PRIVATE CAPITAL INSIGHTS

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RBC Investor & Treasury Services

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Institutional investors' allocations to Private Capital strategies continue to grow from all corners of the globe. However different regions present differing challenges and opportunities for Fund Sponsors in attracting investment. While digitization and standardization offer the potential to help move Private Capital further towards being viewed as mainstream asset class, it still has some way to go.

RBC Investor & Treasury Services presents insights on how these topics are shaping and influencing the evolution of your business.

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REGIONAL

CANADA'S NEW INFRASTRUCTURE BANK

Harnessing Canada's mature public-private model to fill the "infrastructure gap" and create new private investment opportunities

A new Canadian initiative aims to bring together public and private money to help fund large infrastructure projects in Canada, while providing an opportunity to generate returns along the way. The Canada Infrastructure Bank (CIB) is a federal Crown Corporation which has been seeded with an initial CAD 35 billion in funding. It will provide minority funding or loans to large revenue-generating infrastructure projects, particularly those unlikely to proceed without its backing.

While funding for the earliest wave of projects was expected to start to flow in 2019, the CIB announced its first investment on August 23, 2018. A light-rail project in Montreal, led by Caisse de dépôt et placement du Québec, will receive a CAD 1.28 billion, 15- year loan towards the CAD 6.3 billion project.

Banking on an election promise

The federal Liberals first promised to create a national infrastructure bank during the 2015 election, when all major parties advocated for the need to fill Canada's "infrastructure gap". After their election victory, the federal Liberal government announced the bank's launch in its 2016 Fall Economic Statement as part of the government's larger "Investing in Canada" infrastructure plan. The Bank's creation capitalizes on Canada's relatively mature public-private partnership, or P3, environment.[1]

The CIB has a mandate to use public funds to attract private capital to build public infrastructure projects that are funded primarily by revenue from infrastructure usage, such as pipelines, electricity grids and transit. Of the initial CAD 35 billion in public funding, CAD 15 billion is earmarked for public transit; trade and transportation corridors; and green infrastructure projects, such as safe water systems and renewable power generation.

Bringing private and public dollars together to boost global competitiveness

The deteriorating state of local infrastructure could be negatively impacting Canada's global economic success. The World Economic Forum's 2017–2018 Global Competitiveness Index ranks Canada 14th internationally as a result of the quality of its infrastructure, compared to the United States, which is ranked second.[2]

Canada's infrastructure shortcomings may be the result of relatively low levels of contemporary infrastructure spending. Oren Klachin, lead economist at global forecaster Oxford Economics, comments that the equivalent of approximately 0.5 percent of gross domestic product has been allocated to infrastructure spending in recent years, "compared to the 3 percent typical of the 1950s and 1960s".[3]

The CIB announced its first investment on August 23, 2018

While Canada's large institutional pension funds currently include infrastructure investments in their portfolios, a large portion of these are assets outside of Canada. For example, the Canada Pension Plan Investment Board (CPPIB), one of the world's largest retirement funds with assets of CAD 356 billion (as of March 2018), holds a single Canadian investment in its infrastructure portfolio – a 40 percent stake in the Highway 407 toll road in Ontario – with the remainder of its diverse infrastructure portfolio spread around the world, including India, Australia and the United Kingdom.

Similarly, the infrastructure and natural resources portfolio of the CAD 189 billion Ontario Teachers' Pension Plan includes projects in Europe, South America and Australia, with only two projects in Canada. The creation of the CIB is designed to help unlock private investment dollars in support of large projects within Canada, aimed at ameliorating Canada's overall infrastructure status and global competitiveness.

Priming private investors to benefit

As projects are funded, the payoff for private investors will be tied to the amount of risk they assume. "Returns to investors should be calibrated to their investment size and the amount and nature of risk that the investor is undertaking on a project-by-project basis," wrote then Infrastructure and Communities Minister Amarjeet Sohi in a December 2017 letter to Janice Fukakusa, Chairperson of the Board of the CIB.[4]

The creation of the CIB is designed to help unlock private investment dollars in support of large projects within Canada

In selecting projects for funding, the Bank should be careful not to "crowd out" private sector investment "where the capacity to invest already exists", Minister Sohi's letter notes, adding that the CIB "should be open to a wide variety of potential investment partners, domestically and globally", to allow for the development of "competitive tension" and ensure that public dollars go further.

Looking forward

At the end of May 2018, the CIB appointed Pierre Lavallee, a former senior chief executive at the CPPIB, as its first Chief Executive Officer. In the coming months, the new CEO plans to establish the CIB's strategy, pull together a team, lay out investment policies and develop partnerships with global institutional investors.[5]

In developing the list of further funding projects, the CIB plans to work with "provinces, territories and cities to form the list that would provide a five-year time horizon."[6]

KEY INSIGHTS

- The newly created Canada Infrastructure Bank is part of the federal Liberal government's "Investing in Canada" infrastructure plan, building on 2015 federal election campaign promises to find ways to revitalize Canada's infrastructure
- The Bank will focus on partnerships with the private sector that allow large revenue-generating infrastructure projects to break ground, especially those that would be unlikely to proceed without federal backing

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PRIVATE EQUITY MANAGERS TURN THEIR FOCUS TO ASIA-PACIFIC OPPORTUNITIES

The quest for returns in a maturing market

Despite larger deals, broader investment and strong returns in 2017 underpinning another solid year for Private Equity (PE) in the Asia-Pacific (APAC) region, a more challenging environment is emerging as the market matures and competition rises. With high valuations and a dwindling pool of attractive deals expected, fund managers may need to develop new capabilities to boost top-line growth and maintain a competitive edge.

Investors seeking to diversify portfolios propel record year

Softness in traditional markets has prompted investors to turn to the APAC region to seek products and managers to diversify their portfolios. The region's private equity industry achieved its best all-around performance in 2017, with larger deals and more active global investors.[1] Deal value climbed to a record high of USD 159 billion during 2017, a rise of 41 percent year-on-year and 19 percent higher than the previous peak in 2015. The total number of individual transactions (1,015) was slightly down on 2016 but the average deal size soared 47 percent to USD 156 million. Meanwhile, the number of deals valued at USD 1 billion or more nearly doubled to 27.[2]

Consortium deals rise as more company owners welcome PE funding

Growth was driven by investor confidence in the region due to an improvement in the macro climate and by relatively attractive valuations compared to Western markets, which have become expensive due to rallying equity markets in recent years.[3] High equity market valuations have prompted large institutional investors such as Singapore's Temasek to shift investment to private markets, encouraging public pension funds to follow.[4] More "dry powder", money raised but not yet invested, was put to work by significant global players accelerating the flow of large deals, such as the USD 18 billion sale of Toshiba's chip unit to a Bain-led group.[5] With capital better organized and the abatement of market volatility, the region saw an increase in consortium transactions. Almost two-thirds of deal volume involved multiple investors, about 15 percent higher than the previous five-year average from 2012 to 2016.[6] The rise in pooled transactions triggered a sharp increase in USD 1 billion-plus deals as general partners (GPs), institutions and government affiliates competed for targets.[7]

High equity market valuations have prompted large institutional investors to shift investment to private markets

The market has also been spurred by company owners showing a greater willingness to turn to private equity for funding and cede control. The value of buyouts nearly doubled to USD 72 billion in 2017, representing 45 percent of total deal value compared to an average of 38 percent between 2012 and 2016.[8] A rise in public-to-private deals to a new high of 17 percent of total deal value also underpinned PE investment.[9]

Challenges may lie ahead

While 2017 was seen as a watershed year, more challenging business conditions may be approaching due to increased competition and uncertainties in global trade. China, which accounted for almost half of the region's PE activity in 2017, has shown signs of strain as domestic credit restrictions take hold, and trade relationships with the United States remain unclear. Although venture capital and private equity investments have reached record highs in 2018, with USD 56 billion invested up to August 29, fundraising has failed to keep pace.[10] Yuan-denominated funds have been affected, with fundraising running at USD 6.9 billion, or a little over a tenth of the full year total for 2017, according to data provider Preqin.[11] The shrinking pool of dry powder could eventually affect investment returns. Up to 90 percent of operating funds could fail to hit their targeted returns, said a report by Chinese research firm Fuhang .[12]

Embracing digital innovation and transformation is expected to be a key priority for Asia-based private equity firms

The maturing market has resulted in more global firms setting up funds, driving up competition. More than 70 percent of APAC GPs said competition increased in 2017, especially from regional and local private equity companies, raising the difficulty of securing attractive deals while fuelling expectations of more modest returns. A majority see a dwindling pipeline of high-quality deals and excessively high valuations as their top two challenges.[13]

Funds must look to technology

The maturing market will have implications for investment decisions and portfolio management, and firms may need to be more creative about where they invest their capital and their capital structure.[14] To maintain returns, firms will need to help their portfolio companies boost top-line growth, which may require the development of new capabilities.[15] Embracing digital innovation and transformation is expected to be a key priority for Asia-based private equity firms, given the region's companies often lack sufficient market data and analytics capabilities to drive commercial excellence.[16] "Many Asian organizations lag behind in actual adoption and risk ceding a competitive advantage to companies that have built advanced analytics capabilities," a report by McKinsey noted in March 2018.[17] Building these capabilities may also be important to help portfolio companies defend their position against digital disruption.

KEY INSIGHTS

- 2017 was seen as a watershed for the APAC private equity market but funds must prepare for changing business conditions
- Debt restrictions and trade concerns are weighing on China, APAC's largest private equity market
- Amid stiffer competition and a dwindling pool of deals, funds must embrace technology to drive innovation and spur top-line growth

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FIVE MINUTE FOCUS:

The REIT landscape in Singapore

Since the listing of the first Singapore Real Estate Investment Trust (S-REIT) in 2002, the industry has undergone significant growth with a market capitalization now close to USD 80 billion.[1] While S-REITs' year-to-date 2018 performance has dipped nearly 9.5 percent, annualized returns over a 10-year period have been strong, delivering gains in excess of 7.0 percent to investors.[2]

RBC Investor & Treasury Services' Hong Paterson, Country Head and Managing Director, Global Client Coverage for Singapore, shares her insights into some of the key trends currently underway in the S-REIT industry, and the potential market impact of Singapore's Variable Capital Company (VCC) fund structure roll-out in 2019.

1. What is the state of the S-REIT market today?

Despite the recent challenges facing S-REITs, they have enjoyed stable and consistent returns over the last few years, generating performance which is broadly uncorrelated to equities and other market drivers. The sector was left fairly unscathed by a number of recent geopolitical and macroeconomic developments such as the 2013 Taper Tantrum, Chinese equity market volatility in 2015 and 2016, and the ongoing inflationary concerns following the US election.[3]

The asset class has a number of fixed-income characteristics, as it provides investors with a regular income stream derived from rental cash flows.[4] S-REITs are appealing to investors looking for stable returns as well as capital appreciation, particularly as traditional asset managers have found it tough to produce returns. The investor interest in the asset class is evidenced in the flows, which have helped turn the S-REIT market into one of the region's largest REIT markets, just behind Australia.

One interesting dynamic, which could further accelerate flows into the burgeoning domestic industry, has been the growth of exchange-traded funds (ETFs) offering exposures to baskets of S-REITs, thereby giving investors access—at a significantly lower cost—to real estate located in both Singapore, and the Asia-Pacific region more generally.[5] Lion Global Investors, for example, launched its Lion-Phillip S-REIT ETF in October 2017, providing investors with access to S-REITs screened by Morningstar,[6] and has accumulated approximately CAD 128 million as of October 31, 2018.[7]

2. What type of investors are purchasing S-REITs?

While S-REITs are publicly listed and available to retail investors, most of the capital allocations have been made by institutional clients, many of whom want exposure to the real economy. The most enthusiastic buyers of S-REITs are small to mid-sized institutions, as they do not have the resources and real estate expertise which larger organizations are endowed with. In contrast, sizeable institutions—such as major pension funds—will typically invest directly into real estate as an owner-operator or through a co-investment vehicle.

3. What are S-REITs investing in right now?

Most S-REITs invest in Singaporean or regional real estate—especially in Australia—comprising a diverse range of property types. As more businesses invest in technological innovations such as artificial intelligence, and look to protect themselves against cyber-criminals, secure data centres and innovation labs are springing up, which S-REITs have identified as a growing sector for potential investment.

As Singapore is a small country, there is only a finite amount of real estate for these organizations to invest in, which is prompting some S-REITs to internationalize their presence and build up exposures outside of the local markets to achieve better diversification.

4. How will the VCC impact the S-REIT?

Legislation introducing the VCC fund structure was passed in October 2018. It is expected to come into force in 2019, and will be available to managers operating both open-end and closed-end fund structures, including real estate. The VCC has generated interest among market participants, but it is not seen as a direct competitor or rival to the S-REIT, partly because the former is more diverse and open to a wider range of managers covering multiple strategies and asset classes, whereas the latter is focused purely on real estate.

Generally, however, the underlying strategies and sources for fund raising determine whether a manager would opt for using a VCC or a REIT. Given the growth of Singapore as both a fund raising and investment hub in Asia, there is capacity for these complementary products to co-exist.

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STICKING WITH TRADITION

Private Real estate managers favour familiar domiciles as they face disruptive times

Unprecedented pressures are bearing down on fund managers' operating environments due to regulation, investor demands, data and technology. Priya Nair, managing director and global head of product management, and Dirk Holz, private capital lead at RBC Investor & Treasury Services, explain the key findings of a manager survey produced with PERE.

PERE: Is choice of domicile more important now given the complex regulatory climate?

Dirk Holz: Yes. We've seen more focus, discussion and scrutiny over domicile choice in the last five years. A high proportion of the PERE 100 are US fundraisers, so it's not surprising that Delaware and Cayman are top domicile choices in the survey. The flexible regulatory and tax framework of these jurisdictions is a key factor. There's also been growth in fund structures based in Luxembourg, which was quick to react to AIFMD and continues to offer flexibility to private real estate funds by complying with new regulatory frameworks. The UK, Ireland and Channel Islands are the other popular European jurisdictions used to access European capital. But the UK's decision to leave the EU means there are unresolved questions about access to European investors in the long term.

PERE: Brexit terms remain largely unresolved. How are RBC's clients preparing to minimize the potential impact and how is it determining domicile choice?

DH: The impact could be significant. Many managers that before the referendum were planning to domicile in the UK to leverage the AIFM passport are now looking at Luxembourg or are creating parallel fund structures to navigate through the uncertainty. The latter approach limits the costs of establishing an EU investment management platform. However, ESMSA has warned that UK managers will have to prove 'substance' in the offices where funds are domiciled, so there's complexity on how parallel fund structures will operate post-Brexit. The risk of a hard Brexit still exists and UK managers that have not already done so need to review operational set-ups and determine what they will require to re-domicile or consider establishing a third-party management company within the EU to minimize disruption.

PERE: Outsourcing is gaining traction in some parts of the business. What's driving that?

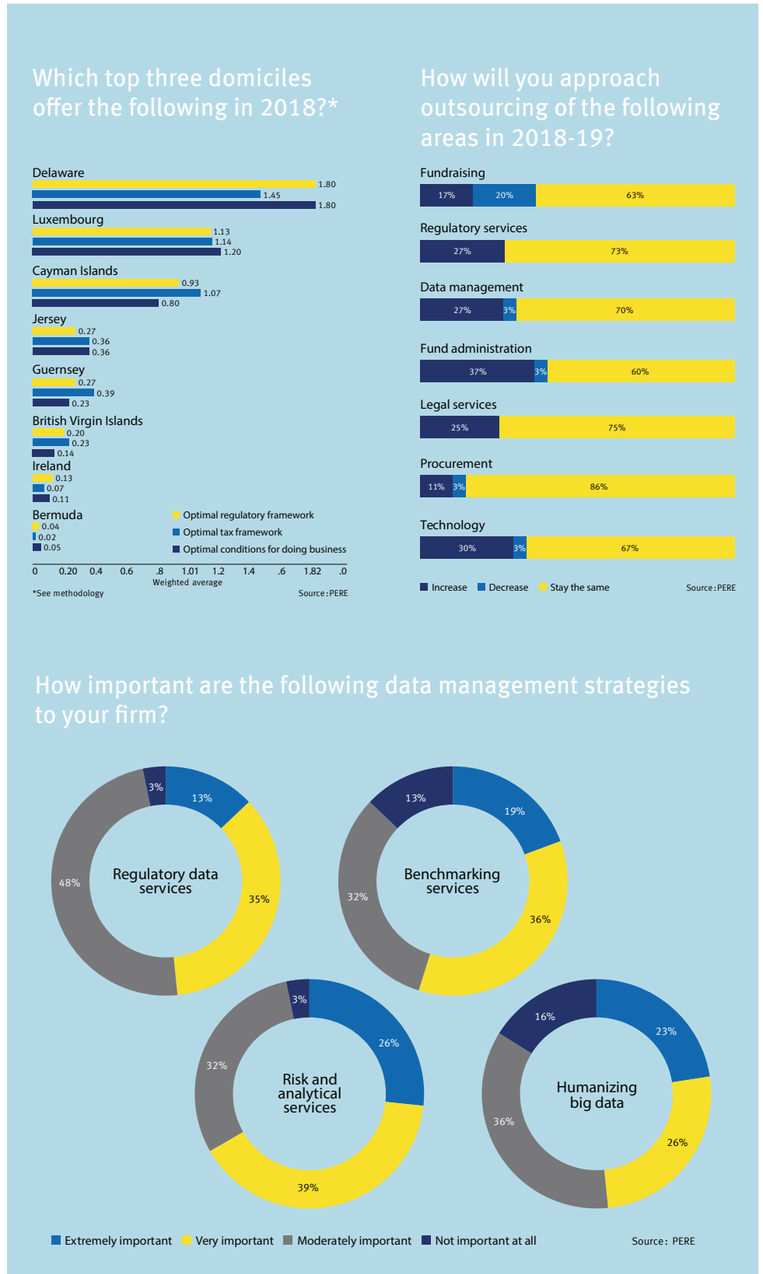
Priya Nair: A lot more complexity now exists in terms of fund structures and the size, scale and the multijurisdictional nature of managers, so the focus on creating operational efficiency is greater. There's a strong connection between domiciliation, regulation and outsourcing. The survey revealed fund administration as the most popular discipline for future outsourcing. That's not a surprise given AIFMD requires enhanced reporting, so there is a greater need to appoint a third party to help with oversight and reporting. Many of our clients recognize that fund administration is no longer part of their DNA and with market competition intensifying, asset managers are consciously choosing to focus on their core competencies. However, part of the survey showed that aspects of the outsourcing value chain are still not part of mangers' mindset. But with the size and scale I referred to, there's more need for managers to start thinking about how best to utilize outsourcing. I do see it as a trend that will continue to grow.

PERE: How important are data management strategies and technology?

PN: Currently only one in three respondents are thinking about outsourcing technology or data management strategies.
We expect to see this increase over time as these tools become more advanced, and there's greater need for investment and expertise in these areas. We've pivoted our business to focus more on digitization. There's a great opportunity for us to partner with managers to help them utilize structured and unstructured data in a manner that offers value-add to investors and to their own operations.

Methodology

PERE surveyed the 75 largest private real estate managers. We received 51 responses: 31 are headquartered in North America, 11 in Asia and nine in Europe. Answers were given on a strictly anonymous basis and the results aggregated. Where respondents were asked to give three answers, the first answer was given three points, the second two points and the third one point. An average was then taken of the total.



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TECHNOLOGY

DIGITISING PRIVATE CAPITAL

Funds Europe talks to Priya Nair about the challenges in bringing new technology to the private capital markets

Digital transformation may be a pervasive concept within financial services but it has yet to reach all corners of the market. In particular, it has had a limited impact thus far in the private capital services space, says Priya Nair, managing director, Global Head of Product Management, Private Capital Services at RBC Investor & Treasury Services.

This is not to say there are no applications for new technology. It is more to do with the idiosyncrasies of the private capital world and its investors. Firstly, it is a varied marketplace dealing with real assets, from companies to real estate, that do not lend themselves to standard-processes.

Secondly there are the characteristics of the typical private capital investor, who tend to be more individual than institutional and therefore not as driven by the demand for more operational efficiency and standardised-processes.

Indeed, change occurs slowly within the private capital market, particularly around operations and there is a relative immaturity in technology adoption terms. For example, outsourcing is still a rarity among private equity managers. Manual processes are still commonplace, in part because the tangible assets involved (from real estate to private companies) do not lend themselves to digital technology.

But things are changing, says Nair. Slowly but surely, the specialist fund managers in the private capital space, a market that encompasses funds in private equity, real estate, private debt and infrastructure, are coming under the same regulatory requirements and operational challenges as their mainstream counterparts.

> "The market has been growing in scale and is slowly coming under more regulatory pressure to be transparent."

"The market has been growing in scale and is slowly coming under more regulatory pressure to be transparent," says Nair. "There is a greater need to be more efficient and to deal with operational complexities."

For example, more private equity funds will come under either MiFID II or AIFMD reporting requirements, depending on their classification. There has also been a greater institutional interest in the private capital sector, as more pension funds look to alternative sources for greater returns. This has in turn brought more expectations of the same reporting standards and transparency levels seen in mainstream investment vehicles.

Nevertheless, these pressures are still greater for mainstream investment managers. The processes in the mainstream market are easier to scale, standardise and ultimately automate. And the threat of disruption from outside competition (big tech firms or more nimble start-ups with more efficient processes) is greater than for private capital service providers where a track record is still a necessity.

Motivations

There is also a difference in the characteristics and motivations of the typical private capital investors and what influences their choice of manager. The managers' expertise is the primary attraction rather than low fees or efficient processes.

Furthermore, there is a paradox at the heart of the effort to drive digitisation, says Nair. "On the one hand, investors are primarily looking to private equity and real estate fund managers to provide value through their expertise and the fact that they are different to their competitors. On the other hand, they are demanding a more generic standardised digital service from all of them."

In many ways, the typical private capital investor could not be more removed from the millennial investor looking to carry out their wealth management transactions on their smartphones. High-net-worth private investors are willing to pay high fees in return for managers' expertise and differentiation.

What is indisputable is that new technology has a role to play in the private capital world, says Nair.

Advanced analytics can be used to create insights from the data that managers hold while distributed ledger technology (DLT) and robotic process automation (RPA) have become more relevant in terms of operational efficiency.

In the private capital world there are contracts that need to be exchanged between multiple parties. Technology such as DLT allows for replication across multiple systems. It can also be used to help with the KYC and AML requirements during the onboarding process. The use of RPA is also becoming more prominent, says Priya. "Where you have data-intensive processes, RPA allows for scalability and to extract data more efficiently and with a clear audit trail. We have not yet seen its full impact but we have seen it used to address some of the more clunky processes carried out on Excel spreadsheets. It can reduce manual error and increase operational efficiency."
But how close are we to digitising the client experience? While it is difficult to see any private capital investors seeking a more 'cost-effective' service delivered by a chatbot or robo-adviser, is there a growing demand for more digital influence in some of the client focused processes?

There has been some movement, says Priya. The use of RPA for client onboarding is increasing and the interest around applying DLT is also on the rise among private capital fund managers.

> "It is possible to apple rulesdriven technology and still retain the individual expertise that investors value."

As for the persistence of manual processes and the human intervention for which investors are willing to pay extra fees, there is a period of time when the fund is active and requires a lot of manual processes and those value-added elements, says Nair. This is also true in relation to extracting data insights and providing additional value to investors.

But once you've invested that initial capital, there is little else that happens actively and more opportunity to apply operational efficiency, freeing up managers to concentrate on another round of fund-raising.

"There is a little bit of push involved in promoting the digitisation of the market. It also depends on who you speak to. The operations staff are more open to the idea of digital technology. The fund accountants may be more focused on manual intervention initially. But if we have an idea of how to make processes more efficient and reduce errors, then everyone is interested."

Private capital managers looking to pursue the use of digital technology need to pick their partners, whether they be digital start-ups or incumbent providers who are themselves looking to partner with digital start-ups.

Asset servicers such as RBC are well started on their own digitisation paths. "Digital technology is an enterprise-wide initiative for us and is at the heart of the drive to futureproof our business," says Priya.

The challenge RBC now faces is to encourage the same demand for digital services and the value of data among the investors in the private capital services market, the last bastion of manual processes.

PRIVATE EQUITY TAKES TO STANDARDIZATION

Standardizing private equity against all odds

Private equity is generally considered a diverse sector given the wide range of investments, which feature unique characteristics, supported by distinct operational processes and fund structures across managers. Similarly, institutional investors have distinct priorities and individual requirements, which general partners (GPs) have to take into consideration. Nonetheless, these varying characteristics and approaches have not deterred the over USD 3 trillion[1] industry from trying to standardize core operational activities, most notably fee reporting and limited partner (LP) agreements.

Finding a way to standardize private equity fees

One of the primary architects of standardization has been the Institutional Limited Partners Association (ILPA), an industry body that designed and developed a private equity fee reporting template in conjunction with more than 50 LPs and 25 GPs globally.[2] The resulting template seeks to inject more transparency into how private equity firms disclose their costs to clients,[3] an issue that has come under greater scrutiny.[4] That a number of managers settled SEC charges linked to incongruous fee allocations has also heightened investor focus on the need for cost transparency.

"The ILPA template has been a great effort to provide LPs with more detailed information about private equity costs and charges, allowing them to assess and benchmark managers. GPs are targeting the same institutional clients, and they commonly seek to achieve the goal of greater transparency from the industry," said Priya Nair, Global Head of Product Management, Private Capital Services at RBC Investor & Treasury Services. Nonetheless, adoption of the template is not yet widespread,[5] perhaps owing to a focus on aggregate returns over standardization opportunities.

Fee standardization stalemate

While many private equity firms are supportive of the ILPA's underlying principles and the need for standardization to an extent, they point out that managers already share detailed information about costs with clients. Managers also argue that many investors have specific reporting needs driven by demands from their own LPs or regulators, making standardization impractical in certain circumstances.

"The ILPA template has been a great effort to provide LPs with more detailed information about private equity costs and charges, allowing them to assess and benchmark managers"

The limited adoption of the ILPA's template may be the result of the abundance of standardization initiatives elsewhere. Invest Europe has been producing comprehensive reporting guidelines for private equity since 2000,[6] which many GPs incorporate, so they are reticent about assimilating the ILPA's template into existing disclosures. Meanwhile, the UK's Financial Conduct Authority (FCA) is inviting asset managers, including private equity, to sign up to its voluntary cost disclosure regime proposed by the Institutional Disclosure Working Group.[7] Some UK managers may consider sidestepping the ILPA's template if its contents are duplicated in the FCA's new reporting framework, which is expected to launch later in 2018.

The standardization does not stop with fees

Private equity managers regularly comment about the legal and administrative costs associated with Limited Partner Agreements (LPAs), documents which have steadily expanded as a result of new regulatory and tax obligations introduced by rules such as AIFMD and FATCA.[8] In response, the ILPA is developing a model LPA along with a number of international law firms in what it hopes will help standardize fund documentation even further.[9] The ILPA's LPA standardization endeavour has received a number of GP endorsements, but there is some skepticism about its chances of success, despite the sound intentions.

> "Efforts to expedite and standardize client onboarding through the rationalization of AML and KYC processes is another area of potential focus"

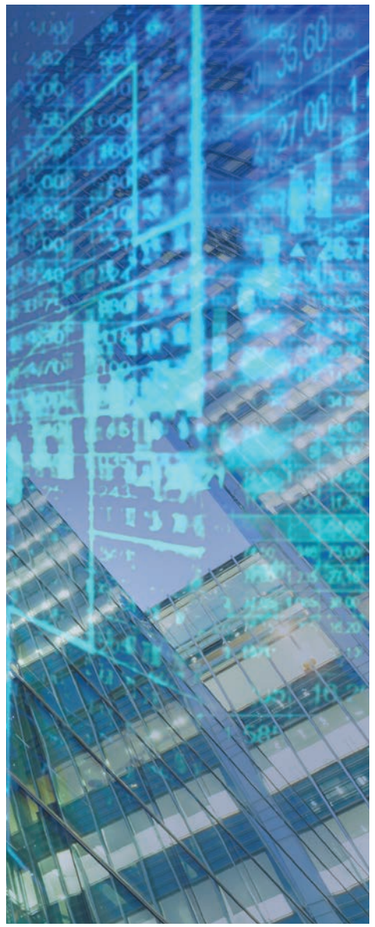
Law firm MJ Hudson notes that, "A model LPA would have to be suitable for use by first-time domestic small-cap funds, multi-billion-dollar international mega funds, and everyone else in between. While it may make a serviceable starting point for a new fund manager, well-established GPs that have raised a number of funds may well be reluctant to junk their intensively negotiated, long-trusted suite of documents. There is also the added cost and effort of managing legacy funds and successor funds side-by- side when they are operating on quite different documentation."[10] Juggling the competing interests of multiple institutional clients in a model LPA is also not without challenges.[11]

Future targets for standardization
Standardization initiatives in private equity to date have delivered mixed results, but some managers at the Super Return CFO/COO conference were vocal advocates of the need for more harmonization of industry practices. One private equity firm said that while guidelines for valuation processes had been created, such as the International Private Equity and Venture Capital Valuation Guidelines, managers valuing the same assets often reached wildly different or conflicting pricing conclusions, an issue that could be remedied through further standardization. Nonetheless, valuing investments is highly subjective, making it very difficult to systematize.

Efforts to expedite and standardize client onboarding through the rationalization of anti-money laundering (AML) and know your customer (KYC) processes is another area of potential focus. Compliance departments at private equity firms frequently engage with high volumes of documentation during AML and KYC checks, while institutional investors in some markets question the need for sharing of personal or sensitive information. Enhanced AML and KYC standardization would accelerate onboarding and potentially make these mandatory checks less invasive for clients and more cost effective for fund managers.et, the last bastion of manual processes.

KEY INSIGHTS

- The surplus of standardization initiatives and assurances from private equity managers that they already provide clients with information about costs has impacted widespread adoption of the ILPA fee template
- ILPA efforts to streamline LPAs are welcome, but may not be sufficient to accommodate the needs of the diverse private equity industry
- Some private equity firms, despite the challenges facing ILPA, believe areas such as valuation and client onboarding could also be improved through standardization initiatives



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TRENDS

A NEW DIRECTION FOR PRIVATE CAPITAL STRATEGIES?

Portrait of an industry at the crossroads

There is more money in the global private equity (PE) industry today than at any other point in its history but challenges may lie ahead on the PE horizon.

Private equity - facts and trends
Private equity is booming. Global PE fundraising totaled an unprecedented USD 453 billion in 2017, topping the previous record set in 2007 of USD 414 billion.[1] The global PE industry now has more than USD 2.8 trillion in assets under management, higher than at any other time in its history. This is a significant rebound from the doldrums the industry found itself in following the financial crisis in 2008. In a persistently low-interest rate environment, the appeal of PE is clear. PE funds returned 17.3 percent in the 12 months through June 2017, a slight increase on the 15.4 percent annual gains registered for the five years through June 2017.[2] With the post-crisis bull market in public equities moderating and valuations in both equities and bonds starting to look stretched, institutional investors have begun to allocate more illiquid alternative investments into their portfolios.

As money pours in, however, PE finds itself at a crossroads. The challenges facing the industry are a combination of medium-term and cyclical, as well as long-term and structural.

Medium-term challenges: more competition, less value
In the medium term, the flood of institutional capital entering the asset class and increased competition are driving deal multiples higher. The number of PE firms chasing deals has risen steadily each year for decades and now totals 7,775 globally.[3] In addition, high-net-worth individuals and family offices are entering the field and the number of multi-asset class direct investors has also increased. Several sovereign wealth funds and pension funds have begun exploring direct private investments on top of their allocations to PE managers. The California Public Employees' Retirement System, for example, has said it will invest USD 13 billion in PE directly every year in addition to its existing USD 27 billion PE allocation.[4] Corporate buyers are more present in the market today than they were a decade ago and they look to capitalize on several advantages that improve their odds when bidding against PE firms, including a lower cost of capital and a willingness to bid higher for assets of synergistic value to their core businesses.

As money pours in, PE finds itself at a crossroads

At the same time, however, the number of deals being done is essentially static. According to data from Dealogic, the number of annual buyout deals has remained range-bound between 3,000 and 4,000 since 2010.[5] More investors and money chasing the same number of deals means that valuations are rising. Buyout multiples climbed to a record 10.2 times Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA) in 2017, according to S&P Global Market Intelligence, and remain elevated this year at an average of 9.5 times. This is a level that has surpassed the 2007 peak of the pre-crisis buyout boom.[6]

Dry powder (i.e., money promised by investors that PE managers have not yet spent), reached its highest level ever at USD 1.7 trillion in 2017, which underscores the degree to which suitably priced valuations have become increasingly difficult to find.[7] However, as dry powder accumulates the pressure to do deals continues to build. This will test the PE industry's ability to maintain discipline in the years ahead.

Long-term structural challenges: time for a new model?
Debt continues to be a preferred source of financing for many PE deals, particularly buyouts. S&P Global Market Intelligence estimates that buyout debt levels averaged about 5.7 times EBITDA for the year to date, up from as low as 3.7 times in 2009, and not far from the pre-crisis peak of 6.0 times.[8] The end of easy money in the United States and the tapering of the European Central Bank's quantitative easing program present medium-term growth challenges for buyout companies that have debt. An uncertain macroeconomic outlook in both the United States and Europe compounds this cyclical stress that is likely to weigh upon the PE industry in the medium term.

As dry powder accumulates the pressure to do deals continues to build

Amid increased competition for deals, rising valuations and the likelihood of an economic downturn over the next five to 10 years, the long-term structural challenge for PE is to figure out a new model that can continue to generate superior returns for investors. For decades the fee structure, a 2 percent annual management fee and 20 percent carry on investment returns, and the operational approach of PE managers have remained largely unchanged. Future value projections have rested on a combination of multiple expansion and cost cutting. Neither footing looks particularly sure today so a new model may be needed.

The disruptors
While the future state of the PE industry remains unclear, several elements of the industry's current approach are already being disrupted and may intensify in the years ahead. Firms are looking to become more competitive on fees, and many are shifting the emphasis of operational turnarounds in portfolio companies from cost cutting to top-line growth generation, a potentially decisive shift for an industry that has long seen restructuring as the key to value generation. In addition, firms are exploring ways to integrate technology and data, for example blockchain, into portfolio management as a way to increase efficiencies in custodianship and compliance. Finally, add-on investments, such as synergistic opportunities "added on" to a primary "platform" investment, are growing in importance. Add-ons represented 24 percent of total global buyout deal flow in 2017 by value, up from 10 percent in 2007.[9] Greater pooling of add- on investments and smarter sectoral specialization could become an important competitive edge for PE firms in the years ahead.

KEY INSIGHTS

- A significant influx of capital and new players in global private equity is driving concerns of an overheated market, making it difficult for PE firms to source good opportunities
- Multiple expansion and cost cutting, conditions that have historically formed the basis of future value projection in the PE industry, look increasingly fragile
- New long-term approaches to value generation in the PE industry could see a growing number of firms adopt top-line growth strategies in portfolio companies, explore creative uses of technology and pursue more add-on investments

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INFRASTRUCTURE INVESTMENT: AN ALTERNATIVE ASSET CLASS GOES MAINSTREAM

Pension funds' evolving investment needs are aligning with the opportunities provided by P3 infrastructure projects

As institutional investors, including pension funds, seek to place funds in diversified opportunities, there is growing interest in alternative asset classes.

Canada, with its successful model for promoting investments in public infrastructure through public-private partnerships (P3), is particularly well-placed to provide for this growing demand.

Canada has been using and refining a P3 model for nearly three decades. Institutional investors across the country, notably pension funds, have increasingly invested in private market assets, including infrastructure.

P3 infrastructure investments offer potential long-term returns and diversification
The P3 model involves public authorities putting public infrastructure projects, like roads or schools, out for competitive tender. All parts of the project are covered by one agreement, so bidders must form into consortia of different team members required to complete the project.

This structure allows for the selected private consortium to finance as well as design, deliver, operate and maintain the asset, in return for either a share of the revenue generated by its use or a stream of availability payments from the public authority - while the public authority retains ownership of the infrastructure.

Institutional investors, including insurers and pension funds, have come to appreciate the value of long-term investments in infrastructure as part of a general shift away from liquid and listed assets. Infrastructure, particularly for pension funds and other structurally long-term investors, has appeal as a natural hedge against inflation, as many of the returns generated from infrastructure assets, such as tolls or availability payments, adjust with inflation.

Expanding infrastructure investments
According to the Pension Investment Association of Canada (PIAC), infrastructure, private equity and real estate have significantly expanded their share of the Canadian pension fund investment mix since the financial crisis.

In 2017, for PIAC members, these categories collectively accounted for more than a quarter of all defined benefit pension plan investments, up from around 13 percent in 2006.1 Infrastructure's share of this figure has grown every year since 2006, when it accounted for 2.4 percent of the total, to 2017, when it accounted for 7.9 percent - exceeding the share of Canadian equities at 5.7 percent.

Institutional investors have come to appreciate the value of long-term investments in infrastructure

One particular attraction of infrastructure for pension fund investors in Canada and elsewhere is that projects typically require large amounts of long-term capital to be invested up front. Deploying cash in this manner provides an opportunity to mitigate risk associated with the low interest environment marked by compressed yields.

Keeping pace with demographic changes
As Canada expands it use of P3 to deliver more of the country's infrastructure requirements, the number of early-stage infrastructure investment opportunities is expected to grow. This will potentially enable pension funds to better match liabilities from an expanding demographic of retirees with reliable, cash-generating assets. At the same time, the assets they deliver will help to improve the competitiveness of Canadian industry, the economic prospects of future generations and quality of life. Infrastructure creates an economic or social value that ensures its performance over the lifetime of the investment while aligning with the stated purpose of the institutional investor and its beneficiaries.

Canada launches infrastructure bank
There is an expanding universe of P3 investments in infrastructure, encouraged both by the current government's focus on accelerating infrastructure development and the creation of Canada's new Infrastructure Bank.

There is an expanding universe of P3 investments in infrastructure

The Canada Infrastructure Bank, part of the government's Investing in Canada infrastructure plan, is investing CAD 35 billion of federal capital into infrastructure projects.2 This initial funding is designed to attract private sector and institutional investment to new revenue-generating infrastructure projects that are considered to be in the public interest, such as public transport, social and green infrastructure. The private investment and expertise that the bank's funding attracts should help public dollars go further.

The Infrastructure Bank model will continue to build on Canada's mature P3 market, which now accounts for more than a third of total infrastructure procurement. Access to bank funding will be available to provincial, territorial and indigenous government partners as well.

A globalizing market
There is also an increasing level of institutional awareness of infrastructure as an asset class around the world. This parallels the increasing need for renewing and upgrading infrastructure in many major developed economies as well as the unfulfilled requirements of economies everywhere.3 It is an asset class that is well-suited to the disciplines and diversified investment portfolios of Canada's institutional investors. To invest effectively over the long term, however, it is important for these institutions to continue to develop their global knowledge and a suitable service model for managing a diversified global infrastructure portfolio.

KEY INSIGHTS

- Canada's well-developed P3 model offers pension funds a ready and growing pool of infrastructure investment opportunities that may better match the funds' long-term liabilities
- Infrastructure investment can provide a natural hedge against inflation, as well as sufficient ticket size to allow funds to deploy large volumes of cash
- Investing in infrastructure does not have to be limited to domestic projects, however, any move into foreign markets must be accompanied by an in-depth understanding of the local situation and a robust service model

Sources
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