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2015 DUANE MORRIS LP INSTITUTE
TRANS-ATLANTIC SIMULCAST:
LONDON-NEW YORK

CONNECTIONS

IN THE MIDDLE MARKET

SUMMER 2015

INSIDE THE MIND *of the* LIMITED PARTNER III

THIRD ANNUAL CONFERENCE

THE EVOLVING *REGULATORY* REGIME

CO- AND DIRECT *INVESTING* to reduce EXPENSES

GP SUCCESSION *PLANNING*

WHAT ARE LPs *THINKING?*

FEATURING
INSIGHTS FROM

Adams Street Partners

Buyouts Insider

Hamilton Lane

Monument Group

OPTrust Private Markets Group

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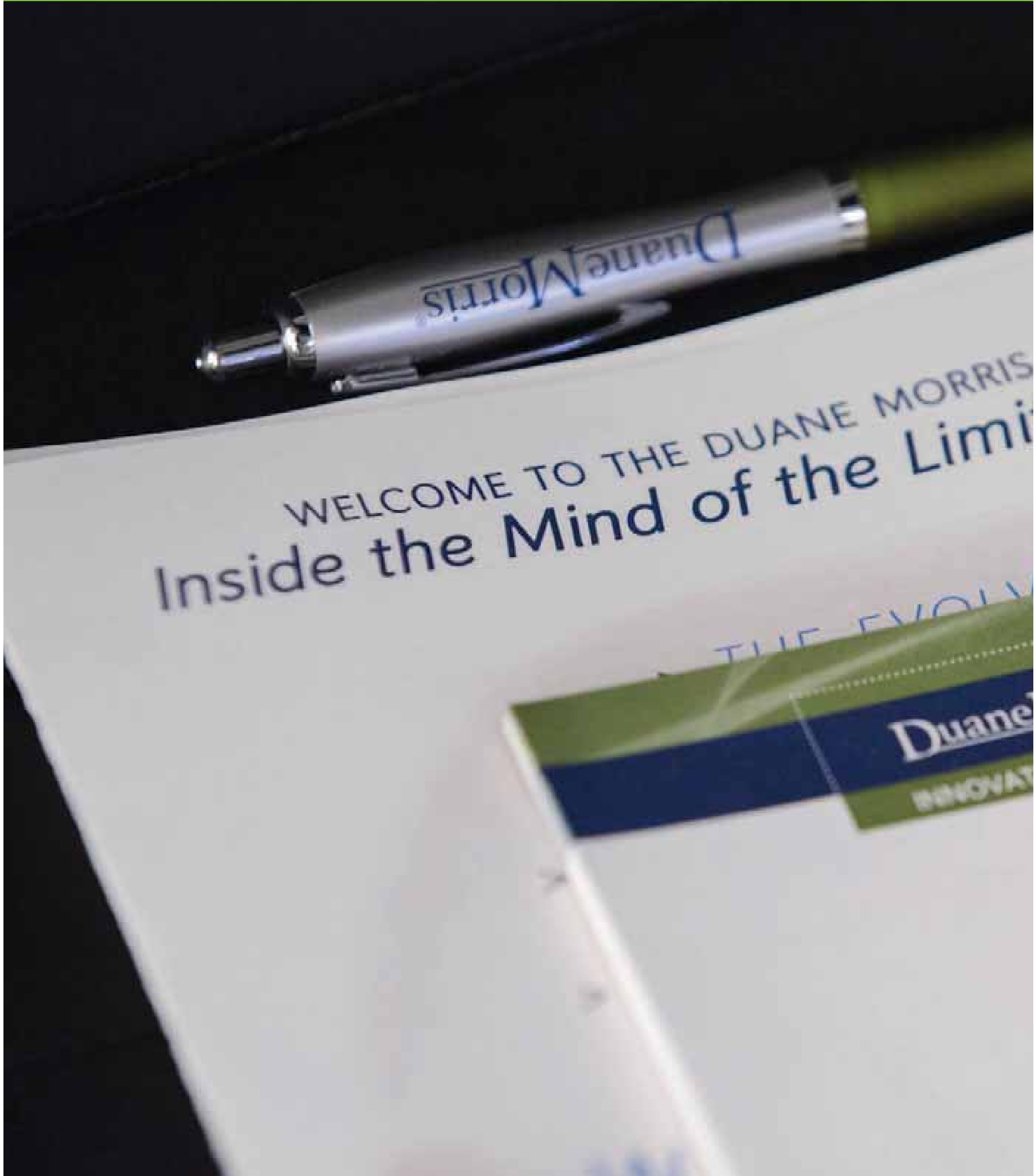

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INNOVATIONS IN GLOBAL PRIVATE EQUITY LAW

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A LETTER TO OUR READERS

This marks the third annual Duane Morris LP Institute *Inside the Mind of the Limited Partner* event, which we launched to facilitate a deeper and richer trans-Atlantic dialogue on the challenging issues facing middle-market private equity investors.

Our goal is to continually seek to contribute to the knowledge capital of the private equity industry for the benefit of LPs, private equity fund managers, corporates, regulators, business owners and the media.

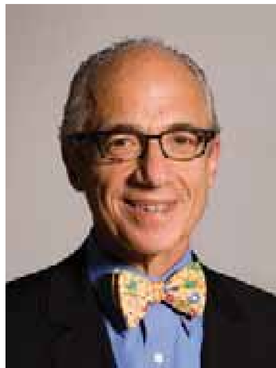
As with our past reports, we are excited to share with you esteemed views and supplementary industry information on leading trends and perspectives. We believe it is important to share, debate and clarify ideas that impact LPs, GPs and the broader economy. One of the most salient and consistent messages that we've heard over time is how much more work is needed to explain how private equity works—and how essential this task is in eliminating unnecessary and unproductive regulation, as well as in establishing a better public image.

As this and our earlier LP Institutes demonstrate, the middle-market private equity business—although mature—is still highly dynamic, evolving and ever-adapting to new market and economic conditions, along with investor demands and growing regulatory requirements. Our recent trans-Atlantic panel discussion brought to light challenges for LPs that come with record distributions and an increasingly competitive GP field where persistent top performers are no longer readily identifiable. These are indeed exciting times.

While the ever-changing, often-innovative nature of private equity makes it more challenging to follow, we think it makes it even more vital to do so. We thank all of the participants who contributed to this LP Institute event, and we look forward to your future involvement and voice in a highly interactive and productive dialogue.

We hope that you find this issue of our *Connections* series both informative and thought-provoking.

Very truly yours,



Richard P. Jaffe
Co-Head of Private Equity
Duane Morris LLP

Pierfrancesco Carbone
Co-Head of Private Equity – UK / Europe
Duane Morris LLP

INTRODUCTION

Early this year, Duane Morris' LP Institute held its third annual investor panel in New York and London aimed at providing real-time commentary on the key issues facing investors in middle-market global private equity investing.

Like last year's event, which we captured in *Inside the Mind of the Limited Partner II*, our trans-Atlantic panel this year included leading private equity investors and a placement agent representative to offer an on-the-ground perspective of activity in the North American and European middle markets.

New York

- MIKE KELLY, *Managing Director, Hamilton Lane*
- DAVID TOLL, *Executive Editor, Buyouts Insider (New York Moderator)*

London

- JANET BROOKS, *Managing Director, Monument Group*
- SPENCER MILLER, *Managing Director, OPTrust Private Markets Group*
- ROSS MORRISON, *Principal, Adams Street Partners*
- JENNY WHEATER, *Partner, Duane Morris LLP (London Moderator)*

If 2013 was a good year for investors in the asset class, 2014 and into 2015 have been even better, setting the tone for a lively discussion on the challenge of what LPs should do with record distributions. In addition, a growing concern of both investors and GPs is regulation—especially the multi-tentacle European Alternative Investment Fund Managers Directive (AIFMD) and the increasingly intrusive U.S. Securities and Exchange Commission (SEC). Our panelists shared their views on LPs' growing sophistication and confidence, as indicated by rising levels of "shadow capital" and increasing co- and direct investment.

With lively audiences in New York and London, the panel discussion generated a number of thought-provoking questions for further exploration.

Duane Morris is proud to share our third annual LP Institute report with you. As we wish to continue to improve our efforts at facilitating dialogue and understanding of the global private equity middle market, we look forward to your comments and questions.

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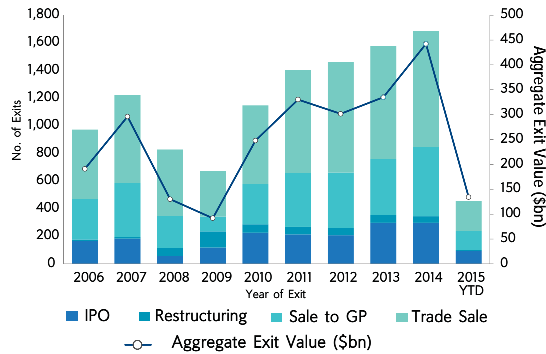
From left: Duane Morris' Richard Jaffe joins Hamilton Lane's Mike Kelly and Buyout Insider's David Toll for the New York portion of our trans-Atlantic LP Institute event.

DEAL AND FUNDRAISING ENVIRONMENT – WELCOME TO "CAPITAL SUPERABUNDANCE"

In its annual global private equity report, Bain & Company pronounced 2014 as the "year of the exit," with exits from buyouts exceeding $450 billion and "surpassing the all-time high by a wide margin"[1] (See Chart 1). This robust exit environment was encouraged by readily-accessible capital as favorable monetary policies drove down interest rates—ensuring pools of cheap, plentiful debt, and rising public market valuations. This also marks the sixth year since the U.S. economy climbed out of the last recession.[2]

Chart 1: Private Equity-Backed Exits by Type



Source: Preqin, Private Equity Spotlight, May 2015, p. 8

However, this new era of "capital superabundance" has brought its own set of challenges to the private equity industry, many of which are testing the current model's discipline and resilience as it adapts to new market dynamics. As seen in Chart 2, the pressure on asset prices continues to rise as LPs look to reinvest record distributions, GPs shoulder record amounts of dry powder and yield-hungry creditors compete to provide low-cost debt.

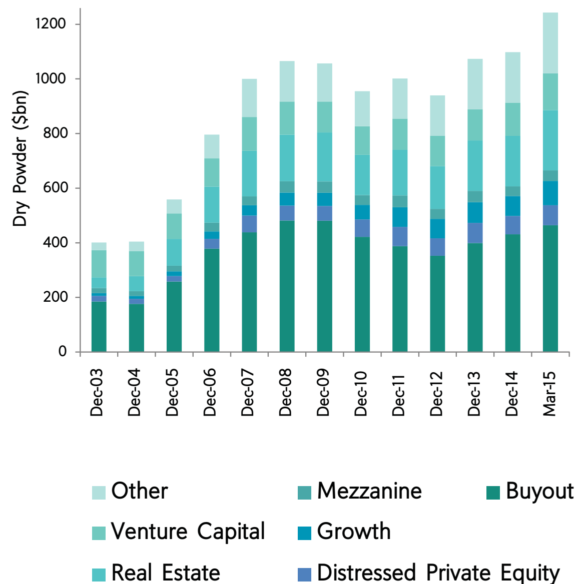
With abundant capital, growing knowledge of the business and a strong desire to lower fees, investors are putting more money to work outside the comingled structure, which has been at the center of the asset class' success. Thus, the rise of "shadow capital," which includes money allocated to special accounts, co-investment, secondaries and direct investment, is fundamentally altering the business. This is at a time when buyout investment activity, particularly for North America, has plateaued over the past few years (See Chart 3).

Fundraising last year reached $537 billion at the global level, nearly in line with 2013.[3] The trend toward fewer and bigger funds continued as the number of funds closed dropped by nearly 8 percent in 2014.

The rise of the secondary market volumes last year to more than $42 billion demonstrates that investors are increasingly taking advantage of the liquidity this market provides. However, the competitiveness of the asset class remains feverish—by the conclusion of Q1 2015, there were over 2,200 private equity funds actively fundraising.[4]

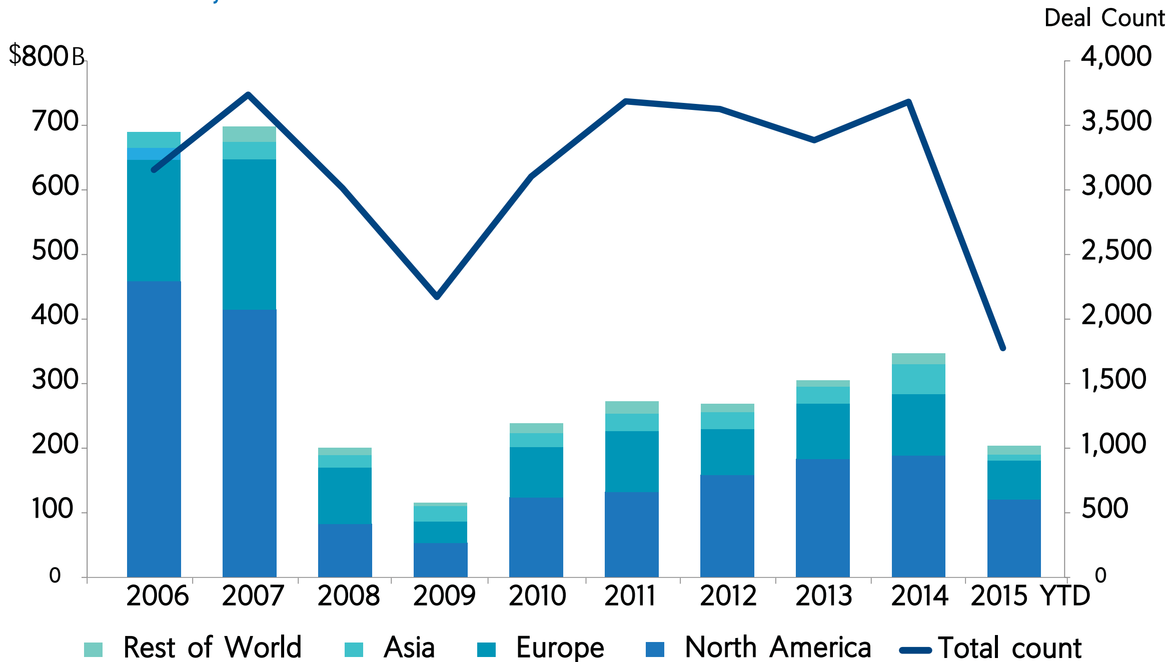
These market conditions set the stage for our panelists' discussion.

Chart 2: Global Private Equity Dry Powder by Fund Type



Source: The Preqin Quarterly: Private Equity, Update: Q1 2015

Chart 3: Global Buyout Deal Value



Source: Preqin Customized Data, July 2015

Record Distribution, but a Tough Environment to Invest

The panelists generally agreed that the record levels of distributions present both an opportunity and a challenge to investors. According to Mike Kelly at Hamilton Lane, "GPs are making good on the promise of selling, whether they're selling a company or creating dividend distributions back to their LPs." He highlights that investors are "paying them to go off and make acquisitions as well." But in that regard, Kelly maintains, "The prices are high and they've been high for a while," although they "are not back to where they were in the peak years of '06 and '07." It is in this environment, he emphasizes, that "making the right selection in terms of which GPs we're backing" pays off.

Agreeing on the huge amount of distributions, Spencer Miller at OPTrust cautions that the "first thing we have to get over internally is our CIO saying, 'Great. Well done, what am I going to do with the cash now?'" He observes that "prices have continued to go upwards, and typically, there's a correlation between high prices and returns." In Miller's view, it is important to stop and think whether the capital returned by GPs can be invested in attractive deals in today's market. "In three, four, five years' time, when you look to exit an investment, are you going to be able to get the same kind of leverage? Are you

going to be able to achieve a similar exit multiple to the price you paid on entry, or can you grow more than expected to compensate for negative multiple arbitrage?" he asks.

"It's genuinely a tough environment today to be investing capital and it's very competitive," Miller notes. With a lot of GPs holding on to excess capital, he says, prices are being driven up. Moreover, "Deal volumes haven't recovered yet from the peak years," he mentions. "This may be the new normal," Miller suggests, as "2007 was a peak year that we are unlikely to see again." He concludes that he worries "about the returns for this vintage."

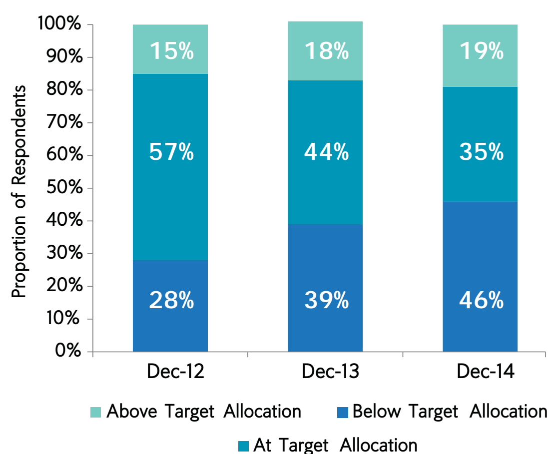
Last Cycle's Lessons and Relying on Smart Portfolio Construction

"This is our third record-blockbuster year of distributions that we've had back from our GPs," notes Ross Morrison at Adams Street Partners. "Absolutely, it's been a time to sell, as valuations are high and the availability of debt is high, specifically in the U.S.; it is more patchy in Europe," he adds. Morrison is confident "that our managers are disciplined and not going to exhibit the same behavior" that got people in trouble at the top of the last cycle. "The lesson seems to have been learned," he says.

Growing evidence indicates that investors have been taking a more cautious approach and are scaling back their allocations to private equity. As far back as 2013, David Swenson, who manages Yale's endowment, announced Yale was cutting its allocation target from 35 percent to 31 percent. CalPERS followed suit, reducing its target from 14 percent to 10 percent. Recently, Commonfund reported that last year, U.S. endowments with more than $1 billion in assets cut their allocation to 12 percent, from 15 percent in 2013.[5] Finally, the proportion of investors with allocations below their targets has been increasing over the past two years, according to Preqin (See Chart 4).

How should managers deploy capital in this environment? When Adams Street thinks about portfolio construction, it takes into account that the bigger the fund and transaction size, the more efficient the pricing, and the fact that valuations will be different across the world. Morrison notes that "seventy-five percent of our portfolio is in fund sizes that are less than $2 billion" and that a global portfolio means price can be arbitraged—"by having a global portfolio, it will be cheap somewhere; there will be value somewhere, whether that's in Eastern Europe, while the U.S. is riding high, whether China is in a slump." He stresses that "A larger emphasis on small and medium-size private equity managers helps put a firm in a good position to participate in the upside, as these managers find inefficiencies in their own markets."

Chart 4: Proportion of Investors At, Above or Below Their Target Allocations



Source: Preqin Investor Outlook: Alternative Assests H1 2015, p. 11

Try Not to Time the Cycles, Best to Take a Consistent Investment Approach

Miller emphasizes that "You've got to be very careful not to try and pick the cycles." In his view, "The historical evidence shows that if you invest consistently, you will do very well against public benchmarks," but "if you try and time your investments," things are unlikely to turn out well. Generally, "People invest way too much money as the market improves, when it looks like there's a lot more deal flow, prices are high and fundraising is very strong," Miller observes. People get overconfident. As a result, he says, "You see a lot more money coming into the industry." Miller notes, "As the cycle breaks, people lose confidence, and as was seen in the last cycle, they worry about liquidity and you see

increased secondary deal flow." In turn, investors typically then reduce the amount of capital that they commit, which is both inconsistent and won't put them in a position to buy undervalued assets.

Investors Becoming Increasingly Sophisticated and Focused on Specialist Funds

Both GPs and investors have had to become smarter and more disciplined. Janet Brooks of Monument Group says that since the global financial crisis, "Investors have taken more time to look at the risk factors around investing in private equity," with "a lot of institutions bringing on board chief risk officers, who are now involved in more of the operational due diligence of funds." That being said, she wonders "if the processes have changed enough to avoid the next crisis."

Brooks also observes a considerable investor interest "in lower- or mid-market, differentiated offerings where people have an operational or a sector-specific approach." At the same time, many billions are going into somewhat undifferentiated large mega funds. She agrees that "lower- and mid-market perform well." In addition, she points out that recent Cambridge Associates research found that sector-specific funds tend to better perform than generalist funds. In Brooks' view, "Sector specialism should allow a GP to avoid the capital losses," as a specialist "avoids making the big mistakes that a generalist might make in these times of high pricing."

Important to Develop Portfolios Dynamically—In Terms of Where We Are in the Cycle

When Hamilton Lane contemplates where it should invest, "We spend a lot of time thinking about all of the different sub-strategies relative to the broader macro environment," says Kelly. For example, "We think about distressed; about U.S. versus Europe versus other places; small, medium and large buyout; venture; growth capital." In addition, Kelly notes that his firm spends a "significant amount of time evaluating where should we be allocating new capital going forward, based on where we think we are in a cycle or macro environment, and what's the impact on performance, relative to a static allocation." For Hamilton Lane, "it's much more a dynamic portfolio development approach of adapting to the environment as you go forward."

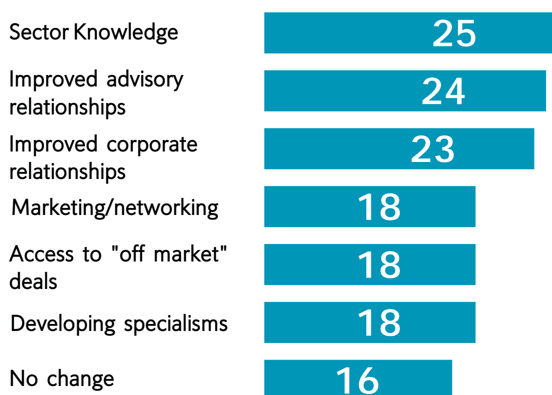
Specialization Takes Many Forms

Morrison points out that, as a more evolved and mature environment, "The U.S. market has experienced a huge amount of specialization." Moreover, he believes, "Specialization takes many different forms: It can be by subclass, size, sector and strategy." Going back to 1997 and 1998, private equity was a pretty unknown asset class in Europe, and therefore, "probably the right thing to do was not to back specialist private equity funds." He notes that "If you had backed pan-European generalist funds, you would have

done very well." Jump forward to 2004–2006, and you see "a greater number of specialist managers entering our portfolio, and if you look at it now, it's probably 50/50 between generalists and specialists," Morrison says.

Morrison emphasizes that even with generalists, "There's got to be something special about the way that they go about running deals." He points out that "People are getting smarter about how they source deals, about how they add value, about how they exit, and they even have in-house debt experts to help structure their deals." Specialization in his mind takes many forms—it may include buy and build strategies, a focus on minority deals, deal structuring or the ability to play up and down the cap table. Ultimately, "They are experts in their own field, or they are executing a strategy that gives them a defensible position," Morrison explains. Hence, they can create value regardless of the macro environment.

Chart 5: In What Way Are PE Firms Having to Develop and Adapt Their Approach to Deal Origination in Order to Identify Deals in Today's Market? (%)



Source: Grant Thornton, Global Private Equity Report 2014/15

Consistent with Morrison's view are findings of a recent Grant Thornton global survey of private equity GPs, which highlighted *sector knowledge* as the most important factor in identifying deals in today's market (See Chart 5). Similarly, three-quarters of the financial sponsors surveyed by Deloitte said that their goal was making investments to create industry-specific portfolios rather than portfolios that comprised hodgepodge companies from diverse sectors.[6]

Stewart Kohl, Co-CEO of The Riverside Company, has pointed out that: "The focus on industry specializations is a long-term trend, which is part of the natural evolution of private equity. In an increasingly competitive environment, it provides you with an edge while also allowing you to be a better buyer, as well as owner."[7]

Specialization but Balanced by Diversified Portfolios

Miller agrees that there are "lots of different ways to break down the market, whether it's by sector, geography, strategy, and so on and so forth." He emphasizes that because you are investing for the long term, you have to build a balanced and diversified portfolio. Otherwise, Miller maintains, "You can get caught out." For example, he says, "If you invest only in one particular sector or geography, that sector or region will go through cycles and may not always be an attractive place to invest." With respect to geography, a more balanced, long-term strategy is to invest globally and take advantage of the fact that Europe "is different to North America, which is different again to Asia," Miller added.

From left: In London, Monument Group's Janet Brooks, OPTrust's Spencer Miller and Adams Street Partners' Ross Morrison are engaged in a thoughtful discussion on investment approach, with Miller illustrating his point on the topic.

"I think either a generalist or specialized strategy can work," Kelly believes. However, "If we're going to pursue a specialist fund, for us, we want to make sure that the specialty is defined wide enough." For example, Kelly says, it's not a narrow niche in healthcare where a GP may be encouraged to make investments, regardless of "there being an opportunity set there or not." He highlights that for Hamilton Lane, "It's most important that managers have a good understanding of what their strategy is, what they're good at, what they're not." Where Kelly sees both specialists and generalists fail is when they "stretch a little bit for this one deal or say we're going to modify and start to chase deals over there." What is important, in his view, is the GPs' ability to "say 'no' to what's an interesting, shiny object over here, but it's not in their wheelhouse."

Narrow Investment Mandate Is More Risky for GPs Than LPs

Brooks tends to agree that there are successes and failures in both generalist and specialist strategies, but in her view, "The more restricted the investment mandate, the more it will be a risk for the general partner than it is for the limited partner." This is because the limited partner is making an investment as part of a wider portfolio, while the general partner has less diversification and may make only five deals per fund. Consequently, she concludes, "For GPs, the risk is very high."

Buyout Insider's David Toll (left) and Hamilton Lane's Mike Kelly listen attentively as our panelists in London share their views on the AIFMD.

REGULATION: AIFMD AND SEC SCRUTINY

Unlike panels in the past two years, this year's participants were much more negative in their outlook regarding how they saw regulation playing out in Europe and the United States. In part, the delayed pessimism can be attributed to the fact that, in Europe, the many-tentacle Alternative Investment Fund Managers Directive (AIFMD) is beginning to bite, and in the United States, the Securities and Exchange Commission (SEC) has only recently taken on a more vocal and activist stance.

Although late in the game, a consensus across GPs and LPs is emerging that new rules are beginning to have a non-negligible impact—both in terms of cost and increased complexity—and it is not confined to just GPs.

Europe – Waking Up to Increased Complexity, Costs and Uncertainty

Janet Brooks summed up her view on the AIFMD: "It is something that European LPs should be very concerned about and fighting against." She believes that "deal flow of non-EU funds must be declining very substantially, and they're certainly not going to be seeing the best performing of those funds." "We've been quite slow to realize how significant those changes were going to be and that they would have cost implications."

Brooks points out that "For those EU-based GPs who are happy to do the administration and pay the costs to become compliant, marketing is potentially getting easier." But, she emphasizes, "For every single non-EU fund in existence, it has a fairly significant effect." Many of the funds will not come to Europe, as they will just say, "It's not worth our while," Brooks adds. Some of her large fund clients have said, "Well, actually, we can still get the capital that we need from other markets, we're a good performing fund and investors will flock to us. We won't bother coming to the EU."

Brooks notes there are still some gray areas in the regulation—for example, in terms of "where there can be marketing, or pre-marketing, prior to any sort of registration." She adds that "For those LPs in jurisdictions deemed more difficult, like France, Denmark, Spain and Italy, one should imagine they would be very concerned by this." Finally, Brooks believes that funds in the business of turning around companies face additional issues as "the asset-stripping requirements of AIFMD may force you to make significant changes to your business model."

Adverse Selection, Lost Market Access, Reverse Solicitation

Miller at OPTrust agrees with Brooks that AIFMD is "a major issue." He has a number of concerns. First, "The LPs are paying for this." Second, there will be "massive adverse selection" from the perspective of European LPs who won't get access to many non-European funds. Finally, there will be "more conflicts arising potentially between the LPs because I'm sure North American LPs are sitting there saying, 'Why should I pay for European regulation, for example?'" Miller says he isn't hopeful, despite an anticipated strong lobbying effort, that when AIFMD II comes about, enough of the practical implications will be considered.

Ross Morrison at Adams Street Partners contends that AIFMD regulations raise two major impediments. The first is that European LPs "are not gaining access to the best firms in the world," which "is clearly not helpful." He highlights that "The U.S. markets are the largest, most liquid, most sophisticated private equity markets out there, and thus, they're home to some of the best private equity firms and, therefore, some of the best returns."

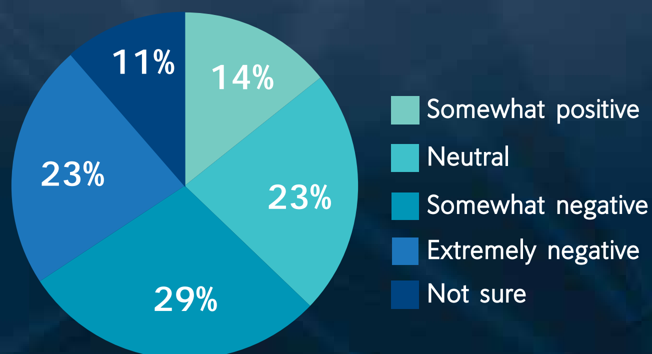
Morrison also notes that under the current rules, "Our GPs cannot directly approach LPs, pension funds and sources of capital in Europe directly." Investors have to proactively seek out GPs. "It's

ILPA Steps in to Voice Strong Concerns over AIFMD

Investors have started to speak out on the rising cost and complexity they are experiencing from regulation, especially AIFMD. In January, the Institutional Limited Partners Association (ILPA) responded to the European Securities and Markets Authority (ESMA) "call for evidence" on the functioning of the AIFMD rules.[8] The ILPA's response was in the form of results it gained from surveying its members late last year and from specific comments of members. As some of the comments indicate, the response appears scathing:

- The majority (86 percent) of European investors surveyed report that marketing activity among non-EU AIFMs has decreased since the implementation of the AIFMD.
- Many investors (46 percent of respondents) also report that efforts to initiate contact with non-EU AIFMs have been rebuffed due to compliance concerns.
- More than two-thirds (69 percent) of European investors said that their private equity programs had been put at a competitive disadvantage since the introduction of the AIFMD.
- "The risk of missing out on a good-quality investment opportunity has increased a lot," said one respondent to the survey of 35 European investor organizations.
- "Deal flow is reduced and access to information is significantly delayed, which has led us to be too late in the fundraising process and missing out on funds," said another.
- Some investors are choosing to stay on the sidelines: 46 percent of the respondents said they would wait to invest in another top-choice fund if they missed out on their first-choice fund.
- AIMFD implementation has contributed to further fragmentation of the EU internal market for private equity as variance around the definition of marketing has raised barriers to investment rather than facilitated capital flows.
- On balance, ILPA's members believe that the AIFMD passport and the registration requirements associated with it have not resulted in enhanced investor protections—52 percent of respondents believe that AIFMD registration requirements have had a somewhat or very negative impact on European LPs (See Chart 6).

Chart 6: What Impact Have AIFMD Registration Requirements Had on Investor Protections for European Limited Partners?



Source: ILPA, "Response to the ESMA Call for Evidence on the AIFMD Passport and Third Country AIFMs," January 8, 2015

The ILPA review highlighted that the limited access reported, especially by smaller European investors, was "a serious concern as our members rely on the performance available from investments into private equity to meet beneficiaries' or members' target returns, whether for retirement planning or meeting other liabilities as they fall due."

not a particularly helpful piece of regulation," Morrison concluded. "There is quite a bit of a gray zone in terms of reverse solicitation," adds Miller, as "people take quite different views as to whether or not they are meeting the rules."

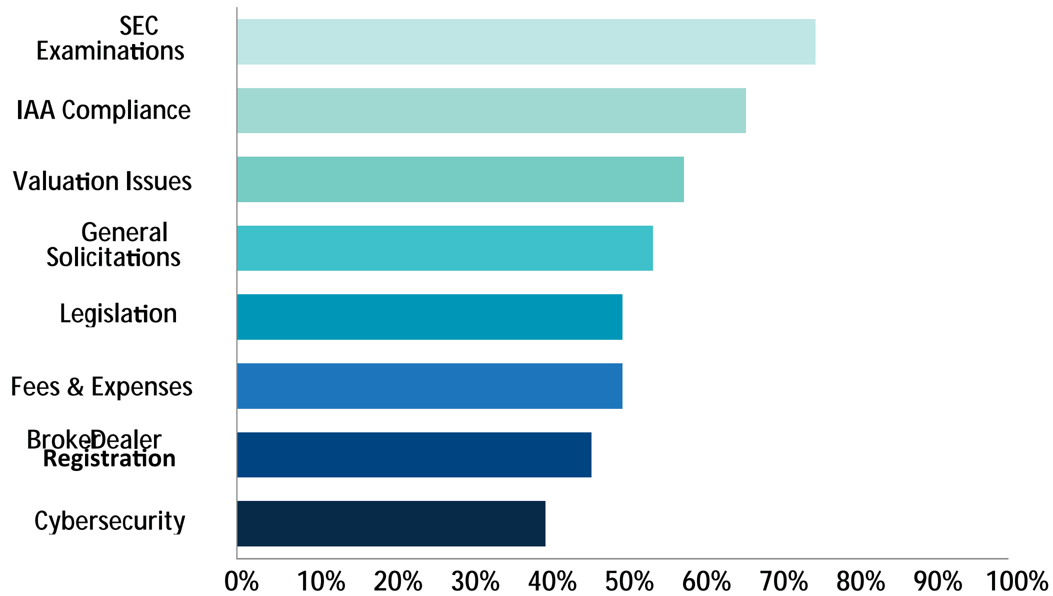
Will AIFMD discourage startup private equity firms? According to Brooks, if you need to raise capital widely in Europe, the costs of starting a firm have risen and that may dissuade some new entrants. In the UK, the situation is slightly easier because "smaller UK GPs can register under the sub threshold exclusion so they won't be immediately affected by such high costs and administrative burden," she explains. As the natural progression of successful managers is to raise larger funds, ultimately, the regulations also will have a cost impact on these groups. Miller agrees, noting that the fundraising market and cycle influence new entrants more than regulation. (See: ILPA Steps in to Voice Strong Concerns over AIFMD.)

The U.S. SEC Takes Aim at Fees, Operating Partners and Co-Investment

Sitting in New York, Mike Kelly at Hamilton Lane agrees that the "growing regulatory burden is causing a lot of increased costs, whether it's hiring people internally, or hiring more accountants, lawyers and consultants." More SEC interaction is "one thing we're seeing on a daily basis," especially on fees and "how they're allocated, how they're shared." In addition, questions revolve around operating partners—"are they employees, are they not?" Co-investments, Kelly notes, "will be in the crosshairs of the SEC next." He is starting to hear GPs ask, "How do you determine which LPs get a co-investment, which don't; how much goes to whom?"

From left: Duane Morris' Jenny Wheater, Monument Group's Janet Brooks, OPTrust's Spencer Miller and Adam Street Partners' Ross Morrison contemplate the impacts of AIFMD and SEC scrutiny on LPs and GPs.

Chart 7: Regulatory Issues That Concern Middle-Market PE Groups



Source: Association for Corporate Growth, "ACG SEC Task Force Survey: A Call to Action," October 2014, p. 5

On the upside, Kelly thinks some benefit will result from working through murky areas, such as for whom operating partners work and the incorporation of specific processes to deal with co-investments going forward. "So, while it complicates matters a lot and costs a lot more today, hopefully at the end of the day, we get some benefits in terms of a little more standardization, a little more transparency," he concludes.

In terms of how the regulations play out toward co-investing, Kelly expects some rational approach to evolve over time. In his view, it may work out similar to how GPs treat valuation, "so there's a valuation policy up front that you want to adhere to, so you are doing what you should be doing." This might address the fact that while "everyone wants to be a co-investor, not everyone should be a co-investor."

A key indicator that U.S. middle-market private equity firms are increasingly concerned about compliance and regulatory impacts was the release last year of the Association for Corporate Growth's *SEC Task Force Survey*. It highlighted how respondents—88 percent of which raised less than $1 billion in their most recent fund—were especially concerned with SEC examinations, followed by Investment Advisers Act compliance and valuation issues (See Chart 7).

The survey follows a speech from Andrew Bowden, then-Director of the SEC's Office of Compliance Inspections and Examinations, on "Spreading Sunshine in Private Equity," which referred to industry contracts as "an enormous grey area" that allowed hidden and "backdoor" fees to be charged to investors.[9] More recently, Bowden's successor Marc Wyatt provided an update in which he noted new "deficiencies" that have come to the SEC's attention, including "shifting expenses from parallel funds created for insiders, friends, family and preferred investors to the main co-mingled flagship vehicles" and inadequate "co-investment allocation" disclosure.[10]

Finally, he noted that it "was reasonable to assume" more private equity enforcement cases were on the way." (See: The SEC's Three Areas of Focus.)

Educating Regulators Is Paramount

In tackling the question "How much regulation do you need?" the panel generally agreed that it was best answered by having regulators that understood how private equity works. This would address what Morrison sees as "the pendulum swing" from too little, to too much regulation. In his view, the industry as a body could do a better job of communicating exactly what private equity is. He sees "venture capital as a good example," as globally, and specifically in the United States, regulation is "light touch" and "that it is a very lively and thriving part of the U.S. economy."

Miller comments that "you should be going in eyes wide open" and "if you don't agree with specific terms, then just don't invest." Investors "know they have to monitor their investments very actively and it's ultimately a commercial negotiation on a variety of terms with a GP," he stresses. Conversely, Miller notes, "We've seen a number of scandals, whether they are some of the fees and costs that the SEC has been focusing on" or "bad practices within the placement agents." Yet coming out of the global financial crisis, he continues, "There appears to be a massive overreaction as alternative asset classes are being negatively impacted by regulatory actions directed at the banks."

"It was very politically motivated," says Brooks, given "that the end users, the investors, weren't looking for these changes and, in fact, they have potentially ended up being hurt by many of the changes." In her view, "The industry over many years has been very good at self-regulating" as industry bodies have done a fabulous job being proactive in addressing valuation, reporting, disclosure and transparency issues.

Kelly is in agreement with the general consensus "that regulators don't fully understand private equity today and that a number of these regulations may not be helpful in the long run." Although he hopes "we get to a good place," he is not optimistic: "I think it's going to be sort of a meandering, uncomfortable path to get there."

"Spencer chairs the British Private Equity & Venture Capital Association's (BVCA) LP Committee, so we do get involved in their work," says Brooks. Ultimately, what she would like to see is "a simplification of the marketing rules under the directive to allow marketing to sophisticated institutional investors prior to registration," which Brooks notes "is very important and I do think LPs in their individual jurisdictions need to make sure that they are lobbying for that to happen."

Morrison stresses that "We, as BVCA, EVCA, have got to educate, but we have got to break the mold that we are not business-friendly." He continues, "The fact that our pension money, our money here, is not accessing some of the best investment opportunities in private equity because of regulation does not make sense." In addition, "The fact that some of our best managers are sitting in Europe, they're trying to fundraise, or want to be solicited, can't do that. That doesn't make sense." Morrison sums up, "These are very, very simple impediments that should be eradicated."

THE SEC'S THREE AREAS OF FOCUS WITH PRIVATE EQUITY

The SEC appears to be taking a "very robust" approach to its role of monitoring private equity fund advisor registration under, and compliance with, the Investment Advisers Act of 1940. It is less apparent whether private equity compliance with the Investment Advisers Act or the SEC's oversight has had any impact on systemic risk or uncovering major fraud. It is in keeping with SEC Chairwoman Mary Jo White's plan to pursue a "broken window" strategy of securities enforcement that comes down hard on minor violations in order to prevent individuals from engaging in even more egregious conduct.

The Dodd-Frank Act requires advisors to private equity funds that have assets under management (AUM) of $150 million or more to register as an investment advisor under the Investment Advisers Act of 1940. Congress exempted venture funds from Dodd-Frank. Private equity funds, irrespective of their size or nature of activities, were lumped with hedge funds even though, unlike hedge funds, private equity funds are structured as committed funds in the same manner as venture funds. One explanation for this outcome is that the middle-market private equity industry failed to effectively advocate in Washington that private equity was more similar in structure and risk profile to venture funds than to hedge funds and, like venture funds, did not pose a systemic risk to the U.S. financial system.

The requirement to register as an investment advisor imposes burdensome regulation on the private equity industry in general, and on the middle-market segment in particular. This is especially true of those middle-market funds that are pure buyout funds that invest in, or lend to, middle-market companies. However, there does not appear to be a commensurate benefit for the investing public or an increase in the protection to the U.S. financial system. The Investment Advisers Act was not designed to regulate entities that have a private equity business when enacted 75 years ago. PE funds do not trade in, or advise on, investment in public securities or engage in other activities of investment advisors.

At the moment, the SEC's attention is focused on a few areas:

Conflicts of Interest in Allocations of Fees and Expenses

1 In a May 2014 speech, Andrew Bowden gave notice to the industry that he was concerned about improper fees and the allocation of expenses to investors that should be paid by the firms. More than half of the private equity firms examined by the SEC were either breaking the law or had "material weaknesses" in controls. One of the most common deficiencies found was the failure of the funds to share with investors how operating partners were compensated.

Although much-feared and discussed, there have been few enforcement actions thus far. Last September, the SEC fined Lincolnshire Management $2.3 million for sharing expenses between portfolio companies in a way that benefited one fund over another, while in October, the agency fined Clean Energy Capital and its founder for misallocating funds and changing distribution calculations without adequate disclosure. In June, KKR agreed to pay $30 million to settle charges that it improperly allocated more than $17 million in "broken deal" costs solely to its flagship private equity funds instead of assigning some costs to co-investment vehicles funded by KKR insiders and large clients. The SEC complaint focused on

the years 2006 to 2011. In 2012, following an internal review, KKR changed its expense-allocation practices.

Allocation of Co-Investment Opportunities

2 Marc Wyatt, the new SEC chief inspector, is expanding his predecessor's focus into the industry by turning to co-investment. In a speech last May, Wyatt suggested that private equity sponsors should consider increased transparency concerning the allocation of co-investment opportunities among existing investors. A potential concern arises when, for example, smaller investors are not afforded the same opportunities to co-invest in deals as their larger counterparts. Wyatt noted that prioritizing larger investors is not a problem per se, but that it made sense to err on the side of fuller disclosure of a sponsor's policy toward allocating co-investment opportunities.

A possible pitfall in limited disclosure practice, Wyatt suggested, was that if co-investment promises are made to certain investors orally or through e-mail, the effect may be that some investors receive priority rights to co-investments of which others are not aware. He noted that the SEC has identified instances where fund investors were not made aware that other investors had negotiated priority rights to co-investments, which his office views as improper. While an advisor need not allocate its co-investments pro-rata or in any other particular matter, Wyatt indicated that all investors deserve to know where they stand in the co-investment priority stack.

Stapled Secondaries

3 Igor Rozenblit, Co-Head of the SEC's Private Funds Unit, has raised concerns about the impact of stapled secondaries on the existing fund LPs. The stapled secondaries issue relates to a strategy a GP may use to wind down an old fund while seeding a new one by offering outside LPs the right to purchase interests in a fund in exchange for investing in the GP's new fund. In May 2015, Rozenblit posed the question of whether a manager is breaching its fiduciary duty by presenting investors what could be bad options—*e.g.*, an existing LP gets the option to either sell its stake in an old fund, usually at a discount, or roll its interest into a new vehicle. Approval for these deals generally is gained from some percentage of the LP base or from the LP advisory committee.[11]

As transactions aimed at restructuring private equity funds, stapled secondaries can play an economic role addressing "end of life" funds and preventing funds from turning into zombies. In 2014, the secondary deal volume was estimated at $42 billion and stapled transactions were thought to account for about 10 percent of the deals.[12]

In sum, despite having one of the cleanest fraud records in the financial industry and the most sophisticated clients, private equity is the focus of increasing regulation and scrutiny. For mega-firms, that are now becoming asset managers and not true buyout funds and who have extensive resources and infrastructure in place, shouldering the increasing requirements of new regulation is not as burdensome as it is for smaller players. EQT managing partner Thomas von Koch pointed out just how resource-intensive compliance is: "Two-thirds of EQT's staff is focused on support and compliance; this is killing the smaller mid-market houses."[13]

Duane Morris' Richard Jaffe (right) conveys his views on capital overabundance and shadow capital as Hamilton Lane's Mike Kelly (center) and Buyout Insider's David Toll (left) listen attentively.

SIGNS OF CAPITAL OVERABUNDANCE: RISING SHADOW CAPITAL, CO-INVESTING AND LP VS. LP CONFLICTS

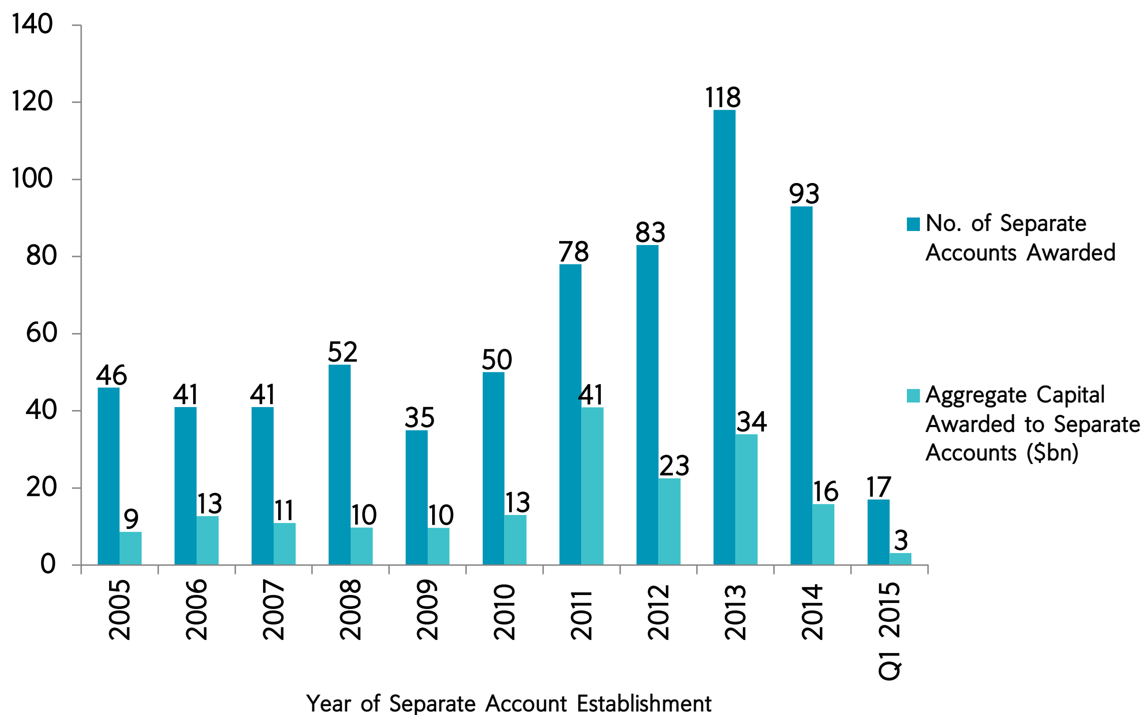
Shadow Capital on the Rise

A key manifestation of capital overabundance is the growing pools of *shadow capital*, which is not the passive capital investors are directing at private equity comingled funds, but more active capital they are allocating to separate accounts, co-investment and direct investment. Miller indicates that when added to the amount of dry powder held by GPs, this total pool of capital is enormous and is helping to push up deal prices. In this environment, he adds, "It is critical to maintain investment discipline."

How big is the pool of shadow capital? According to global private equity fund advisor, Triago, approximately $113 billion in new shadow capital was added in 2014. Between 2007 and 2008, annual shadow capital commitments averaged around 13 percent of yearly fundraising. Today, that figure is more than one-quarter of annual fundraising.[14] With record distributions, Triago expects 2015 to market an all-time high for new shadow capital commitments.[15]

Similar to co-investments, separate account mandates have also seen significant growth (See Chart 8). These custom accounts or solutions, which are primarily provided by larger alternative asset managers such as Blackstone, KKR, Apollo and Carlyle, are offered to large investors who can put significant capital to work. The potential upside for the investors is to gain more control over where their capital is allocated and thus potentially achieve return, diversification or other goals at lower fee levels. At the same time, GPs potentially gain the ability to manage more capital and create longer-lasting partnerships. According to a Preqin investor survey, 18 percent of respondents actively invest via separate account mandates and 63 percent of these LPs state that separate accounts are a permanent part of their investment portfolio.[16]

Chart 8: Separate Accounts Awarded, 2005 to Q1 2015



Source: The Q1 2015 Preqin Quarterly Update PE, p. 15

Co-investing – Resource Intensive and No Guarantees of Upside

Hamilton Lane has an active co-investment program with "a full team around the globe to screen opportunities," notes Kelly. He emphasizes that "You need a lot of people on the ground just as you do for a fund investment team." That said, "It's a different skill set from fund investing with different requirements in figuring out what is the right opportunity to pursue or not," Kelly points out. "Probably 80 percent of the co-investing opportunities we pursue are with groups we have backed on the fund side," he says. But if Hamilton Lane hasn't invested with a GP on the fund side, "It's a good way for us to evaluate a GP in a different light," he says. (See: Co-Investment Study Sees Outperformance, but Warns on Frothy Periods.)

Kelly's bottom line: "If you're willing to make the effort, put the resources in place, you can do well, but it is like anything else—it's certainly not a guarantee that it's going to do better than fund investing." He highlights that "If you're able to get co-investments with no fees, certainly that's an advantage, but it's no guarantee that the underlying investment itself will succeed, so it's a lot of work."

Natural Evolution from Passive to Active Co-Investing

OPTrust has also been a long-term co-investor. A big trend Miller sees is that investors such as OPTrust are "becoming much more actively engaged during the diligence process." He emphasizes that GPs "want or need us at signing, more and more."

Co-Investment Study Sees Outperformance, but Warns on Frothy Periods

Earlier this year, Cambridge Associates released its study, *Making Waves: The Cresting Co-Investment Opportunity*,* which highlights the opportunities and pitfalls of what has become one of the most-sought-after private equity strategies. Based on the consulting group's estimates, co-investing accounts for more than 5 percent of overall private equity investment.

The study analyzed 500 co-investment deals made by more than 40 co-investment funds and fund of funds managers. It found that co-investments generally outperform funds in years when the deal-making environment is less competitive. Yet in frothier periods, such as 2005, 2007 and 2008, the gross returns of the co-investment funds underperformed buyout funds' net performance. Thus, co-investing may prove challenging, especially in times when there is a lot of capital competing for deals.

The study cautions that executing a co-investment strategy "is trickier than it may seem." Investors can choose a direct approach and build an in-house program to source and review deals or entrust the process to a third party, such as a co-investment fund or fund of funds manager. The former "offers the most control but also entails the most risk."

Cambridge offers seven recommendations to help increase an investor's probability of success:

- Think carefully about program goals, set realistic expectations and factor in existing (and potential) co-investment exposure via fund of funds.
- Establish internal processes to facilitate timely investment decisions, as well as effective investment monitoring and performance measurement.
- Prepare and identify necessary resources.
- Work with internal or external professionals with direct investment experience—co-investing is not as passive as it may appear.
- Invest with GPs on which they have done due diligence and in which they have conviction—investors will likely need to rely heavily on the *GPs'* due diligence.
- Focus on investments within each GP's stated strategy, or "strike zone," to avoid adverse selection.
- Do not ignore the macro. Investors should be extra careful in frothy pricing environments and monitor opportunities for indications of procyclicality.

**Andrea Auerbach, Priya Pradhan, Christine Cheong and Rohan Dutt, Making Waves: The Cresting Co-Investment Opportunity, Cambridge Associates, 2015.*

Making Co-Investment Additive to Portfolio, and Yes, There Are Fees

Adams Street also has a long track record in co-investing. Morrison agrees that an LP's ability to execute on a co-investment is vital. GPs "need LPs that have the experience and actionable teams that can execute on co-investment teams," given that they need to close deals in what is "a very competitive environment," he says.

Instead of "looking to marginalize fees," Morrison notes that Adams Street tries "to commingle co-investment deal flow into the wider private equity portfolio that we can deliver for our clients in the hope that the higher return and alpha strategies that our co-investment deal flow bring can generate better returns for our clients." In this way, it is "additive to our overall portfolio" and helps to mitigate the J-curve.

Miller cautions LPs when they say, "It's great doing co-investments because there's no fees and no carry." He recommends stepping back because while "that headline may be true," if you dig deeper, you may find "arrangement, exit, monitoring and consulting fees." You need "to really understand how the GP works," and remember that "alignment of interest between the GP and co-investor(s) is very important," Miller explains.

Deal Flow: A Key Consideration for Portfolio Diversification

Morrison believes investors need to think carefully about where the deal flow is from in order to build a diversified portfolio. "Are you diversified by geography, by subclass, and within those subclasses?" He adds, "If you're overexposed in your underlying private equity portfolio, to, say, large midcap or mega buyout, the type of deal flow that you're going to see is probably going to be a lot more cyclical." In Morrison's opinion, "Having good, credible deal flow and getting access to the best deals is a very, very important starting point, which is why the GPs' selection process is so extremely important."

Do Capital-Rich GPs Need Co-Invest Dollars?

Yet, Brooks wonders: "Are top-performing managers going to have the levels of co-invest that they had in the past?" given they "are raising more and more capital and now are better capitalized than they have been since 2005, 2006." Given where we are in the co-investment cycle, she thinks this will change the dynamics going forward. Added to this, says Miller, is the "huge amount of dry powder, over a trillion dollars now across the industry," which he says doesn't take into account the dry powder of LP's appetite for co-investment.

Investors Bring Different Motivations, Return Objectives and Levels of Capital

The rise of co-investing and direct investing, as well as the increasing sophistication of certain investors, highlights the growing reality that all LPs are not created equal. Brooks notes that under the traditional GP-LP, structure all LPs were equal and that while "they might have different

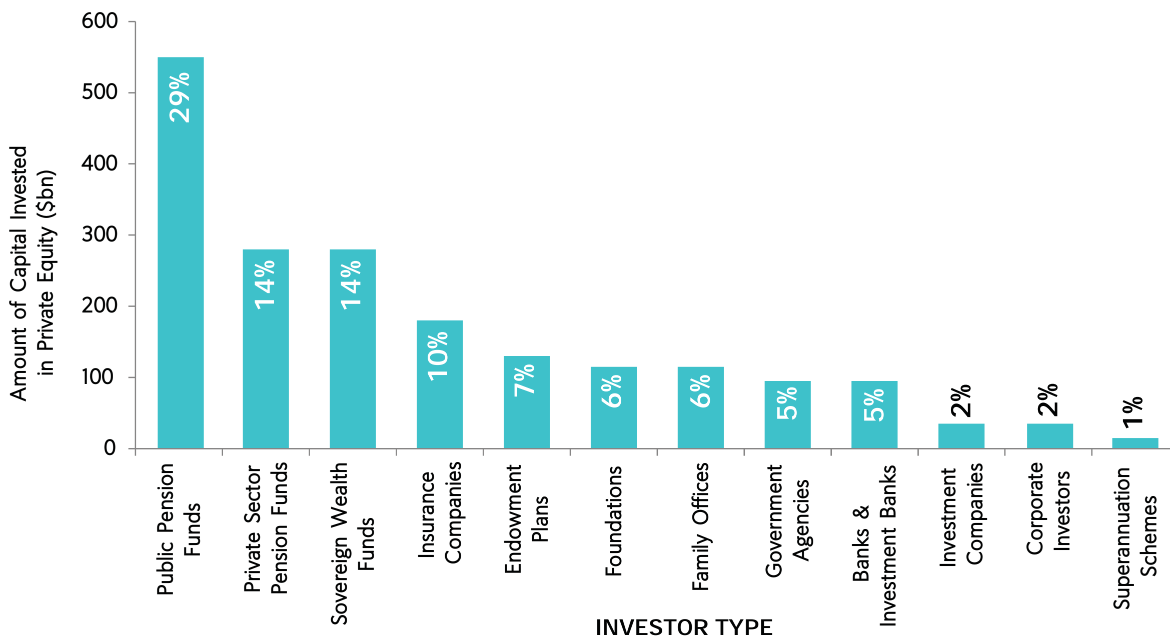
amounts of capital committed, they all had the same motivation, and that was purely the net IRR of that fund." Whereas today, "we've got different types of LPs," and she says there are some "LPs who are primarily motivated by co-invest capacity and some LPs who are just motivated by fund performance." In Brooks' view, LP versus LP conflicts are likely to become an increasingly important issue going forward for the industry.

As a result of private equity's success in generating above-market returns over the last 30 years, the universe of LPs has expanded and diversified. While public pension funds, longtime investors of the asset class, contribute the most capital, relative newcomers such as sovereign wealth funds (SWFs) are growing fast (See Chart 9). In 2010, SWFs accounted for about 6 percent of the total aggregate capital contributed to private equity, whereas today, they represent 14 percent. Like the larger-size pension funds, some of the larger SWFs who also have the distinction of having the longest investment horizons, hold considerable sway with fund managers.

LPs Battle over Fee Schedules and Co-Investment Rights

Kelly agrees with Brooks that "there are LPs who find co-investment a much more important part of what they do," but he suspects that there are only "a small percentage who are really resourced well to do it." He is also concerned that successful GPs are raising more capital and are offering more co-investment opportunities, and

Chart 9: Breakdown of Aggregate Capital Currently Invested in Private Equity by Investor Type



Source: Preqin Investor Outlook: Alternative Assets H1 2015, p. 11

maybe "doing that because they were unable to raise the fund size they wanted." Consequently, Kelly says you're not necessarily going to see deals "you want to be co-investing in." In his view, "it's becoming trickier for LPs to pursue co-investing" and, at the same time, the LPs who are co-investing "are much less experienced."

Tension among LPs, especially the larger versus smaller investors, is likely to rise. Kelly points out that "Much larger LPs are asking for, and in many cases getting, different fee schedules and they're getting benefits in terms of co-investment rights, where others do not." He believes that in the public markets, large investors often get different pricing as well, "so the dynamics are not necessarily unique to this industry." Miller agrees and notes that "The battle that's going on between LPs to get their fair share of co-investment is evolving."

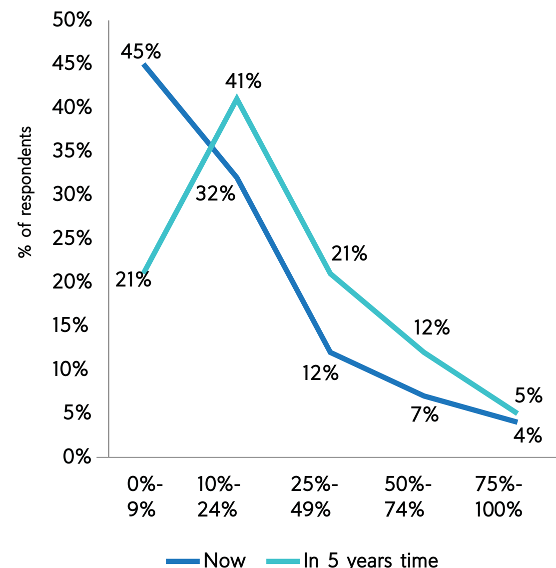
Direct Investing—The Next Step for Only a Few

Will investors increase their exposure to direct investing? According to Coller Capital's latest investor survey the answer is "Yes" (See Chart 10).[18] Miller sees some hurdles. "To effectively compete with a GP, you have to be resourced like a GP—that's from deal sourcing to deal execution, and that's only the start of the journey." In addition, "It's about creating the value and achieving a successful exit," he continues. OPTrust's approach has been to partner with select GPs on direct deals rather than view them as competitors.

An LP might argue, Miller suggests, "Well, I'm trying to grab as much of the 500 basis point spread between my gross returns and net returns," but he says, "that only makes sense if you can achieve the same return as a GP." Except for a few investors, such as the largest pension funds and some sovereign wealth funds, Miller doesn't "think there's any chance LPs will totally disintermediate GPs out of the marketplace." And for the LPs that go direct, the best performers "could ultimately spin out and raise their own independent funds," he believes.

Indeed, this view is borne out by the investment strategy of some of the biggest and most experienced investors. Alberta Investment Management Corp. (AIMCo) manages $67 billion in assets and has been investing direct in private equity since 2009. Robert Mah, the group's executive vice president of private investments, highlights that fund investments and direct investments are compliments. "We need funds to

Chart 10: Direct Investment as a Percentage of LPs' PE Exposure Now and in Five Years' Time



Source: Coller Capital, Global Private Equity Barometer, Winter 2014-15

Chart 11: Top 10 Sovereign Wealth Funds by AUM

COUNTRY	SWF NAME	ASSESTS ($B)	INCEPTION	WEALTH ORIGIN
Norway	Government Pension Fund - Global	$893	1990	Oil
UAE-Abu Dhabi	Abu Dhabi Investment Authority	$773	1976	Oil
Saudi Arabia	SAMA Foreign Holdings	$757.20	n/a	Oil
China	China Investment Corporation	$652.70	2007	Non-Commodity
China	SAFE Investment Company	$567.90	1997	Non-Commodity
Kuwait	Kuwait Investment Authority	$548	1953	Oil
China-Hong Kong	HK Monetary Authority Investment Portfolio	$400.20	1993	Non-Commodity
Singapore	Government of Singapore Investment Corp	$320	1981	Non-Commodity
China	National Social Security Fund	$201.60	2000	Non-Commodity
Singapore	Temasek Holdings	$177	1974	Non-Commodity

Source: Sovereign Fund Wealth Institute, October 2014

deploy capital," he says, and GPs facilitate deal flow and share resources and expertise.[19]

Similarly, Montréal-based pension fund manager, Caisse de dépôt et placement du Québec, with $225.9 billion in net assets, is allocating more dollars for solo deals, co-sponsorships and co-investments, but will continue to deploy large sums to fund partners. As its global reach expands, it sees an advantage of working with partners to gain access to specific markets and opportunities.[20]

Following the direct investment path forged by large institutional investors such as the Canadian pensions are SWFs, which represent a pool of capital reaching nearly $7 trillion. With few if any liabilities, these investors stand out for their ability to lock up capital in illiquid assets and weather volatility for long periods; hence, they are an especially good match to invest in alternative assets such as private equity and make direct investments. The Sovereign Wealth Fund Institute (SWFI) counts over 70 funds, with the top 10 accounting for 60 percent of this investor group's AUM (See Chart 11). During the first half of 2014, direct investments by SWFs rose to $50 billion, up 23 percent from year-earlier results.[21]

Solo direct investments are indeed the shadow capital that GPs worry about as they translate into head-to-head competition. But the number of institutional investors who can mobilize sufficient resources to go down this path is limited. According to Bain & Company, the number is about only 100 investors, or less than 2 percent of the overall LP base.[22] Then for these investors, the question is whether they are capable of replicating private equity's organizational incentives.

Hamilton Lane's Mike Kelly (right) discusses how asset-based opportunities and structures that lower fees are of interest, with Buyouts Insider's David Toll (left) following closely in appreciation of the insights.

EVOLVING FUND STRUCTURES, BUT STILL A BIG FOCUS ON FEES

Another outgrowth of capital overabundance, growing competition among GPs and increasing influence and participation by large investors is the mounting pressure to transform the commingled fund structure. As a dynamic organizational form, private equity has continued to evolve and innovate, but has generally stayed within its 10-year fund life and 2 and 20 structure. A few headlines suggest that this might be beginning to change:

- The Blackstone Group, Carlyle Group, and CVC Capital Partners reported to be looking at new investment structures that would aim for lower returns over a

longer period of time; Joseph Baratta, head of private equity at the Blackstone Group, specifically pointed to Warren Buffett: "I don't know why Warren Buffett should be the only person who can have a 15-year, 14-percent return horizon."[23]

- In late 2007, San Francisco-based Golden Gate Capital decided to employ an evergreen structure during its third fund raise, which meant it wouldn't have a finite investment period or fund life. Under its perpetual structure, the $9 billion in total commitments in its current pool get replenished as deals are made and it can hold assets indefinitely.[24]

- Last year, Elevation Partners joined Ripplewood Holdings in telling its investors it won't be raising a follow-up fund and instead chose to go it alone by investing capital from executives, friends and family.[25]

New Asset-Based Opportunities Are of Interest, So Are Structures That Lower Fees

"To the extent that a new structure provides either a differentiated return profile, or a newer angle on investing," notes Kelly, "it is interesting to us." This is because a number of Hamilton Lane's clients are "looking to the private asset area for not just private equity, absolute type returns, but some more current income, more stable types of plays." Consequently, says Kelly, "To the extent that we can find opportunities that are more asset-based, more current income generating, we're certainly interested in pursuing them and we're doing so today."

Kelly thinks structures "are pretty long today" and thus doesn't "know if we need anything significantly longer." What everyone is "pounding the table on is 'lower fees, lower fees,' which in any maturing industry, margins compress over time," he says. "We're starting to see some changes there and I suspect that will continue." In Kelly's view, the pressure on fees "is also the reason for creating new and differentiated products to try and prop up those margins over time."

Europe – Seeing More Deal-By-Deal Structures

"What we're seeing in Europe (and globally) is a number of deal-by-deal, one-off type of structures," indicates Miller. "Whether it's a team that's spun out from an existing entity or a new team looking to create an independent track record to get funded," he says, the deal-by-deal structure might be appropriate. He cautions that "people get hung up exclusively on fees." Miller adds that "It's one factor out of a multitude of considerations when you are thinking about investing with a particular GP or in a particular investment." In his opinion, you have to look at factors such as strategy, team and alignment, and then determine if you can "get that exposure in a most cost-effective way to try and maximize the ultimate returns."

Conventional Structure Will Continue for the Vast Majority of Funds

In Morrison's view, "The conventional private equity structure of 2 and 20 is going to continue for the foreseeable future for the vast majority of funds." He believes fee experimentation will occur at the margins where managers will explore

different structures for different strategies. For example, Morrison mentions "the low-risk, low-return infrastructure dividend yield model." And, "On the other end of the spectrum, there are new groups that are spinning out, deal-by-deal carry," he adds. Individuals that leave firms or start their own firms, he emphasizes, "have to give away more of the fees in order to attract capital, as investors must be compensated for taking more risk."

In his mind, these are exceptions and more important are the bifurcated fundraises of the "haves and the have-nots." Managers "that are fundraising without a problem or not too much of a problem will continue to command 2 and 20 and those that cannot, because of performance or other reasons, will begin to concede on their fee schedule," he observes. During market downturns such as the financial crisis, Morrison continues, are also when people have had to give ground on fees. "The pendulum has swung back to the LPs' core, and I think progress has been made on certain fee schedules," he concludes.

Brooks agrees with Morrison that there has been very little change in the general structure of funds. What she questions is whether, going forward, we are going to still see the first closing discounts that we saw in the 2009–2012 vintages, or if that was a practice "just of that moment in time." Brooks says that "A lot of our clients are coming back to us at this time saying, 'What should we offer? Do we need to offer anything this time around?'" She thinks that discounts will go away, and equally, a lot of GPs who were prepared to establish separate accounts for particularly large clients will be less inclined to do so in a market where they have regained power.

Excess Focus on Fees

Kelly tends to disagree with Brooks, saying, "I think just like the GP-LP cycle, it will swing back and forth. I don't think it will go away completely." In his view, there "is always going to be a dynamic of whoever has more weight at any given point in the cycle will ask for more." Kelly also "thinks the cost of transactions will always be a factor—not the primary one, but it is always a factor." The focus on fees, in his opinion, will not go away as institutions compare private equity to other asset classes with lower fees.

Fees and particularly their impact on the alignment of GP-LP interest have grown in importance for investors. The most recent Preqin investor survey shows that nearly 40 percent think that fees are their biggest cause for concern in operating an effective private equity program in 2015 (See Chart 12). In December 2013, only 15 percent of investors identified fees as the biggest challenge.[26] Preqin points out that the issue of fees is accentuated given that committed but uncalled capital—that is earning GPs fees—is at a record high.

"We have seen some investors, particularly in the Dutch market," Brooks mentions, "where they have set a cap on the management fees that they are prepared to pay on private equity funds, and it is below the market norm." While

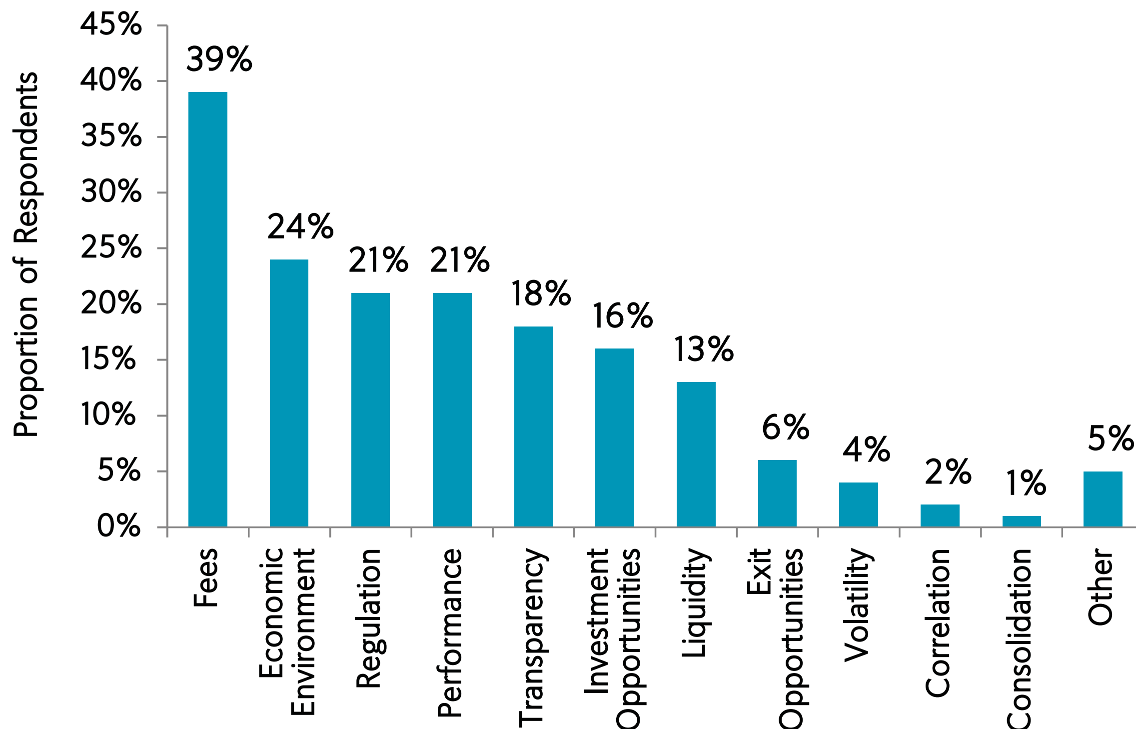
she understands their rationale "as large pension funds they want to be able to show from a corporate governance perspective that they are doing the best job," Brooks wonders about "what opportunities they are going to be missing out on by setting that bar at an unrealistically low level."

"We've seen that in Australia also," observes Miller. He thinks the issue of fees as well as liquidity will become especially important "as the market moves to try and attract capital from defined contribution pension funds." Morrison points out that fees are the highest in venture capital, which also "is the highest-performing part of the asset class, if you have access to the best VCs in the world." That is the logic of the market: "The best funds can charge premium carry, premium fees." Both Morrison and Miller agree that, ultimately, net returns are important.

Longer Fund Horizons and Challenge of Incentivizing Partners

In terms of the length of fund structures, Brooks points out that GPs often want longer but LPs need to be persuaded. Monument "did successfully raise a 13-year life fund for one private equity fund and is currently raising an open-ended structure

Chart 12: Biggest Challenges Facing Investors Seeking to Operate an Effective Private Equity Program in 2015



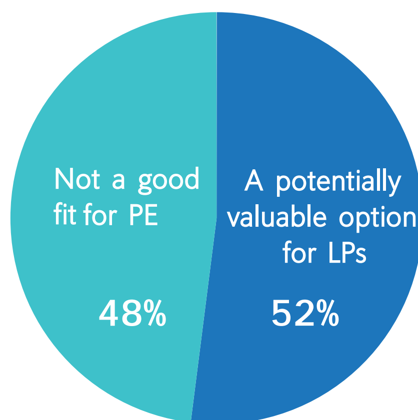
Source: Preqin Investor Outlook: Alternative Assets H1 2015, p. 15

for an infrastructure manager." She says the fund manager had "to work hard to convince investors that 13 years was the right length." Brooks recalls that the manager's thought process was: "Why realize a well-performing investment while it is still growing only to then have the costs of sourcing and executing an equally good new investment?" Instead, the group believed it made "much better sense to hold that first investment for essentially two holding periods," she mentions. In her view, "Having the right length of structure for the right investment strategy is what's important."

According to the latest Coller Capital survey, LPs come down almost evenly on the desirability of "longer life" (funds with lives longer than 10 years) private equity funds (See Chart 13).

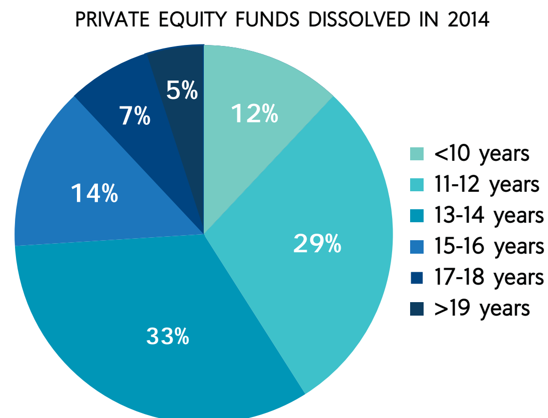
Miller thinks a big question will be what the ultimate vehicle looks like, *i.e.*, "how they incentivize the younger partners and younger executives within the firm especially, because the longer that

Chart 13: LP Views on "Longer Life" PE Funds



Source: Coller Capital, Global Private Equity Barometer, Summer 2015, p. 6

Chart 14: Median Fund Life



Source: Secondaries Investor, PEI, April 1, 2015

investment period, the longer the holds; the longer the wait to get to carry." It is less of a problem with publicly traded vehicles as equity can be sold over time, he notes, but that will be a feature "because you see a lot of turnover with some of the mid-level and junior partners going off in different directions." Brooks agrees, and suggests, "You need to move to a synthetic carry-type structure."

Natural market pressures are at work and they have been pushing out the average lifespan of funds. According to Palico, the online private equity marketplace, the median fund lifespan has expanded to 13.2 years in 2014, from 11.5 in 2008. Indeed, just over 40 percent of the funds that dissolved in 2014 were under 12 years old (See Chart 14). This is likely to lower annual returns as profits are spread over a longer period of time. The only way out for investors is the secondary market, and hence, extended fund life may help this market to grow, according to

Antoine Dréan, founder, chairman and CEO of online PE platform Palico.[27]

Fund of Funds—Adapting and Consolidating

One part of the market that has had to rethink and adapt its model, according to Miller, is the fund of funds industry. He suggests there have been some clear "winners and losers." Morrison agrees and, in his view, much of the problem can be traced to the industry's rapid growth over the past 12 years, which saw "a lot of players enter the business and raise one or two funds." Since then, Morrison says, "There's been a huge consolidation, which we've seen over the financial crisis." In his opinion, "Those with long track records, a global offering, who are very, very selective about their GPs, and all these co-investment, direct secondary strategies will continue to provide a very credible service to their clients."

Our London trans-Atlantic simulcast contributors (from left): OPTrust's Spencer Miller, Monument Group's Janet Brooks, Duane Morris' Jenny Wheater and Adams Street Partners' Ross Morrison.

NEW INVESTORS – FAMILY OFFICES AND HNWI

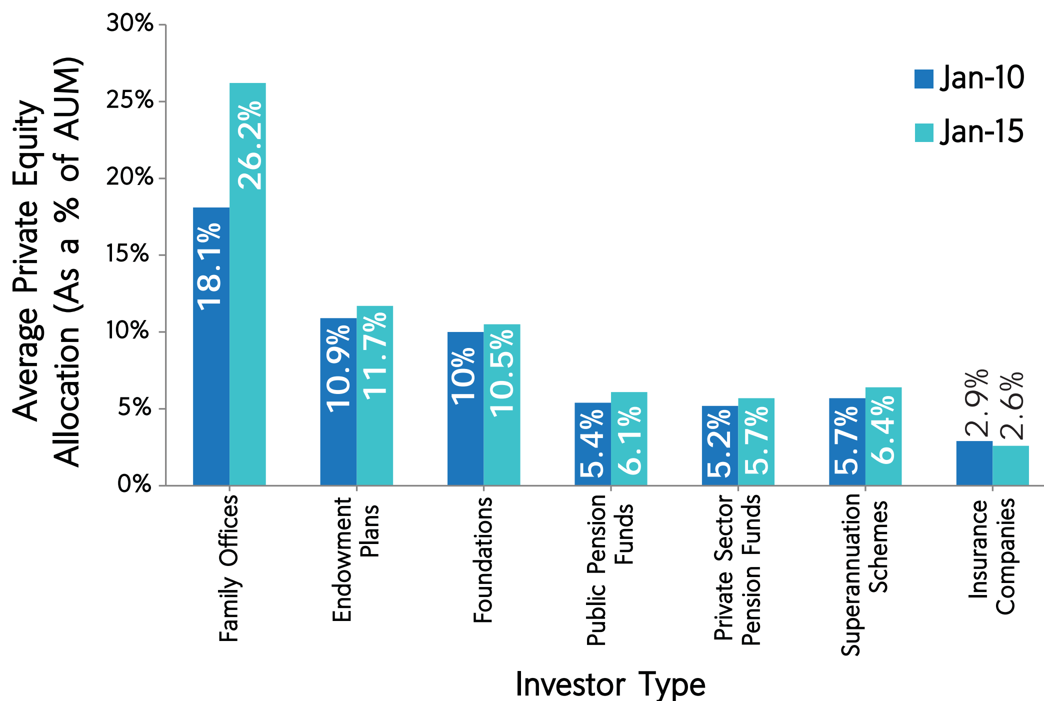
Family offices are increasingly in the target zone of private equity groups. There are an estimated 4,000 family offices globally and they and their advisors manage an estimated $4 trillion. Driving growth is the increasing number of high net worth individuals (HNWI) who have built and sold their own businesses and have organized a family office to manage their assets.

While the press tends to focus on the growing appetite that bigger alternative asset groups, such as Blackstone, Carlyle, and KKR, have for the capital of wealthy families and individuals, the longstanding focus of family offices has been on the middle market, which represents their business roots. That said, high net worth investors account for a growing portion of the large managers' capital. For example, in 2008, HNWI made up just 5 percent of Blackstone's AUM, and today, it is roughly 12 percent of Blackstone's $310 billion AUM.[28]

What attracts private equity to family offices, especially in middle-market private equity groups, goes beyond capital. Also important is their industry knowledge, expertise in buying and managing companies and long-term view, and the fact that they are not encumbered with regulations. These attributes make family offices and some HNWIs particularly good co-invest partners and potential sources of deals. The attributes also explain why family offices continue to be the investor group with the highest allocation to the asset class—indeed, more than double the next investor (See Chart 15).

According to *The Global Family Office Report 2014*, the average global family office invested 9 percent in direct venture capital or private equity,

Chart 15: Average Current Allocation to Private Equity by Investor Type (As a proportion of AUM)



Source: 2015 Preqin Investor Network Global Alternatives Report

Chart 16: Family Office Allocation by Asset Size

	FAMILY OFFICES WITH ASSETS	
	ABOVE $1 BILLION	BELOW $1 BILLION
Developed-market equities	16%	20%
Developing market equities	7%	7%
Developed-market fixed income	9%	11%
Developing market fixed income	4%	4%
Cash or equivalent	10%	9%
Real estate direct investment	17%	10%
Direct venture/ private equity	**10%**	**6%**
Co-investing	**6%**	**3%**
Private equity funds	**7%**	**10%**
Hedge funds	6%	12%
Agriculture	2%	2%
ETFs	2%	2%
Commodities	2%	2%
Tangibles	1%	2%
REITs	1%	1%

Source: Robert Milburn, "Family Office Report Card," Barron's Blog, January 5, 2015

and a further 8 percent in private equity funds—with the large-size offices on the more aggressive side (See Chart 16). The report notes that these figures are expected to rise, as family offices seek out direct deals and introductions to "off-market" opportunities, and as investment banks increasingly act to "flag" targets for minority stakes.[29]

Family Offices and Soon, Retail Investors

In Kelly's view, "high net worths, high net worth families and family offices have certainly been active in private equity," and especially the middle market. A big question going forward is, what will be the impact on the middle market of "the influx of 401(k) money or other retail capital"? In his mind, "The largest buyout firms are gearing up to attack that marketplace and will find a way to incorporate them into their LP base." Once the model has been established, others will follow, he believes. "But I think today, in the middle-market side, it's probably much more of the wealthy family offices that you are seeing."

Europe—High Net Worth Individuals Take Two Routes to Private Equity

Brooks divides the high-net worth investors in Europe into two groups, according to how they access private equity. The first type are the private wealth clients, "which might come through the private wealth management, or the big banks who aggregate funds on behalf of some of the largest vehicles out there, for which they charge a very healthy fee." Although "some of these clients have less capital, less liquidity after the GFC," she thinks "they'll come back fairly strongly, but will continue to be focused on the big brand names." Brooks adds that "At the moment, I know people are raising money, for say, the distressed energy space, so they're very thematic, very current."

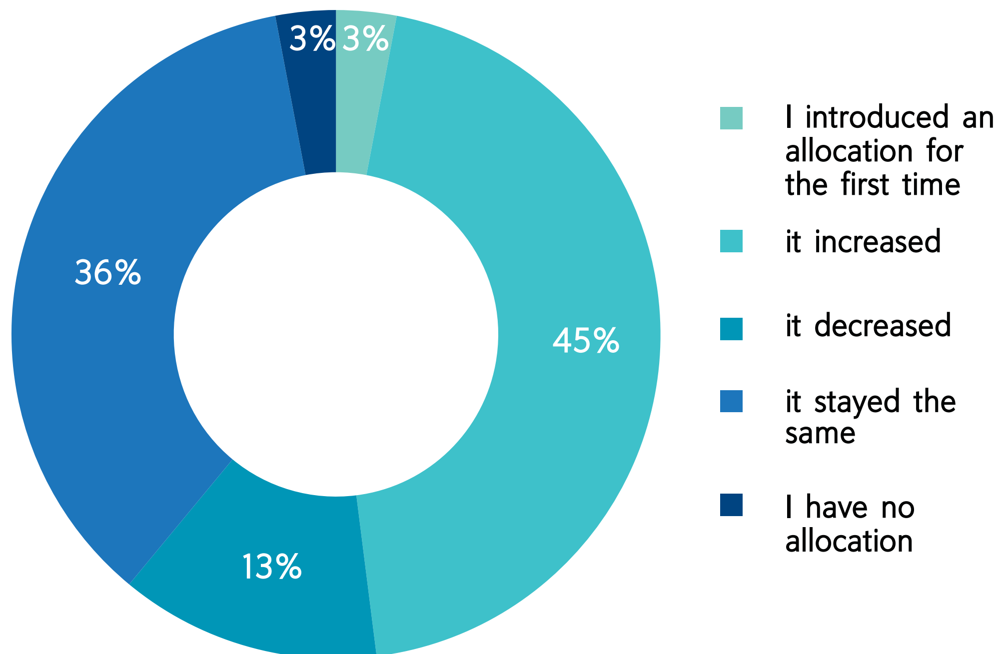
The second group is family offices, who Brooks says, "make their own investment decisions, investing directly into funds." In her view, "They're

still relatively small numbers in Europe investing in private equity compared to what I see in the U.S." Brooks notes that her "colleagues in the U.S. cover a lot of very substantial family offices." A few years back, she explains, "We raised a German low mid-market fund and the largest investor was a U.S. family office that wrote a check for $50 million." In her view, "There are very substantial amounts of family office money investing directly into even low mid-market funds."

The natural affinity family offices have for private equity was highlighted in Montana Capital Partners' second annual survey, which also included foundations.[30] Released late last year, the report found that 45 percent of family offices have increased their allocation in the last year, while 33 percent plan to increase their allocation in the next 12 months (See Chart 17). Secondaries remain an important strategy for family offices and 70 percent of participants said that direct investments are "part of the DNA of a family office."

The report noted that with banks and insurers stepping away from private equity as a result of tightening regulations, such as Solvency II, family offices have proven to be one of the most stable investor groups whose role has evolved with the asset class.

Chart 17: How Has Your Allocation to Private Equity Changed in the Past 12 Months?

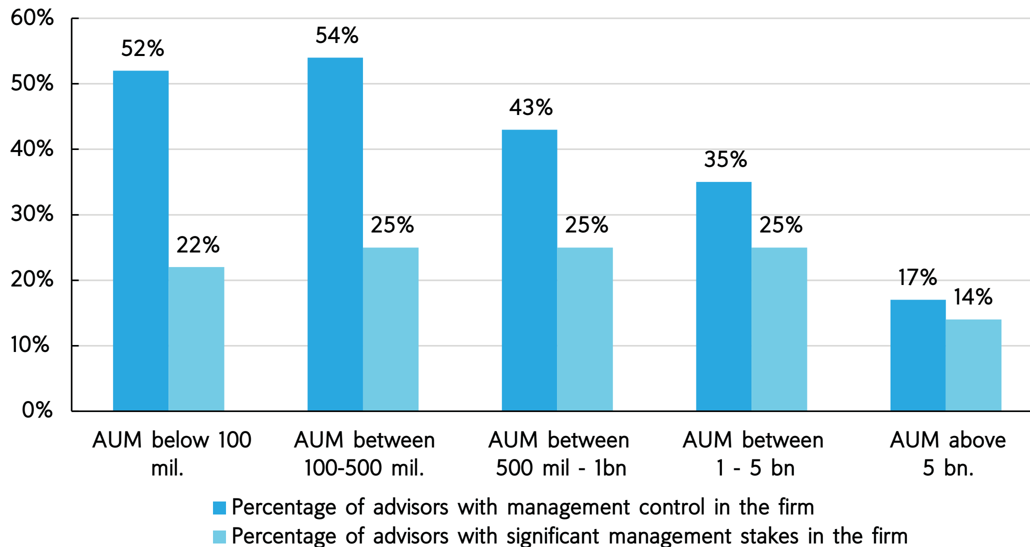


Source: Montana Capital Partners and Private Equity International, Annual Family Office and Foundation Private Equity Survey, November 2014

APPETITE FOR EMERGING FUND MANAGERS

Small, first-time private equity fund managers continue to attract investor attention, and this is particularly true when distributions are high. But there are other reasons. "First-time managers gain market share" was one of Antoine Dréan's 10 predictions for 2015.[31] While investors will continue to put more capital to work with fewer managers, he noted that the weakening of "*top-quartile persistence*," meant that first-time managers will gain market share. This may be the case particularly for emerging managers that spin out from leading funds—for example, when two managers left Silver Lake's mid-market team to establish separate firms last year.[32]

Chart 18: Extent to Which Top Management Owns Shares in the PE Advisor



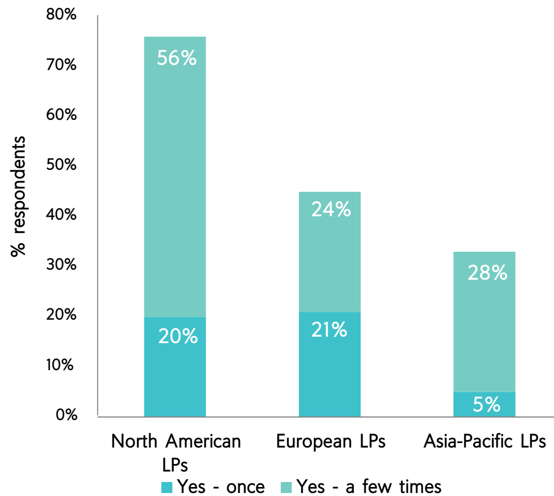
Source: ADVEQ Applied Research Series and Coller Institute of Private Equity, The US Private Equity Universe: A Snapshot from SEC Filings, December 2014

Emerging managers are also attractive because of their size. Investors tend to have a preference for the smaller end of the market. Cambridge Associates found that smaller funds have had both the greatest maximum and minimum return potential.[33] A study released last year by London Business School's Coller Institute found that managers of smaller funds are generally more aligned and focused and less complex—generally incentivized more by carried interest than management fees—all of which contributes to their outperforming larger funds.[34] Better alignment in part comes from smaller firms having greater percentage of management with both a stake and control in the firm (See Chart 18).

North American investors appear particularly inclined to invest with debut funds, as shown by a recent Coller Capital Barometer report: Fifty-six percent of the North American LPs surveyed have invested more than once in debut funds from new GPs, more than twice the number in Europe (See Chart 19). The report also found that nearly all the debut funds from new GPs in which LPs invested since the financial crisis have equaled or outperformed the rest of their private equity portfolios.[35]

With $104 billion in assets, the State of Wisconsin Investment Board is targeting emerging managers. Its senior investment officer John A. Drake noted that "Our peers have done large strategic accounts. We have been going down market."[36] Meanwhile, the $4 billion Colorado Fire & Police Pension Association is targeting private equity funds as small as $200 million.[37] Since 1991, CalPERS has had an emerging managers program that today includes over 170 managers and has a net asset value of about $7 billion, or about 20 percent of its total private equity net asset value (NAV). In addition, through its Emerging Manager Fund-of-Funds Program, it hires fund-

Chart 19: LPs Investing in Debut Funds from New GPs Since the Financial Crisis



Source: Coller Capital, Global Private Equity Barometer, Summer 2015, p. 5

of-funds managers who construct portfolios of smaller asset management firms for CalPERS.

Fund of funds, such as Hamilton Lane and Adams Street, generally are well-positioned to identify and vet first-time managers. As investors in numerous funds, fund of funds can have early knowledge about partners who plan to spin off to create their own firms and thus are able to be early sponsors. Their experienced vetting commercial terms can make fund of funds valuable LPs and signal to other investors a GP's quality.

Two Tests: Good Investors and Can They Manage an Organization?

"Having started the firm around a first-time manager-type mandate," Kelly notes that Hamilton Lane has a long history of working with emerging managers. While it often involves more work to "understand if the organization will survive," he says that his group is "happy to find new good opportunities." Kelly explains that the real challenge is to find teams that have the ability to combine investment skill "with managing, growing and developing an organization." Consequently, he says they "spend a lot more time focusing on the team themselves and are less interested in whether the fund manager is sector specific or a generalist." Kelly notes that "For us, it's more about whether they are one, good investors, and, two, are they able to manage an organization?"

Best Due Diligence Is Doing a Deal

Miller observes that "There's quite a range of what is meant by an emerging manager." For example, he continues, "If it's a team that has worked together spinning out from another organization as a team, that's one thing," but "if it's a group of random people that haven't worked together, than that's a different proposition." He points out that "the best form of due diligence [for an emerging manager] is actually doing a deal together."

Existing Relationships and Proven Track Records Go Far

Emerging managers are an active part of Adams Street's portfolio, as well. According to Morrison, "It can represent about 20 percent of the managers that we back every year." He emphasizes that "As custodians of our clients' capital, we've got to monitor very closely our underlying GP managers; therefore, we find out

who's the best, who, in our opinion, are the best investors at those managers." For example, Morrison says, "We had a spinout from a very highly regarded GP in the Nordic region that came knocking on our door." As a result, "We were invited alongside Yale, Princeton and Harvard to invest. Great opportunity and we were the only fund to funds with access," he highlights. Morrison says, "You've really got to have a lot of tentacles, be watching a lot of managers and hopefully be the type of name and brand that gets the opportunity."

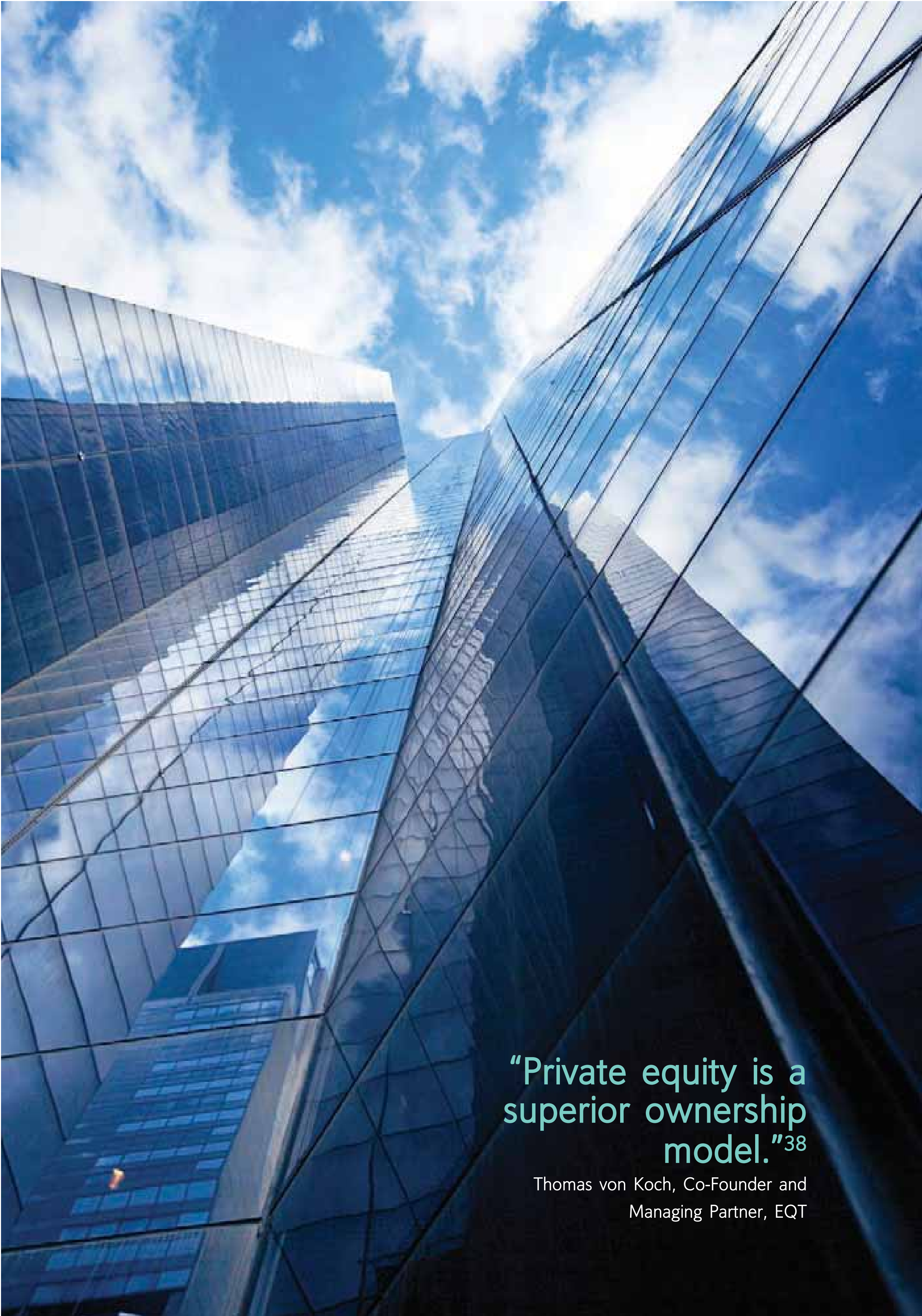
Morrison emphasizes that when it comes to first-time funds, "We typically don't invest in strangers that walk through our door, with whom we don't have an existing relationship." Adams Street tends to back people only with whom it has an existing relationship, "who we can verify their track record, have confidence in their investing ability," he stresses. Having a track record that correlates strongly with what they say they will do "gives us confidence," Morrison relates. So any first-time funds it works with tend to be ones "we know from a previous life." Finally, in his view, "Some people are going to be generalists, but within being generalists, they will specialize." It is less important whether a manager is a generalist or specialist Morrison believes, but whether "they are going to focus on where they've created value in the past."

Get People Who Know You to Invest Alongside You

"We have raised some very successful first-time funds," notes Brooks, but adds that for "The vast majority of people who walk through our door saying that they want to raise a first-time fund, we say that's not going to happen." In her experience, first-time funds need to meet three key criteria: "You need people who have worked together as a team, have an attributable track record to show experience of deal-doing and how you've added value, and you need to get people who know you to commit to invest alongside you because if you can't get those people that you've dealt with in your prior life to back you, it's very difficult for an agent to go out and convince a third party."

"We just raised a first-time fund for a U.S. healthcare team who had previously been with a large investment bank," Brooks explains. "They didn't know any institutional investors, they had never needed to, as they were previously captive," Brooks mentions. "But they got about 25 of their ex-partners within the investment bank to personally invest with them in the fund," she says. This type of commitment from people who know you is vital to get third-party support, she concludes.

Finally, in Brooks' view, "A lot of people think raising a first fund and showing that you can invest it is going to be sufficient to approach the institutional market." But from both her and Miller's opinion, it begs the next question, which is "Well, yes, you have made some investments—but can you exit them?" Institutional investors "want to see the whole circle of investment achieved," she notes.



“Private equity is a superior ownership model.”[38]

Thomas von Koch, Co-Founder and Managing Partner, EQT

CONCLUSION

We concluded last year's *Inside the Mind of the Limited Partner* report noting that the adage, "be careful what you wish for," may have particular relevance given the favorable conditions that the private equity middle market was experiencing. With record distributions continuing into 2015 and the era of "capital superabundance" officially commenced, there appears to be reason to keep this cautionary flag raised. This is especially true as deal prices, fundraising levels and dry capital continue to rise—and the U.S. economy is six long years into its recovery cycle.

A somewhat new wrinkle, which was highlighted in this year's report, and which is a reflection of both the asset class' maturity and growing abundance of capital, is the growing levels of shadow capital—more *active* capital that investors are putting to work in private investments, such as co-investments, secondaries and separate accounts outside of co-mingled funds. Here, we raise a second yellow flag, as it remains to be seen just how well investors will be able to replicate what GPs do in terms of sourcing deals, investing in the right ones, making operational improvements and exiting to realize value.

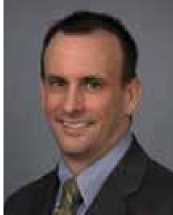
As middle-market private equity practitioners and enthusiasts, we remain optimistic about the future, despite the potentially challenging environment ahead. The basis for our optimism is threefold:

- Fund managers in the middle market tend to be focused on private equity and private equity only, and importantly, they tend to be highly incentivized by the carry they create and not management fees.
- The middle market, and especially the lower end, is unlikely to attract much, if any, competition from investors who decide to make direct investments as these will tend to be on the larger size (*i.e.*, we have more concern about family office competition than with SWFs and giant pension funds).
- Private equity is a long-term investment business, which provides it tremendous flexibility to weather economic storms, create value and select the right time and option to exit.

Our biggest concern has been and remains—regulation. As the discussion on AIFMD and SEC regulation highlighted, significant risk, particularly for the middle market, lies in not getting out ahead to educate regulators and politicians about how the industry works and the benefits it creates. There is a chance, after all, for one of the proverbial geese who is laying the golden eggs for the economy to be inadvertently—or otherwise—eliminated.

The Duane Morris LP Institute's Inside the Mind of the Limited Partner III was prepared with the assistance of the firm's outside advisor **David Haarmeyer***.*

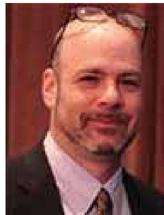
OUR PANELISTS AND MODERATORS NEW YORK



MIKE KELLY

Managing Director, Hamilton Lane

Mike Kelly is responsible for due diligence of primary fund investment opportunities. Mr. Kelly began his career at Hamilton Lane in 1994 and previously was responsible for managing the client relationship and reporting activities of the firm, as well as the analysis of venture investment opportunities. He is a member of Hamilton Lane's Investment Committee and also serves on a number of fund advisory boards. Prior to joining Hamilton Lane in 1994, Mr. Kelly was a Financial Analyst for InterMountain Canola Company and a Financial Analyst for DNA Plant Technology. He received an M.B.A. from the College of William and Mary and a B.S. from Trenton State College.



DAVID TOLL

Executive Editor, Buyouts Insider – Moderator

David Toll oversees the editorial direction and ongoing improvements of a family of publications aimed at private equity professionals, including bi-weekly *Buyouts Magazine*, monthly VCJ, and the peHUB community website. He also writes a bi-weekly column for *Buyouts Magazine.* His areas of experience include venture capital, leveraged buyouts, bankruptcy and institutional money management issues. Previously, he was an editor at Thomson Reuters and Dow Jones. Mr. Toll received his A.B. degree from Dartmouth College.

OUR PANELISTS AND MODERATORS
LONDON

JANET K. BROOKS

Managing Director, Monument Group

Janet Brooks joined Monument Group in 2007 and is a partner in the London office. Ms. Brooks has investor coverage responsibility in the UK, France, French-speaking Switzerland and the Benelux region. Previously, she spent 15 years with ECI Partners, ultimately as a director and board member, where she had responsibility for the firm's investor relations and the oversight of four successful institutional fundraisings, together with the development of firmwide marketing and deal flow strategy. She has served on the Investor Relations committees of the BVCA and EVCA. Ms. Brooks has an M.A. (Hons) from Cambridge University and an M.B.A. from INSEAD.

SPENCER MILLER

Managing Director, OPTrust Private Markets Group

Spencer Miller joined OPTrust Private Markets Group in 2006 and is responsible for the private equity portfolio and the London office. He is a member of the Private Markets Group investment committee and management committee. Day to day, he focuses on both direct deals and fund investments in Europe and Emerging Markets. Mr. Miller has over 15 years of private equity experience and was previously Head of AXA Private Equity's London office focusing on primary, secondary and co-investments (equity and mezzanine). In addition, he worked in the London office at both UBS Capital and HSBC Private Equity focused on sourcing and executing direct mid-market buyout deals, and the London office of Deloitte in the corporate finance advisory team.

ROSS MORRISON

Principal, Adams Street Partners

Ross Morrison is primarily focused on the European Private Equity and Venture Capital portfolio including UK, the Nordic Region and Israel. He is also involved in Emerging Europe and Russia and is responsible for the coverage of Africa. Prior to joining Adams Street Partners, Mr. Morrison was an Investment Associate with Horsley Bridge, where he focused on making buyout and venture investments in Europe, the United States and emerging markets. Prior to joining Horsley Bridge, he was on the Commercial Due Diligence team within the Private Equity group at Ernst & Young. Mr. Morrison sits on advisory boards for three private equity firms within the Adams Street Partners portfolio. He is a Chartered Accountant and a member of the Institute of Chartered Accountants of Scotland.

JENNY WHEATER

Partner, Duane Morris LLP – Moderator

Jenny Wheater focuses her corporate practice on the tax aspects of a broad range of issues. She has significant experience in structuring private equity, venture capital and other funds, including holding companies, carried interest and deal structures. Additionally, she advises extensively on value-added tax (VAT), corporate residence and the various anti-avoidance regimes in the UK. Ms. Wheater has broad knowledge of employment and equity incentive tax issues, notably in the areas of the UK employment-related securities regime and internationally mobile executives. She has also advised on mergers and acquisitions and financing structures. As a dual qualified lawyer, admitted to practice in both England and Wales and New York, Ms. Wheater is familiar with UK/U.S. cross-border tax issues and regularly advises clients on cross-border matters, including the establishment of UK operations, the application of the UK/U.S. double tax treaty and, recently, in the area of the Foreign Account Tax Compliance Act (FATCA) and related inter-governmental agreements.

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