Global Insights on PE Fundraising

Market insight report

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Contents

PE fundraising has bandwidth to accommodate ESG-related regulation

Capital is flowing into ESG investments. Many GPs are on the case. But to stay ahead, they will need credible evidence of impact, not just slick marketing.

Environmental, social and governance (ESG) investing is fast becoming a juggernaut. In European ESG-oriented funds, AUM grew 40 per cent to EUR684 billion between 2015 and 2018, with 290 ESG-oriented funds launched in 2018. In the US, AUM doubled over the same period, reaching almost USD90 billion.

"To be (green) or not to be. That is the question!" states Frederique Duval, Head of Relationship Management and Local Sales, TMF Group (Luxembourg). "What was considered a new trend 10 years ago for ESG/Social Responsible Investment has evolved into a wake-up call and real awareness at every level of the chain. Climate change and other factors combined to make people more aware of ESG investing. Suddenly investors became more concerned about how and where they wanted to invest, and what lay behind the assets in the funds they were allocating to – this signalled the start of impact investing gaining prominence in the global funds industry."

Sachin Vankalas, general manager of the Luxembourg Finance Labelling Agency (LuxFLAG), which certifies funds' ESG credentials, says ESG is playing an increasingly prominent role in the PE space: "The capital deployed via PE has the potential to have much more impact compared to investments in listed equities.

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Frederique Duval, TMF Group (Luxembourg)

Because PE holdings typically involve significant equity stakes in portfolio companies and board representation, GPs know their portfolio companies better and can influence underlying ESG strategies. Holding periods are also longer in many cases which is very compatible with sustainable investing."

Luxembourg is a well-known regulated market and since the AIFM Directive was formally transposed into law in July 2013 global PE/RE managers wishing to use Luxembourg as a distribution hub have gotten increasingly comfortable with regulatory compliance. As well as offering a range of regulated fund products, Luxembourg has an active listed green bond market and LuxFLAG, referenced above, is a foundation that awards the LuxFLAG label to funds that meet responsible investment criteria in **Microfinance**, **Environment**, ESG (Environment, Social, Governance), **Climate Finance** and **Green bonds**.

"These initiatives, which apply to regulated fund vehicles, are also helping to influence the behaviour and investment practices of PE/RE managers running unregulated vehicles. That is a trend I'm now seeing," observes Duval.

LP demands

LPs recognise there are now more opportunities to have a positive impact on the world through PE.

Adam Black, head of ESG & sustainability at Coller Capital, a PE secondaries investor, says LPs want to be seen to be close to ESG investing.

"Their engagement is also becoming more sophisticated," he says. "A few years ago they were asking GPs if they had an ESG policy in place. Today, they want to understand the investment management process in some detail, the level of engagement with portfolio companies, and want to see evidence of an ESG policy being put to work, such as through case studies. They want to be shown that their ESG investment is not just a box-ticking exercise."

However, there are distinct regional differences.

The Coller Capital *Global Private Equity Barometer*, which reports on a survey of 112 LPs from around the world revealed that two thirds of European and Asia-Pacific LPs were either taking climate change into account in their PE decision-making or said they would be doing so within two to three years. In North America, it was one third.

The report stated: "A significant minority of North American investors continue to regard ESG-related investment criteria as irrelevant or inappropriate for their private equity funds." But Dr Andy Sloan, deputy chief executive, strategy at Guernsey Finance, says this is changing quickly: "About a year ago I would have said there was very little interest from North American LPs in initiatives like our Guernsey Green Fund – a regulatory ESG 'kitemark' – but they are showing a lot more interest now, particularly since the launch of the US Alliance for Sustainable Finance (USASF), which is supported by some of the world's largest financial institutions."

There are also regional differences within Europe. The Nordics and the Netherlands in particular seem to have been at the forefront of ESG investing, although it is difficult to pin this down to any specific reason – it seems to be a combination of cultural, structural and regulatory factors.

Walter van Helvoirt, environmental and sustainability expert in the private equity department at FMO, the Dutch development bank (which invests as an LP into emerging market private equity funds and directly in EM corporates) says that in the Netherlands, ESG has been recognised as an important factor in business risk mitigation for many years now.

He points to a close interaction between the wider impact and development finance community and commercial investors, who have mostly been welcoming of society's views. He also says the liberal, more progressive

governments of the Netherlands and the Nordics have probably also played a role – influencing how businesses are governed and putting ESG high on the agenda.

Regulation will also have played its part. According to Morningstar: "In the Netherlands, pension plans are required to disclose in their annual report whether or not ESG factors are incorporated and, if so, how. In Sweden, industry guidelines on marketing and information were updated to encompass ESG factors at the request of the regulator."

In the UK, it's a variable picture, although pension funds on the whole appear to be a little behind the curve.

Nick Spencer, founder of responsible investment advisory boutique, Gordian Advice, says: "I would divide it into two groups. You have 'compliant' pension funds that integrate ESG into their investing policies as they are told to do it. And then there are those that are approaching this from a totally different mindset. They recognise that ESG integration is now a requirement if you want to seek the best returns and mitigate the risks associated with investments."

The 2017 report from Harvard Business School, *Why and How Investors Use ESG Information*, based on a survey of 413 senior investment professionals from 'mainstream' investment organisations (not socially responsible investing funds), found: "The primary reason survey respondents consider ESG information in investment decisions is because they consider it financially material to investment performance … Respondents believe that this information is primarily relevant for assessing a company's reputational, legal and regulatory risk. The second reason relates to better ESG performance serving as a proxy for management quality."

Another trend, which is leading to even more LP interest, is the growth of private capital funding of PE. Sloan says: "This is a trend we have been seeing for over five years now. And those private capital providers are very interested in green and sustainable assets. They are also more likely to be quicker than larger institutional investors to move their asset allocations into the ESG space."

Moreover, part of the reason for increased ESG investing in the PE space is down to the fact that millennial investors, who after all represent the next generation of investors, are far more switched on when it comes to socially responsible investing. Because of this, says Duval, fund sponsors are doubling their efforts "to make sure they do not risk losing a booming segment of business created by the 'millennial effect'."

"Today's millennial generation and soon the Z generation care about the future of the planet and PE/RE managers – as well as long-only fund managers – are building ESG-compliant funds to attract younger investors, and impact the environment in a more positive way," she says.

ESG investing correlating to better returns

This shift of LP focus hasn't caught PE by surprise. The Coller Capital *ESG report 2018* reported on a survey of 71 GPs representing 278 PE funds and found that 85 per cent already have an ESG policy in place; 88 per cent integrate ESG principles into their investment process; and 51 per cent reported to their investors on ESG (up from 40 per cent in 2016).

It is also a phenomenon clearly led by European GPs.

Seventy two per cent have signed up to the United Nations supported Principles of Responsible Investing, compared with 40 per cent of Asian GPs and only 19 per cent of North American GPs, according to the ESG report.

While PE interest in ESG is becoming more widespread, the intensity of activity is also increasing.

Black says: "Where the ESG role started out in some firms as a function in investor relations or communications, today, firms are making more 'operational' ESG hires to engage with their portfolio companies. They are realising the most important place for ESG skills is the deal team."

Private Equity fund administrators are moving swiftly to

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> **Tom Whelan, Hogan Lovells**

embrace the virtues of ESG investing in tandem with GPs and LPs, none more so than TMF Group, which has seen its PE clients increasingly adopt ESG principals into their investment decision-making processes.

As Duval explains: "UN PRI has seen an increase of signatories and that testifies to this collective awareness and shows how important ESG has become. At TMF Group, we are on board the ESG train and currently submitting our file to UN PRI supported by strong local initiatives, efforts and management."

Tom Whelan, global head of private equity and partner at law firm Hogan Lovells, says the sharp increase in ESG investing activity by PE funds over the last two to three years isn't necessarily driven by pressure from LPs or altruism.

He says the biggest driver is that GPs are realising that ESG investing is highly correlated with better returns on investment: "ESG investing tends to be in high-growth sectors anyway – for example, an investment into recyclable or degradable packaging is odds-on to beat an investment into non-recyclable plastics. Also, as more investors get into this space, you see valuation multiples being driven higher in comparison to non-ESG investments."

There is growing evidence to back this up. Bain & Company studied a sample of 450 PE-led exits (between 2014 and 2018) in the Asia-Pacific region and found that the median multiple on invested capital was 3.4x for deals with social and environmental impact, compared with 2.5x for other deals.

"More and more of our PE clients in Luxembourg are looking at ESG. It is being discussed more widely. We have a number of ESG-oriented PE funds and we are seeing appetite grow in the market for these types of investments," confirms Duval.

Regulation – an unlikely ally?

GPs should also expect regulation to accelerate LP demand for ESG investments, and to impact on their own operations.

France was an early regulatory mover. In 2016, it introduced Article 173, a mandatory reporting framework for institutional investors to demonstrate how climate change considerations are incorporated in their investment and risk-management processes.

In the UK, the government released its *Green Finance Strategy* in July 2019.

It expects all listed companies and large asset owners to disclose in line with the recommendations of the Financial Stability Board's *Task Force on Climate-related Financial Disclosures* (TCFD) by 2022. It is also looking into the appropriateness of mandatory reporting.

But it is the EU's **Action Plan on Financing Sustainable Growth**, launched by the European Commission on 8th March 2018 that will probably have the biggest impact.

The Action Plan aims to connect finance with the specific needs of the European and global economy for the benefit of the planet and has three objectives:

- Reorient capital flows towards sustainable investments to achieve sustainable and inclusive growth;
- Manage financial risks stemming from climate change, natural disasters, environmental degradation and social issues; and
- Foster transparency and a long-term outlook for financial and economic activity.

Part of this strategy will be to ensure that asset managers, institutional investors, insurance distributors and investment advisors include economic, social and governance (ESG) factors in their investment decisions and advisory processes.

While it is still early days as the plan has not yet come into law, it is proposed that: advisers will be required to ascertain their clients' ESG investment objectives and preferences; managers of investment products will need to publish written policies regarding the integration of sustainability risks in their investment decision-making process; and disclosures will need to be made in accordance with a common taxonomy, to ensure consistency of ESG reporting, making investment products easier to compare.

Van Helvoirt says this common taxonomy will be useful, saying the lack of a common ESG reporting structure today is an unnecessary burden on GPs.

He says: "For us as an LP, it is a necessity to be able to evaluate and compare the impact of different ESG investments, but there is no value in the reporting itself, so it has to be lean and efficient."

Regulation is even being used to stimulate the flow of capital. Sloan of Guernsey Finance says the Guernsey Green Fund has been developed as a regulatory framework to provide confidence and transparency in the underlying investments, which are verified and certified for their ESG credentials.

"It is a very deliberate strategy to go 'upstream' to the sources of fund capital and be a generator of green assets in Guernsey," comments Sloan. "The Green Fund is an ideal 'wrapper' for PE funds because that's where you often find highly focused investment strategies – and ESG can be one of these. There is a growing acceptance that it lends itself towards being able to attract capital."

Attitudes to these regulatory moves tend to be sanguine or even positive, and as Duval states: "I think people tend to see regulation as a barrier or an additional constraint that will involve more compliance costs; it takes additional work and manpower to comply with the regulation(s) but I think ultimately it is always to protect the end investor. If you take the UN PRI, this is not a regulation but a way to encourage best practices and for GPs to show that they are making an effort. I would say that is a very good start."

Whelan says that PE houses have become more comfortable with a more demanding regulatory environment and over the last few years have taken on more compliance and administrative staff, even general counsel, to keep up.

He concludes: "There's more bandwidth in the industry to handle a new ESG-related regulatory burden. I think they'll take it in their stride." ■

A Luxembourg perspective

Insights on Luxembourg's Private Equity fundraising market

No matter who you talk to, global private equity has enjoyed a period of enormous growth in the last few years and, in Luxembourg, this has proven to be a key factor as it has looked to drive interest, globally, in regulated private equity funds.

As the Association of the Luxembourg Fund Industry (ALFI) reported at the end of 2018, although the PE fund landscape is still dominated by funds of EUR100 million or less in AUM, the number of large PE funds (EUR500 million and above) has increased to represent over 4 per cent of the total, with the Reserved AIF fund structure and unregulated Limited Partnerships representing 30 per cent of all Luxembourg-domiciled PE funds in 2018.

"Private equity funds are performing well and attracting new investors and the boom seems to show no sign of ending," comments Ramón van Heusden, Head of Client Services, TMF Group, Luxembourg.

Even though total net assets raised (USD426 billion) in 2018 were down slightly on the record level of USD566 billion raised in 2017 according to Preqin, it is fair to say that with more than USD1 trillion in dry powder, PE groups have enjoyed substantial fundraising success over the last few years.

Rising markets have led to an attractive selling regime among PE groups as they seek to lock in solid returns in their portfolios, but one of the dangers in such a highly valued marketplace today is that PE managers, weighed down by so much dry powder, start to acquire portfolio companies at prices that may prove to be overly inflated, in the event of a market reversal. In short, PE managers might still be raising substantial capital from investors but they are under increasing pressure to put that capital to work, and transform companies they acquire, so that even if the market becomes challenging, they can still create sufficient operational value at the time of exit.

"Companies continue to do well in most industry sectors and that has an impact on valuations, which some PE funds are taking a lot of benefit from," says van Heusden. "Private equity is still a sector where institutional investors continue to allocate more and more money in to, and that money needs to be deployed using robust fund structures; and in that regard, Luxembourg is a good jurisdiction to use.

"PE and RE managers have learned the lessons from 2003 to 2007 when prices continued to increase and leading to the credit crunch and subsequent events of 2007/2008. Funds that were launched in these years and bought assets at the top of the market got hit hard, some didn't survive – especially open-ended structures – while others incurred significant losses, when the market went into free fall.

"I should imagine those PE managers who went through the global financial crisis a decade ago are all too aware of over-paying for companies in the current market environment."

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Marleen Dijkstra is a principal in the Funds Investment team at AlpInvest Partners, one of Europe's leading PE groups with approximately EUR38 billion in AUM. Speaking on a fundraising outlook panel at the 'IPEM' event in Cannes in January this year, she commented that a big market correction would be needed for it to materially impact private equity markets.

"What we've learned having invested in private equity for more than 15 years is that a solid and consistent deployment is fundamental to achieving positive returns in the long run," said Dijkstra. "In our experience, it is better to look at multi-year targets in PE rather than year by year to capture the market opportunities at each point in time. There is no need for any sort of radical response to short-term market volatility."

Van Heusden agrees that there is a risk that companies are over-priced and that a major market correction in 2019 could have an impact on net capital inflows to private equity; possibly leading to outflows from some PE funds.

"It depends on the growth of the global economy and whether we start to see clear signs of a slowdown, which could make the markets nervous; as was witnessed in December 2018," he says, observing that some US private equity groups continue to show clear interest in Europe, both in terms of making investments and setting up new fund structures in Luxembourg, as part of a centralised distribution strategy.

"The types of clients we typically work with are mid-sized managers who are new entrants to the Luxembourg market, which requires us and other service providers to provide support and education. They tend to invest in specialist areas

"For example, one client recently set up a fund to invest primarily in cybersecurity companies. Another client is investing in software solutions for the online tourism industry. Technology focused opportunities such as artificial intelligence and biotechnology are also key areas of investment and present a good value proposition.

"As these companies grow, they become the focus of early stage growth PE funds," explains van Heusden.

For PE managers looking to fund raise in Europe, Luxembourg offers many advantages. It has a long and distinguished history, having been home to UCITS funds for the last three decades. Indeed, it is the second largest onshore jurisdiction in the world, after the US.

When the Alternative Investment Fund Managers Directive ('AIFMD'), the Grand Duchy moved swiftly to update its alternative fund products, introducing the Special Limited Partnership (SCSp or *société en commandite spéciale*), which took inspiration from the Anglo-Saxon GP/LP model to make it more appealing to global PE groups.

Since 2013, more than 1,400 special limited partnerships have been established, most of which are unregulated.

The Luxembourg limited partnership has a number of advantages over the English limited partnership. Although the SCSp does not have its own legal personality or capacity, all contributions, acquisitions and dispositions of assets are made in the name of the SCSp and not the in the general partner's name nor any of the limited partners.

Aside from the SCSp, another highly attractive product for PE groups to consider is the Reserved AIF, which must

be managed by an authorised EU AIFM. It can be created in the form of a company or a contractual common fund (FCP). If it is established as an investment company with variable capital it is set up legally as a SICAV. There, it can choose to operate as a partnership (SCS or SCSp), a limited liability company, or a limited company form; whatever suits the manager best.

"The Special Limited Partnership and the RAIF have proven popular with PE groups. All the large law firms are here, the Big 4 accounting firms, technology firms, administrators, custodians and so on. And in addition, the jurisdiction is well located, being in close proximity to Frankfurt, Berlin, Paris, London.

"More managers are also choosing to set up operations here as authorised AIFMs and establish economic substance; some of the functions are then outsourced to third parties, so there is a big push for talent," comments van Heusden.

Those two structures alone should, over the next five years, lead to a good level of new business for the Grand Duchy says van Heusden.

Looking ahead for the rest of 2019, van Heusden is broadly optimistic on the overall fund raising dynamics.

"There is some uncertainty, with Brexit and other political factors, which could have a negative impact on valuations and, ultimately, on the level of fund raising. There is some risk of a slowdown in the market but I don't think it will be anything significant," concludes van Heusden. ■

A Jersey perspective

Why technology can play a role in PE fundraising

In a recent **PE Outlook Report 2019** produced by *Private Equity Wire*, Andrew Bentley, Partner at Campbell Lutyens, a leading global placement agent in private markets, made the following comment when asked how he viewed the fundraising environment for 2019: "We expect most capital will be applied to servicing re-up requests from LP's core existing managers, with new relationships being harder to consummate versus 2017 and 2018. Smart money will be looking for cycle-tested managers, proven cross-border reach and a technology edge."

With the US/China trade war far from resolved, after the Trump administration decided on 9th May to impose a 25 per cent tariff on USD200 billion of China imports – swiftly followed by China imposing its own tariffs on USD60 billion of US imports – PE managers face the prospect of buying companies in more uncertain market conditions.

The risks of overpaying for companies, especially those exposed to global trade, are likely to be at the forefront of managers' minds when seeking out where best to deploy dry powder. It is no surprise then that seasoned investors are likely to allocate to managers who have a track record of improving companies' fortunes during the bad times, as well as the good.

"It's hard to say given where the markets are today whether or not we might be teetering on the edge of a market correction and increased volatility," comments Thomas Erichsen, Head of Fund services, EMEA, **TMF Group** (London). "Any sophisticated investor is going to be interested in the track record of a manager when allocating to private equity, just as they are when investing in other asset classes. They want to understand how that manager has run their portfolio during difficult market periods and in that regard, emerging managers may not necessarily be viewed as a safe pair of hands.

"An investor might park some residual capital with a newer manager...but they're not likely to back them with substantial capital, given the current market environment."

The more forward-looking PE managers in the middle-market space are beginning to embrace the use of technology to help them improve their fund raising efforts and better connect with investors. Platforms like CEPRES, for example, are improving the whole portfolio monitoring and reporting aspect of investing in private markets. Its PE.Analyzer tool is the first benchmarking platform of its kind and as CEO, Dr. Daniel Schmidt, says: "Exchanging data with LPs builds confidence and it helps GPs by knowing exactly what their position is in the market.

Using technology to better understand the vicissitudes of LPs, and how they think about their PE allocations, can go a long way to improving the fundraising process because it gives managers a more focused, tailored approach.

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Still, Erichsen believes that compared to the hedge fund industry, PE managers are at least five or six years behind the curve when it comes to using technology.

"There's a lot of catching up to do," he remarks. "There is still a lot of manual intervention in PE firms, and also in PE/RE fund administration groups.

"We see our PE clients asking for more bespoke middle-office reporting services, which we can provide. The dynamics are changing thanks to technology advances. Managers want to be armed with more real data when they do their modelling and shadow accounting. As an administrator, we house all of this data. The question is, how do managers access it on a day-to-day basis without having to constantly call up their administrator to ask them to send a particular report? That relationship between PE managers and their administrator is likely going to continue to evolve."

Technology is not just important for managers to improve their internal operations, it is also one of the most attractive market sectors to look for growth opportunities. In Europe, there are numerous 'fintech' or digital hubs in Luxembourg, Ireland, the UK and Germany that are home to a diverse range of early stage tech companies looking to make the next step in their evolution.

"A lot of companies in Europe are developing disruptive technology solutions to challenge the way a lot of things in traditional business are done. When analysing companies, PE managers want to see if they have the right supply chains in place, the right sort of market segmentation, and whether, by injecting a certain amount of capital, they might better streamline their operations with the use of technology to reach more customers.

"Another sector that we've seen clients exploring is the clean tech space; which one could categorise as a sub-sector of the technology space. A lot of people want to be first movers in this area and as a result a lot of capital is being deployed in that direction.

"PE groups with impact funds are also looking at Africa to invest in sustainability projects spanning agriculture, clean water production and so on," says Erichsen.

One of the risks to investing in technology companies is having a high enough level of confidence that when it comes to exiting the investment after five years, for example, they are still relevant and well suited to serving the needs of its customers. This is no easy task given the rapid speed of technology innovation and the changing habits of consumers.

"What is going to be the next wave in terms of how people communicate and connect with each other? What is the next tech solution to emerge? Tech companies that launched a number of years ago are trying to redefine themselves to remain relevant. Is there business model sustainable for long-term use? These are questions that PE managers have to think about when investing in the broader technology space," suggests Erichsen.

Another finding that came out of the PE Outlook Report 2019 related to co-investing. According to Andrea Auerbach, Head of the Global Private Investments Group, Cambridge Associates, approximately USD30 billion of co-invest opportunities were seen last year "but given that we don't see all the deal flow, you could double that figure to USD60 billion".

"Co-investing is a way to calibrate investors' private investment exposure by investing in specific, individual opportunities. It allows investors to express their portfolio views in what can be a very distinctive way.

"Overall, I believe we could easily see USD100 billion-plus in co-investment deals this year," suggested Auerbach.

Erichsen is not surprised by this forecast. In his view, "I think we are going to see a whole host of ways to attract capital into a fund and deploy it. You don't see co-invest deals everywhere, however. They are typically only offered by investment managers who feel they are right for their strategy."

Part of the reason for such solid investor interest in private equity, aside from the obvious return dynamics and decorrelation benefits to their traditional public security investments, is that it now offers much greater tactical investment potential. This is thanks to an ever deepening secondaries market, which has evolved in such a way that GPs, by and large, are less reticent to LPs wishing to relinquish their interests in a fund; be it for short-term liquidity needs or other factors. It is no longer the preserve of distressed sellers.

The PE secondary market has an estimated **USD50 to USD60 billion** of dry powder and as Erichsen says: "With so much dry powder out there, I think there will be situations where investors want to change their strategy and when you have a healthy primary fund market, there's always likely to be spillover to create an equally healthy secondaries market."

To underscore the fundraising power of those offering secondaries funds, the global behemoth Blackstone earlier this year raised at least USD6.9 billion for its 8th secondary fund, Blackstone Strategic Partners Secondaries VIII. The 2017 vintage raised an equally impressive USD7.5 billion in 2017.

Erichsen notes that part of the attraction for PE secondaries is that it gives investors an entry point further in to a fund portfolio's investment cycle.

"Investors aren't as close to the beginning of the J curve or too far towards the latter part of the J curve; investments haven't evened out. There is still growth but the window of opportunity is shorter in terms of how long one's capital is locked in.

"For some investors, that is a very attractive proposition. They can calculate what their returns are likely to be, over a shorter period of time. If you look at it from a risk perspective, it's probably a lower risk/return profile.

"It's an important way for investors to exit certain investments and redeploy their cash elsewhere. I think that is part of what's driving the growth of the secondaries market," concludes Erichsen. ■

A Guernsey perspective

Insights on Guernsey's Private Equity fundraising market

The last two years have been a boon for global private equity managers. In 2017, total net new assets reached USD552 billion according to Preqin, and although slightly down in 2018, the asset class still attracted USD426 billion.

With close to USD1 trillion in net inflows, it seems investors can't allocate to private equity fast enough, snapping up co-investment and secondary opportunities to supplement their primary allocations as they seek to maintain healthy long-term returns in what remains a low-rate, low-return environment.

Large managers have dominated the fund raising environment, with Carlyle Group closing the largest fund, Carlyle Partners VII, with USD18.5 billion. In Europe, PAI Partners secured a EUR5 billion raise, Triton Partners targeted EUR3billion for its fifth flagship fund, while Inflexion Private Equity Partners LLP, secured GBP1.25 billion for the Inflexion Buyout Fund V.

"We continue to see investor interest in private equity," says Mark Hooton, Director, TMF Group (Guernsey). "It's fair to say though that while investors have capital to deploy, they are being a lot more careful as to who to allocate to. In this current environment, given uncertainty over global economic growth, they are focusing heavily on managers' track records and experience."

Although the fund raising dynamics are likely to remain strong in 2019, it remains a significant challenge for smaller and mid-sized managers to attract investor interest. Institutional allocators will often flock to high pedigree, well-established names when market conditions start to get choppy. As such, 2019 could be a period of even more concentrated positioning, with fewer GPs featuring in PE portfolios.

"Some of these investors are willing to write significant tickets to build closer relationships with a smaller number of managers but that comes with its own challenges for managers. If they have a dominant investor in the fund (in terms of percentage of Fund AUM), they might exert more of an influence over the manager than they would have in earlier fund vintages," suggests Hooton.

In respect to jurisdictional fund raising, from his vantage point in Guernsey Hooton confirms that people are choosing to use the island to raise new funds but admits that the uncertainty from Brexit negotiations between the UK and Europe hasn't helped.

"We are having to educate managers and investors that the Channel Islands lie outside of the EU already and therefore, Brexit doesn't have any real impact on how sponsors set up and launch Guernsey investment funds to market them across Europe. The same regulatory mechanics as we use today will still apply, once Brexit is concluded, so launching a fund amidst all the political uncertainty should present no particular concerns to PE managers," explains Hooton.

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According to Guernsey Finance, the total net asset value of Guernsey's funds under administration reached a five-year high last June, at GBP276.2 billion. Private equity was central to this growth trajectory, growing GBP6 billion through the first quarter of 2018 to GBP112.7 billion.

The closed-ended sector overall, increased by GBP4.2 billion in Q4 2018, to GBP176.3 billion. Private equity funds made up 59 per cent of that total, equivalent to GBP115 billion.

"Guernsey's private equity industry continues to grow," says Hooton. If you look at the local marketplace a lot of the administrators have capability in multiple jurisdictions and if a manager wants to raise a fund where the right answer is to use a different jurisdiction to Guernsey, we will issue the necessary instructions to our global network.

"But for those who do choose Guernsey, they can enjoy good speed to market when raising new funds. The Guernsey Financial Services Commission have very clear timings that they work to, to approve fund applications. We have a variety of different routes. One being the administrator-led 'fast track' regime. As an administrator, we carry out due diligence on the fund manager, and will make an application to the GFSC on the basis of our findings."

Under this arrangement, the manager can be authorised within 10 days. Funds registered under the Registered Collective Investment Schemes Rules 2018 ('RCIS' funds) will be approved within three working days, while applications for those who opt for a Private Investment Fund ('PIF') are approved within just one working day.

"We are working on a couple of fund launches at present as well as a few managed account vehicles. One is a registered fund for an existing client and the second is a registered fund for a new fund promoter. The regulatory regime has been designed to be simple and can be applied to a broad range of investments.

"The island has a workforce that's been working in the funds industry for many decades. There is a deep source of knowledge and expertise and that allows for a very practical approach to helping managers set up their funds and get them to market," adds Hooton.

With ESG/sustainable investing becoming an important trend among institutional investors, those who can offer fund vehicles with green credentials could be well placed to attract new assets in 2019.

Cognisant of this growing awareness to invest more responsibly, for the good of the planet, last year Guernsey introduced a new regulatory wrapper called the Guernsey Green Fund.

"It has attracted a fair bit of new interest. It is basically a regulatory overlay to our existing funds regime that allows the manager, if they meet certain criteria when investing in green technologies, to apply the label to their fund and market it to investors as an ethical investment vehicle. For pension funds and other large institutional investors who have strict ESG guidelines, it's a nice product as it allows them to tick the right boxes for their specific investment criteria," explains Hooton.

Under the Guernsey Green Fund Rules, Green Funds must invest 75 per cent of their portfolio in investments meeting the green criteria. They include: low-carbon technologies, renewable energy, lower carbon and efficient energy generation.

"From a general investment point of view, there is growing interest in this area of impact/green investing. There are numerous emerging technologies and it is providing something slightly different for fund managers to consider in the marketplace. The GFSC has put in place strict criteria (to avoid mis-use of the GGF) for investment managers to get one of these funds approved," says Hooton.

He admits that although there is still work to be done educating fund sponsors on how to launch funds and understanding the constitutional rights of the jurisdiction, it offers a stable funds environment.

The GFSC is very approachable, he says. If one wants to launch something that looks a bit different to other fund strategies, the regulator is happy to have a conversation with the manager to understand how it will work. "We've had some very positive comments from clients in the past about the GFSC, and how accessible they are," says Hooton.

"The island is very much geared towards the funds industry and we've always had access to the EU through National Private Placement Regimes, which we've been doing for the last six years under AIFMD without a problem. Everything is tried and tested. We know what we are doing and AIFMD works for all of Guernsey's regulated fund products.

"The UK, by contrast, has yet to go through that whole learning experience when it finally leaves the EU.

"We hope NPPR will continue to remain an option for managers to market their Guernsey funds to UK and European investors."

Regardless of the outcome of Brexit, Guernsey will continue to work closely with the EU via NPPR regimes, and in that sense, it will continue to be business as usual. Having that certainty will be important for managers when looking to actively fund raise in the EU. ■

The U.S. perspective

US managers dominate fund raising activity

The United States dominates the PE marketplace when it comes to AUM size. It is estimated that the top 300 global PE managers manage USD 1.5 trillion in assets, of which US-based managers account for USD 1 trillion; this compares to USD 177 billion among UK-based managers.

Over the last three decades, the US has been at the vanguard of the PE growth story so it is little surprise that their top managers rule the roost.

As Anastasia Williams, Head of Fund Services, Americas at **TMF Group** remarks: "The big PE fund managers keep getting bigger and I think that is a trend that will continue to play out, certainly among those managers who are US-headquartered.

"If each fund is 20 or 30 per cent bigger than their previous fund, these managers will continue to attract the majority of capital inflows."

The net effect of this is that the gap between the top 300 managers and the rest of the industry will widen. Williams agrees. She points out that the KKR's, Apollo's and Blackstone's of the world are on a wave of momentum, "doing a lot acquisitions but also engaging in greenfield investment activity, building their own offices, etc."

These US-based managers are dominating fund activity across the globe. In Asia Pacific, for example, TPG Capital recently became the fourth US-based firm in the last 10 years to raise more than USD4billion for an Asia-focused buyout fund, closing TPG Capital Asia VII with USD4.6 billion.

Moreover, these multi-billion fund managers are backing up their fund raising success by producing good returns for their investors. They have the economy of scale and depth of experience that institutional investors appreciate, relative to an emerging manager.

"We see global pension plans relaxing their rules on alternative investments, in terms of what is considered an allowable investment or not, and this is making them more open to PE investments," says Williams. "We have seen this in Brazil, in Chile, and there was an announcement last year from Mexico. Pensions are making huge PE allocations that I don't think an emerging manager can capture."

As **PEnews** reported, in the past eight months, firms such as KKR, Lexington Partners, BlackRock, General Atlantic, Blackstone Group, Partners Group and Actis, among others, raised more than USD 600 million from Mexican pension funds, according to a report from 414 Capital, a Mexican financial consulting firm.

One of the reasons why LPs gravitate to the biggest US managers is the fact that they have so much money they need to invest. Size matters for these investors. When they are looking to write tickets of USD 300 million or more, they have to go to established names as they cannot take the risk of becoming a dominant investor with a PE manager who might only have USD 1 billion in total AUM.

> *"The big PE fund managers keep getting bigger and I think that is a trend that will continue to play out."*
>
> Anastasia Williams, TMF Group

One of the effects of there being so much dry powder in the market – which is now north of USD1 trillion – is a trend towards private equity funds engaging in take-private activity.

Williams also notes that some companies are receiving significant capital investments just as they plan to IPO, from PE groups.

According to **MergerMarket**, one in three takeovers of listed companies priced above EUR200 million involved private equity last year. It is thought that the number of take-private deals could rise further in 2019 as markets begin to show signs of a global slowdown. Healthcare has proven to be an attractive target for such activity.

As **PitchBook** reports, three of the four take-private mega-buyouts in the US in 2019, to date, were in the healthcare industry with **KKR** purchasing **Envision Healthcare** for USD9.9 billion, including debt, in October 2018.

Williams believes that as PE groups take these companies private, there will be even greater governance oversight from LPs given that de-listing leads to less transparency and less frequent reporting. Since the mid-90s, the US stock market has halved in size. By 2016, there were only 3,627 listed companies, according to data from the Center for Research in Security Prices at the University of Chicago Booth School of Business.

It is forecast that fundraising in North America could reach USD401 billion in 2019. This compares to USD251 billion in 2018 and, revealingly, USD40 billion in 2017; that's a 10-fold increase in fundraising in just two years, should the forecast figures prove accurate.

That statistic alone underscores just how much acceleration there has been in the North American private equity market in recent times.

By comparison, Europe is forecast to see fund raising levels reach USD150 billion; up from USD88 billion last year but only slightly up on USD123 billion raised in 2017.

"Fund raising activity among US managers is incredible. If one looks at the top fundraising activity right now, Advent International is targeting USD16 billion for its ninth fund, for example. Warburg Pincus has raised USD13 billion for its latest fund, and BlackRock has raised USD10 billion.

"The public markets have rallied for so long, investors are perhaps deciding that there are fewer opportunities to make the desired returns, which these large PE managers are taking advantage of. These are long-term investments, which may protect investors in the event of a near-term market correction, if and when global equity markets fall.

"I think the appeal of private markets is that they offer some protection," outlines Williams.

She believes that one way for emerging managers to succeed in fund raising is to focus on specialty investing. After all, mega-funds need to have a very broad investment strategy to deploy all their committed capital; they can't afford to be limited by a narrow investment universe.

Smaller managers who run a 'pure' strategy that only invests in Asian real estate debt, or LatAm mid-cap companies, or only in industrial or energy assets, have the potential to still attract meaningful assets in this competitive landscape, provided they can articulate their message clearly, and can demonstrate a proven track record.

"I do believe there is still plenty of room for mid-market managers to invest in innovative companies that are too small for the big PE groups to invest in. They need bigger targets if they are looking to put USD16 billion to work.

"If smaller managers can find a niche to attract some of this institutional capital and present themselves to investors as genuine specialists, this could work to their advantage; and in turn help investors diversify their portfolio within the broader private equity space," concludes Williams. ■

An Asia Pacific perspective

Insights on Asia Pacific's Private Equity fundraising market

Fund raising activity for PE funds focused on Asia Pacific proved to be buoyant in 2018, with an estimated USD37.8 billion of net inflows recorded through the first nine months of the year according to Private Equity International's Q3 2018 Fundraising Report. This compared to USD37.7 billion raised for the entire calendar year 2017.

"Hillhouse Capital Group raised USD10.6 billion for its Fund IV, while Carlyle Group raised USD6.55 billion for its Asia Partners V fund," comments Rajindar Singh, Sub Regional Director, APAC Fund Services at **TMF Group**, based out of the group's Singapore office. "It shows that investors continue to allocate to top names in the PE space."

Regional players such as the aforementioned Hillhouse Capital, and PAG, have tended to dominate fundraising in the region but according to **PitchBook**, heavyweight US names, including KKR and Carlyle Group are prospering in the region, from a fundraising perspective, with TPG Capital becoming the fourth US-based firm in the last 10 years to raise more than USD4billion for an Asia-focused buyout fund, closing TPG Capital Asia VII with USD4.6 billion.

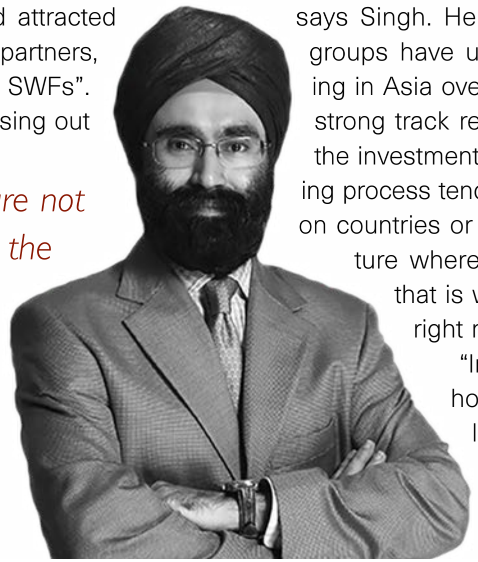
"Asian institutional investors are not too particular as to whether the manager is locally-based or a global manager, as long as they have a proven track record," explains Singh. "When we speak to some of our client fund managers, and their LPs, we find trust levels are good, which helps when raising capital for new PE funds and also RE funds. Knowledge across PERE is a good way to differentiate their offering and appeal to investors.

"If people have worked for global PE groups and chosen to spin off and set up on their own, even if they were well-known when working at that global manager it's not guaranteed they will be successful. Some managers launch and close down within a year or two. It shows that the platform, the team, the historical returns and the track record are key attractions to potential investors."

Interestingly, of the ten largest private equity funds in the market, six are Asia-focused. According to Preqin, in Q3 2018, 36 funds with an Asia focus closed having raised USD25 billion in aggregate capital; 2.5x that of Europe, where 39 funds closed with USD10 billion in aggregate capital.

Outside of the US, Asia is a major fund raising centre for global and regional PE players. It has helped, says Singh, that the performance of private equity against other asset classes has fared well and attracted strong interest among a range of limited partners, "especially global pension funds and SWFs". There is, he says, a sense of fear of missing out among LPs, when new funds come to market, especially among the household names listed above.

> *"Asian institutional investors are not too particular as to whether the manager is locally-based or a global manager, as long as they have a proven track record."*
>
> Rajindar Singh, TMF Group



This has led to record levels of more than USD1 trillion in dry powder, with GPs facing increased competition with their peers to put capital to work in the best possible deals; all the while contending with record valuations in the marketplace, especially in the technology sector.

Singh says this has influenced the market to some extent, citing the activities of SoftBank Group, the Japanese internet conglomerate whose Vision Fund has directly invested more than USD70 billion in technology companies, with no sign of this abating according to **Bloomberg**.

"The SoftBank Vision Fund is a phenomenal development; it is unprecedented compared to previous years," says Singh. He notes that while some global PE groups have undoubtedly had success fundraising in Asia over the last few years, thanks to their strong track records, the more regionally-focused the investment strategy is, the easier the fundraising process tends to be in Asia. "If they are focused on countries or certain sectors, such as infrastructure where the investment horizon is longer, that is where it takes longer to draw in the right number of LPs.

"In areas such as logistics or warehousing in India, we have seen one leading PE client of ours successfully raise not only one but two funds, attracting a range of high profile pension funds.

"Some of the global players are also exploring opportunities in distressed assets, buying them from financial institutions in India and improving the fortunes of companies to generate good upside returns for investors. It is something we've started to observe – more sector-focused and country-focused strategies," says Singh.

According to Preqin fundraising 2019 research, Singh remarks that of the 290 private equity real estate funds being launched globally currently, approximately 25 per cent of them are focusing on the Asia Pacific region. Investors, he says, are looking for early stage growth funds, secondary funds, buyout funds and private debt funds.

"Private equity remains a core part of investors' portfolios," says Singh. "That said, 2019 could present a number of challenges in the market. We are seeing liquidity tightening in China and there is the ongoing trade conflict with the US to contend with. There are also valuation concerns; this is putting pressure on GPs to generate future returns to meet investor expectations. There could be a degree of market correction this year, which could impact some PE funds.

"Moreover, on the opportunity side the same deals are being chased by numerous PE groups. Competition is very high in terms of putting dry powder to work."

Indeed, this remains the case across global markets, not just in Asia.

But when one considers that in China and India, Asia is home to the 2nd and 5th largest global economies, each with its own burgeoning middle class and tremendous technology advances being made – for example, Chinese car manufacturers including BYD, JAC Motors and JMEV are leading the electric vehicle revolution – there is little surprise that global PE groups are looking for an 'in' to Asian private markets. The region is home to huge numbers of private enterprises, yet to transform their potential into regional, let alone global players.

For an ambitious PE group, this is an exciting time to be investing in the region.

"Aside from China and India," says Singh, "some managers we speak with are looking closely at established markets such as South Korea and Japan for the right opportunities to explore. To some extent, Vietnam is favoured. Indonesia is interesting too but PE groups are buying their time and waiting for the dust to settle following the recent elections in April. The dynamics there are still very good, especially in the consumer and financials space.

"Global PE managers whose strategies have broad pan-Asia exposure will also consider the Philippines, Malaysia and Thailand, whereas regional managers will tend to be more country-specific, or chose to focus on SE Asia (Indonesia, the Philippines) or North Asia (China, Japan, South Korea)."

In that regard, local PE groups present something different to the global behemoths when going after the same investors for investment dollars, able to demonstrate more of a niche and expertise in certain markets where local knowledge can uncover good companies to finance.

On the private equity fund administration side, including doing valuation work on the underlying portfolio companies on behalf of its clients, Singh feels there is plenty of future growth yet to be realised in respect to Asia's private equity marketplace.

"We continue to differentiate ourselves in the region and offer a strong value proposition. We leverage our strong global network and technology, operating in over 90 jurisdictions worldwide. We have deep local knowledge in Asia Pacific and can offer one-stop shop solution for PE and Real estate clients, globally, depending on where their fund mandate needs to be serviced.

"In 2019 and beyond, we will continue to focus on small to mid-sized PE and Real Estate managers in the region," concludes Singh. ■

The UAE perspective

UAE is not a mature PE market but technology might help managers' fundraising efforts

One of the biggest issues facing the global PE industry currently is allocating capital to the right investments without falling into value traps and overpaying for companies, such are the record levels of dry powder in the market.

When it comes to fundraising, roadshows are still important but according to Thomas Erichsen, Head of Fund services, EMEA, **TMF Group**, "technology is beginning to play quite a big part, with some managers raising a particular amount and finding new, quicker ways to allocate the capital via technology".

"This has changed the allocation process to some degree in the private fund marketplace, as managers use technology as well as traditional methods to connect with the right profile of investor," says Erichsen.

For newer, less mature PE markets, such as the one being developed in the United Arab Emirates, technology tools combined with traditional roadshows are enabling managers to connect with new investors, be it for primary or secondary PE fund products.

Erichsen notes that the UAE has always been an early adopter in technology, in general. He says that the majority of the fund managers in the region are vertically integrated, "meaning they have their own middle and back office".

"With that said, a fair amount of technology is implemented in order to handle the work load. The usage of technology for fund raising is simply a natural step," says Erichsen.

Technology platforms like Murano, which aims to help better connect GPs to LPs, and CEPRES, which gives institutional investors a way to effectively benchmark private capital market investments, using technical and fundamental analysis, are reshaping the way that fundraising is conducted.

Abu Dhabi-based Gulf Capital, one of the Middle East's largest private equity firms, is gearing up to launch its fourth fund in 2020 with chief executive Karim El Solh telling **The National** that the new fund is likely to be larger than the USD750 million GC Equity Partners Fund III. Reflecting the fact that PE managers need to be patient when putting capital to work in the current economic climate, El Solh said he expected Fund III to make between three and five more investments in 2019, stating: "It's hard to say exactly when as [deals] can take a long time to bake."

The number of PE funds being set up locally within the UAE is on the rise, not only within the traditional jurisdiction of the DIFC (Dubai International Financial Centre) in Dubai but also in the Abu Dhabi Global Market (ADGM), a financial free zone established in 2015. According to Preqin data, there were 17 private equity-backed buyout deals in the MENA region in 2018. Although this was the same number as those recorded in 2017, the average aggregate deal value increased from USD350 million to USD743 million year-on-year.

"In the UAE, investment fund regulation is very clear and straightforward to understand for international businesses and investors. It's becoming an attractive jurisdiction to set up new fund structures."

Thomas Erichsen, TMF Group

For PE managers considering launching funds within the DIFC, they should be aware that their fund activities are subject to regulation and supervision by the Dubai Financial Services Authority (DFSA). There is a zero rate of personal and corporate tax in the DIFC for a period of 50 years from the date of establishment of the DIFC *(Dubai Law No. 9 of 2004)*.

"In the UAE, investment fund regulation is very clear and straightforward to understand for international businesses and investors. It's becoming an attractive jurisdiction to set up new fund structures," states Erichsen. "At present, these local funds are typically making investments globally but going forward there will be a push by the UAE government for more investments to be made locally."

From a fundraising perspective, many of the private banks in the UAE are well attuned to PE investing but as Erichsen points out: "The market here is a lot more mature than in years past. We are seeing a drive for fundraising to happen within the country and in the wider region.

"In the past, people went beyond the UAE to do fundraising, doing roadshows in

the likes of London, Hong Kong, Singapore. Now, however, those roadshows are taking place within the UAE. That's one of the biggest changes we are seeing, and it is being born out by the number of requests we are getting for fund administration services."

Of course, whenever a PE manager is setting up a new fund, one of the key considerations, jurisdictionally, is the amount of tax efficiency that can be achieved. "For that reason," says Erichsen, "the managers we talk to in the region are keen to launch local funds but at the same time they want to get some sort of European exposure by launching a parallel fund (i.e. in Luxembourg).

"The developmental signs in the UAE are all positive and hopefully we will be one of the first movers to provide all the necessary fund administration and regulatory requirements for those managers wishing to launch funds at the local level. I think we will see more and more fund launch activity going forward."

From an investment opportunity perspective, Erichsen says there is quite a substantial interest among PE managers in fintech businesses. This is a key growth area for the Gulf Region, more broadly. A statement issued by the organising **Committee of the First Arab Digital Economy Conference** last December, said the digital economy can contribute more than USD3 trillion to Arab GDP growth. Currently, the digital contribution to the economies of the Arab countries is only 4 per cent compared to 22 per cent globally.

"We see a lot of focus on fintech investments here, including deals with a crypto element to them, which has been quite interesting.

"There is a drive from the Mubadala and other government-backed institutions to develop the investment platform in the country, moving forward.

"We do see less focus on ESG and impact investing compared to other markets but I think that will change as we now have the Mena Index. More investors are reviewing it before they make investment decisions. Hopefully, we will start to see more local (ESG-focused) investments and fund products being launched as a result," comments Erichsen.

One area of future growth that could propel the size of the UAE's PE market is that of PE secondaries, which, at a global level, has enjoyed some strong momentum in recent years.

According to the annual Setter Capital Volume Report, the private equity secondary market increased 36.2 per cent to USD70.2 billion in 2018.

"Given that the PE primary marketplace is doing so well, it is creating a spillover effect, which we are seeing in the secondary market. Managers may, over the course of time, want to change direction in terms of what they are investing in to, and will look to liquidate out of certain long-term investments. Selling GP interests on the secondary market is a way to do this," says Erichsen.

Erichsen is quick to state that PE secondaries is absolutely an important growth area for the UAE. She says that two main types of secondary deals are becoming prominent, not just in the UAE, but globally: GP-led restructurings and single asset deals.

"Due diligence on each deal includes risk and stability in the region to be invested into. The UAE has become an attractive region for numerous reasons; those that are most familiar from an economic and cultural point of view will always lead the way. To that end, TMF Group is reinvesting into its business to be a part of the UAE growth story," remarks Erichsen.

As **Private Equity Wire** reported on 18th June, Chicago-based Adams Street Partners, one of the biggest private equity investors, announced it had closed its sixth secondaries fund. The Adams Street Global Secondaries Fund 6 attracted USD1.05billion from LP commitments and is the last example of a continuing maturation of the global PE secondary market.

This follows on the heels of Whitehorse Liquidity Partners, who closed its second private equity secondary fund at a hard cap of USD1 billion, in addition to Commonfund Capital, who raised USD 450 million for Common fund Capital Secondary Partners II.

One appealing aspect of PE secondary funds is the risk-adjusted return profile, which typically tends to be a bit lower because the investor is coming into the fund further along the J curve – that is, further into the investment lifecycle – than if they had committed capital to the fund at inception.

Erichsen says that PE secondary managers (and their investors) have a lot more fundamentals to look at from a data perspective and can analyse portfolio companies in greater detail; i.e. looking at things from a fund NAV perspective rather than an enterprise value perspective.

The level of transparency is a compelling feature of PE secondary investing, compared to committing capital blind to a new fund vehicle, he says.

In his view, technology is touching the PE industry at various levels, not just in terms of analysing secondary investments "but also in the way that managers raise capital, deploy capital, and operate their businesses. They may be able to unlock value quicker because of the transparency that historically the asset class did not have." ■

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