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ALTERNATIVES

2020 Views from the LPAC

BARINGS INSIGHTS

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Over our 25+ years of investing across private markets, Barings has held hundreds of Limited Partner Advisory Committee (LPAC) seats—helping mitigate conflicts of interest and making suggestions to General Partners (GPs) and Limited Partners (LPs) on best practices. Recently, the uncertainty surrounding COVID-19 has led to various—and, in some cases, uncharacteristic—actions by GPs. From our vantage point as long-standing LPAC members, we offer the following insights on the issues and actions currently under debate.

As GPs navigate the portfolio impact of COVID-19, their focus is no longer limited to raising capital, identifying new investments and managing their existing portfolios. Instead, issues of business continuity, staff well-being and capital access have become front and center, at both the portfolio company level and manager level.

Through recent and wide-ranging conversations with fellow LPAC members, we've found the following six topics to be among the most pronounced in the current environment. While this is not an exhaustive list, we believe LPs should take these particular factors into consideration as they manage their portfolios and allocate capital throughout the remainder of the year.

1. GPs are Pulling LPA Levers to Build a War Chest

The Current Trend: In this climate of COVID-19-induced disruption, GPs are highly focused on maintaining or strengthening their capital reserves, and increasing investment flexibility. In order to accomplish that, many are seeking LPAC support for changes to Limited Partner Agreements (LPAs)—which can include the extension of investment periods, increasing recycling provisions, loosening concentration limits and greater use of add-on provisions for existing companies. But not only do these changes result in increased access to investment capital for defensive purposes; they also provide the GP with opportunities to build future economic value—which effectively enables the LPA's provisions to function beyond their intended purposes.

Our View: As long-time investors in private equity, we tend to take the view that supporting our GPs will pay dividends. Still, we—like all LPs—have designed our portfolios and liquidity profiles to manage existing investments while still ensuring the targeted long-term exposures are met through new commitments. We believe the allowance of added capital flexibility and time should be decided on a case-by-case basis, influenced by each underlying fund's performance and the overall capabilities of the GP. As such, we propose that LPs ask the following questions as they evaluate existing managers:

- Does the GP still believe in the value of the assets?
- Is the GP the right manager for the issues at hand?
- Is the alignment and motivation of the GP in sync with the LPAC and other LPs?

2. Capital Call Facilities are Creating Complications

The Current Trend: Capital call lines were originally put into place as a means for GPs to better manage cash flows and streamline interactions with LPs. But over time, the strategy has increasingly morphed into an IRR enhancement tool, as some GPs will borrow capital and allow it to remain outstanding for extended lengths of time. In fact, we presented our views on the same topic in our 2019 Views from the LPAC—including inconsistency of capital call line application, along with risk tolerance differences across GPs and LPs. A new round of discussion on the use of credit facilities has been catalyzed by COVID-19 and the economic concerns of today, as lenders become more conservative and GPs use their facilities more aggressively. GPs, for example, have been seeking to draw on their lines to gain cash reserves, increase capital availability, and lengthen repayment schedules, with the intention of protecting current portfolios from the pending economic slowdown.

Our View: There are many valid administrative benefits to capital call lines, particularly during a period of economic turbulence, when capital availability can be a lifeline for portfolio investments. And we believe the GP's goal, as the portfolio manager, is ultimately to maximize value—but to do so within the LPs' guidelines of strategy, duration and risk. The value of investing equity at the cost of debt capital can be an attractive arbitrage, but that strategy 'comes home to roost' during periods of higher economic uncertainty. In today's environment, increasing the size or duration of capital call lines also has the potential to increase fund expenses—but without the corresponding upside associated with capital allocations during periods of growth. It can also potentially put LPs' own liquidity positions under pressure. In our view, matching the duration of invested assets and liabilities is the most prudent portfolio management decision, and this view is compounded as portfolio stress is magnified.

3. GPs are Weighing Existing Investments Against New Opportunities

The Current Trend: Many GPs are facing a dilemma, as the economic downturn has led to the deterioration of financial performance across a wide swath of existing portfolio companies. Realizations will be delayed; value creation strategies are being reassessed; and value preservation plans are being implemented. Funds that are beyond their investment period will require greater human and capital support to bridge companies to an exit—while both are already stretched thin. Further, funds currently in their investment period have the dual requirement of value preservation and sourcing new opportunities. Cross-fund investment activity is becoming an option that some GPs contemplate as a solution to both support current investments and originate new opportunities—resulting in a potential conflict of interest to be addressed by LPACs.

Our View: GPs are expected to have the ability to allocate appropriate time and attention to their investments, and maneuver through the complications of funds at different stages of their lifecycles. Multiple influences—such as remaining fund life, performance, distributions, carry and capital availability—can steer a GP to one strategy over another. Alignment of business interests between LPs and their GPs may not always be in sync. And cross-fund investments are an example of the type of exposure that can exacerbate conflicts across funds. Hence, we are not an advocate of cross-fund transactions in any climate. The LPAC and LP base must be engaged in understanding how GPs are striking this balance, as well as the potential conflicts that can arise.

4. Clawback Discussions Will Increase Between LPs and GPs

The Current Trend: Similar to what we experienced during the global financial crisis (GFC), we expect that LPA clawback provisions will once again become a point of discussion between LPs and GPs. The question is not 'if' but 'when'—as performance fee waterfalls weigh the impact of portfolio company write-offs against prior portfolio company realizations. Currently, there is very little formal engagement between managers and the LPAC on this topic—but with increased expectations of asset write-downs, capital infusions and delayed realizations, pressure on fund returns will increase and the conversation will likely become more prominent.

Our View: At times, the GP will take its performance fee early, under the expectation of achieving a minimum return associated with the fund. While this is not a situation that will apply many times within an investor portfolio, it creates uncomfortable conversations between GPs and LPs when late write-downs create clawback situations. The ultimate outcome can vary on a fund-by-fund basis, and GP delays to write-down companies may occur due the impact that clawbacks have on employee retention within the GP. With the current downturn exacerbating the potential for future clawbacks, the time is appropriate to address the topic and future plans. Turning to future GP distributions, and having a plan to address underperformance for past carried interest allocations, should be discussed between the LPAC and the GP. Within that conversation, there must be a recognition of the implications that clawbacks have on former members of the GP, and on the retention of current investment professionals.

5. COVID-19 Related Disruptions are About to Flow Through Valuations

The Current Trend: On the whole, GPs did not expect COVID-19-related disruptions to be a major influence on valuations in the first quarter of the year, but the level to which they expect the pandemic's effects to be reflected in their second quarter valuations varies. Private equity valuations are not subject to the daily gyrations of public markets but rather are "smoothed" over quarters and therefore lag public market valuations in terms of timeliness and reporting. This smoothing of daily up's and down's is typically part of the asset class's attraction, but today's unstable environment means that valuations don't reflect the state of the markets in real time. As such, the GP and its LPAC play an important role in ensuring reasonableness of valuations and integrity of reporting amid a swiftly shifting climate. A fair reflection of portfolio value is necessary to:

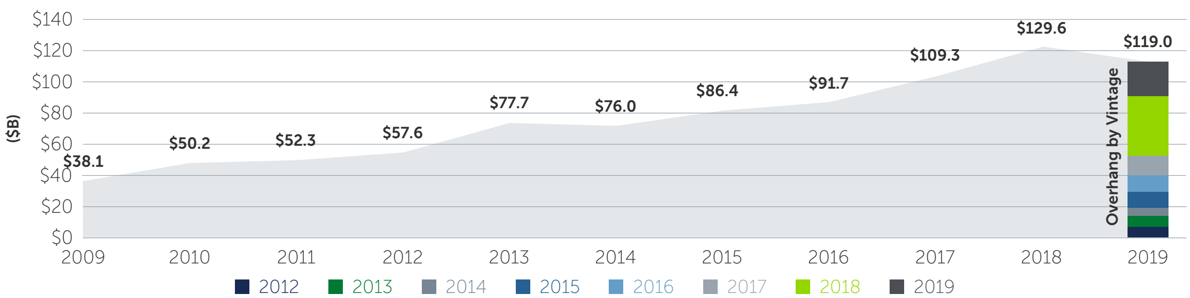
1. Accurately assess GP performance on a relative and absolute basis
2. Set LP performance expectations
3. Control how the GP is compensated by LPs (in both management fees and performance fees)
4. Correctly report portfolio values in the books and records of LPs

Our View: COVID-19-related market distress has brought private equity valuations to the forefront of LP discussions, as there's a notable disparity when comparing them to the actual market environment. This, in turn, creates a struggle for GPs: How can they remain consistent with the reporting methodology, while also accurately reflecting the environment in which they are operating? During the GFC, because of the lag in private equity reporting, coupled with changing accounting standards at the time, valuations took four quarters to fully reflect the trough. This time around, we would expect reality to be reflected more quickly, but ironically, due to the rapid recovery experienced in public markets from the March lows, we anticipate the GPs may be less aggressive with regards to marking down valuations. In other words, notwithstanding a potential second wave of COVID-19 and/or worsening economic conditions, the extreme gyrations in public markets may be smoothed away in their private market comparables. That said, LPs need guidance to determine the degree to which performance has realistically been impacted—and their conversations with the GP should be focused on integrity, fairness and consistent valuation methodology in the context of the current climate.

6. LPs are Increasingly Interested in the Secondary Market

The Current Trend: Across the board, LPs are dealing with internal portfolio issues, and preparing for a potential continuation of the economic slowdown through the remainder of 2020. All else equal, at the end of the first quarter, private equity exposure grew as a proportion of LPs' overall assets, due to the denominator effect caused by volatile public market declines. In some cases, this resulted in breaking LP diversification rules, CIO mandates and Board approvals—ultimately creating a need to rebalance portfolio allocations and liquidity. This, in turn, should bring greater attention to the secondary market—where, in recent years, LPs have increasingly turned to manage exposures, and sell down non-strategic or underperforming funds **(FIGURE 1)**.

FIGURE 1: Secondary Market Cumulative Dry Powder Has Risen Steeply Over Time



SOURCE: PitchBook. As of September 30, 2019.

Our View: Similar to the GFC, we expect LPs to increasingly leverage the secondary market to manage their private equity exposures. However, we would advise that LPs be patient with their secondary processes, as the uncertainty surrounding private market valuations will keep bid-ask spreads on secondary transactions very wide and volumes very low. Forced sellers in 2020 will be seeking liquidity at the very moment that pricing in the secondary market reflects significant uncertainty and limited demand. If we look to the past as our guide, the experience of LPs who sold positions in 2008 and 2009 was not positive—as they locked in losses or limited future markups. Additionally, in many cases, LPs opted to sell positions with higher quality GPs in order to 'find a bid' and facilitate a secondary transaction. This resulted not only in losses to reported NAV, but also in deterioration of portfolio quality and gaps in portfolio exposure. We believe this is a critical time for LPs to understand:

1. The details of their underlying assets
2. Their GPs' ability to navigate their remaining companies through these difficult times
3. The fairness and timeliness of GPs' valuation methodology
4. The strategies being deployed to preserve portfolio company value

The Takeaway

For LPs, this is the time to be engaged and understand the potential conflicts at hand with their GPs and LPAC members. The LPA provides investors with a number of protections, but it does not contemplate nuances. Additionally, with the sheer volume of requests coming in to LPAC members from GPs—as well as the complexity of even the simplest adjustments to LPAs—it can be a heavy burden for LPAC members to stay diligent in their review and maintain the protections originally constructed in the LPA. With such a slippery slope, minor allowances today have the potential to become permanent allowances, or give broader discretion to GPs, when greater discipline should be the true focus. As such, we believe LPs should know the issues in depth, feel empowered to ask the tough questions, and understand the motivations of all parties involved in decisions being made on behalf of limited partners within a fund.

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