KEYNOTE INTERVIEW

Answering LPs' transparency needs

IFM Investors' Stuart Wardman-Browne, Adrian Kerley and David Odgers explain how LPs are seeking a better alignment of interests with GPs

Last September, Melbourne-based institutional fund manager IFM Investors made an unusual announcement.

The firm, with A$127 billion ($89 billion; €79 billion) of funds under management (including A$1.8 billion in private equity, including direct investments in the Australian mid-market), declared a 7.5 percent fee rebate to its 370 clients. IFM, which issued its first fee rebate in 2011, challenged other managers to follow suit. Such a move is rare in the world of funds management, in particular, where there has been little deviation from the traditional fee structure.

We asked IFM global head of private equity Stuart Wardman-Browne and IFM private equity executive directors Adrian Kerley and David Odgers what it signals about the changing nature of the LP-GP relationship.

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Q You're very close to the pension fund sector. How are LPs evolving their approach to private equity investing?

Stuart Wardman-Browne: Among pension funds we are seeing a shift in the deployment of private equity allocations. In part, this is driven by a misalignment with GPs. Australia is a smaller market. Pension funds are growing and trying to find new ways to invest capital. They are looking for more scale opportunities and direct access to mid-market companies, and not necessarily sub-scale diversified investments through blind-pool funds due to being a small investor in a fund. They are willing to take a much longer term view than traditional private equity funds.

Q What other issues contribute to this misalignment?

Adrian Kerley: As an LP, if you're looking to tie up your illiquidity budget in private equity you need to be rewarded with alpha that is commensurate with the risk you're taking. In traditional private equity funds, the LP ends up with far less control over what sectors it invests in, the timing of deployment and the size of the equity cheque. Over-diversification blurs out the illiquidity premium.

GPs can also promise certain sector focus and value creation capabilities but can't deploy it. There is little transparency on the companies that you [the LP] actually own. The LP is committing to funds but doesn't know what it's going to get. That's blind-pool

risk. And the alignment may diverge over time depending on performance. The LP may have funds that have underperformed and the manager is not willing to exit positions and instead prefers to collect management fees. The traditional fee structure leads to this misalignment of how much of the outperformance is captured by the GP and not given to the LP for deploying the risk capital.

Q You mentioned transparency. How demanding can LPs be?

AK: You only have to look at the reporting templates on the ILPA [Institutional Limited Partners Association] website to see there is a greater demand for transparency. There is more detailed reporting at the portfolio company level and that helps mitigate some of the principle and agency risk inherent in closed end fund structures. LPs want to be sure the GP is investing in that opportunity for the right reason, and that's to deliver the appropriate return per unit of risk – not to get off to a quick start because they've just finished fundraising or squash in a last deal so they can get back on the road and raise the next fund.

The need for transparency is far more fundamental than just wanting to know what's inside your portfolio. If you're a big institutional investor and you've got 10-20 percent of your funds under management allocated to private equity you want to understand what risk exposure you're taking on the ground. You don't just want to know what funds you're invested in.

David Odgers: With environmental, social and governance implementation, it's after the event reporting. The LP doesn't have the opportunity to input into any of that decision-making [in a traditional fund structure]. A more aligned partnership would be one where the LP has a seat at the table when deciding when to make an investment and when to exit so those decisions align with their broader ESG and investment strategies.

Q How have succession issues in the Australian market impacted the balance of LP/GP interests?

DO: There are several examples of what were successful mid-market firms that disintegrated as senior folks left, which was not the expectation of LPs when they committed funds.

AK: Especially in the mid-market, Australia is probably a decade behind the US and Europe in terms of GP sophistication and maturity. They are great investors, but they are not necessarily great fund managers. Those with significant key-man risk haven't solved their succession issues. Compare that to the US where there are a handful of firms older than 50 years that have been through multiple successions and have a clear path.

Q And fees. Why did IFM issue a rebate to its clients?

SWB: The business outperformed its objectives and because we're an investor-owned institutional fund manager, the 7.5 percent was returned to our clients due to our focus on net returns for investors and their members rather than corporate profit.

Q So, what are LPs doing to redress this misalignment?

AK: Pension funds are moving into co-investment and not just to reduce the fee burden but to control portfolio construction. The ability to get exposure to a specific sector risk premium is extremely difficult in a closed end fund. In a situation where you're a partner of choice, the LP can access those co-investment opportunities and control at least some of that portfolio construction. Over the last 10-15 years the large players – LPs and GPs – have become exceptionally good at this and pivoted their business models toward co-investment. Now smaller LPs are looking to access that portfolio control and flexibility.

They are doing it cautiously over a fair amount of time. Having that second filter to work out what they want to invest in versus what risk they want to take is important. As more and more LPs join that market they embark on a learning curve. It's the GP's job to some extent to guide their asset owners to ensure there is a win-win situation for both GP and LP.

Q And GPs' response?

AK: There are those, especially in the mid-market sector, that don't need to facilitate co-investment opportunities, or if they do, charge fees for access. That's a little bit short-sighted. The world is moving at a

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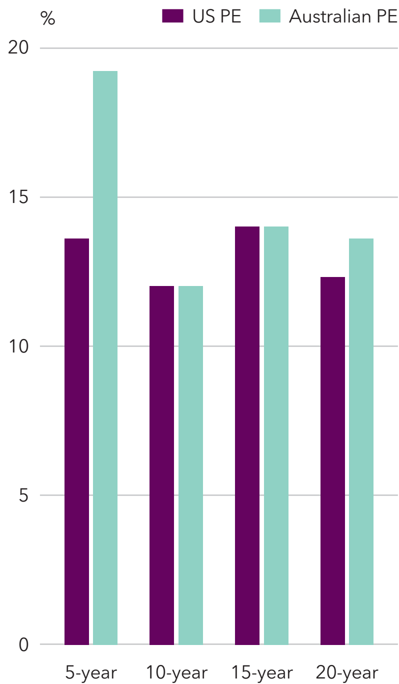
> **ADRIAN KERLEY**
> **IFM Investors**

Returns for Australian funds are more than matching their US counterparts



*Net of fees as of 30 Sep 2018. Indices are horizon calculations based on data compiled from 1,492 US private equity funds and 72 Australia private equity funds

Source: Cambridge Associates

Q In terms of returns, how does the Australian mid-market compare with other markets globally?

SWB: Returns from the Australian mid-market have been better than in the US. There is no doubt that part of that is because the market in Australia is less mature. The industry here has been around for a shorter period of time and there is still plenty of dealflow, especially in the mid-market space, and it is less competitive. The market remains very attractive because of that. We see plenty of deals, and enough that are either exclusive or semi-exclusive. We often interact with founders or entrepreneurs and they are not just looking for the last dollar on the price. They are looking for help to take the business to the next level.

minimum toward co-investment, but what IFM is trying to do is lead the way around bespoke relationships where every deal and all of our investors' exposure is essentially 100 percent co-investment.

DO: Typically, the co-investment model has been a way for LPs to get better alignment on bigger deals. But the mid-market is where there are the most attractive returns and it's challenging for LPs to co-invest there. There tends to be much less opportunity. There are also fewer institutional investors with the right governance and risk management skills.

Our response has been to execute mandates for individual LPs. There is the potential for us to broaden that into a platform for a small number of LPs to group together to access the mid-market opportunity directly. And beyond that, to take more of a long-term private capital approach: larger deals, longer holds, through a more club-based approach where we partner with a small number of LPs. This provides access to the mid-market opportunity and more meaningful input into how their capital is deployed.

Q How does that work in practice?

DO: We have fully invested our first single LP mandate. As we sourced and screened investments, the LP had visibility; as we diligenced businesses, they had access to diligence materials and even the data rooms and investment committee materials and had a right of veto on investments. Through the ownership period they have had access to board materials in real time and observer rights to attend board meetings should they wish to. We're giving them detailed updates on strategy and performance on a more regular basis than an annual report. When there are potential exit events, they will have a seat at the table to determine whether that meets with their broader investment requirements or not. As a GP we are managing those investments, but it is much more of a partnership with the LP to take account of their needs.

SWB: We are finalising the platform now that's been designed to offer the smaller pension funds access to some of the smaller deals. We have an investor that has committed to seed it and we are fine-tuning the details and will go out to market with that shortly.

Q How do you allocate opportunities between vehicles?

SWB: By equity cheque size. With the mandates, our clients are specific about how much equity they want to invest into each opportunity. As an institution, we have conflicts committees that we consult so our investors don't feel unfairly treated. So far that hasn't been an issue.

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DAVID ODGERS
IFM Investors

Q And where are the opportunities?

SWB: I've been in the industry 18 years now. If I look at the opportunity set 10 years ago versus now, we probably see exactly the same number of opportunities in the mid-market but some of the industry sectors are different and clearly factors like disruption risk are more prevalent these days across a wider range of industries.

We look at a number of sectors and some are quite broad, like business services. We also look at healthcare, technology, consumer and brands. Those four sectors have a lot of longevity although the types of businesses and models might change within them. A key factor is backing the right management teams and I don't see that changing. ■