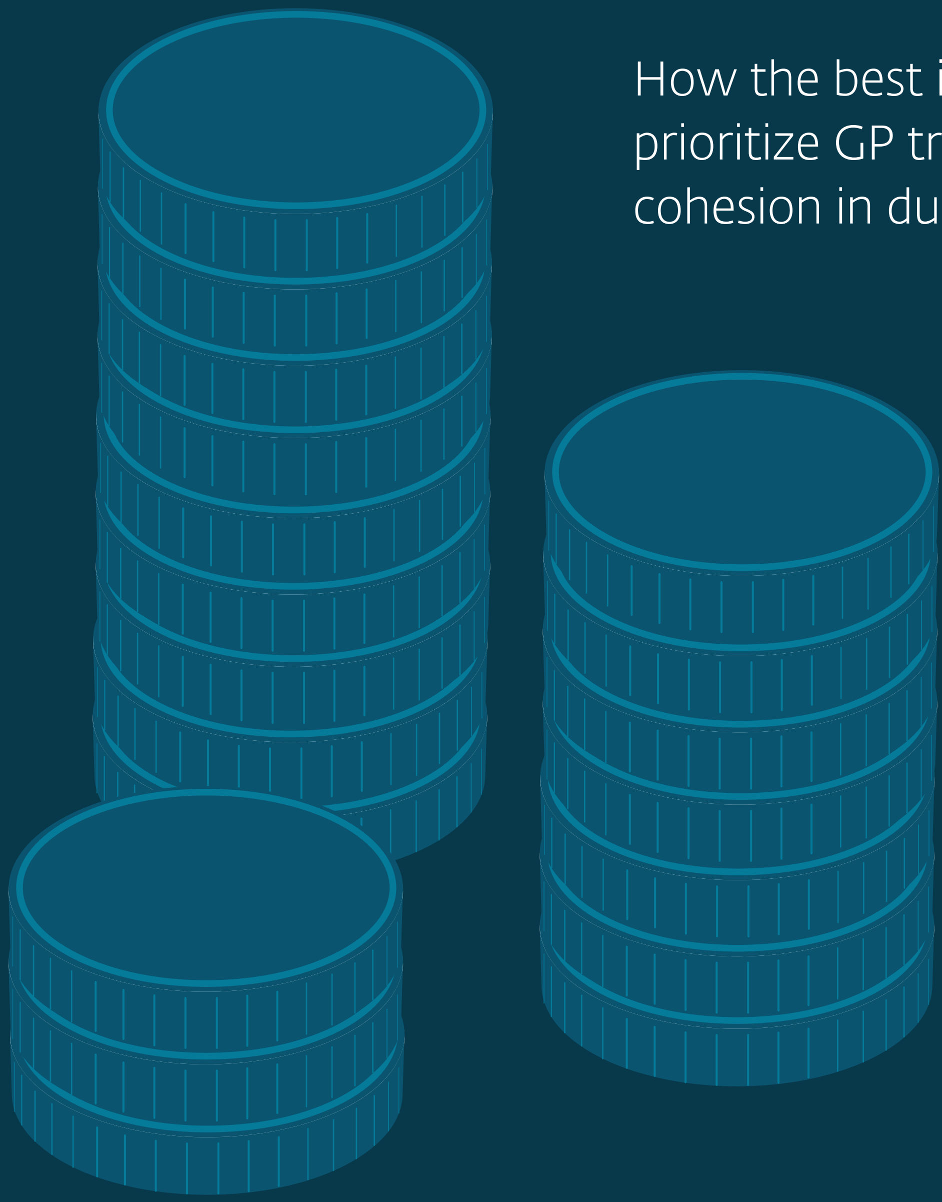
Q3 2017

Privcap/ Report

Forget Fees—Focus on the Team

How the best institutional investors prioritize GP track record and cohesion in due diligence



Experts

Michael Elio
StepStone

Gregory Stento
HarbourVest

Graeme Faulds
eVestment

Forget Fees—Focus on the Team

How the best institutional investors prioritize GP track record and cohesion in due diligence

Privcap recently organized an expert webinar exploring the top considerations that limited partners have when weighing a commitment to a private equity fund. What follows is an edited transcript:

Privcap: Graeme, eVestment recently completed a survey of LPs regarding how they perform due diligence on fund managers. What were the key findings?

Graeme Faulds, eVestment: I think one of the headline results from the survey was that when asked to rank and rate the important factors in the due diligence process, the one that came out on top was the team, by quite a significant amount.

We also saw that fees, although important, actually scored quite far down the scoring system, when we got into the detail of the track record analysis that investors are performing. So fees, in and of themselves, are not a critical part of the due diligence process. But the impact of those fees on performance is quite important.

We also saw that investors tend to trust the numbers that they're getting from the fund managers, but interestingly, 76 percent of investors said they will recalculate the performance they're receiving and do the slicing and dicing of the quantitative analysis more often than not.

Michael, with those numbers in mind, why is the team such an important part of the due diligence process?

Michael Elio, Stepstone: Obviously the team is who you're giving your money to, right? So when it comes to being an LP and assessing a general partner, you're not doing what a general partner does. A general partner can look at a company, look at the balance sheet, the numbers, all the metrics, and say, okay, this is the company I can support. When you're an LP, instead, you are effectively writing a blank check to a team, and that team, that cohesion, that dynamic, and their skill set is the most important aspect of what you're investing in.

Gregory, what are your thoughts?

Gregory Stento, HarbourVest: This is a people business. No question about it. All you really have is the people and the limited partnership agreement. And so you're putting all of your confidence and trust and conviction in that team, in their ability to execute their strategy and to deliver the results that are compelling you to make the investment.

Gregory, LPs now have access to much more data than in the past. How do you use that quantitative data to support the qualitative analysis of a team?

Stento: We think a little bit of investing in private equity partnerships is a mosaic. You've got lots of little tiles, lots of little pieces that you're trying to assemble together to get an overall picture of what the investment opportunity looks like, and that data helps you to assemble a lot of those little pieces to the puzzle. So the data can help you to quantify aspects of the investment to create measurable and comparable points that you can utilize in thinking about an opportunity relative to other opportunities. But it can also obviously help you very specifically with regards to the opportunity that you're looking at.

We want to make sure, through the data, that we understand what a manager is good at and what a manager is not so good at, and we want to make sure that the manager understands that as well. A lot of times we'll have someone come in and make certain assertions about the way they invest and create money, and when we start to run data around that, we realize that sometimes it's not quite aligned with what the manager says. So we want to make sure that we're using that data to verify what we're picking up during the due diligence process.

Michael, how are you using data to sort of help ask better questions of your LPs?

Elio: It's not often I quote Donald Rumsfeld, but when it comes to assessing a manager right, you've got your "known knowns," your "known unknowns," and then your "unknown unknowns." Data really helps us ignore the "known knowns," so that we can truly focus on what are the list of questions from a qualitative perspective that the quantitative side have just eliminated.

The trick is to make sure that you don't spend too much time on data and do that at the loss of too much qualitative time on the team itself.

Can you talk about some of the major qualitative factors that you look for when you're assessing a team and why those factors are particularly important?

Stento: We're looking at the continuity of the team, working together, trying to understand any turnover that's occurred.

↓ CONTINUES ON NEXT PAGE

When you look at a track record, are the current partners really the ones that are responsible for that track record, or is it people who have retired or left the organization? We try to understand the performance that's been generated by the team. Is that balanced by a person or balanced by a partner at the firm? Is it more skewed towards certain individuals, or parts of their strategy or geographies or industries that they invest in?

How are they structured to share information with each other and communicate with each other, and how do they leverage off that entire team to understand whether or not the investments that they might be putting forward in one geography or one industry sector are as good as the opportunities in other geographies or other industry sectors. What kind of bandwidth does the team have? In other words, what kind of capacity they have when they're raising a new fund to invest that fund.

We also look for the balance of the team just from a generational perspective. Is there age diversification? Do they have a talent management program? Very much, this is an apprenticeship business in which you hope that there is mentoring that's going on and in developing people into good investors.

Michael, of the factors Gregory mentioned, what are the ones that are most difficult to sort through? How do you try to overcome those hurdles?

Elio: One, you've got the length and quality of the experience of the team. That's pretty straightforward, or it sounds it. But in order to figure out whether that's truly the case, you really have to spend some time getting to know the firm. I know it sounds like basic common sense, but common sense should hopefully rule a lot of our investment decisions that we make every day.

Number two, it's team cohesiveness and the integrity of the leadership. We can do a lot of analysis, and you can do a lot of numbers, but really to get deep into whether this is truly the case, this has to do with reference calls.

Third is really their network. So if you've gone through one and two, so you know they have a history, and you trust them that they have good leadership and it's a stable team. Then it's "do they have a network?" Right. Can they actually source deals and add value to them, and the data can help you determine the value add and who was responsible for what. But you really need to look at a detailed assessment of the portfolio responsibilities–who has done what.

It's amazing some GPs put CEOs on their reference list, and when you actually talk to them, they give a reference on something completely different. So I think GPs should be fully aware of what's up to speed with their portfolio company references. And then the last that really comes to the top is capacity. Gregory alluded to this as well: Assets under management per partner. How many board responsibilities do they have, do they have the capacity to take on another fund?

Graeme, what's the perception in terms of how well GPs are helping to provide this information, and to really give LPs a good sense of the team?

Faulds: The industry has improved greatly in recent years. I think the smart managers appreciate that they have to be providing more information, and they are doing that.

One of the issues that we hear from GPs is that the amount of information that is being requested is putting a constraint on them. It's tying their deal executives up for quite a significant amount of time during the fundraising process.

Gregory, what are your thoughts? What improvements, to your mind, need to be made?

Stento: When the general partners come in, they're usually open to having a transparent, open discussion. I will say that even some appear to have been coached in their ability to present, and how to present and what to say. I'd say that's only a minority, but nevertheless some come in and they're incredibly polished, and you have to be very thorough and comprehensive in your due diligence to make sure that you're not investing in a good marketing pitch.

Elio: GPs are doing okay. I have to say that some are far more prepared than others. I think when ILPA came out with the DDQ, it kind of sent a shot across the bow that here is this massive extensive list of questions that could possibly be asked. I'm not saying you have to answer all of them upfront. But the reality is, when an LP is looking at a GP and assessing their fund, they're assessing the team as much as the data itself, and how the general partner handles this inquiry is really an indication of how they're going to handle the transfer of information when the LP becomes an actual limited partner in their fund.

If GPs could be more upfront and open earlier on in the process, I think limited partners would really go beyond the data and focus on all of those qualitative factors that we've been talking about today.

How does a first-time fund handle questions about the team?

Faulds: First-time funds shouldn't get hung up in trying to create a track record. The good thing is, from our survey we know the primary focus is on the team. I think when people are looking at their track record, they're slicing and dicing it, and it's very difficult to do that with a track record which has perhaps been compiled from a number of individuals from different backgrounds and different shops.

I would suggest that one of the better things they could do would be to do more in the way of case studies of

➜ CONTINUES ON NEXT PAGE

particular deals they have done as individuals, and try and highlight some of the things that they have learned in their past experience.

Is there anything that you often see as the biggest stumbling block that LPs have with GPs?

Faulds: Inconsistency of message. A key part of the analysis they're doing is asking lots of questions in lots of different ways to lots of different sub groups of the team. And if the message doesn't stack up consistently, then that's a big red flag. ■

About eVestment:

eVestment is the leading provider of data and analytics to the institutional investing community, with over 2,000 asset managers, investors and consultants using our solutions. eVestment's Private Markets Intelligence Solutions provide LPs and GPs with sophisticated fund performance analytics and deep market insights to aid in managers' investor relations and fund analysis, and investors' due diligence and fund selection.

www.evestment.com

Access a copy of eVestment's 2017 LP Due Diligence Survey referenced in this report here:
www.evestment.com/project/private-markets-due-diligence-survey-2017

The Experts

Michael Elio
Partner,
StepStone Group

Michael Elio is a partner at StepStone. He focuses on global investments. Prior to StepStone, Elio was a managing director at ILPA, where he led ILPA's programs around research, standards, and industry strategic priorities. Prior to joining ILPA, he was a partner and managing director at LP Capital Advisors and led the firm's Boston office where he served as the lead consultant to North American and European institutional investors. Elio served as the primary consultant for many of the firm's largest clients, including public and private pension plans committing in excess of $5 billion annually. Elio held several progressive positions in private equity, including VP at State Street Corporation and VP at Credit Suisse First Boston Private Equity overseeing the funds management group.

Graeme Faulds
Director of Private Equity Solutions,
eVestment

Graeme Faulds joined eVestment in 2015 with the acquisition of TopQ Software Ltd. Prior to founding TopQ in 2013, Faulds was one of the founding partners of SL Capital Partners, a leading private equity fund-of-funds. During his 15 years at SL Capital, he was responsible for making private equity fund investments and direct co-investments throughout Europe and North America. He has sat on the advisory boards of a variety of private equity funds during his career. Faulds has an M.A. in Economics & Management from the University of Glasgow and an M.Sc. in Investment Analysis from the University of Stirling.

Gregory Stento
Managing Director,
HarbourVest

Gregory Stento joined HarbourVest in 1998 and focuses on global partnership investments. He is a member of its global investment committee and also serves on the advisory boards of several private equity partnerships. Stento joined HarbourVest from Comdisco Ventures, where he was a managing director and provided equity and debt capital to startup and emerging growth technology and life sciences companies. Prior to Comdisco, he was a general partner at Horsley Bridge Partners, where he was responsible for making and managing investments in a variety of private equity partnerships and companies. Stento also spent six years in marketing and sales at NCR Corporation, where he focused on information technology solutions for financial institutions.