GP-LP: Dangerous liaisons

A diverging supply-demand dynamic in private equity fundraising is threatening the GP-LP alignment of interest. Concessions on both sides are needed in the interests of long-term stability

IN EARLY MAY, CLSA CAPITAL PARTNERS (CLSA CP) became the seventh GP to close a Japan mid-market fund in the space of three months, hitting the hard cap of its Sunrise Capital III at $400 million – almost double the size of its predecessor. Demand for exposure to private equity in Japan, not least from a swath of domestic LPs that had previously steered clear of the asset class, had never been higher.

But details of the fundraising bring more fundamental – and consequential – themes to light. Like many of its fellow Japanese and Asian funds this year, Sunrise III was comfortably oversubscribed. This translated into an approximately eight-fold increase in CLSA CP's LP base and an apparent hesitancy among the eager new backers to exert too much pressure around contract terms.

"We had 30-plus LPs saying all kinds of things at the same time, so managing that process was quite challenging," says Shota Kuwaki, a director with the private equity firm. "Although they did have some specific requests in the side letters, most of the terms were quite consistent with the market standard."

However, Sunrise demonstrates that the skewing of GP-LP negotiating leverage implied by such scenarios is not necessarily a fait accompli. Indeed, CLSA CP proactively pursued a number of alignment of interest initiatives as part of the fundraising process independent of any particular LP demands. Notably, this included a redrafting of the key person clause used in previous funds to cover a larger number of senior executives.

Times of plenty

These efforts highlight a relatively faint but growing awareness that the supply-demand imbalance that characterizes some – but by no means all – fundraising processes in Asia will not last forever. Longer-range thinking, both on the part of both fund managers and their backers, is necessary to ensure the private equity industry has the operational sturdiness to survive the kind of economic shocks that often bring investment booms to an abrupt end.

In its latest global PE report, Bain & Company called the fundraising environment of the past few years "as good as it gets," noting that the industry has raised $550-600 billion a year since 2013. Ominously, the only natural comparison for this level of activity is the pre-global financial crisis period, when annual fundraising fluctuated in a range of $540-690 billion.

"We certainly feel this is an environment to be pulling back in, and we are pulling back, but unfortunately, we don't see that when we look out in the LP community," says Steve Byrom, head of private equity at Australia's Future Fund. "What we're seeing is allocations increasing and the chase for yield spreading to private equity. People are scrambling to get more money into the asset class, and therefore more capital is being raised, more dry powder is sitting on the sidelines and high transaction multiples are being paid."

For many LPs, the primary concern is that as higher demand for PE exposure hardens GPs' negotiating leverage, alignment of interest will break down, potentially undermining returns. The classic gripe with global PE firms is that their asset bases grow so large that accumulating management fees becomes more important than carried interest. Further down the spectrum, alignment issues tend to revolve around team stability and governance.

The optimization of long-term alignment of interest is seen as a key method for defusing this risk of consistently lower returns since it would in theory support a more robust and sustainable private equity franchises. However, a logical tendency among GPs to exploit a cyclic windfall and competition among LPs under pressure to deploy larger sums have stymied best intentions.

"The only chance for pushing for terms is when you have a group of very like-minded LPs who are willing to work together," says Edmond Ng, a managing partner at fund-of-funds Axiom Asia. "But the relationship among LPs is very interesting because everyone is fighting for allocation. GPs will always try to divide and conquer."

While GP-LP talking points typically revolve around management fees, co-investment and other specific rights, a number of terms around alignment of interest are distinctly long-term in nature. For mid-market funds, these include key person clauses, no-fault divorces, GP removal clauses and the distribution of economics within the firm. Bigger players, meanwhile, may see more concern around issues like hurdle rates. This came to the fore in 2016 when Advent International removed the hurdle from its most recent fund. CVC Capital Partners subsequently lowered its hurdle from 8% to 6%.

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> – Steve Byrom

As a universal case in point, GP commitments offer an interesting look at the difficulty of agreeing mutually satisfactory terms on long-term issues. For firms such as CLSA CP, this area of negotiation – alongside the engagement of a placement agent – represents perhaps the best opportunity to improve the geographic scope of its backers.

"One of the things that contributed to the success of the fundraise was the fact that a lot of LPs really do focus on alignment of interest between GP and LP, so they were reassured by the employee side-car commitment," says CLSA CP's Kuwaki. "I think that stood out when LPs were assessing other GPs across the board."

According to Megumi Kiyozuka, a managing director at CLSA CP, the GP commitments across Sunrise II and III have represented the maximum amount the Sunrise team members were able to put in, amounting to 5% in both funds only by coincidence. As a result, CLSA CP employees not on the Sunrise team who would have otherwise contributed were cut back.

Meanwhile, much of the new thinking on GP commitments revolves around the notion that percentage-based standards are a less reliable way to calculate alignment compared to establishing what proportion of the GP's net worth is being invested. This can lead to complex discussions involving non-cash components – which are usually not recommended – and controversial attempts to delve into personal finances. As a result, one of private equity's key alignment of interest talking points tends to boil down to a substantial amount of guesswork.

"If you're backing someone who has been a successful professional, no matter how much money they have, I feel that $5-10 million more than the cumulative fee that the GP will be receiving over the fund life has got to be something that hurts," says Axiom's Ng, referring to funds around $500 million in size or less. "That would almost always be a meaningful amount."

Lyfe Capital is another GP that has closed a new fund at double the size of its previous vehicle but maintained the same percentage GP commitment. The firm closed its second China-focused healthcare fund this year at $420 million by increasing its LP base from around 15 to at least 20 backers.

James Zhao, a founding partner at Lyfe, emphasizes a strong focus on setting terms during the fundraising process based on long-term goals around alignment of interest, even when engaging LPs that were not participating but could be brought into future vehicles. Transparency and education were considered essential since about half of the new backers were entering Chinese healthcare for the first time.

"You should always put yourself in the LP's shoes just like you should also put yourself in a portfolio company CEO's shoes," Zhao says. "The hard part is to align the GP, LP and CEO's interests – that is really based on being very proactive about communication."

Walking away

The reciprocal style of this approach offers a reminder about the need for action on both sides of the GP-LP divide. Although terms are generally expected to become more LP-friendly from one fund to the next, a lack of capital rationing from LPs is said to have resulted in the opposite effect among more established buyout shops. To some extent, this puts an onus on LPs to react by taking a firmer stand.

"You don't see the LP community focusing on improving alignment of interest – or even making sure alignment is as good as it was last time around," says Future Fund's Byrom. "But at this part of the cycle, our antennae are up more than usual to misalignment of interest, so we are definitely walking away from groups where we aren't getting the alignment mechanisms we're looking for."

LPs' underwhelming reaction to growing concerns around alignment of interest is at least partially explained by the issues related to increased deployment expectations and staffing shortages. These pressures can in turn be problematic to the due diligence process of picking a GP partner.

The trend of LPs paring back their GP relationships is sometimes seen as a motivator of short-term thinking around alignment of interest. Although less diversity in partnerships suggests an ability to establish more intimate and communicative GP-LP relations, the larger commitments involved often revert the talking points back to the most immediately pressing points of friction.

"You hear a lot about LPs being dissatisfied with specific terms on specific funds where the GP is being particularly egregious," says Wen Tan, co-head of private equity Asia Pacific at Aberdeen Standard Investments. "But the acid test on that is how often you hear about LPs walking away from those scenarios – we don't hear about it that much."