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FUNDRAISING

A whole new game

The investor dynamic in the next 10 years will be less of a US dollar-denominated performance-based business, says MVision chief executive Mounir Guen

***Guen:** there aren't enough GPs in the market*

Q How would you characterise the current fundraising environment?

If we look at the macro patterns there are two strong trends that dominated prior years: all-time high fundraising which has been driven by large funds getting bigger. At the moment, the volume of capital coming to the asset class relative to the development of general partners is very mismatched, with money almost forced into the large funds for the lack of anywhere else to deploy.

Historically, the US market was unbelievably popular. If new investor money came to market, it went to the US first. If LPs were reviewing 10 funds, eight of them were US. There was this overwhelming US focus because of its big bench of general partners and excellent capital markets and support infrastructure. The US GPs have been outperforming globally – note the Russell 2000 Index is also at an all-time high – and if we are investing with a rear mirror perspective we should be continuing to give them money.

On the opposite side of the spectrum, we have the non-US, non-EU markets, where the bulk of capital in private equity is focused on China and the rest of Asia. About $450 billion plus of aggregate capital is raised per year, of which between 70 percent and 75 percent is US dollar-denominated investors. This meant that for these other markets, the performance was seriously lagging in USD terms when we factor in the recent currency volatility which impacted US dollar equivalent returns by GPs. We were bullish on emerging markets including Asia and expecting the Asian marketplace to have a much higher allocation in a global portfolio, but currency movements meant that it went backwards. There's actually less capital available. Given that in Asia there is a limited pool of GPs and a concentrated selection, this means the large pan-Asia funds should naturally be oversubscribed. In fact capital is getting more scarce. Note China is still very active domestically and internationally.

Q What's your view on the rise of shadow capital over traditional fundraising in Asia?

Asia is still difficult to get money into. The large investors need to consider going direct. Some are opening multiple offices as a result. They have to deploy the money and they believe in the region, but they can't put enough money through funds. Access can be extremely difficult especially for large commitment numbers – large investors are lucky if they can put $100 million to work in a new fund and this is rare. Pension funds, sovereign wealth funds and family offices are increasingly getting savvier, boosting internal know-how and deploying capital directly under their control.

There was a time when there was quite a gap in the compensation structures between LPs and GPs – that's disappearing quite quickly: GPs are becoming heavily regulated, carried interest in many countries is viewed as income tax, and the waterfall mechanism has moved to a more delayed access to profits. LPs now are more experienced, considering new ways to put money to work. Shadow capital is here to stay and grow. In my view this presents GPs with new opportunities to partner with LPs. For us that means trying to figure out how to create new products, reposition existing products or a GP's business, and creating more first-time funds.

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Q Where do you see new pools of capital for the asset class?

US investors are among the most mature investors in the industry and it's interesting to see how the country is constantly in a creation cycle with new pools of capital emerging. We see, for example, technology-related businesses and families creating new pension plans, new foundations and family offices.

When we start looking around at the underlying historical programmes that have been in the market for 25 years or more, there are two things that stand out. First, if you are a new GP it's extremely difficult to access some of these investors because they already have around 50 to 60 core GPs so you can only displace another firm. Second is the potential for growth in the defined contribution market. In addition, savings and personal pensions are a significant multiple of the public and corporate pensions that are huge investors in private equity. It's a dramatic pool that's been inaccessible, but as the industry finds DC solutions and creates new fund structures to tap into broader groups, they will unlock that pool of capital. However, the question to address is: 'What happens to the return profile as the volume of capital in the market expands?' I don't know what the impact is but I believe that returns are being adjusted to what the capital is seeking.

New capital will also come from China, Japan, Taiwan, Korea, and Latin America also has big potential. There will be a significant demographic shift as this capital activates and the new pools of capital are no longer US dollar-denominated in their benchmarks. In the next 10 years, we will have a very different investor dynamic compared with what we've had throughout the whole history of the asset class when it was a US dollar-denominated performance business.

Q Looking at funds and fundraising, does the market currently favour LPs or GPs?

Follow my thesis that there aren't enough GPs in the market, those GPs that are popular will be in a stronger negotiating position. However, they also have to remember that LPs have limits, and they are sensitive on net returns, fund sizes, net gross spreads, as well as succession and the depth of the bench. If a GP can't tick these boxes, LPs can walk away.

One of the big trends is Institutional Limited Partners Association reporting and how the regulators are converging on their views about full transparency. When a GP draws capital from an investor, the ILPA reporting template and the regulators will want to record exactly what happened – how much went into different fees and expenses, how much went into the investments and whether there's any other capital usage. There is a real openness to accountability, visibility and responsibility.

Within this is a new nuance which focuses on the uniformity of disclosure of the fees, expenses and profits of a GP. Under AB 2833, new legislation that California introduced at the beginning of this year, alternative investments must disclose more granular information and it must be made public. It's a new world for the GPs.

Q What other current themes have you observed in the industry?

GPs are also encouraged to integrate ESG factors into their private equity investment activities. This means managers not only need investor relations plans but also require internal counsel to deal with regulators and all these investor policy changes that are coming to the market. It's no longer what it was like 20 years ago when two people can get together and outsource a lot of the corporate structure, hire an external lawyer and placement advisor, and then they are in business. Today GPs need to have quite an extensive infrastructure – finance, legal, compliance, IR – and that again becomes another barrier to entry. This pushes the capital towards existing GPs and, as a consequence, some GPs are going into multi-products, an area I expect to grow.

There is one theory that the whole asset class will just converge to a dozen firms, while others believe it will keep its depth. In the ideal world, we would have vertical and horizontal activity – from the mega funds to the smaller funds whereby companies can be listed, sold to trade or to another private equity firm. There is another new trend that's taking quite a limelight in our industry reflecting the sophistication of the secondary market. We've seen some very clever restructuring of GPs that involve repositioning of their older attractive investments into new structures. This is a whole new game and one that creates newer liquidity in the asset class. ■