All the pieces matter

Private markets fundraising

May 2021

Black Business Growth Fund®

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“Yeah now, well, the thing about the old days: they the old days” – Slim Charles (The Wire)

Introduction

The Wire is an American crime TV drama which aired in the 2000s, set in the city of Baltimore, chronicling how the choices of institutions (e.g. law enforcement, drug dealers, newspapers, schools and municipalities) ultimately have positive or negative effects on a city and its people. President Obama called it one of the greatest pieces of art ever made and, not that it matters, but I also rate this as the greatest story ever told with many lessons to take from it.

The quote references Slim Charles (“muscle” for one of the original drug organisations in The Wire) who states the obvious through such a memorable line - that times change and that you have to change along with them or get left behind. This came out in the findings from our recent survey contrasting the responses received from institutional investors and private equity fund managers to key factors that form part of allocations to private markets. The results highlight that what was considered market norm by private equity fund managers should no longer be considered the case, and that change is needed in the industry.

Over the coming weeks we will be issuing a number of thought leadership pieces entitled “All the pieces matter”, where we will provide insight into how private equity fund managers can better align their offerings with the needs of institutional investors. These will cover our views around fee structures, deal pipeline development, impact and outcome measurement.

Finally, we would like to thank all the participants to this survey for their input and hope the analysis supports the acceleration of funding to private markets, in particular for independent black private equity funds and women-led teams.

Chad Potter

27four Investment Managers
Private Markets

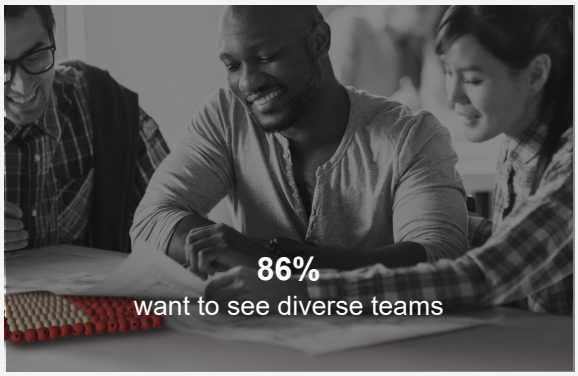
Survey highlights

We found that private equity fund managers and institutional investors were aligned on the important factors such as the attractiveness of the investment strategy and the experience of the team. These factors were closely followed by demonstrable track record as a team being another perceived area of importance to both sets of participants, but less so to investors.

On the other hand, there is a clear disconnect with regards to the importance of attractive commercial terms, measurable impact and outcomes, and diversity of teams. We unpack this in more detail in this report, but highlight here the key areas of misalignment that private equity fund managers need to improve if private markets are to gain a greater share of South African institutional investment allocations.

Investors

100%
seeking attractive commercial terms



100%
want the fee model to change

Fund managers

78%
consider attractive commercial terms as important to investors

70%
think that the existing fee model works

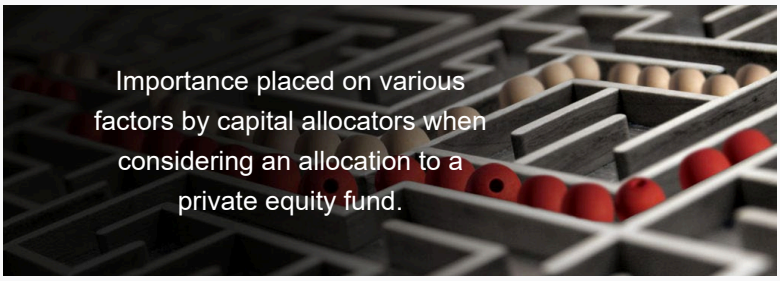
Participants

In this survey, there were 14 participants representing institutional investors and 27 participants from the private equity industry. Although the sample size is smaller on the institutional investors' side, we consider it sufficient for the purposes of providing insight into how the current market is viewed by allocators of capital to private markets.

The survey posed a number of questions:

Views on private equity fundraising and whether COVID-19 has had any impact.

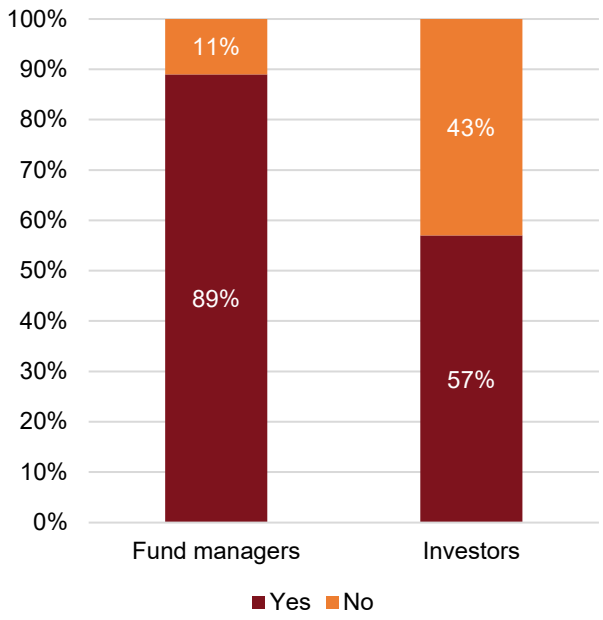
Whether the private equity fee model requires a change to drive better alignment.



The similarities and contrast between responses across these participant categories are presented below.

Survey results

Has COVID-19 negatively impacted allocations to private equity in 2020

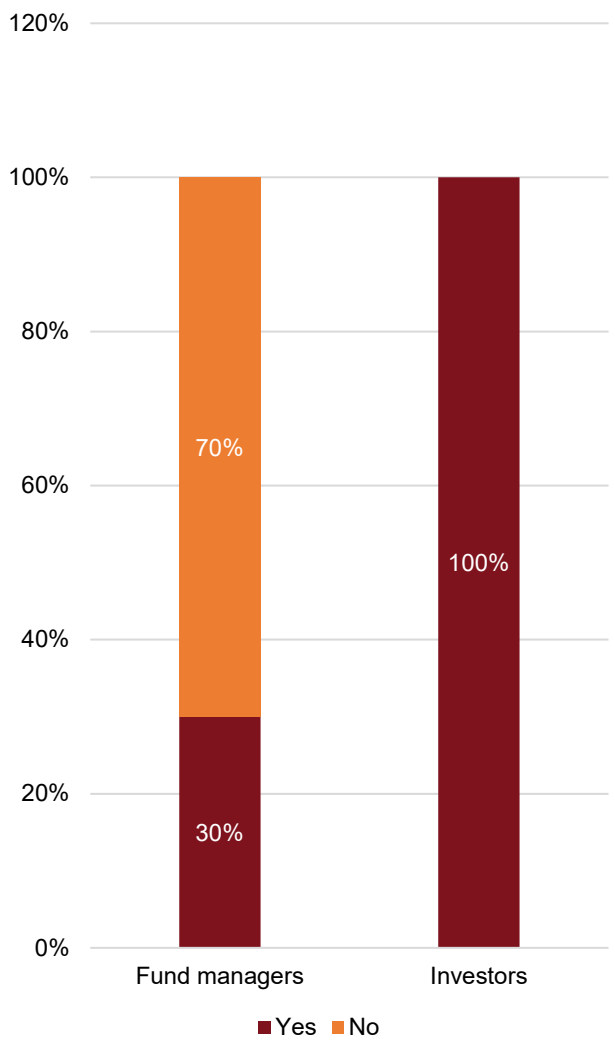


The fundraising environment for private equity managers, particularly black and independent managers, is notoriously challenging. The impact of COVID-19 overlaid with specific challenges faced in South Africa (i.e. high unemployment rates and poor growth prospects) has made the recent private equity fundraising environment almost impossible with only a handful of managers able to raise capital from investors, outside of specific mandates targeted at supporting emerging managers.

The majority of participants were of the opinion that COVID-19 negatively impacted allocations to private equity, with the fund manager group overwhelmingly in agreement that COVID-19 has had a negative impact on fundraising. Based on our engagements with the market, only a handful of managers had any

meaningful success in their fundraising campaigns, with many fund managers looking to extend their initial expectations for first and final close out by 6 to 12 months. However, their engagements with potential investors remained ongoing throughout 2020, albeit at a slower pace. Our view is that interest in private markets has gained momentum since the turn of the year and that the fundraising environment has improved for managers that have been able to retain teams and demonstrate that their investment propositions are still valid in the current environment.

Should the private equity fee model change to drive better alignment?



When asked about the private equity fee model, and whether there should be a change to the traditional 2 and 20 model to drive better alignment, 100% of the investor participant base answered in the affirmative, while only 30% of fund managers surveyed were in agreement. This shows the stark contrast in views on the private equity fee structure and points to a need to consider more innovative fee structures better aligned with investor needs. For example, do commitment fees that raise retirement funds overall fee ratios make sense or would a base fee to cover manager costs plus a performance incentive based on deployment work better to align participants? Does the 20% carry structure, including 100% catch-up, really create alignment or is this an outdated commercial term?

It's worth noting that the Institutional Limited Partners Association has issued a set of guidelines around improvement of "Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners", which we would encourage all fund managers to consider in developing their respective funds' commercial terms. One of our thought leadership pieces will present considerations for improved private equity fee models and alternative levers to drive better alignment.

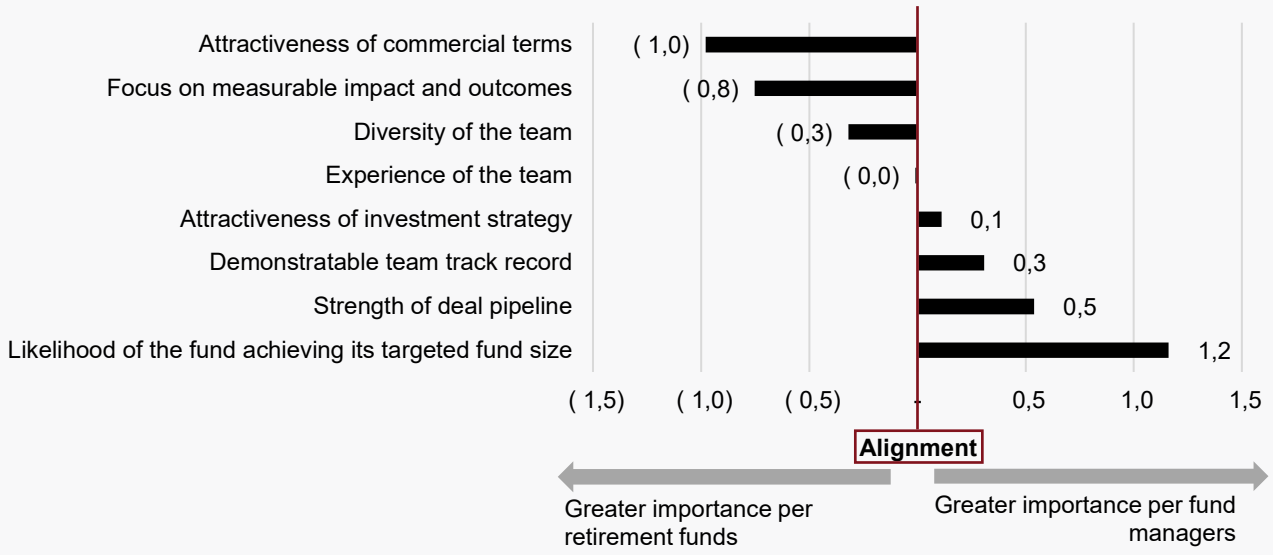
100%

of investors believe the private equity fee model should change to drive better alignment

6 - 12 months

Period in which fund managers look to extend their initial expectations for first and final close

Fund manager vs investor perception of importance of certain factors relevant to inclusion of private markets in institutional portfolios



Note: The analysis is based on the variance between the weighted average scores of completed surveys by participants

In analysing the responses to our survey question ranking the importance of what investors look for when investing in private markets, the following observations were noted:

- The attractiveness of commercial returns was considered very important by investors, but significantly less so by fund managers. This was the second largest difference between the groups of respondents. We discussed this earlier in our findings.

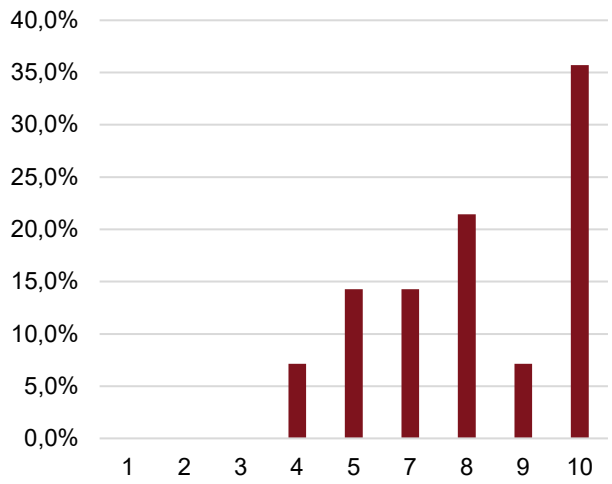
- The issue of measurable impact and outcomes has become a priority for investors allocating to private markets, more so than fund managers seem to believe. The challenge is for fund managers to consider how impact measurement is built into their investment processes and ongoing monitoring of portfolio investments and that real and measurable outcomes are identified and reported regularly to investors.

- Diversity of the team has become a key consideration for investors. Admittedly this has been at a slow pace, but we are seeing more and more attention being given to this by retirement funds specifically aimed at addressing the challenges around transforming the financial services industry while creating a more inclusive private markets sector through supporting women-led teams.

- Both sets of participants are broadly aligned when it comes to fund managers being able to demonstrate track records, the experience of the investment team, presenting convincing investment strategies, and strong deal pipelines.

- Interestingly, fund managers perceive the importance of achieving targeted fund sizes as much more important than investors do. As an investor, we consider the targeted fund size but place more emphasis on the desired minimum fund size to ensure sustainability of the fund manager over the fund term and a level that allows the manager to execute its investment strategy. We found that some fund managers aren't sufficiently focused on demonstrating this to investors, which adds to the potential delay in fundraising. Perhaps reaching for the clouds first rather than shooting for the stars should be the focus when fundraising.

Does liquidity and easier access matter to investors

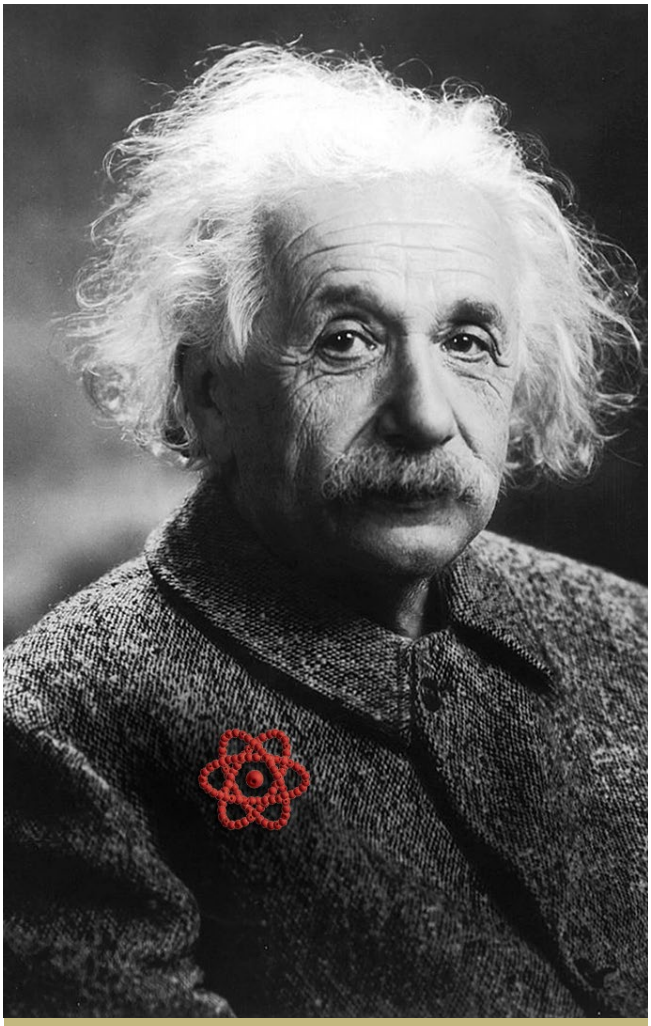


We surveyed investors on a scale of 1 (highly unlikely) to 10 (highly likely) they would be to allocate to private equity if a simplified allocation mechanism was available and provided some form of liquidity. 79% voted 7 or higher that liquidity and a more efficient way of allocating to private markets would further persuade investors to make contributions to private markets.

Conclusion

More can and has to be done by fund managers to improve alignment, particularly in relation to the private equity fee model, measuring and reporting, and team diversity.

Our experience of the market is that fund managers are willing to walk a path with investors in considering ways to improve alignment; embracing change is key.



Look out for our thought leadership pieces on:

Returns
The gross to net IRR conversion conundrum

Fee structures
To catch-up or not to catch up

Reporting
What matters to investors?

Originating pipeline and demonstrating track record
Convincing investors

Team matters
Building team diversity

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