MANAGER SELECTION

Money talks but LPs still have questions

Track record speaks loudest to investors, which can be a challenge in a new arena like private debt. But investors are being won over, finds **Claire Coe Smith**

A manager's track record, clarity of strategy and alignment of interests with LPs are paramount for investors when they are asked to rank the most important factors when selecting a private debt fund manager, according to the *Perspectives* survey.

These three categories stand well ahead of other factors, such as issues like adherence to ESG principles, preferential terms for early and/or larger investors and the quality and quantity of manager communication.

"In terms of manager selection, I don't think there's really anything different for private debt from any other asset class," says Damien Webb, head of income and real assets at First State Super, one of Australia's largest superannuation funds with more than A$52 billion ($37 billion; €35 billion) in funds under management.

"We are looking for a very close relationship with our partners, because we have a very large mandate. So we want to craft a relationship in such a way that we are almost regarded as an embedded partner.

"We are looking for something very tailored that works for us, and that's not because we think we can second-guess the manager on their capabilities, we just find it helps in the sense that we can erect a strategy that allows us to seek out large exposures to particular areas at any point in time."

Webb says his firm's preference is for largely self-owned managers with a strong track record in credit selection, and an ability to control their fundraising to have a managed approach to the business: "We like managers with a very defined area that they are seeking to work in, and who are not seeking to grow out of all proportion to what they can handle."

STRATEGY

Advisors echo the view that LPs are primarily looking at private debt managers' strategies alongside a strong track record.

David Waxman, managing director of Azla Advisors, a secondary market and primary fundraising advisory firm, says: "The main things that investors are looking for are probably not that different from private equity. It starts with strategy, and that is probably less manager-dependent and more about what the LP is looking for within their programme at any one time. And next it is track record."

For a long time the biggest concern for investors was finding fund sponsors who had been in private debt long enough to have a track record. Now, says Waxman: "That question still remains, although it has certainly been somewhat mitigated by the amount of capital that has been deployed in the last few years, such that managers are now coming back to market with stronger track records."

Asked whether they had ever invested

Newsome: investors prefer teams who rely more on carry than management fees

"IF YOU ARE TRYING TO GET A FUND CLOSED RIGHT NOW, IT DOES YOU MORE FAVOURS IF YOU DROP THE MANAGEMENT FEE RATHER THAN THE CARRY"

James Newsome

with first-time managers, 64 percent of LPs surveyed said they had not, of whom three-quarters had no intention of doing so in the next 12 months.

Other considerations that Waxman points to include the size of the fund and how much capital the LP can expect to be able to deploy with the manager, not only in the current fund, but in the future.

Investors told *PDI* a manager's track record is clearly the most important criteria, though a few stressed that it is about individuals, rather than the firm, and that a manager's ability to source transactions is a key aspect.

Fees are also a serious consideration, but while there had been a lot of movement in fee structures in recent years as the asset class developed, arrangements have started to solidify such that market norms for private debt funds are beginning to emerge.

LPs said the three most important issues to them when it comes to fees, terms and carry, are competitive management fees and carried interest, the division of expenses between LPs and GPs, and waterfall arrangements. Asked how important the level of the management fee is to a fund's investment decision process, 70 percent said "critical".

Waxman says: "Certainly there is still more flexibility around fee structures in private debt than there is in private equity, but it has started to firm up in terms of different fees for different strategies. The higher-return strategies justify higher fees, and most fees are charged on invested capital rather than committed capital."

Four out of five of respondents agreed that management fees to GPs should be paid only on invested, rather than committed, capital.

"Now that things are a bit firmer, if management are going to take a very different stance, it may exclude them from consideration by an LP, where in the past it wasn't that cut and dried," says Waxman.

The other key investment issue is alignment of interests, and often that manifests in so-called "skin in the game", or how much the sponsor has at risk if transactions go awry.

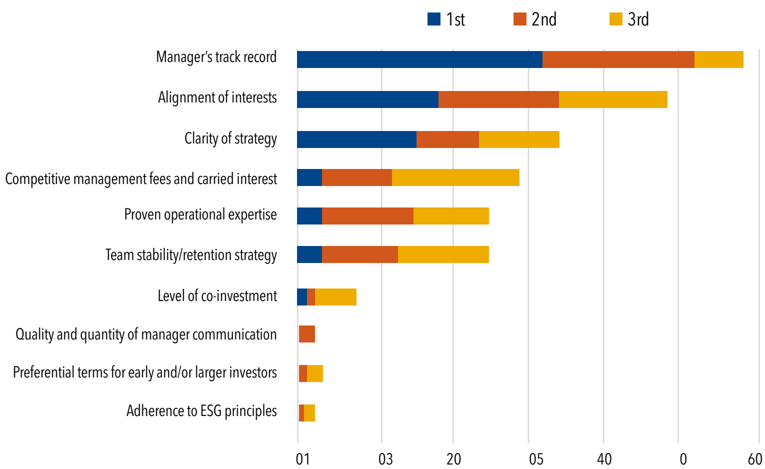
Webb says that alignment is something he looks at closely when selecting a manager: "I think that alignment comes in many forms, so in certain areas, and perhaps more so in the equity space, we are more demanding of skin in the game. In credit, if you are investing in groups with other forms of alignment, it's not necessarily a must-have in the private debt space, particularly if you're investing in groups that are more boutiques, who have more material amounts of their own invested in the business.

"We don't necessarily say you must have skin in the game. We can capture alignment in other ways, around the structure of performance fees, perhaps by limiting how they can grow, for example."

James Newsome, managing partner at

Waxman: flexibility around fee structures has started to firm up

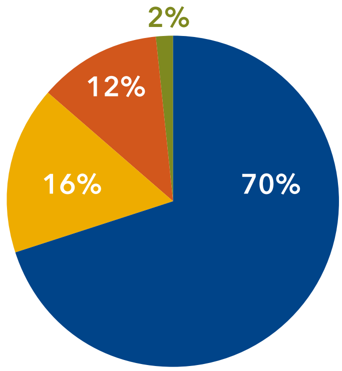
PLEASE RANK THE TOP THREE MOST IMPORTANT CRITERIA WHEN SELECTING A PRIVATE DEBT FUND MANAGER



Source: PDI Research & Analytics

MANAGER SELECTION

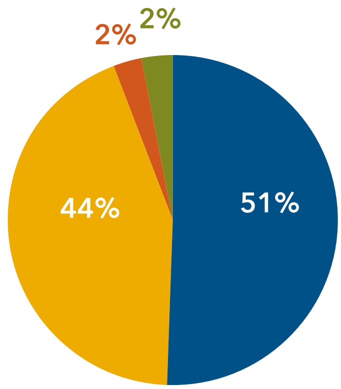
HOW CRITICAL IS THE LEVEL OF MANAGEMENT FEE TO YOUR FUND INVESTMENT DECISION PROCESS?



Very
Extremely
A little
Not a lot

Source: PDI Research & Analytics

HOW IMPORTANT TO YOU IS IT THAT A POTENTIAL GP HAS A SPECIALISED LOCAL DEAL TEAM REPONSIBLE FOR SOURCING DEALS?



Essential
Very important
A little important
Not very important

Source: PDI Research & Analytics

Arbour Partners, a placement agent helping managers raise and deploy capital, says investors "seem to prefer the teams who are relying more on the carry than on the management fees".

"So if you are trying to get a fund closed right now, it does you more favours if you drop the management fee rather than the carry. People want to see that teams have a real reason to work extremely hard," he says.

PORTFOLIO MANAGEMENT

Portfolio management is, of course, critical to the success of any fund, but is difficult for LPs to get a handle on at investment stage. Investors said the three areas they are most alert to when it comes to portfolio management are a lack of active risk management, a lack of reliable performance metrics and benchmarks and, on the plus side, team stability and talent retention.

Once invested, 72 percent of respondents like to receive financial reporting information on a quarterly basis, which is the frequency that 87 percent of investors are currently seeing.

More than a quarter would like monthly reporting, currently only enjoyed by 11 percent of respondents. As one investor says: "There are very few bona fide excuses for not allowing complete transparency."

In terms of management, a GP with a specialised local deal team responsible for sourcing deals was considered essential or very important by 94 percent of respondents.

"A local execution team is clearly the preferred route among LPs, but if you have got very good organisation and can give very good reasons why you believe your team should be located in London, for example, because that's what fits with your strategy, then it is possible to make that story stand up," says Newsome.

> "THERE ARE VERY FEW BONA FIDE EXCUSES FOR NOT ALLOWING COMPLETE TRANSPARENCY"
>
> **LP respondent**

Due diligence processes in the asset class have changed slightly with the arrival of fixed-income investors who care about different issues from the traditional private equity investors, such as liquidity, adds Newsome. But most manager evaluation processes still involve lengthy questionnaires from investors asking similar questions.

LPs say the biggest problems with these processes are the inconsistent methodologies being applied by different managers, as well as insufficient information being made available and slow responses.

"Due diligence processes do vary from investor to investor, and operational due diligence has become much more of an issue for GPs," says Waxman.

"Many pension funds use outside consultants who have extensive questionnaires, all generally asking for the same information, but no due diligence questionnaire is quite the same. Managers have to be sure to have the resources available to spend on responding to investor questions in a timely fashion and very intelligently. It is not something you can go through by rote."

The good news is that for those managers committed to the sector, demonstrating clear track record and strategy, investor appetite continues to grow. ■