THE EVOLVING RELATIONSHIP BETWEEN LP & GPs

A Study Prepared for the Multilateral Investment Fund's Fund Manager Meeting

by

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Introduction

Relationships between limited partners and general partners in the private equity industry have changed more over the past five years than over the prior 50—which is roughly the age of the industry. These changes have been driven by a number of forces: the unprecedented run-up in the sizes and activities of private equity funds to 2007; the subsequent crash and the unexpected liquidity pressures suffered by some of the LPs of longest standing; the persistent underperformance (relative to public markets and expectations) suffered by venture capital funds since the NASDAQ crash; and the decisions of some major buyout funds to go public, among them. Such developments have influenced the nature of the industry in ways that are still evolving and still being understood.

In emerging markets—most particularly, the Latin American and Caribbean, or LAC— the scenario is different. Development finance institutions (DFIs) and global firms have operated in these markets since the mid-1990s and various efforts have helped create domestic venture capital industries. In contrast to the market in more developed countries, all members are learning how best to interact with each other within the context of regulations, expectations, and uncertainty. It is unclear how LP-GP relationships in the emerging market venture capital ecosystem will evolve. Nor does the developed market, experimenting on its own, provide a clear roadmap.

This paper draws from interviews with more than 50 participants in the private equity world in emerging and developed markets playing different roles in the industry. It also refers to a number of cases, white papers, and other studies. We are deeply grateful to those experts who shared their insights with us.

The paper is organized as follows. First, we briefly set out the current fund-raising environment. We then consider the dynamics of the LP-GP relationship over time and explore current trends in developed and emerging markets (mostly LAC). Finally, we conclude with guidelines for effective LP-GP relationships in emerging markets and our reflections on what may happen in the future.

The Private Equity Playing Field

At the start of 2012, 1,814 private equity funds—an industry record—were raising money on the global market, seeking a total of $744.2 billion.[1] Within these totals, some details merited attention: in particular, 604 funds targeting Asia and the Rest of the World sought to raise $198.8 billion, representing increases of 23% and 17% over the previous year. Although Asia led this group, Latin America-focused funds came second, targeting $21.5 billion.[2]

Several trends could make general partners (GPs) feel hopeful that they would reach their targets. First, unlike in 2011, funds were closing more quickly: while the average private equity fund closed in 18.5 months in 2011, the first half of 2012 found the process had fallen by almost two months, to 16.7 months.[3] This likely stemmed from greater demand from the limited partners (LP): 35% of those interviewed by Preqin indicated that they were below their target allocations to private equity and therefore wanted to increase their allocations. Several noted that after a few years of restrained allocations to the asset class, they had substantial amounts of dry power to commit. Moreover, almost all investors expected their private equity investments to out-perform the public market benchmark.[4]

Secondly, returns to global private equity (both venture capital and buyouts) had improved. Part of the VC recovery was simply statistical: the ten-year calculations had worked through the NASDAQ collapse of 2000-2001. At the same time, there had been a shake-out of early-stage firms that had made their names during the bubble and never quite managed to regain their stride.

Overall, the picture of private equity was encouraging. As shown in Figure 1, private equity had performed competitively with public markets for much of the past ten years. Moreover, many emerging markets had performed well enough, relative to both developed markets private equity and developed public market, to warrant widespread interest from limited partners in developed and emerging markets. According to the Coller Capital/EMPEA survey, a majority (66%) of respondents planned to increase their emerging market exposure to some extent, due to a desire for exposure to high-growth markets, the increased skills and experience of emerging market GPs, and an improved

Figure 1: Comparative Returns to Private Equity and Venture Capital (to December 2011)

Index	One Year	Three Year	Five Year	Ten Year
Emerging Markets PE & VC	–1.54	18.50	10.12	11.23
Emerging Asia PE & VC	–1.66	21.29	11.42	11.38
CEE & Russia PE & VC	7.74	10.63	6.73	15.56
Latin America & Caribbean PE & VC	–9.99	15.68	11.11	6.96
MSCI Emerging Markets	–18.17	20.42	2.70	14.20
US VC	13.18	10.00	5.29	3.27
US PE	10.90	15.03	7.22	12.02
Western Europe PE	3.07	11.37	3.28	17.11
S&P 500	2.11	14.11	–0.25	2.92

Source: Cambridge Associates LLC Proprietary Index: pooled end-to-end returns, net of fees, expenses and carried interest.

The index is an end-to-end calculation based on data compiled from 376 global emerging markets private equity and venture capital funds (includes funds investing primarily in Africa, emerging Asia, emerging Europe, Latin America and Middle East ex Israel), including fully liquidated partnerships, formed between 1986 and 2011. The Asia Emerging Markets Index consists of 237 funds, the Central & Eastern Europe Index consists of 52 funds, and the Latin America & Caribbean Index consists of 42 funds. Please note that the Emerging Markets Index contains 45 funds that do not fall into these specific regions stated above. Middle East and Africa index is not calculated because of insufficient sample size.

Source: EMPEA, "Emerging Markets Private Equity Review," Vol. 8, Iss. 2, July 2012, p. 22.

risk-return profile.[5] In fact, 54% of the LPs expected their emerging market portfolios to produce annual net returns of more than 16% over the medium term and 25% expected the returns to exceed 21%.[6]

Noteworthy for Latin American funds was the increased attractiveness of that region, and Brazil in particular. In 2011, Brazil had surpassed China in terms of investment attractiveness among LPs, and the rest of the region was viewed more favorably than India (although less so than China). As a result, Brazil and the rest of the region would likely see an influx of new investors over the next two years.[7]

One of the challenges introduced by such an influx of new investment is working effectively with the institutions providing the capital. This is an ongoing challenge for private equity firms regardless of their domicile—witness the tensions between limited partners (LPs) and GPs over fees and the resulting promulgation (and adoption) of the Institutional Limited Partner Association (ILPA) principles. In emerging markets, where institutions new to private equity are investing in fund managers who may also be learning the ropes, working together effectively is likely to be every bit as challenging—but in different ways—as it is in developed markets.

Basic Dynamics Between LPs and GPs

To understand the relationships of LPs and GPs, it helps to have a sense of the industry's history. In the beginning—that is, until the mid-1950s in the United States—private equity meant venture capital and it was mostly the business of families. Families such as the Phippses, the Rockefellers, and the Whitneys invested some portion of their wealth in high-risk, high-return opportunities.[8] In this nascent version of venture capital, the providers of capital—the LPs—were practically indistinguishable from the fund managers, which would become known as the GPs. Over time, the family offices hired individuals to manage the investment operation, but to a great extent, the family oversaw the business and the managers were salaried employees. All investments, regardless of stage, would be approved by a committee that generally included some family members.

Over time, the providers and investors of capital separated and professionalized. In the 1950s, the first formal U.S. venture capital limited partnerships, Draper, Gaither, and Anderson, was founded. The limited partnership structure had several advantages when it came to high-risk/return investments. LPs provided capital and paid a management fee, in exchange for the eventual return of their capital and, typically, 80% of the gains. The money went into a pool with (usually) a ten-year life, which provided flexibility but required eventual accounting for results. The LPs' limited status shielded them from losses over and above their committed capital—they could not be found liable for a product that did not work as hoped—as long as they were not directly involved in managing the fund. The GPs invested the capital and managed the portfolio. They could be liable for losses above the committed capital because they directly managed the fund.[9] They received 20% of the gains (carried interest).

By the 1980s, when U.S. pension funds started investing in private equity (which by then included buyout funds, structured on very similar terms), the limited partnership had become the predominant structure for private equity funds. As fund sizes grew, the proportional representation of high-net worth individuals and families fell. LPs invested in funds, GPs invested in companies, the LPs received their committed capital, sometimes a hurdle rate, and gains, and the GPs received carried interest and management fees, augmented in the case of buyout funds with various other fees. The fees were supposed to support the GPs until their investments generated cash, while the carried interest kept the GPs focused on choosing and creating successful investments.[10]

This relationship is complicated by the fact that private equity is a business of cycles and time lags. As above-market returns attract more LP money to the sector, GPs raise larger funds, which increase their fee-based income yet require them to put more money to work. Without a concomitant increase in the supply of good investment opportunities, GPs have three options: invest more money in each company (leading to valuation inflation); invest the same amount in more companies (either backing second tier ideas or forgoing the close supervision and advice GPs traditionally provide their portfolio companies); or hire less experienced and possibly less skillful partners.[11] Each strategy tends to reduce returns, the very reason for which LPs invest in private equity funds. When returns fall, many LPs reduce their allocation to the asset class, particularly to the lower-performing funds. This occurred in recently in buyouts and in the late 1990s in venture capital, with the Internet bubble and its subsequent crash. In both cases, GPs have found it more difficult to raise money after the crash and LPs have been able to make some headway in addressing their long-held concerns about the bases and levels of various fees.

Supply and Demand for Fund Management Services

The cycles described above reflect the laws of supply and demand, both of money and of opportunities to invest. It is complicated by the matter of performance—“Good GPs,” observed one long-time private equity industry observer, “perform well enough often enough that the LPs will forgive them their bad funds.”[12] Historically, LPs have whipsawed between annoyance at the fees that GPs demanded in bad times and gratitude that the same GPs would accept their money in good times.

Especially at the top end of the performance scale for venture capital, there is a distinct imbalance between demand for and supply of money. Returns to all private equity firms decline markedly below the first quartile. The highest return to venture capital funds between 1980 and 2008 was 721%, but the upper quartile was 14.1% and the median 3.5%. The S&P 500 over the same period returned 10.0%, with the added benefit of liquidity.[13]

Not only do top quartile firms dramatically outperform others in the industry, but this outperformance persists in a type of virtuous cycle. Academic studies have corroborated this persistence of performance.[14] The informal feedback works as follows: a partnership raises money and invests in good firms. It generates above-average returns, allowing it to pay above-average compensation to its partners. The partners remain with the firm and become known for building good companies. LPs want to invest. Good entrepreneurs prefer to deal with this firm, and further enhance its reputation for success. It can continue compensating its partners and attracting talented entrepreneurs and its LP base remains committed and stable.

There is, however, a substantial scarcity of LP positions at high-performing venture capital firms. They rarely raise funds large enough to accommodate all the LP interest inspired by their success. The imbalance is smaller with buyout firms, which have recently raised funds beyond $12 billion. The LPs in earlier funds generally have preferential access to the next fund, often leaving little room for new institutions. Those new investors are usually chosen based on the non-monetary contributions they can make, whether access, prestige, or networks. The issue for an LP, then, is not just getting one’s money into a private equity fund but getting it into the best ones. Otherwise, it should be in the public markets.

Once an LP has invested in a fund, there are additional challenges. As the head of private equity for a major university endowment said, “Signing up with a private equity firm for 10 years is like being in the jungle with a lion on top of you. You have to hope it’s a friendly lion.”[15] LP-GP relationships can be very contentious. How to make them work well has been evolving over time.

Who Are the LPs?

In developed market funds, LPs are fairly well defined. They are individuals or institutions that invest in long-term illiquid assets with the expectation of holding them for at least seven years. Such groups include public and private pension funds, endowments, foundation, banks, insurance agencies, sovereign wealth funds, funds-of-funds, and, to a smaller extent, high net-worth individuals and family offices. While not passive investors, they cannot intervene in the management of the fund or its investments without risking their limited liability status, so their involvement is generally at a distance.

In LAC, the investors in domestic private equity (especially venture capital) funds generally are more involved in the fund management. The participation of pension funds varies among the different countries: in Brazil, Colombia, and Peru, pension funds invest in venture capital; in Chile they do not. In Mexico, they participate through a separate vehicle. High net-worth individuals and family offices play a larger role than in developed markets. In addition, Develop Finance Institutions (DFIs) and various government agencies, whether departments that support innovation or banks that encourage agricultural investment, often participate in venture capital funds. While these groups have a certain interest in financial return, they are also motivated by the desire to encourage entrepreneurship, economic development, and/or the development of a venture capital ecosystem. As such, they play different roles in the funds than does the typical LP in developed markets.

LP-GP Relationships

Ever since the start of the private equity industry (defined here as both venture capital and buyouts), there have been three guiding issues behind LP-GP relations. We will describe these in broad context in the section that follows and then explore how these play out in emerging markets. These three issues—alignment, transparency, and governance—are at the root of the committees that are created and covenants that are signed. These committees take their power from the LP Agreement. While not discussed in depth in this report, this document establishes the ground rules within which LPs and GPs operate: covenants regarding such things as information provisions, fees, key people, and distribution of gains are critical for empowering the LPs.

The first of the three issues, alignment, is largely implemented through the LP Agreement; the other two, transparency and governance, come through the LP Advisory Committee (LPAC) or the Shareholders' Assembly, as different countries may call it.

- Alignment: The universal comment from LPs is, "We don't want GPs making money they haven't earned. We want them to get wealthy through capital gains, not transaction or monitoring fees."[16] This concern is primarily addressed in the Limited Partner Agreements where it appears in LP-oriented terms such as hurdles before premium carry; expenses that are not covered by the management fee being split 80/20 (LP/GP) as opposed to the traditional 99/1; management fees charged only on invested capital or gradually phased in during the investment period; complete offset or, at least, 80/20 sharing of transaction or monitoring fees; complete cessation of the practice of charging portfolio companies the net present value of monitoring fees forgone when the company is exited; and more frequent clawback true-ups.

Most LPs have pushed for, and many GPs have provided, the so-called "European" waterfall, or complete return of capital and preferences in contrast to the earlier deal-by-deal carry distributions.[17] Not only does this hasten the return of the LPs' commitment, but it reduces the likelihood of clawbacks due to over-distributed carry. Finally, the LPs want the GPs to focus on their specialty and not indulge in style drift. One of the most distressing style-drifts, according to LPs, is the tendency of large firms to go public. "There's no alignment there," said one. "The GPs will never give on any fees because they're essential to keep the stock price up, on which their wealth is based." Since the 2008 liquidity crunch, the LPs investing in many buyout funds have been able to receive more favorable terms. The situation with LPs in venture capital funds, though, seems less changed. The best funds can usually raise money with little trouble while preserving their historic fee and carry levels, while those that are not quite top tier have had to raise smaller funds and/or provide more favorable terms.[18]

A further complication may occur when GPs share fund economics with specific LPs. When trying to raise a first-time fund, the GP may agree to give special consideration to a cornerstone investor, who provides a substantial amount of capital and, often, a marquee name. In such a case, the LP may pay reduced fees and/or receive a share of the carry, and if not handled carefully, the arrangement can create conflicts between the LP and the GPs and between the cornerstone investors and the other LPs. Creating similar concerns, some buyout funds have sold portions of their management companies to LPs, entitling them to a share of the fees.

- Transparency: Private equity firms are notoriously opaque in their communications with the outside world, even with their LPs. Yet many LPs now face increased scrutiny from their own advisory boards or oversight committees and must produce more detailed reporting. As their private equity portfolios grow, the LPs need more standardized information. In response, GPs have augmented their customary annual and quarterly reports and annual meetings by providing additional information. Some enhance capital call notices with explicit information about the use of the proceeds; others write monthly letters, or organize quarterly webinars or phone calls; and many will have special communications to explain extraordinary events. Some GPs have standard time limits within which to return calls and emails from LPs. They note regular visits both to and from LPs, usually amounting to at least one additional visit each year beyond the regular LP meeting. For the LPs, it is all part of building a detailed understanding of the firm. "We want to know what's going on," said one LP. "We want to understand the partners, the portfolio, and the areas of expertise. We keep extensive records."[19]

- Governance: Given the long-term illiquid nature of a private equity portfolio that LPs cannot manage directly without risking their tax advantaged status, governance is a difficult matter. The usual approach has been to create LP Advisory Committees (LPACs) (in different countries this name may vary but the concept remains: it is a governance body made up by all LPs or LPs with a significant ownership in the fund) that represent the LPs on various issues facing the firm. These have a mixed reputation. Some LPs view them as critical parts of a firm's governance process. Many LPs in developed markets, though, see them as little more than rubber stamps, rarely given the information or power to make informed decisions. In their view, LPACs have become unwieldy at best and inept at worst. In LAC and increasingly in developed markets, firms create one LPAC for each fund and empower them to meet *en camera*, create subcommittees to approve valuation and other matters, and consult with lawyers and other experts in considering difficult issues such as cross-fund investments and key-person situations.

  In LAC, LPs tend to have more governance power than in most of the developed markets—in part because the industry is so new. Often, LP participation in a fund comes with strings attached: positions on investment committees, as described later, or on LPACs where they have a substantial amount of control. New or young funds with scant track records, can hardly dictate terms to their investors. Instead, the relationship at its best becomes an educational process through which the DFIs or other experienced LPs teach both the less experienced LPs and the GPs how to participate in venture capital. Stresses arise with conflicts of interest, and can range from a high net-worth individual who wants returns before the end of a 10-year fund to conflicting goals that different LPs want a fund to achieve to differences over investment philosophy.

LPACs[20]

The easiest way to define an LPAC is by what it is not: it is not a Board of Directors. Lest they be seen to have a fiduciary responsibility for the fund, the LPAC members do not control the firm or make investment decisions. The concern about being seen as having an oversight role stems from fears that they will lose their limited liability status. The advisors' role is instead to represent the LPs' concerns to the GPs. Among many developed-market firms, the LPACs are organized on a firm-wide basis and each fund might have a representative. In Latin American and the Caribbean, the LPACs are more often specific to each fund.

The LPACs have three main responsibilities. They approve the GP's valuation method and the valuations assigned to portfolio companies; they review potential conflict events such as key-man situations, fund extensions, or concentration exceptions; and they give broader advice, such as opinions on where the market may be going or the timing of the next fund-raising.

LPACs can consist of as few as five to as many as 20 members. Most LPs felt that the most effective boards had between five and 11 members; a few named eight as the maximum. Effectiveness was a function not only of the number of representatives but also of their quality and level of preparation. As GPs raised larger funds and more LPs wanted positions on the LPAC, the bodies could become increasingly large and unwieldy. Some GPs resorted to a *de facto* or official executive committee, or to simply calling a few valued LPs for opinions and treating the formal LPAC as a rubber stamp for a decision already made.

GPs choose their LPACs in various ways. Increasingly, Advisory Boards reflect the LPs who have invested the most capital in the fund. In other situations, a fund would offer a seat to an LP who was seen as providing value in terms of a marquee name that made fund raising easier or experience in the industry.

LPACs usually meet quarterly, b-annually, or annually. Usually, the function was primarily investor relations. Some GPs held annual State of the Market meetings for the LPs, designed to provide them information on the market and the fund's portfolio. In other cases, the LPAC might be called upon to make decisions regarding cross-fund investments or even to help with matters involving the removal of a GP. In one such case, a founding partner called the head of the LPAC to inform him of that the partner had fired his co-founder, triggering the key-man clause. After a long discussion, the LP decided that the move was warranted and rallied the rest of the LPs in support of the founder.

Why Are LP-GP Relationships Important

Good LP-GP relationships are more than just about making LPs happy. There is a real financial benefit to the LPs and, thus, to the GPs.

For LPs, early and continuous access to information from the GPs helps to produce better returns. In the article "Smart Institutions, Foolish Choices," by Josh Lerner, Antoinette Schoar, and Wan Wongsunwai investigates the performance of different classes of institutional investors in venture capital funds. The authors found that university endowments' private equity results outperform the average by 21%.[21] Much of this appeared to stem from better access to information (by being on the LPAC and having strong networks) and better ability to act on it. The longevity of the endowment staff played a role in this out-performance as well.

Longevity matters because a staff that is accustomed to working with each other and with the GPs is more efficient and more knowledgeable. Information is shared more widely within the firm, and staff has a longer time frame from which to draw. Moreover, private equity is a long-term business—funds last 10 years; companies may take seven years to mature. Staff that moves frequently lacks the long horizon necessary to build understanding with a fund manager. In some cases, staff with a short time horizon is seeking to find a new position. This would motivate the individual to support short-term, low-risk investments rather than long-term, higher-risk options that might yield better returns to the institution and to the fund. Therefore, LPs with rapid turnover among their staff may be less welcome at more exclusive (and better performing) funds.

For GPs, a well-functioning LPAC can provide a number of benefits. As long as the fund is producing good returns, good relations with the LPs can speed fundraising and its consequent distractions. The LPs can also provide feedback regarding how much and when to raise a fund. The network provided by a good LP network can assist in due diligence. Finally, a group of high-quality LPs gives the GP a cachet with potential investee companies. A charitable institution that invested widely in private equity would contact potential investees and describe the importance of private equity returns to its charitable mission, helping its GPs differentiate themselves and win deals.

LP-GP Relations in Emerging Markets

In emerging markets, private equity is a much more recent phenomenon. Although a few funds can trace their ancestry to the 1980s, their background generally differs from that of funds in developed markets. Many of the initial entrants into emerging market private equity were global funds who did larger deals using money raised in developed markets with the structure previously described. Domestic emerging markets fund have evolved in their own economies with their own regulations and distinct concerns. Moreover, developed markets had family offices and governments accustomed to investing in early stage opportunities. Until recently, many emerging market economies were, to some degree, centrally controlled, making government more familiar with large enterprises than with small high-risk ventures.

Speaking about "emerging markets" as if they are a monolith is misleading. They differ substantially, in terms of their backgrounds, population, educational systems, economies, tolerance for risk, entrepreneurial spirit, and degree of regulation. The laws surrounding private equity can be complex and are often evolving. Noted one venture capitalist in China, "We check the government legislation website every day, like the weather."[22] Even in Latin America and the Caribbean, the focus of this paper, countries and their private equity/venture capital ecosystems vary dramatically. Some countries have developed their own regulations (Brazil, Chile, Colombia, Peru, and Mexico), while others prefer to use the laws of the U.S., Canada, U.K. or other countries. The case of Mexico is different: although it has regulations for private equity most funds prefer to incorporate in Canada.

For this section of the report, we interviewed a dozen groups that participated in private equity in Latin America and the Caribbean (LAC). Many were institutional investors, although some both operated funds of funds and invested in funds, serving as LP and GP. We also interviewed several fund managers (GPs). Each participated either in a 30 minute phone interview or responded to questions online. We thank them all for their time.

Like relationships in developed markets, those between LPs and GPs in LAC are focused on alignment, information, and governance. It is particularly important that GPs acknowledge that they have a fiduciary duty to the LPs. Because all members of the venture capital ecosystem are learning about the asset class, education—which can be seen as a mixture of information and governance—is particularly important. Without the longer history of the developed markets, most actors are feeling their way. Because many of the most experienced LPs are development finance institutions (DFIs) and because many of the LPs are keenly interested in overseeing their investments, where regulations permit, LPs serve on the investment committee.

The presence of LPs on the investment committee in emerging markets appears most frequently in Brazil, Mexico, Colombia, Argentina, Uruguay, Central America (where most funds are funded by multilaterals and DFIs), and China. In India, it is extremely rare and appears to occur mostly in first-time funds when a GP of a private equity fund that was investing in the young operation took a place on the investment committee. In a first-time early-stage Chinese fund, two spots on a six-person investment committee were held by LPs who had committed substantial amounts of capital. A late stage Chinese private equity fund also had LPs on its investment committee, but this body primarily approved investments that had already been considered by a management committee of internal GPs.

LPs on the Investment Committee

The presence of LPs on the investment committee does seem counter-productive at first. These institutions are already paying management fees to have the GPs find, assess, and manage investment opportunities. Theoretically, the LPs entrusted substantial amounts of money to the GPs on the basis of their ability to perform those functions. But the reason for the LPs' presence stems mostly from the youth of LAC's venture capital market. The funds may be very young, investing in young and fragile companies, and sometimes are managed by relatively inexperienced GPs. Only now LAC is experiencing a period of economic growth: previously, macroeconomic volatility added to the LPs' worries that a young manager may not be able to handle young companies in the face of an uncertain economy. Some of the LPs, especially the DFIs, have vast experience in best practices for venture capital. Having them serve on the investment committee teaches the GPs about due diligence, deal terms, portfolio management, and exit strategies, and also teaches the other LPs how to perform their duties. In addition, the presence of the DFIs resolves concerns that other LPs may hold. This educational role can also be played by other more experienced LPs, often investors and sometimes GPs from other funds, as cited in the example about India. Finally, in LAC, there is a delicate balance between trusting the GPs' expertise and worrying that they may act without due concern for fiduciary responsibility. Hence, a seat on the investment committee provides comfort to the LPs that someone is watching their interests.

Yet potential drawbacks do exist. If an LP has conflicting interests—for instance, a position in a company in which it hopes the GP will invest—it may advocate for actions that are not in the fund's best interest. Similar situations can occur in the case of an exit if the LP owns the potential acquirer. Furthermore, if LPs on the investment committee receive information that they do not share with those who are not, the latter group could be substantially disadvantaged.

The educational role played by LPs, whether on the investment committee or on the Advisory Board, can be very important. Some LPs request a seat on investment committee simply to provide instruction, explaining in an interview, “We don’t say where they should invest their money. They make proposals and send us the information. We’re on the investment committees to educate the GPs about how the industry works. We ensure that the process has been done correctly.”[23]

Others prefer to have a more direct role in choosing investments while the fund is young. Treu Ramos of BNDES was quoted as saying, “[Serving on] the investment committee is always a deal-breaker for us. We have sat on the investment committee of every one of our fund managers. It is important that we have influence on investment decisions. [24] One GP noted a similar concern from his LPs, “In a first-time fund, we have a lot of money from individuals who are reluctant to let go.”[25]

Another option is LPs who observe deliberations on the investment committee, rather than having votes. A number of the DFIs use this approach. Some firms provide observer positions to those LPs who have committed smaller amounts of capital. Such an arrangement provides the LPs with information about the workings of the fund, while the GPs can still benefit from their knowledge and contacts.

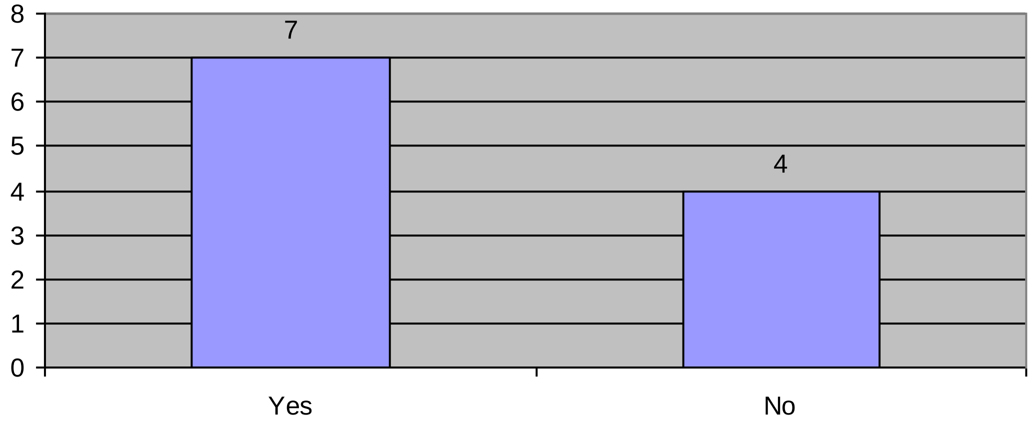
For many LPs, once the GPs have raised later funds, the need for close guidance falls. Commented a GP from a long-standing firm in LAC, “We have built up a reputation with our LPs that they are comfortable just being on the Advisory Committee. We have created trust with them that we will take care of their concerns.”[26] Another fund manager looked forward to a later fund when the LPs “will make the decision to invest once and trust we’ll make the best decision for them.”[27]

Most LPs agreed with this assessment. One commented, “If we can get good results from funds that look like typical international private equity funds, the market will have an overt signal regarding which GPs it can trust. And then we’ll be able to relax.”[28] Ramos from BNDES went on to say, “Once GPs get to their second and third funds, then it makes more sense to start thinking about turning the investment committee into an advisory committee.”[29]

The Role of LPs on the Investment Committee

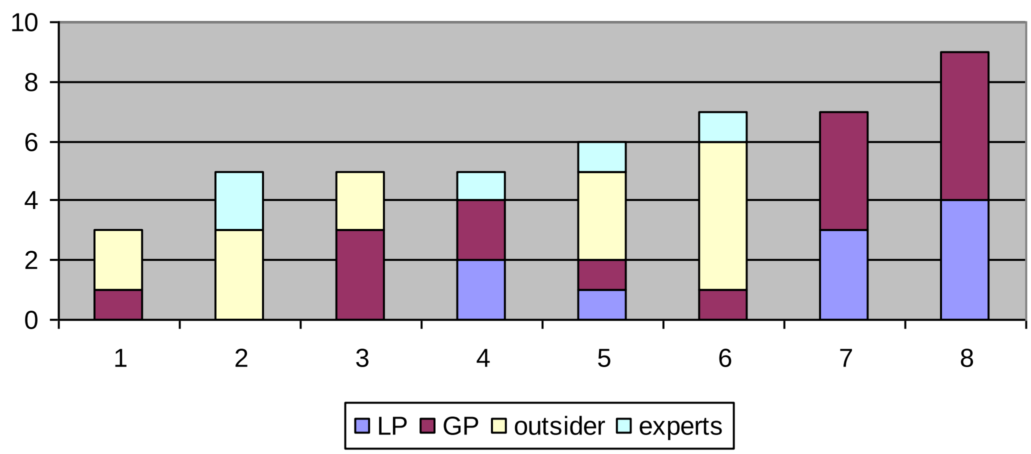
Many LAC fund investment committees have relatively few GPs, which contrasts with developed markets where the GPs or some subset of that group take all investment decisions. In our small sample, seven groups were involved in funds that had some LPs on the investment committee. The balance, four, did not have LPs on their investment committees, as shown in Figure 2, below.

Figure 2: LPs on Investment Committee?



An interesting detail was the variety of individuals on the investment committees. A few of these groups were composed entirely of LPs. Others had a mixture of outsiders (defined as non-Development Finance Institutions, sometimes high net-worth individuals or members of the local business community), GPs, and experts (Development Finance Institutions or DFIs). In another example of the youth of the industry, the outsiders are seen as particularly helpful in terms of identifying investment opportunities and doing due diligence on them. Figure 3 shows the mixture for the funds in this study.

Figure 3: Composition of Investment Committee



Choosing LPs for the committees appears to be based on a number of factors. Some institutions, as BNDES as noted earlier, require a seat on the investment committee as a condition of their investment. In some funds, LPs who commit more than 20% of the fund's capital are automatically on the investment committee. This leads to a concern about the smaller investors, which is usually resolved by appointing an individual to represent their interests. Another factor, as mentioned earlier, can be the expertise that the

LPs provide and their ability to educate the GPs and encourage new LPs to participate in the asset class.

Other institutions, such as national banks, can provide important contacts throughout the economy, helping the GPs with due diligence and connecting portfolio companies with possible customers or members of the management team. Pension funds, new to the asset class and to the fund manager, are often very interested in being involved in decisions. Again, this likely stems from their eagerness to learn more about the asset class. One GP noted that they were "very passive and seem mostly interested in getting the information."[30] Yet that is not atypical. Some representatives on developed market LPACs have been described as "sitting there like lumps."[31] In addition, getting information is an important part of being an LP; better information helps an LP make better decisions about investing in future funds.

One fund with a small investment committee has no LPs on that group. To help keep its LPs informed, it created an LP Advisory Board on which any LP can sit. The LP Advisory Board observes the deliberations of the investment committee, which includes a current GP and two independent members, one of whom has extensive development private equity experience and the other who is well-connected in the local market place. "The observers are important for their input and participation," commented the GP. "Communication, cooperation, and support from all the investors are critical to our success. We want everyone to feel that they have a voice."[32]

Indeed, most GPs spoke highly of the assistance rendered by the non-GPs on their investment committees. One noted that a local high-net-worth individual had provided critical assistance in several deals. Another GP had been able to retarget the fund thanks to the help of an expert outsider who was deeply involved in the investment process. In addition, the ongoing education process helped the GPs perfect their approach.

Similarly, the LPs who served on LPACs rendered assistance in terms of contacts for deal opportunities and due diligence.

Process

The process of the investment committees was generally consistent, both across the funds and with research done on developed world private equity funds.[33] An investment opportunity was identified and discussed with the investment committee. The identification process might occur through the LP network, national banks, or the efforts of the GPs. Deciding on a good deal involves many factors: the fund's stated investment objectives, the quality of the opportunity, and the amount of time available to pursue the deal and, if approved, to manage it.

This process is similar to deal sourcing in the rest of the world: proprietary deals are rare and precious. One developed market firm mentioned a three year process of building trust before a deal occurred.[34] In many cases, the GP wrote a brief description of the company and the likely deal structure. This would be sent to the committee between a week (in the most cases) and a month (in a very few) before a meeting. At the meeting, the committee would decide whether to pursue the investment.

Such "approval to diligence" is very common. In essence, the committee is allocating time, which is more precious than money. In addition, it ensures that GPs are spending money on due diligence for deals with the LPs' knowledge and that, should the deal be abandoned, the expenses were not imprudent.

At this point, the GP would start intensive due diligence, sometimes reporting periodically to the investment committee and always reporting if the terms of the deal change substantially. Sometimes reports are written along the way.

For the final approval, the GP returns to the committee with a 50-100 page Investment Memo, describing the opportunity, the due diligence findings, and the terms of the deal in greater detail. Sometimes the company would present. In one case, the investment decision was made immediately after the presentation, and a negative decision was accompanied by a letter that detailed the reasons for the committee's decision. In other situations, the investment committee never met with the company but left such interactions to the GPs. In most cases, after the approval of the Investment Memo, the GP would negotiate the final details of the deal, returning to the investment committee if the structure differed from that which had been approved. There are, of course, some variations of timing around these steps.

This process of sourcing-summary-feedback-due diligence-formal memo-decision-final negotiation is very similar to that observed in the majority of developed market funds. It differs only in the number of company presentations to the investment committee. In our research on decision-making, a greater number of developed market GPs note meetings between the investment committee and the company than were described here. This may be a factor of our small sample size for this study. It may also reflect the educational role of the investment committee and its interest in good process, rather than an expertise in a particular type of sector.

As with developed-market funds, the vast majority of decisions were consensual if not unanimous. Even if there was a vote, as one GP said, "It would have to be a super-majority if someone was opposed."[35] This dynamic reflects the importance of a shared sense of ownership about the deal.

After the investment committee's decision and the deal's closing, the GPs continued to keep the committee informed. In some cases, the investment committee approved major decisions, such as replacing the management or accepting an acquisition offer. In very rare situations with early funds, the investment committee might serve as a type of Strategic Board of Directors for the portfolio companies, in addition to the GPs serving on the company's own board. In addition to exit options, it would consider such high-level strategic issues as regional expansion, largely because the committee members might have contacts that could help with the project.

Such interaction between the investment committee (let alone the LPs) and a portfolio company is very rare in developed markets—nor is it the norm in LAC. Typically, a GP provides board-level supervision. If the deal does not include a board seat, the GP may have observer status or simply play a passive role, trying to exert influence behind the scenes. A GP on a portfolio company board might ask his/her fellow GPs for advice about how to handle a situation that has arisen or for contacts who might assist with a particular issue. More rarely, the GP might ask a particular LP for an introduction to a potential customer. While certain LPs (especially high net-worth individuals or DFIs) might interact closely due to their unique knowledge and experience, this is relatively unusual.

Whether the LPs served on an investment committee, an LPAC, or neither, they wanted information. Such information took a variety of forms ranging from monthly or bi-monthly newsletters to quarterly reports, semi-annual meetings or conference calls, and annual general meetings. Noted one GP, "Success comes through dialog. If there are any changes in expectations around a company's performance, we communicate it immediately."[36] This is not always the case among developed market GPs, as has been demonstrated in issues around portfolio valuation.[37]

After a fund's investment period, it was still very important that the LPAC or investment committee continued to meet on a regular basis. In developed markets, LPs were regularly informed through newsletters, calls, quarterly reports, and annual meetings. The GPs in some LAC funds would reduce communication with the LPs, if the portfolio's progress fell short of expectations. Noted one LP, "This just provokes more anxiety."[38] Carefully detailed information rights in the LP Agreement can help to address this situation.

While LPs could be very helpful on investment committees, they could present some challenges. In part, this could be a matter of distance. If an LP was based in Europe, for instance, getting its attention for a small LAC deal could be difficult.

A more difficult situation could occur when interests were not aligned. An LP on investment committees might want the fund to invest in one of its companies or to sell a portfolio company to a particular acquirer, regardless of the economics that would result to the fund. Another concern arose if the patriarch of a family office had committed to the GP, but placed a junior staff member on the investment committee. The representative might have grave doubts about being associated with young, high-risk opportunities, fearing for his or her career or incentive compensation.[39] Such situations had to be addressed on a case-by-case basis.

The educational role of the LPs could create frustration on both sides. An experienced LP, seeking the best outcome for the fund, might give suggestions that the GP ignored, believing that he is being micro-managed. Said one LP, "The infuriating thing is that the best GPs are the ones that take the suggestions! We don't do it to be annoying; we're trying to help them succeed."[40]

In the end, there must be an element of trust in the relationship. A contract cannot possibly cover every contingency that might arise in a 10-year fund life. The LPs must trust that the GPs will deal honorably with them and take their fiduciary responsibility seriously. The GPs earn that trust by performing well, demonstrating that they are responsible, and being humble. Susana Garcia-Robles of the Multilateral Investment Fund, a long-term DFI in LAC's venture capital funds, says "The best outcome for the LP is to negotiate the contracts and all protections with great intensity, but then put agreements aside for the next ten years because you have a good personal relationship with your GP. If you have to go back to the contract all the time, there is something going wrong in the fund."

Brave New World

The private equity world is evolving in both developed and emerging markets. In developed markets, LPs are trying to address some of the weaknesses in the limited partnership model that became apparent during the venture capital bubble in the late 1990s and the buyout bubble in the mid-2000s. Documents like the ILPA principles attempt to restrain aggressive fees, give LPs power through no-fault divorce and key man clauses, and generally encourage partnership behavior. Separate account agreements like that of the New Jersey Investment Department with Blackstone and Texas Teachers' Retirement System with Apollo and KKR, in addition to Canada Pension Plan's longstanding co-investment program, all testify to more activist LPs who acknowledge the potential gains from private equity but not at the previous fee structure.

These, though, are examples from buyouts. The venture capital world still has limited places among the top-tier firms. As long as the managers continue to perform, they will to be able to raise funds with their historical fees and carry levels. The key to this, however, is "as long as they continue to perform." Studies have shown that raising sharply larger funds tends to reduce the fund's performance.[41]

For venture capital funds in LAC, effective LP-GP relations are critical to support the new venture capital ecosystem. Venture capital is a long-term asset class. Waiting for returns from a long-term asset class is difficult, but an excessive short-term view distorts performance and can damage the ecosystem. Pension plans cannot expect to have instant returns. Everyone is learning in the early stage arena. The fact that the INOVAR program has encouraged so many of Brazil's pension funds have started investing in early stage companies over the past seven years, is remarkable.[42] Seven years is merely one fund's life and it has been a difficult seven years.

To a developed-world observer, having LPs on the investment committee is unexpected. GPs are supposed to be sector experts in addition to knowing how to guide young companies to maturity. But in LAC, where some GPs may not be expert in these topics, it makes sense to recruit experts to assist. The mix of DFIs and external experts, in general, seems reasonable given the state of development of the venture capital industry in LAC. Over time, the GPs will learn the nuances of venture capital investing. As they succeed, they will be able to raise funds where LPs are not on the investment committee. Moreover, as the GPs acquire a track record[43], LPs who insist on being on the committee may find themselves replaced by those willing to sit on an Advisory Board. The LPs will become more confident in the GPs. Increased familiarity with LP Agreements will assure them that interests are aligned, that information will be provided, and that good governance practices are being followed.

As GPs raise their later funds, they need to remember and act upon the lessons of their earlier vehicles. Just as LPs are learning to evaluate GPs and GPs are learning how to do due diligence on their companies, the GPs must also do due diligence on the LPs.

Learning the qualities of a desirable LP is an important lesson, as a strong LP group can help a firm survive many difficulties.

Successful GPs can choose their LPs to a large extent. Unsuccessful GPs will find their choice of LPs constrained until, over time, they cannot raise money. As a market matures, it breaks into tiers, as has occurred in most of the developed markets where there is little change in the top firms. In emerging markets, this process is still under way: there are a few top-tier firms but room for others. Firms that perform well—that take advice from their LPs, treat their LPs as partners in terms of interest alignment and information provision, and pursue good governance—have a much better chance of being in the top than those who do not.

For GPs, then, the recommendations for successful LP-GP relations include:

1. Choose your LPs carefully. Make sure they bring more than money—networks or experience. It is better to raise less money than to do so with your LPs at cross-purposes.

2. Ensure that interests are aligned. LPs have said, "We want the GPs only to make money when we make money."[44] But GPs must be aware of interest alignment as well. LPs who want to share fund economics, have co-investment privileges, or want to pursue a particularly narrow mission (exclusively focused on social returns, for instance) can create great turmoil in a fund. High net-worth individuals must be aware that private equity is a long-term investment

3. Familiarize yourself with the ILPA Principles.[45] These are Best Practices from the point of view of many LPs. If you don't follow some of them, be prepared to explain why.

4. Provide information to all LPs, not just those on the investment committee or the LPAC. As one LP said, "No surprises—bring us the bad news early; most things can be resolved."[46]

5. Be as transparent as possible regarding portfolio company progress, audits, inter-fund dealings, and the like. The fewer surprises your LPs receive, the happier they will be.

6. Ask the LPs for advice and listen to it.

For new LPs, recommendations include:

1. Choose your GPs carefully. Be sure you want what they provide and that you trust them to do their fiduciary duty. While doing due diligence on the GP, determine if there is true alignment in the investment strategy.

2. Create a long-term culture. This applies to incentive schemes and career paths as well as asset allocations. It is important that an LP's organization understands that private equity overall is a long-term investment. The J-curve

(that is, the pattern of spending money on investments before it is returned as gains) can be unsettling for inexperienced investors. Under-performing investments are usually identified and written-off before out-performers mature, which can also distress a new investor. If a member of the LP's staff is incentivized based on year-over-year performance, the early years of a typical private equity fund are challenging indeed. Therefore, it is important that the institution understands what a private equity investment program means in terms of short-term evaluation and performance, and adjusts its measurement and incentive programs accordingly.[47]

3. Review the LP Agreement carefully and be sure you understand the terms. The time to negotiate these is during the initial due diligence process, not at the first LPAC or investment committee meeting.

4. Be prepared. Read the materials provided before the meeting.

5. Distinguish your organization, whether through its mission, expertise, or contacts. This will help ensure your organization a place in future funds.

6. Share information, whether from other LPs or from the GPs, to the extent possible.

Conclusion

No one knows whether the venture capital industry in LAC will leap-frog the 40 years of history that the industry went through in the developed markets and arrive in a few years, fully formed on the global stage. Already the industry has made huge strides and occupies an important place in the portfolios of many international investors. Domestically, too, it is starting to find its feet.

At such an early stage—in most cases, the industry is roughly 15 years old—it is not surprising that all the actors are still learning. Having LPs on the investment committee, where regulations allow, makes certain sense. Being able to participate allays the fears of investors new to the asset class. The involvement of experienced DFIs provides immediate feedback regarding best practices in investing. Well-connected local partners can assist with due diligence and portfolio company management.

In the long-term, though, it seems that most LPs might eventually move to an LPAC or some other advisory role. This comes from two angles. First, the GPs will develop expertise in their sectors and industry, making them less reliant on advice from LPs. Secondly, the LPs will learn how to ensure alignment with their GPs through terms in the LP Agreement and, should worst occur, be able to sell their positions on the secondary market or even dissolve the fund through a no-fault divorce. Finally, both will recognize that their futures are linked. LPs are limited, not powerless. Wise GPs can rely on the networks and knowledge of their LPs. All of this will contribute to a more vibrant venture capital ecosystem.

At best, LPs on LPACs gain access to in-depth information and develop an understanding about the nuances of the partnerships in which they have invested. At the very best, they can develop a respectful working relationship with the GPs and the other LPs and help the fund perform beyond all expectations. Whether this occurs is up to the GPs, in determining how they want to run the fund and use the LPAC, and to the LPs themselves, in deciding if they want to work constructively and openly or “sit there like lumps.” But if skilled use of the information received through LPAC participation helps to explain even part of the performance differential cited in Lerner, Schoar, and Wongsunwai the effort may be well worth it.

In LAC, LPs play more varied roles at this point. Yet the hallmarks of good relations between LPs and GPs remain unchanged regardless of the market’s state of development. As the market evolves, LPs will increasingly move to LPACs and leave the GPs to handle investment decisions and portfolio management. The critical aspect of LP-GP relations, though, is the elusive quality of “Partnership Behavior.” It is impossible to write a contract that covers every issue that could arise in a 10-year fund life. It is far better and more efficient if the contract can outline basic expectations and rules, while honest communication, transparency, and a degree of trust allows the two groups to work through the challenges that will inevitably arise.

Endnotes

[1] *The 2012 Preqin Global Private Equity Report – Sample Pages*, (London: Preqin Ltd., 2012), p. 7.

[2] Preqin, p. 9.

[3] Preqin, "PE Fundraising gains momentum in Q2 2012," July 2, 2012, http://www.preqin.com/item/preqin-pe-fundraising-gains-momentum-in-q2-2012/102/5354, accessed September 3, 2012.

[4] Preqin, p. 9.

[5] Coller Capital and Emerging Market Private Equity Association, *Emerging Markets Private Equity Survey: 2011* (Coller Capital/EMPEA, April 13, 2012), p. 4.

[6] Coller Capital and Emerging Market Private Equity Association, *Emerging Markets Private Equity Survey: 2011* (Coller Capital/EMPEA, April 13, 2012), p. 6.

[7] Coller Capital and Emerging Market Private Equity Association, *Emerging Markets Private Equity Survey: 2011* (Coller Capital/EMPEA, April 13, 2012), p. 8.

[8] For more on the Phipps family, see Tom Nicholas and David Chen, "Bessemer Trust: Guardians of Capital," *HBS Case No. 811-031* (Boston: HBS Press, 2010).

[9] GPs are usually protected from unlimited liability by establishing the firm as a limited liability corporate (LLC).

[10] Issues around fees and fund structures have become well-publicized. We exclude them from this discussion.

[11] For deeper discussion of these topics, see Paul Gompers and Josh Lerner, "Money Chasing Deals?: The Impact of Fund Inflows on the Valuation of Private Equity Investments" *Journal of Financial Economics*, 55 (February 2000) 281-325.and Paul Gompers, ""Grandstanding in the venture capital industry," *Journal of Financial Economics*, Elsevier, vol. 42(1), September 1996, pages 133-156.

[12] Josh Lerner, Felda Hardymon, and Ann Leamon, "A Note on Limited Partner Advisory Boards," *HBS Case No. 808-169* (Boston: HBS Press, 2008).

[13] Data from Thomson One Banker.

[14] Steven N. Kaplan and Antoinette Schoar, "Private Equity Performance: Returns, Persistence, and Capital Flows," *The Journal of Finance* 2005, vol. 60 (4), pp. 1791–1823.

[15] Josh Lerner, Felda Hardymon, and Ann Leamon, "A Note on Limited Partner Advisory Boards," *HBS Case No. 808-169* (Boston: HBS Press, 2008),

[16] Confidential interview.

[17] This is also recommended by the Institutional Limited Partners Association, "ILPA Private Equity Principles," Version 2.0, January 2011, http://ilpa.org/index.php?file=/wp-content/uploads/2011/01/ILPA-Private-Equity-Principles-version-2.pdf&ref=http://ilpa.org/principles-version-2-0/&t=1346814085, accessed September 4, 2012.

[18] Data from news reports including Pui-Wing Tam & Spencer Ante, "A Have and Have-Not Venture World," *The Wall Street Journal*, February 18, 2011; Pui-Wing Tam "Venture Funds Sweetening Terms," *The Wall Street Journal*, Nov. 22, 2009; Keenan Skelly, "Blackstone Alters Fee Structure Again," F*inancial News-LBO Wire*, September 6, 2010; Jennifer Rossa, "Partnership Terms Show Hints of a Shift in Favor of Limited Partners," *Dow Jones Private Equity Analyst*, June 2009, p. 12; Laura Kreutzer and Sabrina Willmer, "GPs Sweeten the Annex Fund Pot to Lure More Investors," *Dow Jones Private Equity Analyst*, June 2009, p. 18; Laura Kreutzer and Keenan Skelly, "Draper Fisher Rounds Up $196M for Scaled Down Fund," *Venture Capital Dispatch*, July 20, 2009; "GTCR Closes $3.25 Billion Buyout Fund," Business Wire, February 22, 2011.;

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[19] Confidential interview.

[20] This section is informed by Josh Lerner, Felda Hardymon, and Ann Leamon, "A Note on Limited Partner Advisory Boards," *HBS Case No. 808-169* (Boston: HBS Press, 2008), pp. 2-8.

[21] Josh Lerner, Antoinette Schoar, & Wan Wongsunwai, "Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle," *Journal of Finance*, April 2007, vol. 62 (2), pp. 731-765.

[22] Felda Hardymon, and Ann Leamon, "Gobi Partners," *HBS Case No. 805-090* (Boston: HBS Publishing, 2005).

[23] Confidential interview.

[24] Sabrina Willmer, "BNDES's Treu Ramos on Investing in Brazilian Funds, Investment Committee Requirement," *Bloomberg Brief: Private Equity*, June 20, 2012, p. 8.

[25] Confidential interview.

[26] Confidential interview.

[27] Confidential interview.

[28] Confidential interview.

[29] Sabrina Willmer, "BNDES's Treu Ramos on Investing in Brazilian Funds, Investment Committee Requirement," *Bloomberg Brief: Private Equity*, June 20, 2012, p. 8.

[30] Confidential interviews.

[31] Lerner, Hardymon, and Leamon, "Note on Limited Partner Advisory Boards" *op cit.*

[32] Confidential interview.

[33] For more on the Deal Decision-Making process of venture capital firms, see Felda Hardymon, Josh Lerner, and Ann Leamon, "Decision-Making Among Venture Capital Firms," *HBS Case No. 804-176* (Boston: HBS Publishing, 2004).

[34] Ibid.

[35] Confidential interview.

[36] Confidential interview.

[37] Felda Hardymon, Josh Lerner, and Ann Leamon, "Between a Rock and a Hard Place," *HBS Case No. 803-161* (Boston: HBS Publishing, 2003).

[38] Confidential interview.

[39] For more on the tensions between short- and long-term policies and the way they manifest themselves in measurement issues, see The World Economic Forum, *Measurement, Governance, and Long-term Investing,* (NYC, NY: World Economic Forum USA, March 2012), http://www.weforum.org/reports/measurement-governance-and-long-term-investing.

[40] Confidential interview.

[41] Unpublished analysis by Josh Lerner and Antoinette Schoar based on Preqin data, 2010.

[42] Josh Lerner and Ann Leamon, "Creating a Venture Ecosystem: FINEP's INOVAR Project," HBS-MIF Working Paper, 12-099, May 2012, http://www.hbs.edu/research/pdf/12-099.pdf

[43] How long it would take to acquire that track record is uncertain. It might be Fund 3; or after Fund 1 if the GPs had delivered good returns. It might be a function of the GPs' backgrounds and performance. Such a question provides a fertile area for future research.

[44] Confidential interview.

[45] Institutional Limited Partners Association, "ILPA Private Equity Principles," Version 2.0, January 2011, http://ilpa.org/index.php?file=/wp-content/uploads/2011/01/ILPA-Private-Equity-Principles-version-2.pdf&ref=http://ilpa.org/principles-version-2-0/&t=1346814085, accessed September 4, 2012.

[46] Confidential interview.

[47] For more, see the World Economic Forum Measurements report, *op. cit*. It may seem odd that we address incentive systems for LPs and not for GPs. While GPs certainly struggle with retaining talented staff, especially in the face of competition from deep-pocketed international funds seeking to establish domestic offices, the topic is somewhat beyond the subject of this paper.