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# The Power Pendulum: GP and LP Dynamics in Private Equity

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Although private equity general partners ("GPs") and limited partners ("LPs") have always had a symbiotic relationship, the power dynamic between GPs and LPs ebbs and flows with the business cycle. As GPs capitalize on M&A, IPOs, and recapitalizations in a bull market and deliver attractive returns, GPs are able to secure capital and command better terms in fundraising. In contrast, when there is a dearth of IPOs and M&A transactions such as the post-financial crisis period of 2008-2009 (the "Great Recession"), LPs gain power and can command more attractive deal terms. And so it goes, the yin and the yang of the GP/LP power pendulum.

## Mutual Dependency in a Budget Tight Environment

Private equity GPs and pension fund LPs are mutually dependent on one another. In fact, the majority of LP investment in U.S. private equity is derived from pension funds and sovereign wealth funds, representing 43% and 9% of capital invested in private equity funds, respectively (according to industry-leading sources, Private Equity Growth Capital Council, Preqin). As pension funds seek to bridge the gap between expected actuarial payouts to pensioners and current asset values in their portfolios, more assets are shifting to higher risk, higher return asset classes such as private equity.

State pension funds in particular have been under pressure since the Great Recession due to reduced contributions because of lower tax revenue and tight fiscal budgets. As a result of belt tightening and hiring freezes, state pensions have been evaluating ways to cut costs and improve net returns on their investment portfolios. The response to budget pressure has taken shape in many forms, including cutting GP sponsor fees and "insourcing" by bringing investment expertise in-house, as well as instituting co-investment programs.

## Fee Compression Post the Great Recession

Post the Great Recession, pension funds sought to reduce overall fees in an environment where losses on investments were at record levels, enhancing LPs negotiating leverage. In September 2009, the Institutional Limited Partners Association ("ILPA") published the "ILPA Private Equity Principles" (a.k.a. the "ILPA Principles"), which was intended to improve LP/GP alignment of interests, governance, and transparency. GPs generally were asked to adopt the ILPA principles and many LPs required that terms in the follow-on fundraising documents include the ILPA Principles. Adoption of the ILPA Principles was a major accomplishment by LPs who gained ground in the power dynamic vis-à-vis the GPs coming out of the financial crisis.

The ILPA Principles call for a sharing with the fund of all transaction and monitoring fees charged by the GP to its portfolio companies, in order to provide a better alignment of interests among GPs and LPs. Widespread adoption of this principle has been supported by the increase in the median share of transaction fees rebated to LPs by GPs of recent vintage buyout funds, from 75% in 2008 to 100% in 2012, according to Preqin.

Although adoption of the ILPA Principles, and specifically the increased rebating of transaction and monitoring fees, was an accomplishment by the LP community that enhanced LP economics, it did not result in meaningful changes in management fees received by GPs. Median management fees were 2.0% in the 2007-2008 timeframe and were unchanged at 2.0% in 2012, while average management fees compressed only slightly from 2.01% in 2007 to 1.92% in 2012.

In addition to improved economics for LPs, the ILPA Principles resulted in improved transparency and reporting to LPs. Most LPs have reported significantly improved communication, disclosure, and reporting by the GPs of more recent vintage buyout funds.

## Insourcing and Going Direct to Address Fee Burden

Given that LP efforts to reduce management fees paid to GPs have, overall, been quite modest, some of the largest pension funds have stated their desire not to pay "retail" management fees to investment managers, and they have sought alternatives to alleviate the typical "2 and 20" fee structure charged by GPs (e.g., 2% management fees and 20 percent carry). Moreover, with the lack of success in negotiating widespread management fee reductions, LPs are increasingly bringing their assets in-house.

Depending on the size and maturity of the private equity program, LPs invest in private equity directly with GPs or through a fund-of-funds model. Often when an LP is new to private equity investment, the management is outsourced through a fund-of-funds, which chooses, manages, and reports on private equity investments in exchange for another layer of fees, say 100 basis points. As LPs mature and develop in their investing style, they often move away from the fund-of-funds model. In fact, the savings from moving private equity in-house has been estimated to result in 140 basis points in savings from external management and almost 220 basis points in savings from a fund-of-funds model (CEM Benchmarking).

## Private Equity Co-Investment Programs

LPs are also increasingly implementing private equity co-investment programs as a means to reducing fees, as co-investments are offered by GPs to their investors without management or performance fees, which result in an overall reduction in fees that LPs pay to GPs.

Despite reduced economics, GPs also benefit from LP co-investment programs given the trend away from club deals in recent years. In larger private equity transactions, GPs historically used to band together in club deals where the size of the equity check was large and, therefore, could not be underwritten by a single PE sponsor acting alone. As a result, during the financial crisis, LPs learned the hard way that they had exposure to the same private equity investments across different funds managed by multiple GPs, particularly within their large cap buyout allocation. As a result of having the exposure to the same investment across multiple GPs, some LPs experienced amplified fund losses across the portfolio when they expected, instead, to have greater diversification among funds. In addition, regulators investigated a few high-profile club deals citing possible collusion among private equity sponsors and the investigations were never really closed or resolved, leaving LPs necessarily with a cautious approach to club deals. Co-investment is an attractive alternative to club deals, especially when GPs still have the need to syndicate the equity checks they write.

Even more important than reducing fees, LPs have discovered that they can improve net returns by asserting more control over the private equity investment portfolio. Co-investment is one of the most attractive ways for LPs to take a more active role in driving excess returns in the portfolio (a.k.a. "alpha") and impact industry and deal type within their portfolios. Driving alpha in the portfolio requires staff to actively select, diligence, and manage the co-investments and allows LP staff to determine the amount of capital to deploy. Active management also allows staff to pass on deals that are not sound or that would unduly add to concentration in a particular sector or deal type in their portfolio. This is a refreshing contrast for LPs who have historically relied on committed funds that can sometimes result in unintended concentration.

The most effective and fee-efficient method of implementing a co-investment program is through a direct model rather than a fund-of-funds approach. A direct co-investment model allows for control of the investment selection to rest with LP staff to ensure GP/LP alignment in the deployment of capital. Most important, the direct co-investment model eliminates the conflict of putting money to work simply to put money to work and earn a management fee. A direct co-investment model also eliminates the unnecessary layer of fund-of-fund fees, which are at odds with one of the co-investment's main purposes of reducing fee burden.

## Reduction in the Number of Relationships and Increased Concentration Among Large GPs

Given the administrative burden of managing too many GP relationships, some of the largest LPs are reducing the number of GP relationships they maintain and eliminating GPs who are either too small to make a meaningful contribution to overall LP returns or who have not performed in the top quartile. LPs are seeking GPs with consistent track records of delivering returns over long periods of time, which benefits the largest GPs and has added to the concentration of capital among the largest private equity sponsors. This trend has continued for several years and approximately 21% of LPs surveyed in 2012 expected to reduce the number of GP relationships they maintain, according to Preqin. Often this results in a sale of a portfolio of illiquid positions on the secondary market, enabling the LP to sever the GP relationship permanently and reallocate most of the capital as the LP sees fit.

With this flight to scale and quality among GPs, first time fund managers have had difficulty securing commitments. In fact, first time fund managers raised only 8% of the capital in private equity in 2012, while first time fund managers represented 45% of the GPs who abandoned their fundraising.

## Zombie Funds

For those funds that are either too small or underperforming to attract follow-on funding, the funds enter the zone of the walking dead, with no prospects of a new fund and oftentimes a portfolio of investments that are either distressed or too lackluster to justify an exit. For funds that are not in carry position, the GPs have no incentive to liquidate the portfolio since they will not earn a carry and to exit means a loss of their ongoing management fees. In fact, there are an astounding number of zombie funds in today's market, estimated by Preqin to top 1,200 private equity funds in investor portfolios worldwide with total unrealized assets of $117 billion. It seems certain that the number of private equity funds will decline in the future as these zombie funds are wound down in one way or another.

Despite the conflict of continuing to pay inactive GPs without prospects of enhancing return, LPs loathe to remove GPs or dissolve the fund except in the most egregious situations. This may be about to change given the record number of private equity funds in limbo. Several groups are working on strategies to restructure zombie funds and create solutions that incent GPs to perform against new metrics and also create additional value for LPs. Other LPs have created separate accounts and simply allow the assets to naturally wind down. Time will tell whether new solutions for rectifying zombie funds will result in improved economics for LPs.

## Conclusion

The future for private equity funds appears to be forever changed and the golden age for the majority of private equity sponsors may be behind us. Current trends in U.S. private equity investing suggest that there will be increased concentration among GP private equity sponsors given the reduction in the number of GP relationships that LPs are willing to manage, concentration among certain GPs in fundraising, and a record number of "zombie" private equity funds that will not receive follow-on funding. Given a future with significantly increased GP concentration and reduction in the overall number of funded GPs, the LP/GP power dynamic can be expected to shift toward a select number of "golden" GPs who can command attractive fees and terms. Unless, of course, LPs continue to shift and bring assets in-house en masse… and so it goes…

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Sources: Pension & Investments; Preqin, Private Equity Growth Capital Council, CEM Benchmarking Inc.