KEYNOTE INTERVIEW

An asset class propelled by innovation

Private equity's resilience and innovation have allowed it to continuously meet the needs of GPs and LPs, say Proskauer's Monica Arora, Howard Beber and Nigel van Zyl

The private equity industry has grown in size and sophistication over the past two decades, to the extent that it is almost unrecognisable from where it stood when *Private Equity International* was first published in 2001. Monica Arora, Howard Beber and Nigel van Zyl, co-heads of the private funds group at law firm Proskauer, tell *PEI* that the ability to innovate has been key to the industry's success and, despite the current downturn, they believe the asset class can look forward to a bright future.

Q What are the main changes you have seen in PE since 2001?

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Howard Beber: Everything about this industry has become exponentially bigger in the last 21 years including the sheer number of private equity firms, assets under management, fund sizes, and the universe of LPs and service providers active in the industry. Managers have not only grown in size, but platforms have expanded and evolved. Years ago, most managers focused on one strategy or vertical in a single geographic region. While those managers still exist, today many managers now manage multiple fund products focusing on diverse strategies and geographies.

Private equity used to be a small, niche and opaque market. It was under the radar and a relatively small part of investment portfolios.

The asset class is much more visible now than it was 21 years ago. As one would expect, as the asset class has grown and become more visible, it has attracted more attention from regulators and political administrations than in earlier years.

I don't think anybody could possibly have predicted, 21 years ago, what this industry would look like today.

How have private equity firms adapted as the market has grown?

Monica Arora: We have seen managers of private investment firms lean into the opportunities and challenges that have accompanied the evolution of the market. Many managers have grown by augmenting legacy businesses with new platforms, either organically or through consolidation. They have recognised the need to broaden, as well as deepen, their areas of focus and expertise as part of the natural progression of a maturing industry.

To achieve this growth, managers have continued to prioritise talent, and have become more sophisticated in utilising tools to attract and retain talent. For example, there has been a renewed focus on internal economic arrangements and the manner in which talent may participate.

This has coincided with a period in which founders and senior leaders of private investment firms are retiring, making succession a large focal point for managers and investors alike. Twenty-one years ago, it was common to have the investment manager of a private fund governed by a barebones document; those days are long over as managers understand the value of their franchise and the importance of their internal arrangements, both with respect to talent as well as potential third-party investment.

Another area where managers have particularly adapted is increased investment in their internal infrastructure. In addition to compliance, which has been essential, the investor relations function has become more important than ever. Whereas it used to be that a firm would raise capital every couple of years, fundraising has now become perpetual. And the technicalities and the manner in which fundraising is conducted have become more complicated, which has highlighted the importance of the compliance and the investor relations functions working together.

What trends have you seen around deal terms over the last two decades?

HB: The fundamental two-and-20 economic deal, generally speaking, hasn't changed all that much, but that is about the only thing that hasn't changed. Before the creation of the Institutional Limited Partners Association, LPs lacked the means to organise and act in a concerted manner. LPs, for the most part, had very little leverage from a negotiating standpoint. Once ILPA was established and received a lot of institutional backing, that changed.

What has changed most is the transparency of the industry. That comes from more robust and standardised reporting and much more intense due diligence. Limited partners now require much more transparency throughout the life of a fund than they had years ago. In addition to ILPA, the regulatory landscape for private equity managers has changed dramatically in the US and Europe, which of course has led to more robust disclosure and transparency.

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>
> MONICA ARORA

Given that the industry is more sophisticated, is it harder now for emerging managers to come into the space?

Nigel van Zyl: There are always going to be peaks and troughs in terms of when emerging managers enter the market. Right now, given the crunch on capital in the fundraising market, it is more challenging.

But in order for the industry to grow, we'll continue to see spinouts, and we'll continue to see emerging managers setting up new and different strategies. One of the things the industry is very good at is evolving and

finding solutions to capital needs in the global economy. For as long as the industry maintains that adaptability, we'll continue to see emerging managers enter the market.

MA: Early in the pandemic, the thought was that activity related to emerging managers would come to a halt. However, contrary to belief, we've seen that investors like the idea of emerging managers. It is no doubt difficult to get traction, but superstar investors setting up their own firms with successful deal experience and strong relationships have done well.

In many cases, emerging managers initially launch on a deal-by-deal basis. This permits them to deepen relationships while building a proprietary track record that can help create momentum in the community.

Q One of the big changes is the growth of the secondaries market. Do you expect to see continued growth there?

HB: The secondaries market for LP interests used to be a very closed market. There were few buyers and if you were a seller, you were probably in, or perceived to be in, a distressed situation. This meant that portfolio sales were kept very quiet. That sentiment began to shift about 15 years ago as the industry grew and LPs started using the secondaries market as more of a portfolio construction mechanism, as opposed to a way to offload assets in a distressed situation.

In addition, as the PE market grew, many new firms entered on the buy side and the market for agents and other service providers expanded exponentially. This of course created a more efficient market. Of course, the GP-led secondaries market was virtually non-existent until relatively recently and has now become a very large part of the overall secondaries market.

Right now, the market happens to be down, but in normal conditions, it is a fluid and liquid market for LP interests and GP-led deals. We expect that it will come back as markets stabilise.

> *"The industry is successful because it involves smart people who innovate to meet capital needs"*
>
> NIGEL VAN ZYL

NvZ: The industry is successful because it involves smart people who innovate to meet capital needs. Secondaries is a great example of this. Whether it's the buying and selling of LP interests, which has now become market practice, or the more recent development of continuation funds set up to provide GPs and investors the opportunity to continue to own assets beyond the traditional hold period while providing liquidity to those LPs who want it, I think GPs and LPs recognise that private equity is not necessarily the illiquid asset class it was once perceived to be.

One of the other innovations we have seen is the longer life, 15-to-20-year, fund. These have evolved from a recognition that for some assets the value proposition is longer than a traditional 10-year fund. These are all examples of an industry that does not stand still, it innovates, it evolves and it solves.

Q What has driven the rise of ESG in private equity?

NvZ: The industry cannot exist in isolation or ignore macro events, whether they are financial, social or environmental. ESG impacts everyone, from consumers to employees and investors, and therefore impacts the sustainability of the industry. Environmental and social issues are at the forefront for almost every investor and every manager and are also now a focus for regulators.

The rise of impact funds has been a particularly interesting development over the last few years. That is another example of innovation – seven or eight years ago, there were just a handful of impact funds but now impact investing is becoming a large subsector of the asset class.

Firms are asking their portfolio companies to be accountable to all stakeholders, whether that is their owners, their customers, or others impacted by their activities. It is also about the industry being relevant to the broader economy and society.

ESG issues are going to become increasingly urgent – and I am sure private equity will, as it has done on many other occasions, be one of the solution providers.

Q Will the political controversies around ESG force PE firms to change their strategies?

MA: There are many components of private equity that have been politicised, particularly in the US. Whereas some investors have mandates that require the incorporation of ESG-criteria by managers, others (specifically certain US state plans) have more recently enacted investment mandates requiring investment decisions be made solely on pecuniary factors (ie, disallowing the consideration of ESG principles under the theory that ESG comes at the expense of returns).

Despite this divide, it is standard for large asset allocators – globally, and particularly in Europe – to require that GPs have robust ESG policies and procedures. I do not know of any of our private fund clients that do not have a policy related to ESG. Firms are going to have to perform a continuous balancing act. ■