KEYNOTE INTERVIEW

LPs look to diversify amid uncertainty

In the face of macroeconomic headwinds, investors are readjusting their private equity allocation strategies and eyeing co-investment and secondaries opportunities, says Tim Toska at Alter Domus

Q As the credit cycle turns and interest rates rise, how are LPs managing their PE exposure and what does this mean for LP appetite going forward?

Interest rates, geopolitical tensions and rising energy costs are a challenge for the private equity market. LPs are reviewing their portfolios and looking to the secondaries market as a means to generate liquidity, rather than ramping up their programmes in absolute terms. M&A activity has slowed considerably as a result of higher financing costs and concerns around target company valuations.

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But there are still positive signs out there. There is still significant dry powder available to managers to invest and, although M&A and fundraising activity are below the levels observed in 2021, 2022 will still be a strong year when compared to the pre-pandemic period.

Everyone recognises that the bull market of recent years is closing out and LPs are responding by taking a much deeper dive into due diligence to parse through which managers made their returns by investing in a rising market and which GPs unlocked value through operational improvement and growing EBITDA.

Q In a more selective fundraising market, what are LPs looking for from managers?

As the macroeconomic cycle turns, LPs are taking a forensic look at net returns and how they deliver maximum value from their allocations. One way to do that is to lower fees by participating in co-investment opportunities alongside their most trusted managers. It has become commonplace for our clients to create co-investment funds alongside their fund structures due to the increase in demand from LPs.

Investors do not necessarily want to reduce their allocations, but instead of simply waving through a commitment to a new fund, they want to split that commitment between the blind-pool fund and co-investment opportunities. While co-investments have been a focus for some investors for some time, the changing macro situation is accelerating a market shift.

LPs are also looking to diversify their exposure into other strategies, such as secondaries, credit and real estate. We have seen a great deal of consolidation in the manager space in recent years and managers moving to build out a more robust offering on their platforms. This appeals to LPs, which can go to one manager and create a trusted relationship to fulfil various investment mandates.

Q Amid uncertainty, to what extent is transparency and a manager's ability to harness data and report portfolio performance at pace a factor for LPs in manager selection?

If you had asked me the same question a year ago, I would have said it was a differentiator, but the market has moved so fast that now it has changed from something that makes you stand out to table stakes.

The ability to harness reporting and data for transparency for LPs is a must have. It is critical for managers to have robust, well-built infrastructure that can harness all data throughout the firm. This is especially relevant in uncertain markets when people want updates on what is going on.

Best-in-class data infrastructure is important because it facilitates transparent reporting in a timely manner to investors. However, LPs also recognise that if a firm can provide data to investors in this fashion, then the firm will be able to harness that data across the entire organisation and have a much clearer picture on deal performance and evaluating the pipeline of new deals – in short, everything an investor is looking for when picking a manager.

It is also important to mention ESG in this context. ESG has become a priority for investors. They want to see managers putting frameworks in place to track it across their portfolios and be able to report on ESG performance and supply ESG scorecards.

Q What infrastructure and technological capabilities do managers require to stand out from the pack when it comes to data and reporting?

As private equity grows, the LP base becomes more sophisticated and the asset class opens up to retail investors, the direction of travel is undoubtedly towards getting as close as possible to a real-time look through. Potential retail investors are used to going online and sourcing real-time public markets data instantly. Meanwhile, institutions do not want reporting based on the previous quarter, where the marks are technically tracking the performance of portfolio companies three months ago.

The LP portal has moved far beyond a document depositary. There is more and more investment data available through portals, which feature technology that provide LPs with customisable dashboards. LPs can access data, and in exactly the way they require for their consolidated reporting. LPs and managers are also looking at application programming interfaces and ways to connect and automate data in real-time.

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Providing that functionality upfront is a big undertaking, because you are working with investors, talking to legal and trying to pull all the documents together. But the long-term benefits of moving out of a world of spreadsheets and into an organised system that becomes a single point of truth are significant.

We are working with a number of clients on exactly this, by identifying the pain points, understanding the requirements and coming up with a well-defined plan to set up the connections and build a data index to pull information from.

It starts with having a vision and taking the time to implement it. The lockdown period has accelerated this process across the industry, and it does feel like there has been a step change when it comes to technology, reporting and transparency.

Q What advice would you offer to a manager preparing to launch a fund in 2023?

Be patient and stay the course. The last quarter of 2022 may be challenging because LPs reupped with a large number of blue-chip managers earlier in the year and worked through their allocations earlier than usual.

LPs are not reducing allocations and still have appetite, but just take your time making decisions. It is important to remember that the typical fundraising used to take 18 to 24 months. Recently we have seen multiple dry closes and single closes. That is going to become rarer, but if you are patient and stick to your core competencies there is still demand from investors. ■

Tim Toska is group sector head of private equity at Alter Domus