ROUNDTABLE

POWER TO THE LP

Examining the growing influence of investors in private equity fund management

Investors are exerting more influence than ever before over the processes, reporting and operations of private equity fund managers. In a roundtable hosted by *Real Deals, The Drawdown* and Aztec Group, a panel of private equity advisers and CFOs discussed how fund managers are adapting to evolving LP requirements.

Photography by **Phil Bourne**

SPEAKERS

David Allan
Partner, CFO & COO, TriSpan

Marco Pierettori
General Counsel, Investindustrial

Steve Darrington
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Joanna Hylton
Finance Director, Cairngorm Capital

Susan Wilkins
Partner & COO, Actis

Matt Horton
Group Head of Private Equity, Aztec Group

Stephen Thomas
Head of Finance, Coller Capital

Alex Postlethwaite
Head of Finance, Queen's Park Equity

James Duffield
Head of Business Development, Aztec Group

Moderated by
Nicholas Neveling, *Real Deals & The Drawdown*

My perception has always been that an LP backs a manager and then leaves the team to get on with it, but I sense that is changing. How have expectations in the LP/GP relationship developed in recent years?

Marco Pierettori: There are two areas where LPs are exerting more influence, both directly and indirectly.

Environmental, social and governance (ESG) investment guidelines are the first. LPs are providing a very clear indication of what they like and what they don't like when it comes to ESG, and they're getting more and more detailed. That is going to have an influence on an investment strategy.

The other area is co-investment. As a GP you have total discretion over how you invest a fund. But in the case of co-investments LPs do have a say: they do due diligence, follow the investment process and this may have an influence over the terms of the transaction.

Both developments change the parameters of the typical LP/GP relationship and in a way make investment decisions much more collaborative than they were historically.

Steve Darrington: LPs have just got a lot smarter. I might be exaggerating slightly, but in the 2000s a fund was raised, you would have your advisory board meetings and you would see each other in five years. LPs are now much more engaged and the gathering of intelligence has intensified.

There are also the ultra-hot topics that LPs are really focusing on. Take ESG. I've been quoted all over the place saying that I crafted a robust narrative around ESG on my desktop for 15 years but then hit a wall because "show and tell" came. LPs want data. They want information. They want strategy. They want proof. That has been a massive change and I think that's probably the one area where they are really dictating what GPs should be doing.

Some of our existing LPs will say that they want Article 8 exposure the next time we fundraise, and that if we want to discuss a commitment, our fund has to qualify an Article 8 core one fund.

ESG has certainly shot up the priority list for investors. Susan, what has that meant for a manager like Actis, which has had sustainability at the heart of its strategy long before it became a mainstream investor requirement?

Susan Wilkins: ESG has been a part of Actis's dialogue with all of its LPs since inception, and the majority of

its LPs have always had that heavy focus on ESG metrics.

We are one of the largest investors in renewable energy globally, so ESG goes to the core of what we do. That naturally directs our reporting structures and comes with commitments around ESG to our investors and ourselves.

We have nevertheless noticed more and more pressure on this, and what we see is LPs really digging into how embedded ESG is. We know that we can demonstrate that, but that doesn't change the growing requirement for more reporting.

Joanna Hylton: We are on our third fund now and there has definitely been a shift. When we raised a fund in 2019 ESG wasn't right at the forefront. Now, we have ESG reporting requirements in place, questions come up regularly in our LPAC and it is common to see it in side letters.

Alex, Queens Park Equity raised is first fund at the end of 2020. What were your conversations with investors on ESG like at that time, and did you ever get the sense that your ESG credentials were a factor in the investment decision?

Alex Postlethwaite: It was certainly front of mind for LPs, and they wanted to see a plan and how ESG fitted in with our investment thesis. For new investments, we undertake a B Corp assessment (amongst other ESG values) and report annually on the movement of this at the AGM. It's the way everything is moving, and it is unwise for any manager not to think about setting up ESG reporting for the future.

As a manager the focus is on working out how to track ESG, turn it into an accurate metric and produce a score for investors that reflects what we have done, how we have progressed and how we have added ESG value.

ESG is now prevalent, but there is still debate on what assessments and benchmarks to use and how to track it. My sense is that LPs are going to become more and more demanding on managers when it comes to reporting on ESG.

David Allan: The key thing for me is how you choose your ESG framework. There are so many points to cover off now. If you go out marketing, will you really able to deliver information covering off all the different standards and frameworks? You have to be in the position to collect that data, interpret it and then deliver it to the investors.

We're finding that there are so many different data points that people want and so many different questionnaires that you get sent. I think it is helpful to have a standard document you deliver to people saying, look, this is our ESG framework, this is where we started, this is where we are now. For us it's all about a journey, because we're at fairly early stage. There are so many questionnaires that it can become a bit much.

Hylton: We are also working out where we have to go next with respect to ESG. We have observed how investors look at ESG from different viewpoints. Some investors focus on the "E" or the "S", while others concentrate on the "G". As a manager you have to respond to what investors require, but at the same time try and find a balance and report as much as possible.

Wilkins: It's amazing what investors can come up with in terms of their own particular focus, isn't it? Obviously, you try for standard reporting if you can. We are fortunate in that we have quite a lot of material to hand. Actis has developed a methodology for tracking ESG metrics from the beginning of the investment life cycle through to the end. It is called the Actis Impact Score and is driven by the investment committee and is available to everyone. We also have our own in-house, responsible investment team who focus solely on ESG and sustainability.

James Duffield: Investors are particular about ESG because they don't want to get burned if a manager's ESG claims don't stack up. It has happened to investors, and they are determined to never let it happen again. All the requests for information can seem a bit much, but the credibility of ESG investment strategies is important to LPs and GPs have to adapt to that.

Pierettori: The one thing that sometimes is underestimated is how constructive the dialogue with investors is about deals where the asset doesn't immediately tick all the ESG boxes. There are sectors where investors have a negative screen in place and there are assets that are already ESG compliant. The interesting area is in between. It is easy to say you won't touch a company that doesn't have a perfect ESG track record, but actually that is where a GP can add the most value by initiating an ESG-compliant transformation for the investment.

Stephen, as a secondaries investor Coller Capital is in the unique position of being both a GP and LP. How do you think about ESG through those lenses?

Stephen Thomas: On the GP side of it, frankly, it can be challenging, when you invest in 500 funds and 2,000 companies. You've got to look at it from where can maximise your influence, and where you have to accept the exposures that you can't control.

It is important to flag, however, that ESG isn't just something the LPs impose on managers, because managers can actually advise and support LPs. At Coller, for example, our head of ESG Adam Black spends a large amount of time with our LPs discussing their ESG approaches and sharing best practice, because a lot of investors actually have far less resources when compared to us.

As an active buyer, we have built out our portfolio monitoring capability and we spend more time on it than our LPs ever can. Looking at how Coller Capital monitors ESG in a portfolio that looks a little bit like theirs, and understanding what data and technology we use, is very valuable to an LP.

And what about when you have your LP hat on, Stephen? How prescriptive are you with the managers in your portfolio?

Thomas: We have to be realistic, especially when we're coming in six years into the life of a fund.

But there are things that we do. Every investment we make, regardless of the strategy, undergoes an ESG assessment and that's largely based on red flagging risky assets.

For the most part, we're focusing on things like the GP-led secondaries. When you are investing in assets in GP-led deals, particularly single assets, you can take a look at the assets closely and make a judgement on whether they fit your own ESG framework and what you're trying to do for investors.

What we'll generally do with the managers is make sure that they have an ESG framework in place, but at the same time we recognise that there may be little to no appetite to revise it subject to our level of influence. Ultimately, we just need to be comfortable with what they say they're doing and check – on a risk driver basis – for certain exposures.

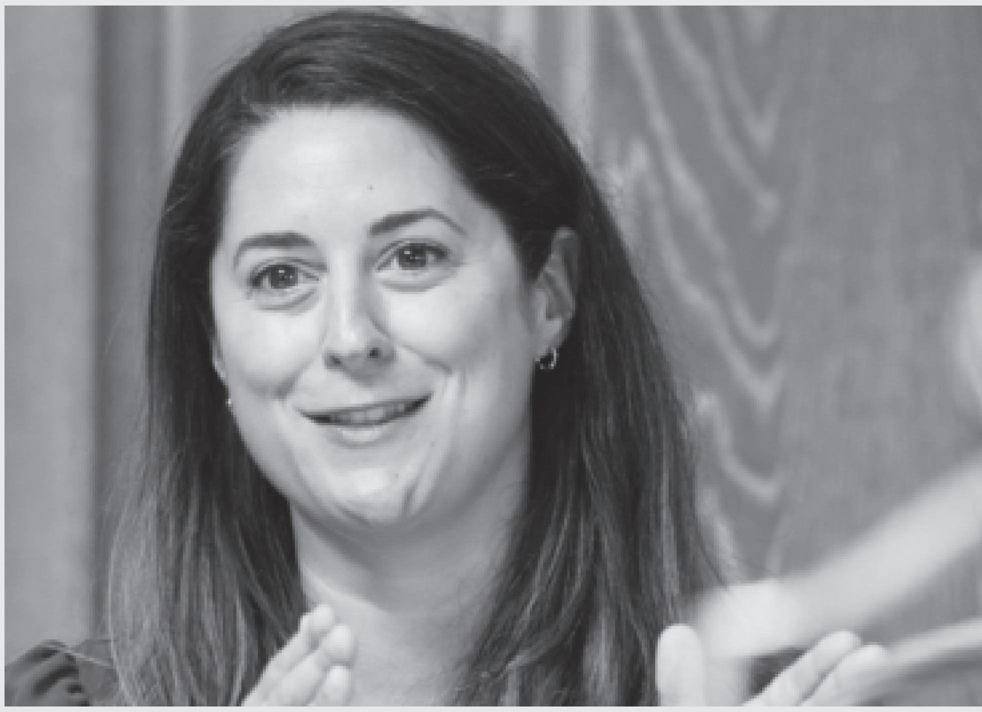
With some of the more inexperienced managers in that space, we have helped to shape their ESG frameworks, and we have been quite influential in that area. You have to take the appropriate approach for each transaction.

Matt Horton: We have the privilege of working with several people in the market at various levels of maturity and what is clear is that there is no sole solution. No one has cracked it, especially with all the different codifications out there.

Going back to the point Marco raised earlier, there is still a big ESG grey area that managers have to navigate. I have seen a fund that invests in engineering assets, for example, and one of the deals it is looking at is for a foundry. Now, foundries are very difficult assets when it comes to ESG – they are energy consumptive and throw up all kinds of health and safety issues. But what do foundries make? Components for wind turbines.

Wilkins: These are questions we look at daily. We don't invest in foundries, but you can't have a wind turbine without components. You can't explore for hydrogen without a downstream impact. We also have conversations about supply chains in countries with human rights or labour issues.

It is a tricky balance, but if you can honestly say that you can improve a situation and deliver a net benefit, then hold yourself accountable, there is not much more you can do.


Joanna Hylton


Stephen Thomas


David Allan

Horton: That makes a lot of sense. Even for an asset like a foundry, you can look at metrics like the volume of renewable metal used in feedstock, waste and emissions efficiency and reducing workplace injuries. The opportunity is there to deliver positive ESG outcomes, even in assets where the ESG drivers are not immediately clear.

To close on this point, does the additional requirement for ESG reporting require investment in infrastructure and expertise? How does it increase the reporting burden and how do you cope with that as a manager?

Darrington: If you see it as a burden and you see it as a reporting requirement, you've completely missed the point.

If you engineer your organisation to have ESG as a fundamental investment criterion, then it is something you need to manage and measure as a matter of course.

And that gets me to data. If something is central to your organisation, whether that is ESG or something else, then you have to make sure you can harvest the data about it in whatever forms it presents itself, and then do something useful with it.

Data used to get done by pointy headed people that sat in the corner, usually away from a window, and never met anybody. Now it is an ubiquitous skill across all business areas in all companies. I have signed up to the data analytics course with Columbia in the US and I'm working my way through, re-engineering bits of my brain to try and cope with some of the new concepts!

Understanding data and how to use it is now central and it has to be a driver of your decision-making and reporting. If you send an investor a

PDF, don't be surprised if they come back asking for data.

That has resonated with me. You have to think in terms of delivering data that you can slice and dice, dump into data lakes and share with others to do their data analytics.

It boils down to two things. Grip the technology and make it fundamentally central, but even more importantly, if it's a burden, then you misunderstand what it's all about.

Thomas: We've taken a very similar mindset on data. We have two core parts of our data team. One of them sits in the finance team and one of them sits in the investment team. So, we have analytics within finance that takes care of portfolio monitoring, and then there is data science within our investment team, that's designed to improve our investment decision making process. Having the data team members in the business rather than in a corner somewhere has two benefits. The first is that they actually understand what the business wants them to produce, and second, it demystifies how scary all this data stuff is.

What does this mean for a mid-market manager that doesn't have the big platform and management fee to invest in data infrastructure? Is it realistic for a manager with a smaller team to have all the data resource?

Hylton: The dynamics are different for smaller firms. We, for example, will outsource some of the data work. Our priority is to work out where we need to put our resources to cover our needs. Our finance team and investment team are closely looped up and the dealmakers help a lot when it comes to pulling together portfolio company data for investor reporting. Teamwork across the firm is essential, as opposed to the natural silos that would have been typical.

Alex Postlethwaite

Marco Pierettori

Susan Wilkins

Allan: Recently we have gone through a process of making our own data lake. We started off very small and took our time to decide what data we wanted in the lake. Our data lake has expanded and expanded and it's fascinating. What I love is that you can overlay the analytics on top of it and use AI and data analytics tools. Once you have your data lake, it's amazing what you can get out of it.

Circling back to that point about the PDF, people want to see the underlying data, understand how you have reached a number and what it's made up of. For us, we're on this journey of building our data lake and working out how we can use the technology to interpret data and generate reports. It's very, very exciting.

Horton: We have invested heavily in this, and we have been hiring in expertise from outside the industry. Our CTO, for example, was previously with Channel 4 and she has brought a totally different view.

Ultimately, what our investment means is that a manager can join our platform without having to hire too many data scientists. We sit in the middle, converse with the LPs about what they require, and pull everything into a format that is compatible with our clients and the story they want to well.

Just to take a step back, what do LPs actually want when we talk about data? What are they expecting from a manager? Do they want to see everything?

Pierettori: I would say everything that is meaningful. The rules of the game have not changed. Transparency and providing a clear, truthful picture of what is going on with an investment remain the key priorities.

With respect to the use of more advanced data analytics to glean insight into a portfolio, the industry is a bit behind, and LPs are looking to GPs to innovate. The problem is that the technology is not off the shelf and it's not easy to implement. We all have the data – you just have to look into our inboxes – but does it really work? Do you have the AI ready to crunch it?

On a positive note, we are in a phase of transition, we are getting up to speed and I believe that, in time, data analytics will be embedded everywhere in our organisations.

What does this transition mean for LP/GP interaction now? Does the GP still need to hold a degree of control over how data is provided to LPs?

Postlethwaite: If you release all this data without fully understanding the way the LPs are coming into it, they might end up interpreting it in a completely different way that you didn't either intend, or that inadvertently changes the narrative of what's there. So, in some instances, releasing too much data can be counterproductive. As we're going through this transition phase, it's better to control the stream of information.

That said, LPs do have many different requirements and you can get lost in the multiple requests for information. That is a big strain on your time, especially when you don't have a particularly large team.

At the moment it's safer to control the narrative, but as data lakes and analytics become more embedded, then you can start releasing data and invest in the type of technology that enables "look through" reporting.

Steve Darrington

Matt Horton

James Duffield

Currently I'm trying to put something in around portfolio monitoring because like most of us, we just use spreadsheets, but it's antiquated. We are moving towards a situation where we will be able to standardise what we collect from our portfolio companies and feed that through to the LPs so they can see what they require, without us sitting in the middle. Obviously, we'll check it, but ultimately, we will be in a place where LPs view real-time reporting at portfolio level.

Duffield: The complication is that we're in a community where we have common LPs. You may end up having a great deal of data, which you distribute to an LP that in the future lands up as an investor in an aggressive acquiring company. If that happens, can they refer back to the data a manager shared previously?

That is something we are all grappling with. We are all trying to get better at sharing, but down the road we may wish we hadn't shared quite so much!

Wilkins: Quite apart from the commercial aspect of that, there's also the legal aspect. Who owns that data?

The other thing is efficiency. No one wants endless infinite data. You want the data you want. What is our role in that?

Personally, it comes back to this dialogue with LPs and discussing what's efficient and inefficient for all of us. That isn't just around us having to produce reports, but for LPs as well, because if you just have endless infinite possibilities, it's like the world wide web, isn't it? There is this bombardment of information, but what's actually useful?

Thomas: This is where your machine learning potentially does start to become quite important. There are a number of tools out there now that can go into unstructured data and pull it out into a structured format for a system. If those tools work the way that they're sold to us, they will cut a lot of the barriers to transmitting information.

Horton: Exactly. What is the problem we're trying to solve? And the trouble is that at the moment there is no single problem, right? There are many things that are articulated and we're putting it all into a melting pot. If the request for information isn't framed precisely you may have a huge data lake, but you will never be able to find the little goldfish you're looking for in there.

Darrington: That's the problem. If you talk to the data analysts, they will say just put it all in there, we'll find it. We know how to get stuff out. This approach is so different to how most of us in the industry think. When we reach a decision point, we use all of our lifetime of experience to make an assessment. Data analysts don't do it that way. They just dump everything into a data lake and then they start working on it. Patterns start to emerge and there are tools to help understand those patterns. They then know the questions to ask. They have no direct experience, just masses of data and the intuition and tools to get it out.

It's that crossing the Rubicon from structured databases in the old days, where you have fields and it was all basic, to multidimensional databases, that's challenging. We're just not there yet, but we are having a look.

To close, I wanted to ask some questions around operations and LP influence when it comes to making operational decisions. Are LPs more particular about operations and IT?

Wilkins: I have not seen investors dictating specific products, but they are more and more interested in it as you fundraise. We fundraised through Covid and there was much more due diligence on the operational side... loads.

LPs are scrutinising whether the right things are in place and whether the controls and functionality are there. I also think that if you don't have a recognised software name, and let's face it, there's only a handful anyway, it gets way more difficult.

Hylton: When we raised our last fund, I was having in-depth, one-on-one conversations on operations, completing questionnaires that would come afterwards and then follow up calls. We would go through everything from cybersecurity, how we handled any outsourcing and what references we'd taken on key suppliers.

I definitely saw more focus on operations, and I wouldn't be surprised to see that focus intensifying further in the future.

Why has there been this focus on the operations, processes, and technology stack of a manager?

Darrington: Deal teams actually don't spend much time with LPs apart from when it comes to fundraising, the AGM and co-investing.

It's the back and middle office that are providing information, having conversations, and dealing with queries. It is in the LP's interest to make sure that the operational and reporting side is up to scratch, otherwise a GP is going to be a nightmare to deal with. LPs are trying to make sure you're a good corporate organisation that can behave and slot in with them.

Cybersecurity and fraud are the other major risk areas when it comes to operations. Criminals know that we move large amounts of money on a periodic basis, and they only have to get lucky once.

LPs want to make sure every precaution has been taken to ensure that you don't get hacked or ransomed.