RRiPE

The Reputational Risk in Private Equity Report

Clear Intentions:
How trust and transparency impact LP decision making

IAG Fund Administration

Thompson Taraz Expert Fund Services

Contents

Methodology

This summer, Limited Partners ("LPs", institutional investors with existing investments in private equity funds) were invited to participate in a survey on investor relations and fund reporting. 128 qualifying responses were received in June and July 2014. The respondents were a representative sample of the global LP community.

LPs from 26 countries took part in the study, and all institution types were included, from sovereign wealth funds and family offices to university endowments, pension funds and insurance companies.

Parallel to the survey of Limited Partners, 101 General Partners ("GPs", private equity fund managers) were also canvassed on fund reporting and how they manage relationships with their LPs.

Once the analysis of the surveys was complete, additional, longer-form interviews were undertaken with LPs and GPs, in order to verify our conclusions and shed further light on the findings.

The study was conducted by Pivot Partners, a research-led communications consultancy for the private equity industry. More on Pivot Partners can be found at www.pivotpartners.co.uk.

Foreword

Dear reader,

Welcome to The RRiPE Report looking at communications and reputational risk in private equity: Clear Intentions – How trust and transparency impact LP decision making.

As fund administrators, depositaries and consultants to the private equity industry, we understand why much of what occurs in our industry is deliberately kept, for want of a better word, "private". Privacy has its advantages.

Of course, opinions differ on what should be kept private and what should be shared but, as an industry, we must recognise that transparency, communications and the associated reputational risks are impacting investment decisions and affecting the way private equity is perceived and treated by legislators and regulators.

At times, private equity has been criticised for its lack of transparency and if private equity is to improve its reputation, there must be more open debate on how the industry communicates.

We hope that our report will encourage and contribute to this debate.

Inside you will find, for the first time:

- Hard data clearly showing the gap between the perceptions of GPs and LPs, with regards to how well they are communicating
- Direct quotes from experienced GPs and LPs expressing thoughts previously shared only behind closed doors
- Practical advice on what this means for your firm and how best to prepare for the risks and opportunities ahead.

Our survey of almost 250 LPs and GPs reveals issues of clarity and reporting accuracy and confirms that LPs sometimes do not give truthful answers when asked by GPs to explain why they have declined to make a follow on investment in a fund.

We also cover the drivers behind changes in reporting requirements, perceptions of fund reporting quality and the kinds of supplementary data being requested by LPs. Attitudes towards new investor relations tools and regulation are, likewise, discussed.

We would like to thank each and every GP and LP that generously gave their time to participate in the research. Without their involvement, this report would not have been possible.

Raymond Page
Managing Director, IAG

Afshin Taraz
Managing Director, Thompson Taraz

Highlights

- Although 92% of GPs believe they are providing their LPs with all the information they need, more than half of LPs disagree
- More than half of LPs have put a manager on review owing to poorly communicated personnel changes and 42% have done so because of inaccurate or incomplete reporting
- 63% of LPs have taken meetings with GPs of funds they had already decided against investing in and 16% admitted to lying to GPs about the reason for deciding not to invest in their fund

IAG delivers specialist fund administration services for private equity, real estate, alternative assets and listed fund structures. Each client is served by a highly skilled team led by a board director. Since its inception, IAG has administered over 400 funds and globally has assets under administration of over $12bn.

Thompson Taraz is a leading UK fund services group offering fund administration, PE depositary, third party fund management (including AIF Manager solutions), and related fund consulting services. Thompson Taraz has been a regulated operator and manager of UK funds for over 10 years.

Thompson Taraz Despositary Limited and Thompson Taraz Managers Limited are authorised and regulated by the Financial Conduct Authority.

The reporting *status quo*

Advances in technology have immeasurably improved the efficiency and availability of reporting at the portfolio company and fund level. Even with these advances, however, GPs may struggle to satisfy the changing demands of an increasingly sophisticated investor base. Despite these significant challenges, most GPs believe they are doing a great job.

HOW DO GPs RATE THEIR REPORTING?

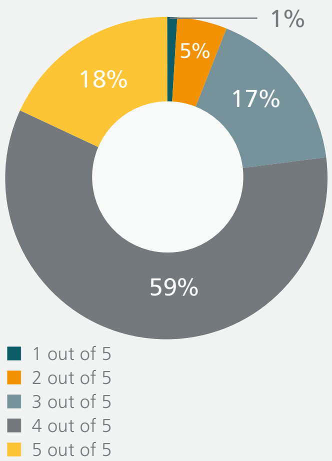
GPs tend to rate their reporting either 4 or 5 out of 5 – very few private equity fund managers recognise any serious issues with their fund reporting (see chart 1, below).

In fact, 92% believe that they are giving their LPs all of the information they need: fewer than one in ten GPs recognises that there may be a problem (see chart 2, below).

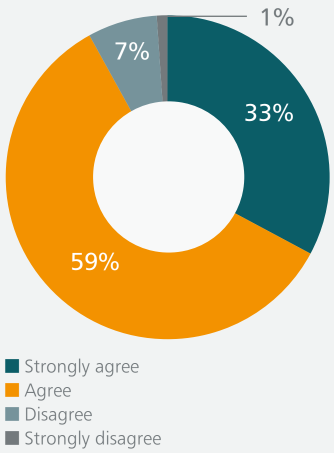
And, in the view of most GPs (96%, in fact), they are also generally very responsive to requests for supplementary data (see chart 3, below).

92% of GPs believe that they are giving their LPs all of the information they need

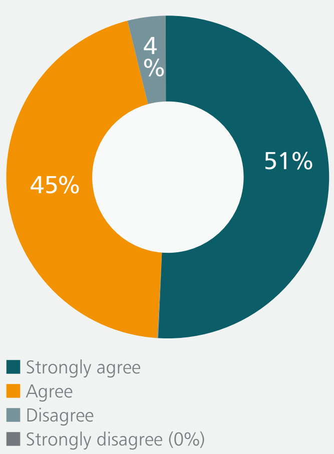
1. How GPs score the quality of their fund reporting (out of a maximum of 5)



2. GPs: I am providing my Limited Partners with all the information they need



3. GPs: I am generally very responsive to requests for supplementary data



A WORD OF ADVICE

Side letters can have a significant impact on what and how GPs have to report to specific LPs. Speaking to an advisor can help outline the specific reporting implications of proposed fund terms and conditions.

"LPs are increasingly looking for total transparency even at the investee financials level. Hardly any small/mid-cap manager has the capacity to do this"

Managing Partner, South East Europe Buyout Fund

So what do LPs think?

As we have seen, GPs believe that their reporting is of a high standard and, consequently, rate their fund reporting very highly. Although the private equity investor relations function has matured, encouraged to no small degree by a shift in the balance of power towards LPs since 2008, there is still some way to go.

As the charts below show, LPs consistently rate GP reporting lower than GPs rate their own efforts. The biggest discrepancy lies with VC funds: VCs rate themselves higher than any other type of GP – but LPs rate them the lowest. GPs must accept that a gap remains between what they are producing and what LPs require (see chart 4, below).

Despite the bullishness of GPs, they are yet to meet the reporting expectations of their investors consistently.

Indeed, whereas more than 90% of GPs say that they provide their LPs with all the information they need, fewer than half of LPs agree. GPs must recognise this issue and adapt, so that they can better support LP requirements (see chart 5, below).

A WORD OF ADVICE

GPs should manage expectations by discussing reporting during fundraising, reaching agreement with LPs regarding what will be considered reasonable requests and what will be considered reasonable timeframes in which to satisfy them. The LP advisory committee can be a useful ally in these discussions if its support can be won.

> "If we can put a man on the moon in two days, what's the hold-up?"
>
> Director, Private Equity, South East US-based LP

4. How GPs and LPs rate Fund Reporting

5. LPs are getting the information they need

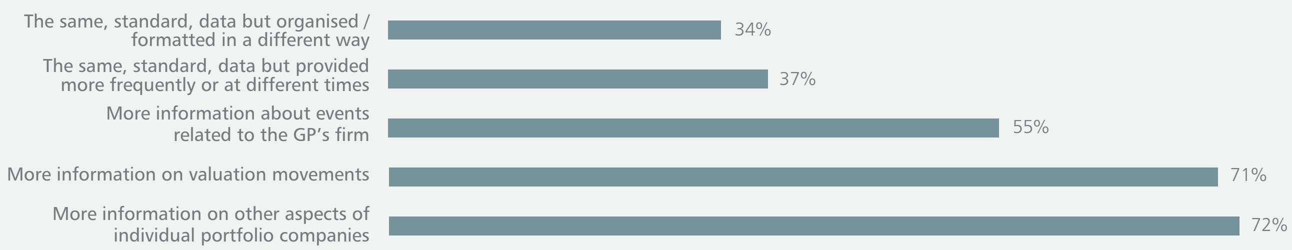
SUPPLEMENTARY DATA REQUESTS

Reporting can feel like a burden, particularly to smaller managers, and the divergent information requirements of today's LPs are resulting in more requests for additional information: one GP told us the investor relations team had received over 9,000 LP enquiries across its fund range in a single year.

We asked GPs the nature of the supplementary data requests they receive. Almost two-thirds of GPs had seen requests for the same standard data formatted in a different way and a similar proportion had been asked for more information on portfolio companies, beyond valuation movements.

When we questioned LPs on what they tend to ask for, their view was different (see chart 6, below).

6. LP Supplementary data requests according to LPs (multiple responses possible)



Good communication is built on mutual trust

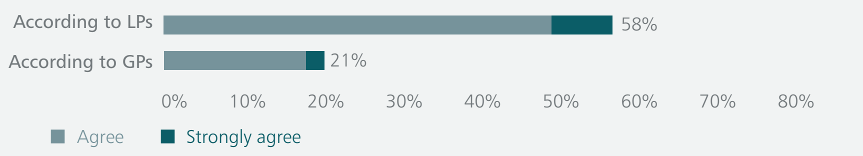
DELIVERING ON PROMISES

LPs now spend more time and money than ever on due diligence and, as a result, even oversubscribed funds are tending to take longer to raise. Increased competition for their investment funds has also meant that LPs are able to take a much tougher line during the negotiation of fund terms and conditions. The greater competition faced by GPs is a strong incentive to deliver exceptional service during fundraising - but are GPs just as service-oriented once the ink has dried on the LPA? Not always, in the experience of the LPs we interviewed (see chart 7, below).

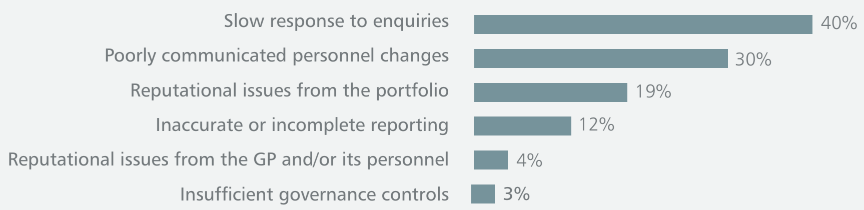
More than 50% of LPs complained that this was their experience but only 1 in 5 GPs agreed that this does happen (see chart 7, below).

GPs do recognise, however, that they could be quicker at responding to LP requests and one in five has had to deal with tricky situations in the portfolio. Just over 10% said that there had been instances of inaccurate or incomplete reporting in the past and close to a third agreed that they hadn't always communicated personnel changes (including succession planning) well (see chart 8, below).

7. Once an LP has committed to a fund it sometimes takes longer to get the information it requires.



8. Issues GPs have experienced at their own firms



A WORD OF ADVICE

GPs that communicate problems quickly and transparently help their LPs stay ahead of any potential reputational issues. As the reputational risk of investing increases in importance for LPs, poor communications can severely undermine support for a GP's next fund.

"Lack of transparency shows a lack of respect for LPs – if communications issues start to add up at one GP, it's a definite red flag"

North Asian insurance company

"Bob, I know I've tapped you to succeed me when I retire. How about leaving by armed escort in 10 minutes instead?"

Succession planning, the wrong way
© David M Toll,
www.privateequitycartoon.com

Communication, communication, communication…

As we have observed, communication between GPs and their investors is far from perfect, even if it is significantly better than it was 10 years ago. But does this matter? Can communication issues affect the likelihood that an LP will put its hand in its pocket when the next fund is launched?

The answer is a definite "yes": Each one of the 128 LPs that took part in the study told us that they had put a manager on formal review for one or more communications or reputational issues (see chart 9, below).

More than half of LPs have put a manager on review owing to poorly communicated personnel changes and 42% have done so because of inaccurate or incomplete reporting. If a problem cannot be avoided, it is important for GPs to communicate this to their LPs as soon as possible. How a GP communicates bad news may have more of an impact on LPs than the news itself.

TRUST IS A TWO-WAY STREET

As we can see in the chart below, almost two-thirds of LPs we surveyed have taken a meeting with a GP despite having no intention of investing in the GP's fund. Everyone knows that this happens – but it is revealing to see the extent to which LPs confirm it! Meanwhile, more than a quarter of LPs have requested sensitive data only to benchmark other funds or have asked for additional data that they did not use (see chart 10, below).

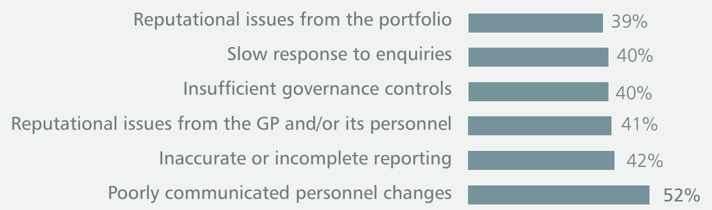
With the increasing workload of the modern LP, it is perhaps understandable that a requested LP portal password might not get used, but it is much harder to defend the fact that (at least) 16% of LPs have lied to a GP about why they did not invest in their fund. Of course, these behaviours are simply symptoms of the increasing commercial awareness of LPs.

But the level of mistrust and suspicion they engender in GPs is potentially damaging to LP/GP relationships, particularly as GPs are prone to exaggerate the extent of LP "bad behaviour".

For example, 99% of GPs suspect that LPs have met them despite no genuine intention of investing in their fund. Further, 91% suspect that LPs held these meetings so they could obtain sensitive information in order to benchmark other funds they were more actively evaluating. Meanwhile, 84% of GPs suspect that LPs have misled them with regards to why they did not invest in their fund (see chart 11, below).

How can the industry hope to improve the quality of its relationships if this level of mistrust exists?

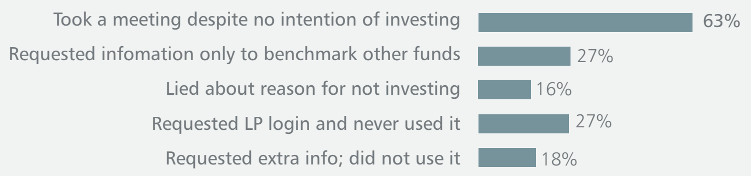
9. Issues that have led to a manager being put on review by an LP



"Sometimes GPs' egos are so inflated that you cannot give them the true reason for passing; they may write you off completely"

Senior Managing Director,
North American Insurance Group

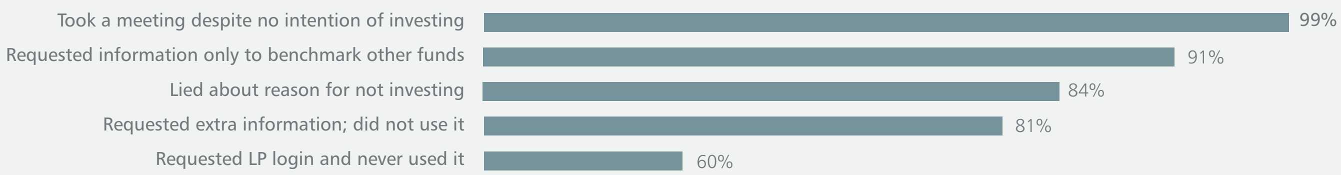
10. An insight into LP behaviour – proportion of LPs that have demonstrated the following behaviours



A WORD OF ADVICE

LPs may not feel comfortable revealing the real reason for not investing in a GP. An independent perception study can be a good way to pick up useful feedback.

11. GPs suspecting LPs of the same behaviours



What can be done to improve LP/GP relationships?

IS REGULATION THE ANSWER?

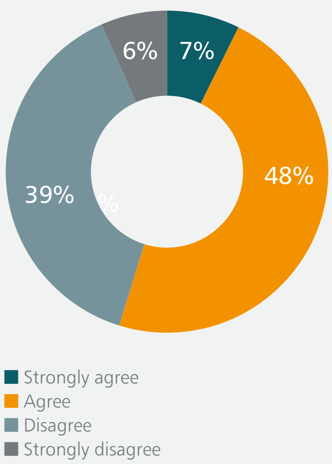
Both GPs and LPs have highlighted instances where transparency and openness have taken a back seat. Regulators and legislators are tasked with protecting pension funds and other investors from damaging and even fraudulent activity on the behalf of fund managers. Roughly half of both GPs and LPs (who end up bearing the costs of regulation) believe regulation is, in principle, good for private equity investors (see chart 12, below).

Does this mean that the apparently poor reception of AIFMD amongst GPs and LPs has been overstated by the press? Sadly not. While regulatory supervision, in principle, is considered a good thing for investors, AIFMD is distinctly unpopular. It is perceived as serving political goals, rather than protecting investors (see chart 13, below).

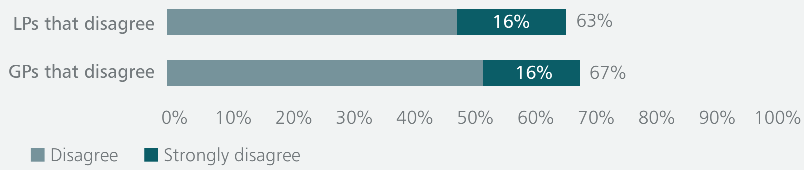
Like it or not, AIFMD is here. It and other regulatory changes are expected by both LPs and GPs to be the most likely driver of changes to fund reporting in the future (see chart 14, below).

Like it or not, AIFMD is here. It and other regulatory changes are expected to impact fund reporting

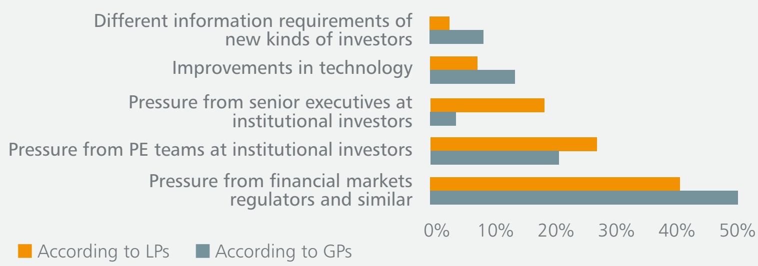
12. LPs agree increased oversight is good



13. "AIFMD represents a good approach to the regulatory supervision of private equity"



14. Most significant driver of future changes to fund reporting



A WORD OF ADVICE

Regulation cannot be avoided – but it can be influenced. GPs should encourage their LPs to be proactive in making sure that policy makers understand their actual concerns and how incumbent and proposed regulatory changes may harm the industry.

"Does AIFMD do a good job? This is a joke question right? It does not address the needs of private equity investors but seems to be designed to fight battles that are only in the imagination of the regulator"

Director, Private Equity Fund Investments, UK Asset Manager

Can technology really deliver?

If changing the rules and increasing oversight isn't the right solution to the communications problem in reporting, then what is? The answer may lie in technology.

Despite the fact that some LPs have previously admitted to requesting credentials for LP portals and then never logging in, technology is nonetheless having an impact on how LPs and GPs communicate and share information.

LP Portals and other online tools are sure to play a bigger part in the industry in the near future. Two-thirds of GPs are expecting to invest more in portals and 83% of LPs are very happy to see them do this (see chart 15, below).

LP Portals and other online tools are sure to play a bigger part in the industry in the near future

15. Attitudes towards GP investment in LP Portals and other online investment tools

"By far the most frustrating issue is that everybody does things differently. It is not the portal…"

Partner, Head of Private Equity, Swiss Family Office

A WORD OF ADVICE

Don't invest in an LP Portal without first canvassing the needs of your LPs. Once everything is up and running (it will take longer than you thought), employ resources to train your LPs on how to use the system for their own benefit.

STANDARDISATION

Another way to tackle the issues at hand is to focus on the standardisation of data interchange. One of the main issues for GPs is that they are asked to provide the same data in a large number of different formats. By standardising how data is exchanged, GPs will be able to run reports just once and LPs will find it easier to compare reports across funds and managers and to view their entire portfolios in aggregate.

One such standardisation initiative is the AltExchange Alliance, founded by a number of LPs, GPs, advisors and intermediaries. AltExchange now has 50 members, including the Institutional Limited Partners Association (ILPA) and released the industry's first data standard in December 2013.

In summary…

We have seen how GPs tend to overrate the quality of their reporting and the information they share with their LPs. Although LPs are mostly happy, some have specific complaints about the timeliness and usefulness of some GPs' outputs.

We've also seen what kinds of supplementary data are being requested by LPs and how it can sometimes take longer than LPs would like to receive them.

LPs have given a clear message that poor or obstructive communications policies can lead to a manager review. However, we also found that LPs are not always communicating with transparency either.

SO, WHERE DO WE GO FROM HERE?

LPs have a right to expect timely, accurate, complete and pertinent reporting from their GPs and they should be able to expect that any reasonable requests for additional data are also dealt with in a timely fashion.

On the other hand, every GP should be able to focus its resources on its core functions and rely on its LPs not to make unnecessary demands for data they won't use or don't really need. They should also be able to expect their LPs to be honest with them.

Practical steps towards stronger GP/LP relationships

GPs

- Be as open as you can afford to be
- Anticipate and forewarn investors of any potential portfolio or personnel issues – speed is important, especially when communicating bad news
- Get to know the data requirements of your LPs early during fundraising
- Invest in technology – it can deliver enormous efficiency improvements
- Support standardisation initiatives – these can save time, but you will need to work with your GP peers

LPs

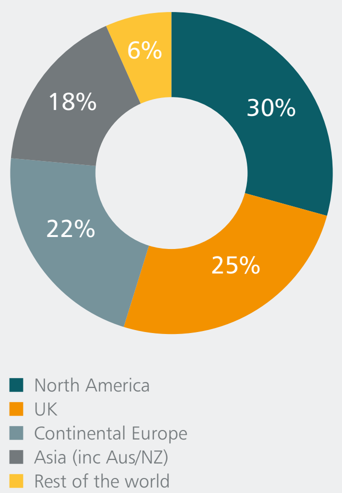
- Think before you ask – do you really need that extra data?
- And if you really do need that data, be reasonable about deadlines – do you really want your GP to drop everything to get you that energy efficiency report from 1996?
- Foster trust - be open and honest about your intentions when meeting or rejecting a fund
- Include the quality of a GP's communications in your due diligence – speak to incumbent LPs about their experiences
- Tackle issues head-on – make sure the GP understands your issues and how you want to be communicated with and be sure to monitor how the GP deals with your concerns

About the participants

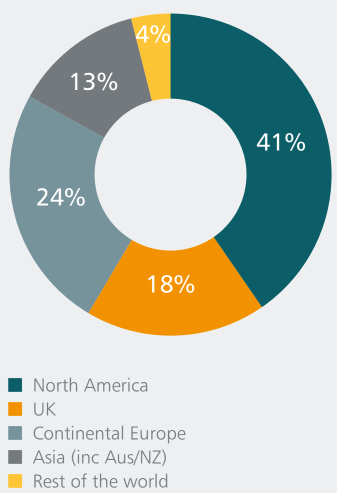
101 GPs and 128 LPs participated in the research study:

LOCATION

Location of GP Participants



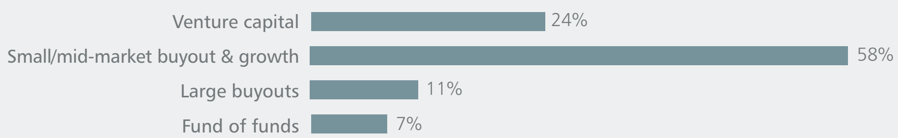
Location of LP Participants



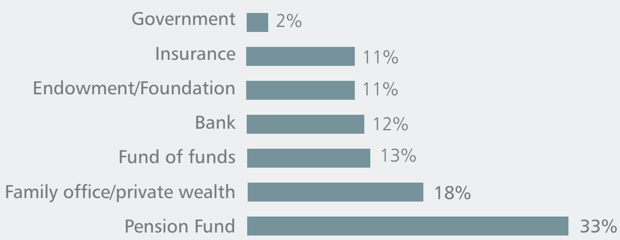
figures total 101% owing to rounding

FIRM TYPE

Investment Focus of GP Participants



LP Institution Type



NB: Participants working at funds of funds were considered LPs if their core function was manager selection, and GPs if their core function was investor relations or fundraising

IAG
Regency Court
Glategny Esplanade
St Peter Port
Guernsey, GY1 1WW

Raymond Page
Managing Director
T +44 (0)1481 723450
E rpage@iag.co.gg

Thompson Taraz
35 Grosvenor Street
Mayfair
London, W1K 4QX

Afshin Taraz
Managing Director
T +44 (0)2907 8787
E afshin.taraz@thompsontaraz.co.uk