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UPDATE

Key fund trends and takeaways from the 22nd Annual International Conference on Private Investment Funds

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A summary of the key themes and discussion points covered at the IBA's 22nd Annual International Conference on Private Investment Funds.

In March 2024, members of the Mourant global Investment Funds team attended the International Bar Association's 22nd Annual International Conference on Private Investment Funds in London.

The conference is a long-established and prominent annual event which attracts influential players from across the global funds sector to meet and discuss the latest trends and issues, and provides the opportunity for global funds lawyers to share experiences and hear from leading fund sponsors and their GCs.

In this update, we've summarised some of the key themes and discussion points covered throughout the two-day event. We'll also be following up in due course with more in-depth articles building on some of these themes and reflecting on our market predictions for the coming year and beyond, as well as discussing these in our Private Capital Perspectives podcast series.

Fundraising environment

With exits constrained by the elevated interest rates and a restricted financing environment, it's believed private funds are currently holding around 28,000 unsold portfolio companies with a value of around $3 trillion. As a result, liquidity is constrained and fundraising experienced a downturn across all private fund asset classes in 2023, with private capital managers currently seeking two and a half times what was raised in the last 12 months.

The general consensus among the speakers and during the plenary voting session was that, although the environment remains tough in 2024, 2025 is likely to see a bounce-back to the market activity seen in previous years, with a significant turnaround in fundraising.

In the short term it is not all doom and gloom, however. Positive fundraising activity around credit and secondaries funds, signifiers of the demand for liquidity, was noted. Investors still want to allocate to private funds and there are a number of noticeably stronger fundamentals as we move into 2024, particularly falling interest rates.

Conference speakers agreed that investors remain confident of the long-term prospects of private markets. This stems from the perception that private markets possess the adaptability to address short-term hurdles, including geopolitical instability (outlined below) and subdued global growth. Indeed, a recent global survey from Adams Street reports that 88 per cent of institutional investors believe private capital will outperform public markets this year.

At the lower end of the market, smaller and mid-sized GPs are tending to re-focus on traditional distressed and turn-around asset strategies, with fee discounts more common to engage potential limited partners.

For first time managers, there is some evidence of spin-outs and emerging managers looking to offer differentiated/niche strategies but it's a challenging period in which to compete for investor capital. Emerging managers represent about five per cent of annual capital raised but are seeking 13 per cent of available capital.

Some are looking to use SMAs as a means of fundraising, deploying their strategy and building track record. In some cases, it's proving harder for people to demonstrate past success with new regulatory disclosure rules and the increasing regulatory burden in some jurisdictions can dissuade some new entrants. One panellist identified the Channel Islands as potentially useful, lightly regulated, domiciles for emerging managers looking to manage those regulatory costs.

Headwinds affecting the funds sector

The conference speakers touched on geopolitical tensions affecting the funds space, particularly concerning the ongoing conflict in Ukraine, compounded by declining populations and the growth of populism; a combination which continues to add global instability. Macroeconomic risk was identified as the key current risk for fund managers, ahead of performance, succession planning or regulatory and legal risk.

Regulatory pressures do continue to intensify though, as the US Securities and Exchange Commission (SEC) adopts a stricter stance, staffing-up to increase the frequency of regulatory exams and enforcement actions in the place of dialogue and introducing new Private Fund Adviser Rules which are inhibiting new fund launches and represent a significant move away from previous reliance on investor disclosure. This reflects the SEC's requirement for greater accountability from the private capital industry, which is now deemed too substantial to enjoy lighter-touch regulation.

These more strained relations will require repair through enhanced communications with the regulator and investors, offering better explanations of how the industry works and its historic benefits, convening GP and LP dialogues and where appropriate, enhancing regulations to protect retail investors. But there won't be an immediate 'quick fix'. The situation is unlikely to be materially affected by any changes in the US administration driven by this year's general election.

Additionally, the institutional investor base is shrinking, highlighting the necessity for newer pools of capital to sustain the industry.

Retailisation

Against that backdrop there was agreement from speakers that UHNW, HNWI and family office investors remain a hugely underrepresented market.

Individuals with assets of up to $5 million combined wealth stand at approximately $100 trillion globally, providing private equity firms with the opportunity to structure products to attract such wealthy individual investors.

In terms of recent trends, bank platforms are increasingly being used in the US to feed HNWI investors into private capital funds and the LTIF fund product is creating a new ability to create equivalent feeders for HNWIs in the EU. However, deploying these platforms does lead to additional lead-in times and, generally speaking, they are currently the preserve of larger managers given their relative cost and complexity.

The market is also seeing more family office investment, often focussing on climate and diversity-related funds, in many cases because family offices are less motivated by pure financial return than traditional institutions.

Embracing these developments was generally encouraged, with an acknowledgment of a need for caution given the likely increase in regulatory intrusion this trend will bring.

Some speakers identified the added risks and responsibilities attached to on-boarding HNWI investors, which pose a potential threat as well as an opportunity, given the on-going struggle with the US regulator.

Co-investments

An area of continued strong activity given the difficult fundraising environment is co-investment, with roughly 50 per cent of institutional investors seeking co-invest and the scale of co-investment becoming enormously greater.

Smaller managers are starting to offer co-invest too, to secure investor tickets in tougher fundraising conditions, but it is harder for them to absorb the no fee/no carry arrangements larger managers can accommodate as part of their investor relationship-building activity. Some managers are using co-investment vehicles and SMAs as part of a more customised approach to fund-raising and meeting diverse investor requirements.

Continuation funds

Continuation funds have historically served a useful purpose in managing tail-end assets and facilitating winding-up processes, but their uses have evolved in recent years, given their ability in some contexts to enhance distributed profits to investors (DPI).

In seeking investor buy-in to their use, it will generally be an easier sell where a particular asset warrants a longer holding period and/or where the fund is approaching its maturity. It will be a harder sell if used purely as a fund-raising tool or as a means of re-mixing good and poor performing assets to mask the performance of the bad. LPAC consultation on conflicts and fair value opinions are key elements too.

While the ILPA guidance in this area can assist in navigating investor interactions, a one-size-fits-all approach won't always work, and speakers generally agreed it was to avoid regulating continuation fund arrangements in fund LPAs given the circumstances driving their creation will vary and it is hard to reach a consensus amongst limited partners. Better to preserve the negotiation capital for other topics – the LPAC will need to be consulted in due course anyway.

When employed alongside primary fundraising efforts, continuation funds can prove a useful tool (as a 'stapled secondary' fund), although the SEC has expressed something of an aversion to stapled secondaries, which may eventually give rise to additional regulation in this area.

NAV facilities

NAV facilities (credit facilities backed by the fund's investment portfolio) remain a valuable tool, notwithstanding higher interest rates, given current levels of dry powder. But discussions at the event outlined that there is a mixed perception amongst LPs, with some in favour and some very much against.

Those against may fear their de-prioritisation upon distribution of divestment proceeds or question the fairness of carry being paid out on distributions funded by a NAV facility. But if a clear framework for permitted usage of a NAV facility is agreed and set out in the LPA (eg reserving its deployment for funding new investments or supporting distressed portfolio companies) and is clearly disclosed to investors, LPs are more likely to accept them.

Credit funds

In a vibrant credit funds panel, the speakers confirmed that credit funds are booming across all strategies (eg leveraged, CLOs, real asset financing) since the interest rate rise in 2022 and as banks have pulled back from direct lending.

There has been a noticeable shift into unitranche and first lien financing and not just mezzanine lending. Preferred equity stakes have also come into syndicated packages as banks have stepped back and interest rates have increased.

A general theme was the growing complexity and customisation of the credit fund industry. Amongst new trends is the desired creation of evergreen credit funds, something of a holy grail. In some respects this seems illogical – an illiquid asset class seeking redemption mechanisms similar to hedge funds - but it is happening. Panellists were seeing multiple series structures with different sleeves (some levered, some unlevered), variable fee mechanics and opt-out or opt-in rights when a series comes to an end of it fixed life.

As regards LPA terms, the relative complexity of tailored credit fund waterfalls (versus private equity waterfalls) was discussed, noting that the presence of varied assets throwing out regular distributions lends itself to customisation. Waterfalls also have to evolve to allow team incentive in evergreen scenarios.

As for the future, some panellists felt we had probably seen the interest rate high water-mark but were worried about the impact of hitting a refinancing wall before too long and the corporate stress that such a dislocation could create. Others were more optimistic, flagging the increased equity supporting portfolio companies these days, circa 60 per cent whereas it used to be around 40 per cent.

Transformative transactions - GP stakes and M&A

One panel focussed on the continuing uptick in transformative GP transactions, including sales of GP interests and GP mergers, querying whether the recent boom would continue or whether we are starting to see a saturated market. The panel consisted of some involved in acquiring stakes and some who've been part of an acquired or merged team.

It was confirmed that the market continues to be active, particularly for stakes in lower-mid-market firms (ie $500 million to $2 billion AuM GPs), with new acquisitive entrants in addition to the six or seven 'usual suspects'. Some buyers are strategic, others purely financial.

Whilst acquisition terms are settling, every deal is based on its particular facts and circumstances and what the seller needs and the buyer can provide, so it's not a commoditised product yet and there remains lots of scope for creativity.

By way of alternative fundraising methods for GPs, preferred equity and debt financing deals are also happening, with sponsors and advisors more comfortable with those structures now and the pool of industry finance players increasing.

Exit avenues for GP stakes are varied, including roll-ups into an IPO (with US listings considered easier than London) and some three to five year secondary deals. But the acquisition drivers can often be strategic and/or cultural and not purely financial – such as a need to build scale or institutionalise or to solve team succession issues and refine governance.

In terms of carrying through transactions smoothly, panellists stressed the importance of careful management of team communications throughout; of investor communications as investor approval is sought post announcement; of planning integration in advance of completion (so as to streamline the business, remove operational complexity and achieve cultural alignment across the team); and of making sure financial counterparties are carefully managed.

How advances in technology are shaping the market

The design of fund terms, including precedents and term sheets, along with the drafting of LPAs and side letters, often starting with precedents or initial drafts, are crucial aspects of fund management.

Sub-documents are increasingly being generated through logic-based e-platforms to streamline the process. Meanwhile, most-favoured nation (MFN) clauses in side letters are a standard consideration, and compliance with fund obligations is increasingly managed through databases and monitoring systems.

In an AI-focussed session at the event, the speaker cautioned that such advancements come with inherent risks, including data privacy concerns, intellectual property risks, and potential misuse of client data for AI training, raising information security and hallucination risks, and EU regulations may also further complicate matters.

Despite these technological advancements, it remains essential to maintain a failsafe approach, ensuring there is human oversight at the helm. The utilisation of AI in designing fund terms presents both security risks in input and reliability risks in output, emphasising the need for cautious implementation and continuous monitoring.

Private fund adviser rules

Another panel at the conference addressed the newly-adopted US Private Fund Adviser Rules. Panellists discussed how GPs are preparing for the compliance dates, the anticipated and ongoing impact on the industry and favoured approaches to the interpretive questions posed by the rules.

The ability to challenge adoption by regulator is built into the new Rules, which came into law August 2023. In September of the same year, a coalition of six US trade bodies representing hedge funds and private markets firms filed a suit against the SEC, alleging that the rules around disclosure are unlawful and harmful for the industry.

The conference featured a session led by Eugene Scalia, who is leading the case against the SEC. In this, he explained he is expecting a positive decision from the Fifth Circuit (on an expedited basis) in May 2024, and that the hopeful outcome will be that there is an absence of statutory authority for the SEC to adopt the rules.

The SEC recently clarified that in most cases the Private Fund Adviser Rules would not apply to advisers outside the US in respect of non-US private funds. As a result, at Mourant we have seen an uptick in clients exploring the mechanisms of migrating US fund vehicles to the Cayman Islands.

We have published a range of guides covering how an entity incorporated, formed, established or registered outside of the Cayman Islands may apply to be registered by way of continuation as an exempted company or a limited liability company in the Cayman Islands, or re-registered as an exempted limited partnership in the Cayman Islands (as applicable).

Environmental, social and governance (ESG)

In a panel session examining the legislative initiatives, investor preferences, and market dynamics that are shaping the role of ESG in the structuring, distribution, and operation of private investment funds, the speakers assessed the effectiveness of current strategies in managing conflicting intranational and international ESG obligations, along with the risk of a lasting market segmentation between pro- and anti-ESG investors.

ESG in the investment funds space has significantly evolved in recent years. There has been notable divergence between the European versus US approach, with some US states being proactively anti-ESG.

However, Europe too has experienced its own form of anti-ESG backlash on basis that it impacts competitiveness in global market, making Europe a less attractive place to do business. Particular support for this view has been from those heavily involved in agricultural and industrial sectors that have perhaps been hardest hit by the ESG agenda.

Europe has been at the forefront of ESG regulation, but European regulators have also acknowledged that sustainability-related disclosure in the financial services sector (SFDR) has led to some unintended consequences, such as an increase in green washing.

The funds sector has also seen an increase in the use of Delaware vehicles that are not subject to regulation rather than Luxembourg vehicles, or being used in parallel to a Luxembourg vehicle, with Delaware vehicle perhaps taking up investment opportunities that the Luxembourg vehicle can't.

Within the last six months, various US states have passed laws that prohibit investing with managers that boycott fossil fuels, for example. This presents a challenge to the idea of a unified sustainability regime in the US.

So where is this movement headed? The consensus at the event, and one we echo at Mourant, is that ESG is not going to go away. There is the possibility that we could get to the point where it is renamed in certain jurisdictions, and we may also get to point where firms have to take a position, even if that means that managers will need to leave money on the table in order to proceed.

The focus to date has been more on identifying ESG data from portfolio companies, such as their emissions and diversity quotas. The focus is now shifting towards questions on what the manager is actually doing to improve the position, and how they are engaging with ESG themes and showing progress between fund vintages (not just applying same risk mitigation approaches).

Get in touch

For further information or if you wish to discuss any of the issues covered in this update, please get in touch with a member of our Investment Funds team today.

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