

The LP/GP divide

INVESTOR RELATIONS

Communication between private equity fund managers and limited partners is still in need of improvement, writes Armando D'Amico.

The relationship between limited and general partners is a complex one. In each fund it involves one GP but multiple LPs with different performance expectations, asset allocation issues and reporting procedures. At the same time, each LP has relationships with many GPs, each spanning multiple funds and a timeframe of up to 15 years.

Considering that not all LPs have sizeable teams, there is bound to be a strain on the relationship if things do not go as expected. Expectations are not always communicated clearly, and sometimes not at all. It is often what is left unsaid that creates tension. Swings in the fundraising cycle further add to this tension by creating dramatic shifts in the balance of power between the two sides.

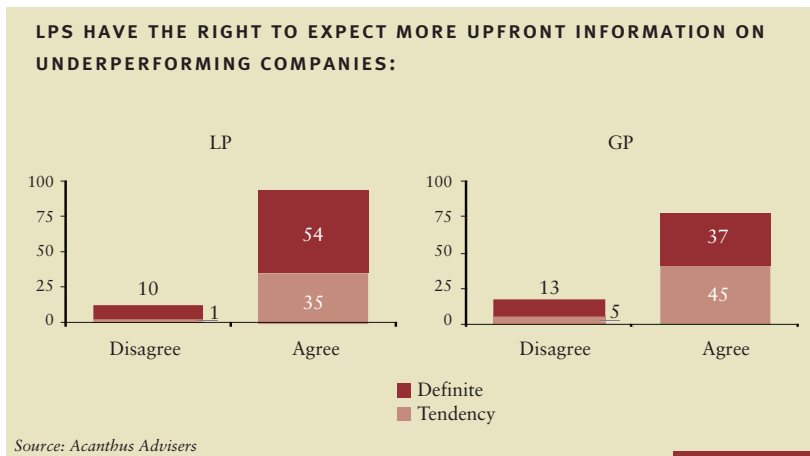
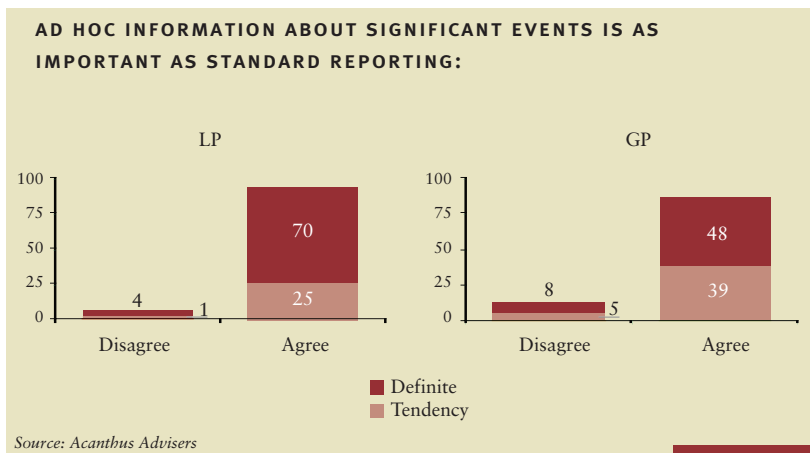
Over the past 12 months, we conducted two confidential surveys to highlight key areas in which LPs and GPs do not see eye to eye. Nearly 200 professionals across Europe were surveyed. Our research found that there is a communication gap between fund managers and investors. Moreover, there is an imbalance of power, with LPs currently taking a back seat in the power stakes. Some blame this on hubris on the part of certain GPs. Others argue that it is a direct result of private equity's recent success as an alternative asset class.

Over the course of these two surveys, the investment and fundraising market changed, which added to complexity of both sides' agendas.

But regardless of these cyclical dynamics, the survey responses made very clear that the LP/GP relationship can be changed for the better once people openly say what they need from one another. Whether they get what they want is a different question, and the answer depends how much the LP needs the GP and vice versa.

IS ANYONE LISTENING?

The surveys focused on the topic of formal and informal communication of current issues and material events in limited partnerships such as changes in strategy, succession issues and staff turnover. Not only did the results confirm that regular receipt of accurate information is critical for LPs, but they also



showed that ad hoc information made available by the GP on an informal basis is considered as important as formal reporting. Upfront information on underperforming companies was deemed particularly important.

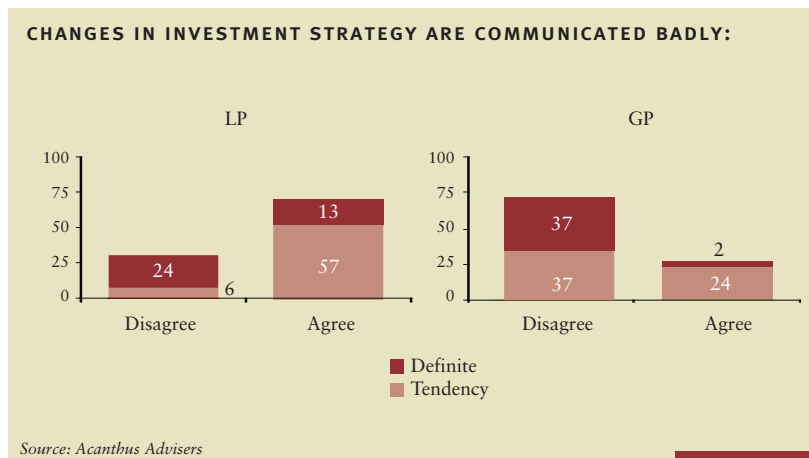
Unsurprisingly, the quality of the information provided is considered crucial. “Just showing up to a meeting won’t do,” said one LP. “It is nice to come to an informative AGM, but regular and clear information flow is more important.” And timeliness is equally important. Commented another LP: “Speed of production of quarterly reports is important. European funds score on average only a 4 out of 10.”

And there are touchy subjects that need to be resolved. For exam-

“The overheated fundraising cycle is allowing funds to relax on transparency and corporate governance,”

ple, where LPs and GPs clearly do not agree is on the issue of communicating material events, such as new hires and departures. Some 70 percent of the LPs surveyed said that these are not communicated adequately, whilst 70 percent of the GPs believed they were. What is more, 75 percent of GPs believed LPs should not involve themselves in personnel issues, whilst over half the LPs believed they should.

Another area where attitudes differed was change of investment strategy such as a manager’s tendency to drift to ever larger transactions, which is a common concern among LPs. Nearly 70 percent of the LPs surveyed said such changes are not being communicated adequately, whilst 75 percent of GPs said they are.

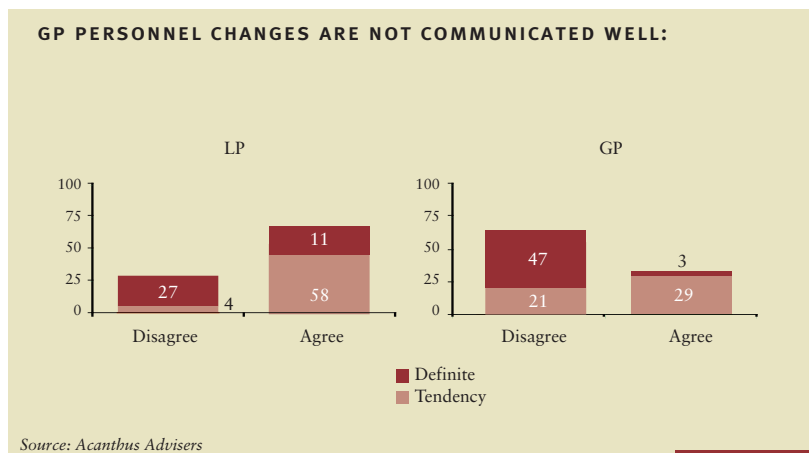


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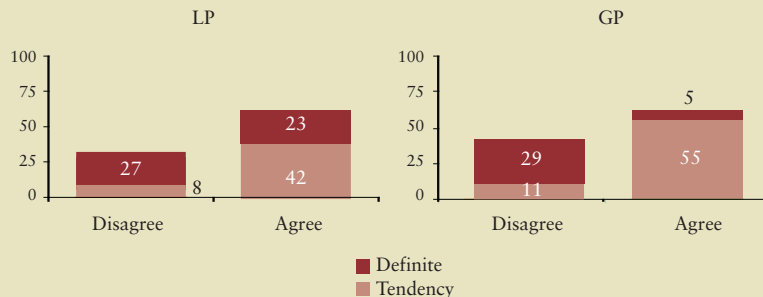
The 2005 fundraising boom created an environment in which access to even the largest European buy-out funds became an issue, which prompted the balance of power to shift in favour of GPs. This change was reflected in the surveys, with LPs voicing serious concerns over fund sizes, management fees and other terms and conditions.

Worries over a lack of discipline on fundraising caps were a recurring theme. Limited partners lamented a “mad dash for cash” and complained that too much money was being raised for funds that were not properly differentiated and effectively too large to reflect the investment opportunity. As one LP commented: “Buy-out groups have had such a good run, there is an assumption in the market that it will go on forever. Too much capital is trying to get in and GPs are not disciplined enough to turn some of it away.”

Management and transaction fees are a related concern: “The GP



LPS WITH HIGH STAFF TURNOVER RUN THE RISK OF BEING BLACKLISTED BY SUCCESSFUL GPs:



Source: Acanthus Advisers

economic model is increasingly based on fees”, said one investor. “Funds are being raised that are fee- rather than performance-driven”, commented another.

More importantly still, LPs fear that the fundraising boom is damaging fund governance standards and reducing alignment of interest between fund managers and their clients. At a time when capital is abundant, the buy side perceive that GPs are becoming less concerned about maintaining good relationships with investors.

“The overheated fundraising cycle is allowing funds to relax on transparency and corporate governance,” said one LP. Another commented that “some GPs with over-subscribed funds tend to get away with inappropriate terms and conditions regarding basic investor protection clauses”. And yet another respondent disliked “the way in which GPs think that a key man clause can be manipulated simply by asking LPs to agree to change”.

TWO-WAY STREET

Needless to say that the GPs also hold strong views on where the other side goes wrong. With regard to the ballooning fund phenomenon for example, they assert that blaming the managers alone is not

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appropriate. Said one GP: “LPs are having to invest more, which leads to too much money flowing into a small number of funds.” Another pointed out: “LPs are often guilty of submission to terms of big buyout funds”. GPs also identified constructive criticism as an area where LPs had weaknesses. Some GPs argued that feedback from LPs to GPs was extremely poor. Furthermore, LPs were described as inconsistent in their demand for information, visits and attendance at AGMs. This lack of clarity, GPs allege, leads to investors making unnecessary requests for information.

Another issue that GPs are finding difficult to deal with is the high rate of staff turnover at the LP level. Over 60 percent of the managers surveyed agreed that LPs with

high staff turnover are in danger of being excluded from future funds by leading managers.

THINKING LONG-TERM

Most fundamental to how LPs and GPs communicate with each other is the recognition that the relationship between them is necessarily a long-term one. This is why GPs must provide detailed and well-timed information to investors. LPs on the other hand should truly behave as long-term investors.

Meeting these expectations is not easy and requires compromise on behalf of both parties. Open dialogue is important. At a time when private equity is enjoying a particularly healthy investment climate, GPs and LPs should not forget that theirs is a relationship that can and should be made work better. As one GP put it, “no one wants a bad fund”, and there are economic, reputational and even emotional incentives to make sure bad funds don’t happen. Good communication will be key to making sure that they won’t. ■

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