KEYNOTE INTERVIEW

A change in the LP-GP balance of power

Investors are taking a swing at establishing better terms and economics in a challenging fundraising environment, say Proskauer partners Ryan Carpenter and Aranpreet Randhawa

SPONSOR
PROSKAUER

Q How have fundraising conditions evolved over recent years?

Ryan Carpenter: While the fundraising market is down in some respects from its peak, we are still seeing a lot of capital being committed to funds. The process has just become a lot more arduous for many managers. This is largely due to the environment for exits, which has been depressed by uncertainties around interest rates and geopolitical tensions, among other things.

The resulting lack of distributions means less capital is available for reinvestment into new vintages. Meanwhile where capital is available, LPs are being more selective in the managers they choose to back, with a focus on established incumbents with strong track records and managers that demonstrated discipline during heady peak periods.

Q What does this mean for fundraising timelines?

Aranpreet Randhawa: Timelines are becoming elongated. While some limited partnership agreements still provide for the standard 12-month fundraise period, a number of GPs are now building in 18-month fundraise periods, or 12 months with the ability to extend with LPAC approval. Also, while fundraising might have only taken a few months a couple of years ago, GPs are now making full use of the periods stated in the LPA. If GPs still have interested investors to close when the initial fundraise period is up, they are seeking extensions.

We are also seeing GPs holding numerous closes throughout the fundraising process. Investors know they have more leverage in the market and so they do not feel the same pressure to hit specific closing deadlines to secure their allocations. Meanwhile, separate

Q How do you expect fund sizes to evolve?

AR: We will see more conservative target sizes than we have over the past five years. There were managers that came back to market with funds in 2022 and early 2023 that were, in some cases, more than 50 percent larger than their previous funds. For many GPs, continuing this growth in fund size isn't going to be sustainable. Capital is not necessarily being deployed at the same rate, and LPs are struggling to scale up to maintain their relative position in those funds.

LPs are also keen to ensure that a rapid increase in fund size won't lead to a change in investment strategy, such as shifting focus to larger deals. There is also a sense that managers don't want to set high fundraising targets and be seen to miss them in this more challenging environment. GPs are either setting more conservative targets or avoiding stating a target altogether.

to the current macro environment, LP due diligence, particularly for institutional investors, has become more rigorous and therefore time consuming. As a result, many firms are holding rolling closes to de-risk capital as and when it is ready to close.

Q What are the key differences that you see between strategies within the private equity universe?

RC: The number of dollars raised by buyout funds hasn't seen a huge dip, though the number of funds raised is certainly down. Generally speaking, the buyout space has been able to hang tough in this market relative to venture and growth capital. This has partly been due to portfolio rebalancing, but also to something resembling a flight to quality within alternatives, with investors sticking with tried-and-true names that tend to focus on more mature companies and more diversified investment strategies. Credit and secondaries are also relatively strong because of the opportunities that investors are seeing in those spaces.

The hit to valuations for venture and growth-backed companies from peak levels has made life difficult for many of those managers from a liquidity and fundraising perspective.

Q Given current supply/demand dynamics, are LPs pushing back on terms?

RC: It has certainly been a 'minimal changes' environment for GPs when it comes to legal documents. Where managers do seek to make changes that are material to the overall business arrangement, investors are looking for a clearly articulated case for doing so.

Meanwhile, many investors of size are looking to negotiate improved economics. Cornerstone investors are pushing for better overall arrangements, whether through fee or carry discounts, or through access to co-investment. Other investors are also using this market to strike at terms they may previously have been prepared to live with but which they view to be overly aggressive. Again, managers should be prepared to justify the use case for certain terms that were pushed through in prior funds.

In particular, LPs are focused on governance around conflict transactions and the exercise of GP discretion involving investment opportunities and activities that could be competitive with the fund. This has been driven in part by the rise of continuation vehicles, but also by manager platform expansion. The bottom line is that many investors are seeking to establish a better overall deal for themselves and rein in outsized deference to managers, particularly where they feel they are taking more risk or filling a vital fundraising hole for sponsors.

AR: Our advice to GPs is to think hard about what they really care about in their fund terms when they are considering making a change. Investors are doubling down on every bit of red line in documents and questioning why those edits are needed. If GPs want to make the process as smooth as possible, then they need to ensure they have a justification for those changes beyond simply the fact that the wider market is changing.

Q How are LP attitudes to continuation vehicles changing?

RC: The secondaries market has grown at an incredible pace, driven in part by the lack of liquidity that we have been seeing in more traditional exit markets. GP-led transactions have really come to the fore, and we don't see that trend abating.

Both sponsors and investors acknowledge that continuation vehicles play an important role, particularly in the current market where hold periods have been drawn out and distributions have been depressed. However, the devil is in the details for these transactions given their inherent conflicts, and so participants are vigilant about their terms and structure.

At a high level, LPs are heavily focused on valuation, and the more thorough the process used to find the market price, the more likely managers are to earn support from investors on both the buyside and sellside. Investors are also heavily scrutinising GP-LP alignment, expecting managers to roll carry and keep skin in the game.

Q How important is co-investment proving for fundraising success?

AR: Co-investment has always been a sweetener, but it has become even more important, particularly for newer managers. LPs get access to deals at a lower blended fee rate and are also able to put more capital to work with their chosen firm. Meanwhile, in this more challenging fundraising environment, it is easier for the GP to transact at its target deal size during what may be an extended fundraising process it if is able to offer co-investment.

However, it is critical to ensure there is sufficient flexibility around these co-investment programmes. GPs do not want to get bogged down in long offering processes that end up hamstringing their ability to do deals. They want to ensure they can choose their preferred co-investment partners.

Q To what extent are you seeing GPs tapping into new sources of capital?

AR: GPs are always exploring new LP relationships, though this has been accelerated due to recent fundraising challenges and increased fund sizes of some GPs where existing LPs have not been able to scale up. There has been a lot of talk about the 'democratisation' of private equity and ensuring that it isn't only institutional investors that can access private equity returns, so we have seen GPs strategically considering whether and how to allow access to their funds by high-net-worth individuals.

We are seeing a number of clients exploring setting up their own high-net-worth vehicles or partnering with distributors to access this capital. Setting up these structures isn't straightforward or cheap, so it is primarily the larger and better-resourced firms that are considering this for now. While fundraising figures remain low, this is clearly an area poised for growth.

GPs are also looking to extend their LP base with new institutional investors in geographies where they currently raise less capital. For example, European firms are looking to build relationships with investors in the US and/or Middle East, including sovereign wealth investors that may currently have less exposure to Europe.

> *"The current environment threatens some market consolidation as a tougher cycle weakens or filters out less competitive platforms"*
>
> **RYAN CARPENTER**

Q How do you see fundraising conditions evolving?

RC: Private markets remain a far smaller component of capital markets than public equity or fixed income, so we see plenty of room for private equity to grow. While we are certainly observing more fundraising momentum building in 2024 relative to 2023, the pace of that growth is likely to remain somewhat modest by historical standards, at least until markets have fewer uncertainties to contend with.

We expect strong performers will continue to thrive, but the current environment threatens some market consolidation, as a tougher cycle weakens or filters out less competitive platforms and since LPs place a premium on the partnerships they value most. In addition to demonstrated returns, we expect that LPs will favour managers that remain thoughtful and deliberate around fund terms, transparency and alignment. GPs, meanwhile, will continue to look to diversify their investor base in terms of both geography and investor type.

Traditional exit markets are showing some signs that they are beginning to thaw, although it seems that patience will be required before general macroeconomic conditions are truly stable. As always, the market will reward managers that create value for their funds by focusing on fundamentally growing and strengthening portfolio company businesses regardless of, or even by leveraging, current conditions. ■