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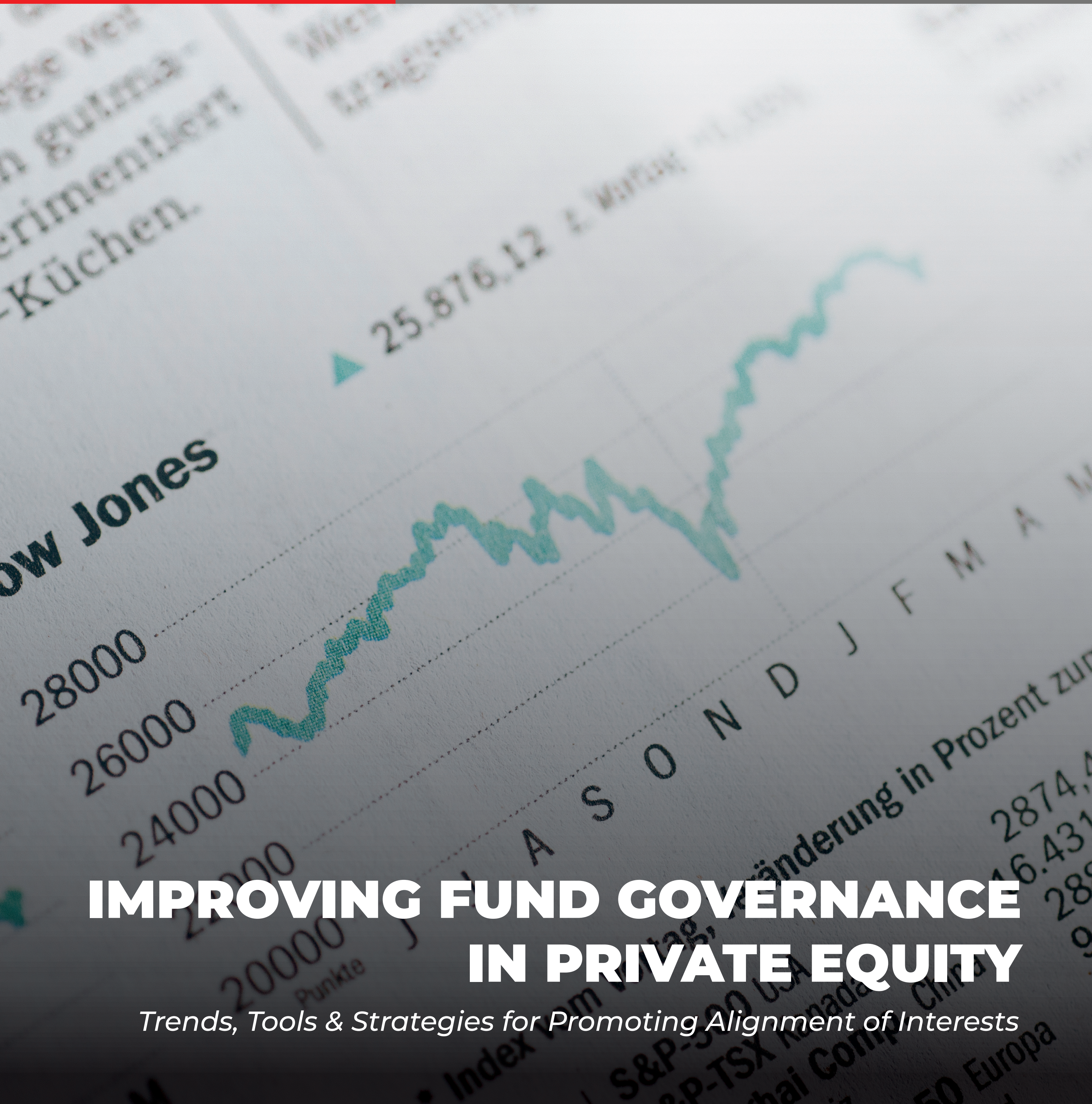

IMPROVING FUND GOVERNANCE IN PRIVATE EQUITY

Trends, Tools & Strategies for Promoting Alignment of Interests

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Introduction

Private Equity (PE) fund managers (General Partners) are accustomed to taking significant risks which could adversely impact on the performance of the fund. Therefore, in order to ensure that PE funds function effectively, the interests of both General Partners (GPs) and Limited Partners (LPs), i.e. the fund investors, must be well protected. However, it is generally considered that when it comes to private equity, in order to foster alignment of interests amongst GPs and LPs, there is a need for effective governance. The increase in Private Equity Funds has led to more enquiry into the governance structures that exists within the funds and increased calls for the alignment of interests of parties.

Nevertheless, what sets Private Equity Fund Governance apart from corporate governance is the ability of Investors/ LPs to engage the GPs/ fund managers to accomplish specific investment objectives over a specified period. Pressure from regulators and demands from investors have also influenced fund governance practices [1].

Issues Associated with and Recommended Strategies for Fostering Alignment of Interest between GPs and LPs

Based on the model by which PE funds are established, LPs are the passive partners and as such investments and risk management are assigned to the GPs. LPs have limited rights when it comes to participating in daily operations of the fund and may be unable to challenge decisions of fund managers or approve significant transactions. There is also the problem of information asymmetry due to GPs possessing more information than the LPs. All of which ultimately in many cases give LPs cause for concern as these can be the basis for potential misalignment.

Generally, the following have been identified as some of the significant reasons for GP-LP misalignment:

a) Management Fees: The management fee gets paid as a way of funding operations and is a percentage of committed/invested funds, usually between 1% - 2% depending on the size of the fund. This fee is not in any way related to the fund's performance. The size of management fee has been known to generate misalignment as there are situations where GPs minimise cost and in turn, maximise profits or seek to raise more substantial funds. In situations where the required management fee becomes more than enough to cater to the GPs and their team, the issue of misalignment could arise, particularly in larger-sized funds.

Therefore, it has been proposed that management fees be paid on reasonable operating expenses and salaries of GP professionals.

[1] Private Equity Fund Governance Establishing Best Practices 2017, The Manager & Investor Perspective

Also, in the formation of a new fund, it has been recommended that GPs provide LPs with a fee model that can be used to analyse and set management fees[2] .

b) Carried Interest: Carried interest is an incentive payment structured as an allocation of profit to the GP. Typically, a GP receives carried interest equal to a specified percentage (usually 20%) of the cumulative net profit of the fund. The LPs receive the balance of 80% of the cumulative net profit pro-rata of their invested capital. It has been recommended that: -

i.) A standard all-contribution-plus-preferred-return-back-plus waterfall is best practice. This implies that GPs will only be entitled to share in the net profit of the fund after LPs capital contributions to fund investments have been returned.

ii.) In the event that a deal-by-deal waterfall is used, the waterfall should be enhanced with accompanying effective escrow accounts and clawback mechanisms should the GP be considered to have been overpaid at the close of the fund[3] .

c) GP Capital Commitment: GPs are increasingly being required to have significant equity investment in the fund, which should be contributed in cash and not by a waiver of management fees[4] . This is required to ensure that the GP has skin in the game and to demonstrate its faith in the fund's investment strategy. The size of the GP capital commitment would vary depending on the nature and financial situation of the management team. For instance, a first-time manager with a limited number of individuals typically may be required to commit 1% of the fund capital commitments, where with the larger managers, the commitment could be as high as 10% or even more.

d) Key Person Event: LPs will want to ensure that certain individuals who are regarded as "key" are incorporated in the day-to-day management of the fund. Key persons are usually top principals of the sponsor or large groups of investment professionals. Misalignment of interest will arise where key persons are distracted with obligations arising from other business interests/ engagements. It has been recommended that key persons be required to devote a substantial amount of their business time to the fund, predecessor/ successor funds and parallel funds[5].

[2] ILPA, Private Equity Principles, (2011) Version 2.0

[3]Ibid

[4]Ibid

[5]Ibid

A typical "key-person" provision will also stipulate that if several specified key persons cease to be involved in the affairs of the fund, the fund will no longer be able to make new investments and would result in the suspension of the fund's investment period.

Overview of Key Trends in Private Equity Fund Governance

Effective Fund Governance requires that there be an investment team as it is one of the crucial aspects when it comes to making decisions to commit to a specific fund. Changes to this team should be communicated to the LPs. There is also the need for an investment strategy and like the investment team, the investment strategy is a key indice for LPs in in making their decision to commit fund, as funds are carefully chosen based on "specific strategy and value proposition[6]". Investment strategies need to be appropriately defined and should be consistent, as well as specific and can be based on the following minimum criteria: (i) the purpose of investment. (ii) limitations on investments should be properly documented (iii) GPs to make room for LPs exclusion policy (iv) authority to invest are to be included in the strategy.

"GPs are to perform their fiduciary duties effectively by bringing matters of conflict of interest to the Limited Partners Advisory Committee (LPAC) as they are not to resolve their conflicts themselves."

GPs are to perform their fiduciary duties effectively by bringing matters of conflict of interest to the Limited Partners Advisory Committee (LPAC) as they are not to resolve their conflicts themselves. Conflicts of interest matters that may arise between investors of predecessor and successor funds should also be brought to the respective LPACs for resolution. Majority of LPs must have the ability to relieve a GP of his duties or terminate the fund. In addition, conditions precedent and other removal mechanisms should be put in place so that LPs can act before there is an irreversible damage to their interests[7] . To ensure further monitoring of GPs, LPs can recruit independent auditors.

However, considering the long-term nature of Private Equity Funds, some changes might occur, and flexibility is vital in order for there to be an easy adaptation to these changes when they arise. Also, there is the establishment of the LPAC with its roles adequately defined by the Limited Partnership Agreement (LPA) in order to foster

[6]ILPA, Private Equity Principles, (2011) Version 2.0, page 7-14

[7]Ibid

transparency, tackle complexities that may arise and also handle a financial crisis.

Consequently, to ensure best practice for Private Equity Fund Governance, the following are the emerging trends: -

a) Transparency: There has been increasing call for more transparency on the part of GPs and LPs of a private equity fund. Issues that have required more transparency include (i) fund structures; (ii) LPAC roles and memberships; (iii) GP fees (i.e. management fees and other fee incomes like monitoring fees, transaction fees and break-up fees) and performance calculations; (iv) co-investment arrangements and agreements. In general, GPs are to provide comprehensive financial, risk management, operational, portfolio, and transactional information regarding fund investments[8].

b) Limited Partner Advisory Committees: Making decisions as regards who can join LPAC as there are no standardisations of LPAC practices.

The research conducted by IFI Global and Vistra identified the following as the primary selection criteria; the size of LPs allocation, contribution to the committee as usually intelligent and experienced people were selected, first to commit capital and proportional selection which meant major LP contributors in the fund were represented. LPACs are saddled with the responsibility of reviewing investment strategies, Advisory roles, fund term changes, conflict of interest issues, a tool for a progress update, matters needing counsel etc. Investors still consider LAPCs to be valuable "oversight vehicles." The Institutional Limited Partners Association (ILPA) Private Equity Principles version 2.0 outlines best practice for LPAC formation and LPAC Meeting Suggested Best Practices (Convening meetings, Agenda, Voting and Records).

c) Co-Investment: There is increased growth in co-investing, LPs opting to do more of co-investing with reduced costs as the major motivation for this trend[9] .

8 Ibid

9 Private Equity Fund Governance Establishing Best Practices 2017, The Manager & Investor Perspective, page 1

Also, transparency, opportunities for direct exposure to new industries as well as better control of their investment, alignment of interest, liquidity, a better understanding of the investment process are other reasons for the growth in co-investment. For the GPs co-investing is a method of increasing available capital and at the same time expand the range of opportunities for potential deals. It is also seen as a means of GPs getting better acquainted with LPs. Co-investments are usually in the form of direct investment by LPs or through the development of separate LP account managed by GPs at a lower fee.

d) Outsourcing: Administrative functions are being outsourced to third parties, a practice which is considered to be more efficient. The GPs consider these third parties as allies. The benefits of outsourcing are; aiding accessibility to skilled specialists, is preferred by regulators, demand for scalability, increased demands by investors for the third party in a bid to achieve operational excellence and access to technology. It is believed that in-house administrative systems are not agile enough when it comes to responding to the market as well as business and regulatory requirements, all of which has led to the increased need to outsource.

e) Fund Structure and Domiciles: Decisions regarding fund structuring are based on regulatory requirements, investor preference and tax issues with Private Fund Partnership being the most popular globally. This preference is based on its flexibility and ease of use. Fund structures will continue to develop and be affected by global economic and regulatory changes.

Reflections from the Abraaj Group

Ensuring adequate fund governance is essential for sustaining investor interest/confidence and sustainability of the funds. Perceived misalignment of interest could result in LPs exercising their rights by authorising forensic audits, relieving the GP of its duties or terminating the fund for cause. The Abraaj Group scenario underscores this point.

Abraaj was the largest private equity fund in the emerging market, with over $ 13 Billion of assets under management. Abraaj's $1 billion Growth Market Health Fund was one of the most ambitious efforts to muster private capital to meet SDG No 3, i.e. "ensure healthy lives and promote wellbeing for all at all ages".

Reports in the public domain suggest the following as reasons for the failure of The Abraaj Group[10];

a) Investors in the Abraaj Group Fund, including the World Bank and the Bill and Melinda Gates Foundation were desirous of finding out why more than $200 Million drawdowns from investors had not been deployed. There were concerns that the funds might have been misapplied.

[10]Landon Thomas Jr., Leading Private Equity Firm Accused of Misusing Fund, The New York Times, February 2018

b) The Abraaj Group defended their actions in discussions with investors that the funds were not misused and that there were misunderstandings about how the fund operates. It was reported that the Abraaj Group had cited delays in obtaining regulatory approvals to build hospitals in Nigeria and Pakistan as some of the delays encountered in deploying the funds.

c) The investors were not convinced, and therefore, Abraaj returned over $100 Million back to its investors. PwC, Deloitte and KPMG were engaged by investors and Abraaj to conduct forensic audit to ascertain the allegations.

Although there is limited information as to the exact cause of failure of the fund, the information in public alludes to questions of alignment of interest and perceived breach of fiduciary duties as the cause of the failure of the fund.

The foregoing information underscores the importance of transparency and alignment of interest in fund governance. LPs will always want to ensure that its GPs are incentivized from the carried interest and not from management fees or funds required to be deployed to portfolio companies. Perceived misalignment of interests could result in LPs exercising their rights under the fund documents which could result in unwanted or unexpected outcomes.

Improving Private Equity Fund Governance

Within the current model of adopting a Limited Partnership Agreement, LPs are allowed to influence the decision-making process but not allowed to influence certain investment decisions. In situations like this, there is total reliance on transparency between GPs and LPs, adequately defined procedures and processes for risk and conflict management[11] . Nevertheless, there is room for more improvements even with the publishing of principles and guidelines centred on governance such as the ILPA Principles, the UNPRI Guide for LPs, and the Model Mandate Initiative of ICGN[12] . As discussed earlier, it is clear that failures do occur and can be tied to governance. The origin of many of such failures is typically a misalignment of interests either between GPs and LPs or between LPs and LPs.

Therefore, it is crucial that measures be put in place to safeguard parties involved as well as their investments.

[11]Martin Steindl, The Alignment of Interests between the General and the Limited Partner in a Private Equity Fund—the Ultimate Governance Nut to Crack, February 2013

[12]Ibid

There have been suggestions for an improvement to the existing model with the inclusion of a more defensive approach geared towards achieving stronger rights to information, more LPs involvement and stronger advisory committees aimed at fostering the alignment of interest[13]. The focus of this model is an improvement in the fiduciary duties for all parties involved and more legal exposure for LPs[14]. Subsequently, there has also been the consideration of "GP of the fund establishing as a limited liability company or a corporation[15]" .

In a nutshell, to better improve PE fund governance, the following can be carried out:

- Ensure that the GP and its fund manager deliver on the agreed investment objectives, undiluted by other interests. This can be effectively carried out by strengthening the advisory committee
- Incorporate the GP, the fund manager and LPs into a corporate holding structure
- Identify risks and have in place oversight procedures to deal with them.
- Develop and establish a governance framework

Fund Governance Framework

Establishing a governance framework is increasingly becoming important. The need to enable investors to understand the unique nature of investment funds and risks attached to investment fund products, avoid ambiguous or fraudulent practices, prevent investor loss due to the negligence of fund promoter organisations; and also minimise conflicts of interest, are some of the reasons behind establishing governance frameworks. The main focus of such frameworks is to protect investors[16].

[13]Ibid
[14]Ibid
[15]Ibid

[16]Margaret Cullen, Michael Hartwell, Sean Smith, Investment Fund Governance: Developing a Risk-Based Oversight Function

A proper framework is made up of the oversight by the investment fund board to oversee operations, and an executive layer comprising of fund promoters/ fund managers, other service providers and support services such as legal and audit.

Furthermore, The Certified Investment Fund Director (CIFD) institute developed a Risk-Based Oversight Framework for Investment Fund Governance, which if implemented, is believe to yield promising results[17]. The following are the key steps towards developing a Risk-Based Oversight Framework for Investment Fund Governance:

- **Step 1: Understanding Fund DNA**

Good grasp about how the fund is legally structured and how it operates. This is fundamental as the framework should be tailor-made to suit the fund.

- **Step 2: Risk Profiling the Fund**

Identifying risk associated with the fund, assigning ownership and accountability for every risk.

- **Step 3: Establishing the Governance Framework**

This involves analysing to ensure all aspects of risk management are sorted out; operating policies that comply with the fund, alignment of escalation and reporting procedures with the fund. And finally ensuring the accuracy of all Service Level Agreements, as this is the structure on which the governance framework is formed.

[17]Ibid

- **Step 4: Implement and Reflect**

Implementing the framework by the fund's board or advisory committees

- **Step 5: Review, Reflect, Revise**

As expected of every process, there should be a review in the event of any change. Consideration is given mainly to new legislation and new products.

The result of following all 5 steps would be the development of a governance framework that includes operation policies that are peculiar to the said fund, defined procedures for escalation and reporting, precise Service Level Agreements (SLAs) and Contractual Agreements, compliance with regulations as well as legal documentation.

Conclusion

Invariably, it can be said that Private Equity Fund Governance is all about better management of funds and protecting investors' interests. In view of the growth in the Nigerian and African private equity industry and the attendant competition for institutional capital by private equity fund managers, it has become important for GPs to develop fund governance structures that ensure transparency and alignment of interest between the managers and the fund investors. This will be key to attracting more capital to the Africa private equity industry and with a right approach to fund governance, managers will increase their chances of attracting much needed capital.

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