# Finding value in PE markets

Market insight report

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# ESG reporting

## When it comes to ESG reporting, we shouldn't let *pretty good* be the enemy of *perfect*

In his **2020 letter to CEOs**, BlackRock CEO Larry Fink wrote that the investment risks presented by climate change "are set to accelerate a significant reallocation of capital, which will in turn have a profound impact on the pricing of risk and assets around the world".

ESG risks are now becoming as important to the way managers think about their portfolios as traditional market-related investment risks, prompting many PE firms to consider what is most important to them, from an ESG perspective, and how best to codify it within their ESG policy.

In his letter, Fink goes on to say that resilient and well-constructed portfolios are essential to achieving long-term investment goals: "Our investment conviction is that sustainability-integrated portfolios can provide better risk-adjusted returns to investors. And with the impact of sustainability on investment returns increasing, we believe that sustainable investment will be a critical foundation for client portfolios going forward," he wrote.

It is hard to disagree with the fact that today, ESG factors represent a secular trend that is only going to continue to evolve over the next decade. In times past, there have been various moments of interest, in an investing context, such as portable alpha and 130/30 strategies, which became all the rage among investors, only to then fizzle out.

But ESG investing, and the myriad implications associated with it, is no fad. This is now a bona fide core element of how institutional allocators assess private market managers.

"ESG really is the question of the hour," says Howard Eisen, Head of Fund Services Sales for North America, TMF Group. "I would say this feels more durable and more structural and that it is not simply a fad. Rather, it is an ethical and existential issue for a growing number of people."

Major financial institutions like BlackRock are taking a lead on ESG, paying careful attention to how they integrate ESG factors into their fund portfolios and focusing intently on ESG. They have to, given that they expect companies they invest with to do the very same thing.

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And whereas in the early days of ESG investing, say 15 years ago, there was a fair degree of scepticism over why fund managers would seek to prioritise sustainability, potentially diluting the financial returns on offer, this mind-set has increasingly faded into the background.

"When ESG first came to the forefront, the biggest argument against it was whether the components of ESG were compatible with return expectations sought out by investors. There were many people who did not see the consistency and that if you put ESG factors ahead of fundamental factors when investing, you would reduce returns. How could you elevate virtue over profit and have that be commercially viable?

"The world is now broad and diverse enough such that there are opportunities to make money if you keep ESG factors high, if not at the top, of one's list of priorities," says Eisen.

One of the unique challenges, however, is that while there is a surfeit of information in the public markets, with technology providers able to create a consistent framework to rank ESG factors, there is no uniform way of gathering and reporting ESG data within private markets.

Nobody yet agrees on what is the right set of ESG factors and even if they did, there is still no consistent way to efficiently gather, rate and rank ESG information.

"Both on the GP side and the allocator side there is a continuing and steepening slope of attention and resources being applied to ESG. People are attempting to engineer solutions so that a PE or VC manager might be able to gather and apply ESG data in a consistent manner across their portfolio. The best approach is to have an independent body – similar to say ILPA – rather than a commercially driven organisation, to develop an ESG reporting standard, with input from industry participants," argues Eisen.

Of course, there are ways for GPs to demonstrate to investors that they are taking ESG risks seriously in their portfolios, such as by asking companies to adhere to SASB reporting, or by demonstrating to investors which UN Sustainable Development Goals their strategies are aligned with. Indeed, the Task Force on Climate-related Financial Disclosures (TCFD) is helping to drive adoption of ESG reporting among corporates, both in public and private markets.

This is certainly helping to bring ESG transparency to a higher plane, but private markets remain at some distance from arriving at a uniformly agreed-upon ESG reporting standard.

As Eisen is quick to point out, this is a fast-evolving concept and the goalposts will inevitably move.

"Like so many other things, the best way to tell how this is going to play out is to follow the money. The managers are focused on expanding their client base. And if a growing amount of money, and a growing number of allocators, are elevating ESG considerations within their investment programmes, there is no question that the economic incentives to managers mean that they have to commit resources to this.

"If you go to the websites of large allocators who really embrace ESG, such as some of the large university endowments and public pension plans, they themselves are fairly vague with respect to this issue of an ESG standard.

"It starts at the top of the food chain with national governments. The Paris Climate Accord is the closest we've come. You have different regulatory regimes in the EU, the US, Latin America, Asia and if we can't agree on regulatory issues, which tend to be fairly black and white, how are we going to arrive at a uniformly accepted standard on ESG issues, which are not black and white?

"We will make progress but I doubt that we will ever achieve global harmony on ESG that every country, and every investment firm, accepts. We're going to have to accept the fact that we shouldn't let pretty good be the enemy of perfect," explains Eisen.

TMF Group's global clients have started taking ESG issues more seriously, across all shapes and sizes of manager, according to Eisen. If investors want more ESG transparency, managers have to respond in kind.

"Investors want to see these issues advance and if you're an emerging manager in growth mode, or a mid-sized manager aspiring to the next level, you're going to want to make sure you can respond to investors' needs," he says.

And even though private market managers have to work hard to overcome the issues of how best to gather and rank ESG data in a consistent manner, it is not as if there is a lack of data. Indeed, ESG data provided by both public and private companies continues to improve.

One of the questions managers need to ask themselves is how best to apply ESG data across their fund portfolios, which might hold a diverse number of assets spanning industrial, software, healthcare sectors and so on.

"The data is available but it will depend on the following: a) how efficiently it can be extracted; b) what are the standards that you determine to be the most important? and c) how is the data applied consistently to get an ESG ranking that makes sense across the entire portfolio, from Fund I through to Fund XX?

For managers and allocators alike to make sense of ESG reporting, and to meaningfully apply benchmarking, it will be necessary to rank different parts of the portfolio, at the individual sector level, using an ESG taxonomy; especially for generalist PE funds. For a specialist healthcare-focused fund, for example, the same ESG ranking could apply at the wider portfolio level.

"For me, it really comes down to addressing the disparate opinions of what is important under the ESG umbrella, and how to apply ESG rankings to different companies operating across industry sectors," states Eisen.

He adds: "You could make a bold statement in your ESG policy that you only invest in companies using supply chains that have no association with human rights abuses. But how does that apply to an advertising agency, for example, where there is no supply chain?

"There can't be a one-size-fits-all approach. I think there will need to be a taxonomy that can be applied by GPs in different ways to different companies, based upon sector, product...things like that. But the question will always remain: 'What is important to you?' Is it more important to have gender diversity in senior positions? Is it more important to lower your carbon footprint, or to ensure there are no human rights issues related to corporate supply chains?"

There are so many facets to how managers need to think about ESG factors. But one thing is for sure: this is a trend that shows no sign of stopping. With climate risk, diversity and inclusion, and closer scrutiny on supply chains, all coming to the fore in recent times, managers cannot afford to take their eye off this increasingly relevant, secular theme. ■

# The role of technology

## Has technology helped managers to remain operationally robust?

2020 was arguably a defining moment for the private funds marketplace, as technology – or more broadly, digitalisation – helped fund management groups maintain business as usual in the face of extraordinary circumstances.

In the main, firms had already been on the path towards digitalisation to varying degrees, and had the technology in place, prior to Covid-19; but what the pandemic did do was to accelerate the pace of adoption to support operational activities.

"It's really been a case of making sure the infrastructure was there to enable a broader business use of technology tools such as MS Teams, Slack, etc. Do they have the bandwidth in their infrastructure? This is something global firms have had to look at over the past 12 months," comments Oliver Sinclair, Funds Services & Capital Markets Application Portfolio Lead at TMF Group.

Technology is becoming an adjunct, an enabler to support GPs, as they steadily modernise their operating model. And while it is difficult to offer broad generalities on the pace of technology adoption, there are a few key areas where technology has made its mark over the last 12 months: 1) Virtual fundraising; 2) Virtual ODD; and 3) Virtual AGMs. The question is, to what extent will these activities remain in the virtual realm. Will they represent long-term change, or a temporary solution?

### Virtual fundraising

On the issue of virtual fundraising, which has enabled GPs to better connect with their LPs without the inefficiency of global travel, it has been a game changer. For example, UK-based Tenzing Private Equity, a tech-focused investor, was able to raise GBP400 million in just nine weeks, without conducting any face-to-face meetings, as reported by Private Equity International on 7 September 2020.

Another example is Waterland Private Equity Investments, who closed Waterland Private Equity Fund VIII with a hard cap of EUR2.5 billion in three months in a fully virtual capacity.

This is evidence of video conferencing technology improving productivity levels.

"I would say a fund marketer is going to have a much higher success rate with existing investors," says Howard Eisen, Head of Fund Services Sales for North America, TMF Group. "For new investors, it is hard to establish anything more than introductory relationships, in the virtual realm. There's an old saying that people do business with people they want to do business with. I don't think the virtual environment is the right format to really get to know a new manager."

He goes on to suggest that a first derivative impact of technology on the current environment is how technology has enabled the flow of documents – i.e. the subscription process, the capital call process – and reduced the amount of friction, "to allow managers to continue to operate and raise capital in this environment".

Anja Grenner is Head of Fund Services Sales for Luxembourg, TMF Group. The Grand Duchy is a popular fund jurisdiction for many of the world's leading private equity and real estate groups, as well as an increasing number of new managers. Grenner observes that last year many of the new managers extended their fund launch dates and fundraising activities into Q1 and Q2 2021.

"They knew that without making the acquaintance of investors it just wouldn't work," says Grenner. "For

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> Oliver Sinclair

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established fund managers, we’ve noticed that investors have tended to stick with them as they’ve sought to concentrate their PE portfolios. What this ultimately means is that the big managers keep on getting bigger and vice-versa. Fundraising as such seemed to be pretty good last year, with managers able to raise higher amounts for their latest funds compared to previous vintages. One can do many more virtual meetings in a day compared to travelling from city to city, so in that respect, technology has certainly made fundraising more efficient. That’s good for the industry, as private equity continues to mature and industrialise.”

As well as improving fundraising speed, established managers have also sought to leverage video technology to get closer to their portfolio companies, hosting more frequent online meetings with management teams to keep on top of operational issues. According to Anibal Wadih, Founder and Managing Partner of Brazil-based GEF Capital Partners, this has fostered a greater feeling of shared responsibility.

“It was a case of saying: ‘Let’s focus on the immediate operational issues, and fix them’. We organised calls among all of the CFOs of our portfolio companies during the early period of the lockdown to talk and exchange ideas. Then we did the same with the CEOs.” He says that GEF Capital plans to introduce this collective idea-sharing approach on a permanent basis going forward.

### Virtual ODD

Much like the fundraising process, one might expect virtual ODD to have long-term benefits only for those with an established reputation and track record in the industry. First time fund managers can’t expect prospective investors to get comfortable with their operational – and investment – processes without meeting in person. There will be limitations to how investors are able to get under the hood of such managers: investment committees have a fiduciary responsibility after all.

An investor needs to know what makes people tick, what their personalities are. They can’t achieve that by looking at someone on a computer screen.

“With regards to virtual ODD, there is a degree of consensus that this is acceptable for managers with whom investors already have longstanding existing relationships,” states Eisen. “It only requires doing due diligence on the manager’s latest fund vehicle, which is far easier to do if they’ve already invested in Funds I and II, for example. However, it does not prove to be as serviceable for new managers, to whom investors have never allocated capital before, and do not have a rapport with.”

**GCM Grosvenor**, the Chicago-based global investment and advisory firm, points out that “many investors fear that without the opportunity to meet a manager face-to-face, watch their body language, assess their culture and tour their offices, the evaluation of that manager may be incomplete, and thus presents risks”.

From an efficiency perspective, virtual ODD allows investors to schedule more frequent, focused meetings, not just with a GP’s operations team, but with executives across the organisation. If this is a new manager, initial groundwork can be done virtually, and give investors more time to assess operational processes and controls. The same is also true for PE firms at the pre-investment stage, when analysing the merits of a potential deal.

Video calls can help to remove some of the usual vagaries of in-person meetings and prioritise key items or risks. Then, if the investor needs to complete the negotiations in-person, that final stage of the ODD process should be smoother. But, for allocations to managers with whom they have not previously invested, it will be rare for investors to become comfortable with either the investment process or operations without some in-person, on-site interactions. Ultimately, any remote due diligence process will need to be comprehensive and provide investors with as much confidence as possible in how the manager negotiates, sources deals, reports and maintains governance controls.

### Virtual AGMs

According to a Rede Partners Covid-19 Pulse Report in September 2020, 92% of LPs believe remote working will be more readily accepted in their organisations over the long term. The implication of this is that virtual AGMs will likely become a more permanent change to the way LPs interact with GPs in their portfolios. This will also extend to due diligence as they re-up with GPs.

"With virtual AGMs taking place, the air we breathe here in Luxembourg has never been cleaner!" smiles Grenner. "We have clients coming over to Luxembourg for board meetings from the US and Asia, as part of a wider business trip to meet investors and other service providers in Europe. I haven't seen any problems with virtual board meetings; but even though you can do everything online it still doesn't replace personal contact.

"That being said, while I doubt we will see managers going back to frequent travelling just for board meetings, I think many will nevertheless be keen to get back to having client and service provider meetings, to address fund-related issues. I hope we see an equilibrium struck between meetings that 'must' be done in person, and meetings that can remain virtual. But if we, as a fund administrator, have a good relationship with the manager, then virtual meetings are perfectly okay."

In Eisen's view, virtual AGMs might be an area where we see more enduring changes within PE groups, once we get past the pandemic: "Speaking to managers, a number of them have said 'We've had our AGM online and found we were able to make videos and show them to our investors, such as pre-recorded videos of our investment principals talking about what had transpired over the last 12 months. Our investors can log in to listen to them whenever they want.' Some PE groups have also used video presentations from CEOs of their respective portfolio companies."

Managers will want to re-establish close contact with investors and portfolio companies, post-pandemic, but video technology will allow them to be more efficient with their AGMs, going forward. "They can do part of it virtually, and compress the length of their AGMs, which sometimes go beyond just one day; video content will allow investors to do things in their own time. So I think AGMs will likely become a mix of physical meetings and web-based interactions," adds Eisen.

### Cloud technology has supported business resilience

One of the key conclusions to take away from the last 12 months is how technology – driven principally by adoption of the cloud – has made all three of the above trends so easy to adopt. They have, almost overnight, become standard practices. The fact that global finance has operated without any serious shortcomings underscores how vital a role technology now plays, in all areas of finance.

"There haven't been any breakdowns in service, from our perspective, because the amount of technology users has dramatically increased," comments Sinclair. "When MS Teams was first launched three years ago, there were complaints about how well it worked, whereas now it is industry-standard. If Microsoft hadn't improved MS Teams, 2020 could have ended up being a very different year for private equity groups – and the financial industry at large."

Not that remote working is without risks. Cyber attacks have spiked during the Covid-19 pandemic, as threat actors seek to exploit vulnerabilities in home office networks to attack financial institutions. This has necessitated the need for PE firms to rely on their service providers to provide strict IT controls when accessing and sharing data.

"That's part and parcel of this new way of working – the amount of security and AI-driven antivirus tools we

have to think about is becoming an increasing chunk of our infrastructure spend as we look to protect our clients' data from external threats," concludes Sinclair.

Technology has unequivocally played a key role in helping PE firms remain operationally robust over the last 12 months. Looking ahead, virtual functions and processes are going to become a permanent feature of the private equity model, with AGMs likely to be the biggest long-term change.

That said, one cannot overlook the importance of substance. Covid-19 pushed all substance requirements out of scope and it remains to be seen exactly how tax authorities will deal with the topic of virtual AGMs, in a post-Covid environment. In a worst-case scenario, it may force boards to revert back to attending AGMs in-person. ■

# Finding value in Latin America

Brazil provides PE investors with a real route to LatAm opportunities

When it comes to investing in Latin America's private markets, Brazil leads the way, accounting for 58 per cent of all Private Equity and Venture Capital investment in 2019, according to the Association for Private Capital Investment in Latin America (LAVCA).

Some of the notable deals completed last year included: SoftBank acquiring shares worth USD344 million in Banco Inter; Brookfield Asset Management's USD1.8 billion acquisition of Ascenty, a Brazilian data centre operator, in a joint venture with Digital Realty; and HIG Capital's acquisition of glassware manufacturer Nadir Figueiredo for USD224 million.

On 20 September 2019, the Brazilian Federal Government enacted Federal Law No13,874 (Economic Freedom Act), which establishes the Declaration of Economic Freedom Rights, with the intention of stimulating economic activity by reducing government intervention in private activity.

This could well encourage greater investment activity among global investors. However, Brazil is not for the feint hearted. It is a complicated country in which to do business. For global asset managers setting their sights on tapping into LatAm's potential, Brazil – and more specifically Sao Paulo, the country's de facto business capital – is the go-to option for structuring onshore fund vehicles.

Mauricio Carmagnani, Commercial Director, International Markets at TMF Group, comments: "Countries like Colombia and Mexico tend to follow what comes out of Brazil and we see a wide number of global PE firms setting up their regional headquarters here in Sao Paulo."

When asked where he feels investors might find value in Latin America over the coming years, he points out that recent discussions in Brazilian law in relation to land investments, mean that foreign investment ownership could go beyond the existing 25 per cent limit.

"This has triggered a lot more interest among global real estate/infrastructure investors seeking to acquire not only corporate offices, shopping malls, etc, but also farmland that relates to the agribusiness (Brazil strongest industry).

"Brazilian utility companies are also interesting, in light of the renewable energy transition. There are good opportunities to invest in renewable energy assets. The infrastructure is good but at the moment these assets don't have the cash flows so Brazil is opening up to more foreign investment.

"There is a lot of untapped potential in Latin America. We are currently working on a large mandate with one of the largest global real estate developers, which is setting up a LatAm fund to deploy approximately USD600 million over the next five years. SoftBank is another example of a large investor, which has a USD5 billion fund investing here. Foreign capital has been invested into many infrastructure and large real estate projects with investor interest showing no sign of waning."

SoftBank has said it intends to deploy nearly USD500 million of the fund's capital into third-party venture capital funds. Reuters reported in September that it had sealed deals to invest in funds run by at least two venture capital firms: Brazilian firm Valor Capital and Argentina's Kaszek Ventures.

In the past few years, a lot of large institutional LPs, including Sovereign Wealth Funds, and renowned global

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Mauricio Carmagnani


asset managers such as BlackRock, CVC Capital, and Carlyle, have established investment offices in Brazil to set up domestic fund vehicles for the purpose of investing locally in Brazilian real.

Other investors don't have that ability, requiring them instead to set up an onshore fund in a developed jurisdiction like Luxembourg, which acts as the focal point for fundraising and investing into LatAm, and other global markets.

Luxembourg is very interesting when it comes to Brazilian funds because it has an excellent tax treaty with the country. On top of being an AAA jurisdiction, the well-established tax treaty between both countries, gives GPs and LPs a stable environment in which to operate. It's a very stable jurisdiction and Luxembourg has invested a lot of time in developing its relationship with Brazil.

> *In Luxembourg we have seen more interest to invest in Brazil, especially among European asset managers.*
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> Joel Cardenas

There have been several trade missions between the two countries and in 2018 Luxembourg opened its first embassy in South America in Brazil as part of Luxembourg's desire to ensure a more visible and operational presence of the Grand Duchy in Brazil in particular and, more generally, strengthen its political-diplomatic, economic and cultural relations with the South American continent.

Luxembourg is seen as a safe harbour when it comes to investing in Brazil, explains Carmagnani. In addition, Luxembourg for Finance sent a financial delegation to Brazil in 2016 and 2018 to promote a dialogue between both Financial Regulators and discussion among asset management, wealth management and capital markets participants.

Joel Cardenas is Director Client Services at TMF Group (Luxembourg) and Head of its LatAm desk. He notes: "In Luxembourg we have seen more interest to invest in Brazil, especially among European asset managers."

Much of Luxembourg's success, says Cardenas, is attributable to it becoming a global hub for cross-border investments, offering asset managers a wide range of investment vehicles; from non-regulated such as holding companies, semi-regulated such as the Reserved AIF (RAIF) to fully regulated investment funds including the SIF and the SICAR. Just like Brazil, it is important for managers to appoint local legal and fiscal experts to advise them properly," states Cardenas.

The complexity of the Brazilian tax and banking system means "this is not a marketplace for amateurs" remarks Carmagnani. He says: "Before planning to invest in the country, asset managers need to spend time to understand the way of doing of business before making strategic investment decisions. The country's fund market is well developed but you need to have good fiscal advisors to guide you through the best structures when looking to set up an onshore fund."

The most commonly used vehicle for private equity investments is the FIP (which translates as 'Investment Fund for Specific Purpose). A FIP does not have a separate legal personality: it is classified as a co-ownership and must be represented by its administrator. For direct real estate investing, the most common structure is an SPE; a company that may be incorporated in the form of a limited liability partnership or a Brazilian corporation.

"There are a number of vehicles one could choose to use, depending on the investment strategy. If an international manager wants to have exposure to the Brazilian real, they could set up a fund for specific purpose but it requires them to hire someone to act as the local GP. There are a lot of good quality service providers in Sao Paulo to help with the fund formation work and represent international PE managers as the local GP."

Language is a major barrier and also, Brazil does not allow international law firms to operate there so anyone wishing to set up a fund is required to use a local law firm to assist with the set-up process and liaise with the regulator; the Securities and Exchange Commission (Comissão de Valores Mobiliários or 'CVM').

There are representative offices of international law firms in the country but they serve only to facilitate the discussion between the fund manager and the local legal advisor. "It helps having the likes of Baker McKenzie and DLA Piper on the ground in Brazil to assist with this communication," adds Carmagnani.

Over the last five years, Cardenas says Luxembourg has seen "a growing number of Brazilian banks, corporations and investment companies either increasing their presence in Luxembourg or opening new offices". Santander Brazil, for example, opened a branch, while numerous Brazilian family offices have opened offices to increase their economic substance and oversee their investment activities from Europe.

"Luxembourg is an international place of business," says Cardenas. "Around 50 per cent of its population comes from overseas locations. The largest single immigrant community comes from Portugal, thus ensuring Luxembourg can support seamless day-to-day cooperation with Brazilian stakeholders."

According to Carmagnani, a number of TMF Group's Brazilian clients investing in Chile, Peru and Colombia are choosing to use a Luxembourg fund structure, due to the legal framework there and protections afforded to investors' capital. "I'm sure this will attract a lot of new players," concludes Carmagnani. ■

# Finding value in Asia Pacific

Analysing where investors look for opportunities in the wake of the pandemic

Asia Pacific's private market attracted USD117 billion in net capital inflow in 2019, led predominantly by private equity where fund raising topped USD94 billion according to McKinsey's Private Markets Review 2020. This represented a 25 per cent reduction year-on-year, led principally by closed ended real estate, which closed 2019 with a modest USD13 billion in fundraising; down 39 per cent on 2018.

The big question for the region now, among global investment groups, is where strategic value opportunities might reside in light of the fall in market valuations caused by Covid-19. One only has to look at oil prices moving into negative territory, crashing to the lowest demand levels seen in 25 years, to appreciate the scale of ongoing macro disruption.

Understandably, this has impacted confidence levels in the markets, as institutional investors scramble to manage their portfolios.

"The governments in each country are fighting hard to overcome this, and hopefully there will be some light at the end of the tunnel very soon. But how long this takes remains uncertain at this stage," says Patrice Lo, Commercial Director for Fund Services, **TMF Group**, based out of the group's Singapore office.

## E-commerce deal opportunities

Lo makes the observation that in such a populous continent – Asia is home to 4.6 billion people – the result of the lockdown has led to a huge shift towards people using e-commerce. This could mean an acceleration of the existing trend and as such present investment opportunities for global fund managers, "and in particular, how this relates to supply chain logistics management," says Lo. "We could well see different dynamics in this area going forward. India, for example, has already seen a lot of investment in logistics as it continues to build out a number of large logistics/industrial infrastructure projects."

According to the IMF, China's share in global e-commerce retail transaction value has risen to more than 40 per cent today from less than 1 per cent a decade ago. Asia's 12 per cent share of retail sales that occurs via e-commerce surpasses the respective shares of 8 per cent for Western Europe and North America. India, China and Indonesia, for example, lead the world in e-sales growth, yet less than 50 per cent of APAC's population is online. The potential for funds to back the right e-commerce companies to ride a further wave in e-commerce growth over the next decade represents a highly viable value proposition.

"Innovation in Asia is on the rise in terms of Fintech, which could pique the interest of global asset managers," says Patrice Lo, Commercial Director for Fund Services, TMF Group. "Overall, the population in most Asian countries is quite young. If you look at the size of mobile payments for instance, it far exceeds what you see in developed countries. India and China have led the way and there has been a real boost in Fintech. Many big multinational technology firms have a significant presence across Asia, and this has helped build a robust infrastructure. So I think this Fintech trend is something investors will be paying close attention over the next few months, and beyond."

To support investors and fund managers, TMF Group is one of the only providers servicing investment structures and assets across the region, with 28 offices in 15 countries, providing a holistic suite of entity administration services; while also providing fund administration services in Singapore, Mumbai, Shanghai, Hong Kong & Sydney.

## Take private deals

In many respects, Asia Pacific has been maturing strongly over the last decade, in the sense that returns and capital inflows coming into the region's capital markets have been on the rise. This is not necessarily true for its private markets, where fund raising has contracted for the last two years. That being said, this could be due to the high level of dry powder available to deploy, which totalled USD419 billion at the end of 2019.

"If you look at some of the biggest fund houses such as CVC, Blackstone and Soft Bank, they've accumulated a lot of dry powder over the last couple of years," says Lo. "Over the next few quarters, we hope things will start to settle down and this could present good opportunities for asset managers to find yield; especially with the reduction in valuations. There were talks recently of Soho China, the Chinese building developer, going private. We might see more take private deals happening in the market given the current situation."

Lo thinks that if private deals do start to increase, in response to increased M&A activity, another sector of interest for funds could be in Asia's healthcare sector.

"Fund managers will be looking at Asia's healthcare sector not only at the micro but macro level. Clean energy will also likely be an investment theme in the region."

In terms of putting the USD419 billion of dry powder to work, one word of caution for fund managers – be they domestic or global managers – is that competition to put that capital to work and complete on deals, could be challenging.

Lo notes that for established markets like Japan, there has been significant interest from private real estate fund managers on logistics and residential sectors applying their own asset management expertise to manage large

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**Patrice Lo**

scale developments. In China, over the last 15 to 20 years, there has been a lot of real estate development but going forward there could be a possibility to look at tech start-ups, fintechs and pharmaceuticals.

"India is still some way behind," he says. "Pension funds are looking at hospitality, logistics and industrial investment opportunities, aside from their commingled fund investments. And in SE Asia, countries like Malaysia are focusing on integrated infrastructure development and logistics."

### Increased buyout activity in Asia…?

GPs are using the cessation period caused by Covid-19 to strategise and prepare to put forward their investment objectives to LPs when there is a period of calm in the market. During '08 global financial crisis, a number of investment managers didn't survive due to liquidity issues and the largest players came through on top. A similar period of consolidation could happen again, and some smaller fund houses might get absorbed by larger groups.

This offers the potential for greater buyout activity in the region, which still lags substantially behind the US and Europe. Traditionally, private equity activity has centred on VC and growth investing, making up in excess of USD800 billion in AUM, compared to USD238 billion for buyouts; that is surely going to change at some point.

"Under the right conditions we may see an acceleration in buyout activity in Asia, relative to the US and Europe which have long been very established markets," suggests Lo.

"The M&A activity in Asia has not been as high but I think now there will be a lot of opportunities in terms of the fall we've seen in market valuations. Especially in the health sector, where there could be opportunities for consolidation across the region. Other sectors which could see more M&A activity are the aviation industry and shipping. A number of Asian shipping companies have historically been funded by private groups but some might look to re-strategise towards private equity capital."

Lo further adds that "at TMF Group, we are gearing up internally to support more M&A deal flow with our teams globally".

### Private debt outlook

One other potential area of finding value in APAC relates to private debt, where distressed debt opportunities could be significant in the wake of the economic shutdown.

Lo explains that while average returns for private debt funds have been on the low side for the last few years, compared to private equity or real estate funds, investors have still remained satisfied. Indeed, according to Preqin's Alternative Assets Investor Outlook H12020 report, only 11 per cent of investors surveyed in November 2019 said they were disappointed with their private debt portfolios.

"It is dependent on the expectations of the individual investor, and finding the right opportunities in the market. In the current environment, investors are looking for ways to deploy their capital effectively; especially in Europe, where investors have to deal with negative interest rates. I think global investors will look to the region to see if there are good opportunities for distressed assets. We expect to grow our private debt business over the next 12 to 24 months," states Lo.

Private debt was a bright spot for the APAC region last year, growing 23 per cent according to McKinsey's report. Sectors like aviation are likely to be the target of private debt investors, with air fleets around the world literally grinding to a halt. This is going to place huge financial pressure of airline carriers.

"For example, some of the major airlines in this region, which have been severely affected by the current environment are thinking of ways of raising new capital through rights issues, convertible bonds, etc. It depends how long the recovery takes but this could present an opportunity for private debt funds to step in, as well as international banks, to provide financing in the capital markets. We might see a gravitational pull of private debt to support the aviation industry," concludes Lo. ■

# Finding value through innovation

## Dynamic reporting and data visualisation tools are set to improve GP/LP relationships

The alternative fund management industry is witnessing a huge rise in the volume and diversity of data being ingested, as technology innovation facilitates firms in their research and portfolio construction activities; not to mention using advanced analytical tools to improve the quality of fund reporting.

Investment and advisory firms have pioneered the use of data science in private equity, using the cloud to process large data sets and build a picture of what is happening in a given business, minute-by-minute, day-by-day.

This is a golden age of data and analytics as asset managers start to increasingly use digitisation to find value in the marketplace.

Fund administrators are well aware of the rapid pace of technology innovation and are themselves evolving in line with the complex nature of fund structures and allocations within those funds.

"Coupled with the rapid pace of technology innovation, fund administration is using technology to approach the new complexities of fund structuring and investor types and needs," says Joanne Baudin, Head of Fund Services, TMF Group (Australia). "Fund administration is no longer just about book keeping but helping fund managers and their investors, through technology, manage their investment portfolio, with visualisations and analysis, help manage documents, data mine and explore information with metrics, etc."

As **Private Equity Wire** reported last year, the growth in data gathering by General Partners (GPs) on behalf of Limited Partners (LPs) is driven by the market developments and the regulatory focus on the space, leading more LPs to delegate the task of data management to their administrators. Increasingly, investors want more granular data on their investment portfolios, especially in respect to ESG criteria and key financial KPIs to better monitor performance.

In a **report** published by US technology group FIS, nearly half (48 per cent) of fund administrators say that asset management clients already routinely request or expect analytics and segmentation services as standard.

As a result, fund administrators, are focusing on becoming evermore technology-driven to best serve their clients.

Baudin says that while common administrative tasks such as keeping funds' general ledgers and tracking investors' commitment and standardised investor reporting are typically automated, other tasks such as ILPA (Institutional Limited Partners Association) reporting or INREV reporting, anti- money laundering (AML) and know your client (KYC) checks are becoming increasing automated.

This is largely thanks to blockchain-enabled technology, which is helping to improve data security and transparency by virtue of the immutability of the blockchain ledger on which AML/KYC data is held; in turn, this is enabling asset managers to speed up the subscription process as they seek to secure new investors for their funds.

When asked to provide one example of a recent tool/solution that TMF Group has introduced – either in the back- or middle-office – to illustrate how the firm is leveraging technology, Baudin explains: "We are making significant investments in automation of repetitive tasks in the spirit of our philosophy that technology should support our experts but not replace them. Holistically we are building an aggregator level within our application landscape, in which we take outputs from all the applications which we utilise around the globe, collating those outputs and producing real-time data on all aspects of a fund structure globally. Added to this we are developing a digital visualisation of this, so essentially a GP will be able to see the status of all deliverables in real time, from any device or location via a single harmonised platform, allowing the vertical connection of the funds stack from fund, to SPVs to OpCos.

"We have recently introduced KYC360 into our global application landscape, a state of the art tool that enables seamless cross boarder management of all KYC and AML obligations. It's a powerful regulatory compliance and risk management software package which we use for own KYC process and for the KYC services we provide for our Fund clients."

"KYC360 works on top of our existing infrastructure and systems, it works hand in hand with how we use for example Investran, which is a market leading fund administration system for private equity funds. A dynamic investor allocation tool, utilising multiple allocation methodologies in consideration of opt-outs, side letter agreements, deemed designated contributions, rebalancing, etc, Investran offers a comprehensive, standard and customised reporting system specifically designed for the needs and requirements of complex funds.

One important feature within Investran is a data mining tool to enable fund managers to analyse their portfolios and underlying portfolio companies as they seek to build in long-term value for their investors. Administrators who can smartly deploy technology based on the specific needs of their clients can, as a result, give some of those clients an edge in the market.

"Managers are able to deep dive into the data and analyse in greater detail as well as manipulate data according to their set parameters," states Baudin. "This means greater agility in investment making decisions and focusing on what managers do best; which is invest and divest."

*"We are making significant investments in automation of repetitive tasks in the spirit of our philosophy that technology should support our experts but not replace them."*

Joanne Baudin

Also, by using technology together with the administrator's robust workflow process and methodology, "will ensure that all the data points for accounting, portfolio tracking, and investor reporting are from the same source", adds Baudin. This alleviates the data integrity and reconciliation issues that might otherwise arise, and hence create better operational efficiency when it comes to data management.

In order for fund managers to optimise the true value of any new technology, it is incumbent upon fund administrators to have the right system architecture in place; one that can adequately support a wide range of technology tools in a single integrated offering.

Baudin currently sees data visualisation reporting tools as one important aspect of innovation, delivered through a digital platform alongside risk analytics and regulatory reporting. "Using a cloud data warehouse, we can integrate data across our services to provide automated regulatory and tax reporting and provide enriched visualisations via the platform to our clients.

This digital client experience will provide GPs and LPs with superior insights and dynamic reporting on the go and therefore allow them to make informed decisions via an interactive experience on their mobile phones or tablets," explains Baudin.

Of course, the wider implication to this, aside from helping fund managers better control their portfolios, is the improved level of transparency provided to institutional investors. This cannot be understated when one considers the growth and complexity of private market funds, which attracted USD919 billion in net new assets in 2019 according to **McKinsey's latest private markets report**.

With investments becoming more bespoke, technology is vital in handling the different investment terms, additional share classes and fund structures.

"GP/LP reporting will improve through document management centres where clients can manage investor capital activity documents, track investor document metrics and upload documents for investors. Notification alerts and security preferences can be built in for each investor," says Baudin.

The value of technology within fund managers deal teams looks set to continue over the coming years as artificial intelligence becomes more ubiquitous. And while in years past fund managers tended to favour in-house administration, there is, increasingly a realisation that outsourcing many of the middle- and back-office functions to a trusted fund administrator is now a sensible, cost-effective option.

"Technology is expensive and needs to be constantly updated. The administrator is continually monitoring industry trends and the associated technology to ensure that its services address the real needs of clients and their investors. By outsourcing the fund administration and accounting function – and not focusing on the mundane book-keeping tasks – with the aid of technology fund managers can focus more on bespoke LP reporting, and analysing/understanding funds' and investments' key performance indicators," concludes Baudin. ■

# Finding value in ESG

## An APAC perspective

ESG investing continues to gain momentum and prominence among global institutional investors as they increasingly look to benchmark not only the performance of funds in their portfolios but the impact they have on the world.

Mutual funds and ETFs with a focus on sustainability attracted USD20.6 billion in net inflows in 2019, four times higher than the USD5.5 billion raised in 2018, according to Morningstar. Within private markets, however, there is still a way to go with only an estimated one third of private equity firms signed up to the UN's Principles of Responsible Investment.

A **recent survey** conducted by Aberdeen Standard Investments found that North America continues to lag behind Europe and Asia Pacific, with Merrick McKay, head of European private equity at ASI, quoted as saying: "The general trend suggests that private equity firms are regarding ESG as increasingly important, with firms based in Europe leading the way." He added: "We are optimistic looking at results from firms based in Asia Pacific, with a number of respondents having implemented initiatives in the last year to improve ESG performance."

With BlackRock's CEO, Larry Fink, suggesting that climate change has become a 'defining factor in companies' long-term prospects', it is likely that ESG investing could become a mega trend in private markets over the next decade, as private market participants embrace ESG metrics into their investment strategies.

There are three key reasons to explain this ESG growth trend.

**Investor expectations**

Allocators are becoming more demanding and want to see evidence of ESG policies and how they are being implemented. Having a policy in place should not be viewed by managers as a simple check the box exercise; investors want to understand how they are incorporating ESG metrics into evaluating portfolio company performance, the level of engagement they have with management teams on ESG issues and so on.

Managers who can demonstrate a commitment to ESG are beginning to be seen in a more favourable light by investors, and this is helping to improve their fundraising profile on the global stage.

But as the ASI survey alludes to above, there remain regional differences in respect to manager adoption.

"I would argue the UK and Europe is perhaps a bit ahead of the curve in terms of asset managers adopting ESG factors into their investment strategies, compared to here in Asia," comments Seamus Fox, Commercial Director, TMF Group (Hong Kong). "However, increasingly Asia Pacific-based managers are taking ESG issues on board because there is increased allocator pressure, especially from investors who are more socially aware and involved in the activist space."

East Asia, he says, is probably a bit on the slow side when it comes to ESG adoption, "but when you look at Hong Kong and China, some of the larger asset managers are setting in place their own KPIs and running more specific ESG strategies. A number of large Chinese asset managers have become UN PRI signatories."

More than half of the top 10 Chinese mutual fund managers have become PRI signatories and interest has recently spread to private equity and the asset management arms of banks, according to the UN PRI's website.

In September 2019, Chinese insurer China Ping An became the first asset-owner signatory, which the UN PRI hailed as a "significant shift in the ESG landscape in China and beyond". It went on to explain that until that point, much of the demand for ESG integration in China had come from international investors, "coupled with China's politically mandated push towards green and high-quality sustainable development".

"I was speaking recently to a large allocator and they are putting measures in place to ensure that a percentage of their overall portfolio allocation goes into impact investments," explains Fox. "The reason being is they have their own end investors, and if they are pushing the agenda on social activism and sustainable finance, they have to respond in kind in terms of the types of investments they allocate to. Investors want to know exactly how their money is being managed.

"For Asia fund managers, the value of getting this right is that it opens more doors for fundraising, compared to those who don't have ESG as part of their strategy. Those managers that have a proven track record in strong corporate governance are well perceived in the market."

There is still work to be done with respect to how Asia managers can think about implementing best practices from their peers in Europe. It is more of a guidance issue than anything else.

"As TMF Group has a large global footprint, we can guide clients not just on what developments we see in Asia but also what we see in North America and Europe. In certain jurisdictions where there isn't much guidance at all, we try and share with clients what their peers are doing in other parts of the world," says Fox. He confirms that noticeably more ESG-dedicated funds are starting to be launched by managers in the region, as well as managers tailoring existing fund products to improve their ESG credentials.

"The only way you can actually fully be seen to be promoting ESG issues is by running ESG-specific fund products. Some managers are setting up impact investing funds and it is certainly something we are seeing a lot more of, especially for those Asia managers wishing to expand into Europe," confirms Fox.

> *"However, increasingly Asia Pacific-based managers are taking ESG issues on board because there is increased allocator pressure, especially from investors who are more socially aware and involved in the activist space."*
>
> Seamus Fox

**Regulation**

On 10 March 2021, asset managers will need to comply with the EU's Disclosures Regulation, which is part of Europe's long-term commitment to meet its climate change targets, and encourage the growth of sustainable finance. The purpose of the Disclosures Regulation is to bring greater transparency on how European asset managers integrate sustainability risks into their investment processes and convey those risks to their end investors.

The UK is expected to adopt these new disclosure requirements even though the transition period is due to end in December 2020 and the UK will no longer be wedded to EU rules. It too is making a commitment to improve ESG transparency and reporting, having last year introduced the Green Finance Strategy, which expects all listed companies and large asset owners to disclose in line with the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) by 2022.

In Asia, Hong Kong has itself taken a proactive stance. Its financial regulator,

the Hong Kong Exchange (HKEX), has moved quickly to tighten ESG regulations and is set to introduce new mandatory disclosure requirements with effect from 1 July 2020.

Under these new rules, companies will need to provide a board statement setting out its consideration of ESG matters; disclosure of significant climate-related issues which have impacted and may impact the issuer; disclosure obligation to comply or explain key ESG performance indicators, and published ESG reports within five months of the financial year-end.

"Hong Kong is seeking to align itself with global ESG requirements. The HKEX has changed its rules and made them much more stringent and it is also encouraging boards of directors to take on the reporting responsibility as well. The guidance being offered to Hong Kong managers is broadly in alignment with the Principles of Responsible Investment and that is what people are looking to follow more closely," says Fox.

For global private market participants, this shifting regulatory environment is pushing them to think about ESG factors more closely than ever before.

## Performance

A third key driver for the growth in ESG adoption among private market fund managers is the value associated with performance. Increasingly, there is evidence that sustainable investing in companies with high ESG credentials not only allows managers to demonstrate their commitment to making a positive impact, it also leads to better financial returns. Investors don't want to allocate capital and not enjoy a good return; they want it in tandem with real impact that can be monitored, benchmarked and quantified by the manager.

According to Global Impact Investing Network's Annual Impact Investor Survey 2018, total assets under management in social impact investing (SII) funds was USD228.1 billion, 56 per cent of which was allocated to emerging markets.

Morningstar's latest report, 'How does European sustainable funds' performance measure up?' says that a growing body of research shows sustainable investing has a positive effect on investment performance.

That is fine within public markets, but measuring the performance of sustainable fund products remains challenging in private markets because data is fragmented and there is still no standardised reporting framework for asset owners to avail of.

As such, performance analysis remains challenging for investors who are keen to guard against investing with managers who fall foul of 'greenwashing', marketing their funds in a way that champions ESG, in principal, but does precious little tom improve ESG at the individual asset level.

Interestingly, the whole debate around performance has been brought into sharp focus in recent months in response to the global pandemic caused by Covid-19.

According to data from Refinitiv, companies in the FTSE UK 100 ESG Select index – which comprises the top 100 UK-listed companies with strong ESG practices – outperformed the FTSE 100, since market sell-off began on 21 February.

"In Asia I would say it is still very much an alpha-driven industry," says Fox. "Performance has always been at the top of people's minds and if they can access good performing funds with a clear ESG component to the strategy, that is a win/win situation for them. There are impact funds that are less alpha-driven and will sacrifice alpha in order to achieve their ESG goals – but for the bigger fund managers, alpha generation is still a crucial factor."

By investing in high-growth industries such as food processing and recycling, or renewable energy, private fund managers are able to build long-term and improve valuation multiples. This is about delivering a strong IRR, at the Fund level, as opposed to doing so for altruistic purposes.

Looking ahead, it is likely that the impact Covid-19 has had on how we think about the environment – in terms of international travel and lowering carbon emissions – will accelerate ESG investing even faster than before.

"Covid-19 could impact infrastructure investing and accelerate the push toward electric cars and electric highways, which in turn will reduce carbon emissions and improve air quality in Asian cities. People don't realise how bad the problem is until it goes away – and that's something that people have noticed in recent months," concludes Fox. ■

# Finding value in EMEA

## Can the European Green Deal unlock opportunities for private equity investors?

When it comes to finding value in Europe, private equity funds have a large mosaic of investment opportunities to consider, given the jurisdictional, regulatory and market differences across the 27 EU member states (which now does not include the UK).

For private market investors, one of the ways to consider unlocking value is to see what is happening in Europe's renewable energy sector, which ties in closely to the European Green Deal; an ambitious initiative that aims to transition the EU to a low-carbon economy. One of the central goals of the Green Deal is to achieve bloc-wide zero carbon emissions by 2050 and a 50 to 55 per cent reduction in emissions by 2030.

Such is the scale of ambition that European commission president Ursula von der Leyen referred to as "Europe's man on the moon moment". Part of the plan to help the EU meet these carbon emission reduction targets, as laid out more broadly under the Paris Agreement within the United Nations Framework Convention on Climate Change, was the introduction of the **Renewable Energy Directive**. Briefly, this sets a new binding target for the EU to achieve at least 32 per cent of its energy needs from renewable energy by 2030.

The upshot to this is that Europe will require significant infrastructure investment over the next decade, and could present a slew of investment opportunities for PE funds to finance green energy companies.

"We need more investment into the green energy sector to meet the Paris Accord that European member states have committed to," says Timo Hirte, Commercial Director Fund Services at TMF Group (Germany).

Global investments in the renewable energy sector are expected to rise to USD3.4 trillion by 2030, including an estimated investment of USD2.72 trillion in solar and wind energy sectors, according to **Frost & Sullivan**'s latest research analysis.

These numbers are substantial but where might the investment opportunities be for investors?

According to a report by the **International Renewable Energy Agency** (IRENA), heating and cooling solutions account for more than one third of the EU's untapped renewable energy potential. They suggest that biomass will remain a key renewable energy source beyond 2030, and in respect to transportation, electric vehicles (including the construction of electric highways) will be need to realise the EU's long-term decarbonisation objectives.

In Germany, investment into green energy has slowed down due to the regulatory environment and difficulties with infrastructure approval.

*"There needs to be more interaction between EU member states to bring green energy to the areas where it is most needed."*

Timo Hirte

"For example, the German courts are preventing infrastructure building to support the movement of energy from offshore wind farms into the southern part of the country," says Hirte. "People want to see the increased use of green energy and recognise the need for getting energy lines in place, but the attitude seems to be 'Not in my back yard, please do it elsewhere'.

"There needs to be more interaction between EU member states to bring green energy to the areas where it is most needed. There is still a lot of room for investment, and need for investment, and I would expect that EU member states will incentivise private market investors. Otherwise, Europe will not reach its Green Deal goals."

Hirte confirms that some of TMF's clients are now preparing to launch new fund vehicles, primarily out of Luxembourg, to capitalise on the green energy revolution.

"One of my clients is preparing to launch the next vintage of their energy fund, which was delayed at the start of the year due to Covid-19. We are also busy onboarding a number of infrastructure debt funds," he says.

By way of a country-specific example, **one of the largest wind farms in Austria** is being built in Burgenland, which is expected to be completed by the end of 2021. The entire wind farm will have capacity

of 143 MW and provide around 90,000 households with electricity. The facility will be run by PÜSPÖK Group, a family-run business based in Burgenland.

To highlight the current investor demand for renewable assets, Foresight Group, an independent infrastructure and private equity investment manager, recently made the second investment by Foresight Energy Infrastructure Partners (FEIP), into two operational wind farms located in the Castile and León region of Spain.

This represents Foresight's second acquisition from subsidiaries of wpd AG ("wpd"), one of Europe's leading wind energy developers and operators, following the acquisition of a 50MW German wind portfolio in December 2018.

Richard Thompson, Partner at Foresight and Co-manager of FEIP, said: "We plan to secure independent EU Taxonomy verification for this portfolio which will make a visible contribution to the EU's goal of Net Zero by 2050."

Hirte believes that private debt structures will continue to be a key investment trend in Europe over the coming years. "There are more and more debt structures being established. It's a trend we've been seeing in Europe for a number of years as banks scale back their lending. Asset managers have sought to close that funding gap since the '08 financial crash.

"I would assume we will keep on seeing these private debt vehicles come to market," suggests Hirte.

**Schroders has just raised EUR312 million** for an initial close of its second pan-European infrastructure debt fund. It is aiming to raise EUR750 million in total.

The Schroder Euro Enhanced Infrastructure Debt Fund II (Julie II) is managed by Schroder Aida, the specialist infrastructure finance subsidiary launched by Schroders in 2015. "We continue to see exciting investment opportunities in the sub-investment grade infrastructure debt space and we expect to deploy this second vintage as efficiently as the first fund," commented Augustin Segard, Head of Enhanced Infrastructure Debt and Fund Manager.

For those who are looking to invest in Europe's green energy transition, Luxembourg remains the preferred jurisdictional option. A large number of global asset managers view the Grand Duchy as their European hub for international fund distribution.

"We do see a lot of US private equity houses using the Special Limited Partnership ('SCSp)," states Hirte. "The way the SCSp has been designed is very similar to what US managers are used to with a Cayman/Delaware structure; it is based on the Anglo-Saxon LP structure. A manager can combine the advantages of both the SCSp, from a legal structuring perspective, with the Reserved AIF, from a fund structuring perspective."

Luxembourg's fund universe is well represented, offering managers a range of regulated and unregulated options. The Specialised Investment Fund (SIF) is a fully regulated AIFMD-compliant fund, requiring an independent depositary and license approval from the CSSF, Luxembourg's financial regulator. As such, this introduces a double layer of regulation, impacting managers at both the AIFM level and the Fund level.

"However, with respect to the RAIF, Luxembourg does exactly what the AIFMD wants, which is purely to supervise the activities of the manager. The RAIF itself is not regulated. As long as you have an approved AIFM managing the fund, you save the fund regulation part, which allows for a speedier time to market. You don't need to wait for CSSF approval before marketing the fund," adds Hirte.

In his view, Luxembourg has done a good job creating a flexible funds environment for international fund managers.

"It started with the UCITS fund but the SIF is now also widely recognised across the globe. The legislator has also demonstrated that it is very flexible. When AIFMD was first introduced, the Luxembourgish legislator created the RAIF, the SCSp. It has always been able to adapt to new regulations very quickly. The jurisdiction has been able to attract a lot of expertise. There is a deep pool of qualified, international talent working in Luxembourg. There is also a well-established service provider infrastructure in place, which has been built over the last three decades to support managers' fund activities," explains Hirte.

With all of the key fund, legal and service provider blocks in place, Luxembourg is well-poised to support private fund groups as they seek out value in Europe over the next decade. Attracting private market participants will be key to Europe achieving its Apollo 11 mission, and realising its man on the moon ambitions. ■

# Finding value in the GP/LP relationship

Maintaining strong ties has become more important than ever with the current move towards remote working

Private equity investing has always been rooted in forging trusted relationships between managers and investors. Relationship building has been central to its success, but the impact of Covid-19 and the move to remote working has arguably put a strain on the GP/LP dynamic this year.

As such, maintaining strong ties has become more important than ever; not only to find value in financial terms, but also in terms of communication, transparency, and a willingness among GPs to evolve with the times, in respect to fee structuring.

Over the past couple of years, the pendulum has swung between an LP-favourable and a GP-favourable market. And despite record amounts of dry powder and seemingly faster fundraising cycles, the coronavirus pandemic has arguably brought the pendulum into equilibrium, as both parties take stock of the upheaval.

## Transparency on asset valuations

"One former colleague of mine who is now a COO at a private equity fund said that Covid-19 had really impacted some of their retail-focused investments in their portfolio," says James Morris (pictured), Senior Commercial Director, TMF Group (London). "One of the biggest pressures managers face is comparing performance with past years and fund vintages. This former colleague added, 'You've got to keep going with your strategy, and stay committed, to ensure your LPs remain loyal.' Keeping investors on side is key for GPs in this environment, especially if they are aiming to raise billions for new funds."

In the eyes of investors, GPs don't want to lose their reputation by having bad investments on their books. Some managers who were hoping to deploy some of their dry powder into opportunistic investments are now using it to support the financial health of portfolio companies.

Even if some underlying portfolio assets have been badly impacted by Covid-19, provided there is good communication and reporting, in terms of potential liabilities, it is likely to give investors the trust they need to continue supporting that GP.

GPs see the value of keeping LPs abreast of developments to strengthen the relationship and technology has been instrumental in this, as investors ask for different levels of transparency and bespoke reporting for conveying key performance indicators.

"What does technology involve?" asks Morris. "It's the output the LPs ultimately see, and it's an ever-evolving target with respect to GPs. It's expensive to do, it takes time to generate reports in the right format and so on. From an LP's perspective, if you are investing a lot of money with a GP you want to see some real clarity on what that investment looks like; short-term and long-term liabilities, potential gains, how the fund is performing from a risk perspective, etc.

"As an industry, I think the whole approach to reporting on real assets has been a little slow to catch up but some platforms are now gaining traction. Indeed, we have implemented a platform, which propagates all of TMF Group's data into one place for GPs to access. Real time access to all relevant information right across the investment structures empowers GPs to deliver that clarity and transparency to their clients."

Accurate valuation reporting is a key part of the value proposition today, given the dislocation in pricing in vulnerable industry sectors such as retail, energy, aviation, and commercial real estate. The near-term focus should be on adjustments to multiples and discount rates rather than long term projections so that LPs are clear on what the fair value of an asset is, should they need to go to the secondaries market to free up liquidity.

Going forward, Morris thinks there's a huge opportunity for more third parties who provide valuation expertise. "I think that the market will evolve if PE wants to be a more open, transparent market; to achieve this, investors will continue to want more information and this will rely on assets being accurately valued. LPs want much more transparency on valuations, especially in this environment."

Bespoke reporting will vary depending on the sophistication of the underlying LP and what it is they want to see reported but Morris is quick to assert: "I have seen a massive shift in this over the last few years. If managers are looking for something more bespoke and flexible, and want speed to market, smaller independent administrators will be better placed than the big bank-owned administrators."

## Side letters and lower fees

Part of the drive behind more bespoke reporting is down to LPs seeking to use side letter agreements to find additional value in their GP relationships. These agreements might be used to re-negotiate carried interest, management fees, and other considerations but all come with their own set of reporting, which the GP cannot standardise.

Morris expects to see more LPs insisting on side letters and separate arrangements. He illustrates the point by referencing an infrastructure manager who recently launched a large fund. However, overall LP commitments were significant, almost 45% were in separate arrangements.

"The bigger LPs have this buying power. If you're one of the more established, large-cap GPs in the market you have to move with the times. Better terms can be absorbed in a side letter, which is much more profitable for them to do so than just reducing the fees for the first tranche of investors coming into the fund.

"However, smaller GPs who want to get their fund to market will have to accept lower management fees to bring investors into the pooled vehicle as opposed to using specific side letter arrangements, as they are timely and costly," comments Morris.

He adds that mid-market GPs may be slower to adopt the use of side letters "but they will follow".

"I don't think GPs, broadly speaking, can realistically maintain their current management fee structures; they are too high. In the current environment, if some investments in the portfolio become insolvent, and a GP's track record is impacted, investors will want a better price for what is potentially a higher risk investment."

For the PE industry to continue to be successful, it will need to look for ways to evolve and mature: maturity as it relates to reporting, transparency, and valuation methodology.

"Everyone has to take a step forward and move with the times to maintain a good GP/LP relationship, and ensure PE remains a viable asset class to invest in," asserts Morris.

> *"If managers are looking for something more bespoke and flexible, and want speed to market, smaller independent administrators will be better placed than the big bank-owned administrators."*
>
> James Morris

## LP investment focus

As LPs evaluate future investment opportunities in private markets, a few areas could look appealing. One is the secondaries market. This market has continued to go from strength to strength, with deal volumes and numbers building up some good momentum in 2019. The outlook for 2020 has obviously been tempered by the pandemic, and while there are a lot of GP-led deals currently, the reality is not a great many will likely be completed on. The same applies for LP-led secondaries; why sell today unless it is necessary?

That said, some LPs will look to capitalise in the lower- and middle-markets where sellers are more willing to accept a discount if they have a low fund liability (i.e. 20 per cent) compared to a fully funded liability. And if valuation reporting is accurate, this too could support further deal activity as LPs divest parts of their PE portfolios.

"Coming into the early part of 2020, especially in the US, we were seeing a lot more PE secondary structures coming to market; mainly Cayman/Delaware structures. With Covid-19, though, I think both GPs and LPs are battening down the hatches a bit, consolidating their position, certainly while the public equity markets continue to perform well," states Morris.

He concludes that UK-based LPs are focusing their efforts on taking advantage of investment opportunities within distressed and dislocation credit portfolios, core and value add infrastructure as well as specialist private equity strategies: "Infrastructure will continue to be strong and in the real estate market, we might see some UK Government-backed bailout funds. Much depends on what happens next with Covid-19 and whether there ends up being a second wave. I see more distressed assets coming into view as we head in Q4." ■

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