for recruiting, training and retaining in-house resources, we allow clients to focus their efforts on their ultimate value add – the ability to recognize and act on market opportunities.