FUNDS OF FUNDS

Conflict diamonds

What lies ahead for funds of funds? Consolidation in search of greater scale is inevitable – but more innovation is also needed, writes Cyril Demaria

GPs surviving the competitive pressure are the object of consolidation battles – hence 'conflict diamonds'

Demaria: *more consolidation to come*

PERSPECTIVES

In 2013, the funds of funds industry will charge between $4 billion and $8 billion in management fees (assuming fee levels of between 0.5 percent and 1 percent). Of the 168 active managers (excluding public and purely captive operators) we have counted, 157 provide data about their assets under management, year of inception and breadth of expertise (see Table 1). They collectively manage an estimated amount of $818.2 billion; median assets under management are $2.1 billion (the average is $5.2 billion).

Assuming a return on assets under management of between 1.1x and a 1.2x, carried interest (of 5 percent to 10 percent, no hurdle rate computed) should reach $4 billion to $8 billion in total. For the median manager, management fee income will be between $10.5 million and $21 million (assuming same fee levels). As such, these managers are attractive targets, given the recurrence of the cash flows over a 13-15 year period.

CONFLICT DIAMONDS

Indeed, the fund of funds industry is at the forefront of the much-vaunted consolidation in private equity, which seems to have plenty of room to continue. GPs surviving the competitive pressure (the 'diamonds') are the object of consolidation battles – hence 'conflict diamonds'.

Among the issues to resolve, the most pressing (beyond the lack of convincing track record) are a lack of critical mass of assets under management; and/or a lack of international reach, which prevents GPs from offering a compelling expertise to limited partners already well-informed about mature markets.

To address this, three strategies are currently at play (in some cases all at once).

The first is organic growth through a branding push, focusing on brand control and direct management of distribution, to address the institutional market.

Retail is the next frontier for organic growth: some estimates suggests retail funds could reach 25 percent of the overall capital raised for alternative investments by 2015, due to:

i) the retreat of banks (with exceptions such as Rothschild and Pictet) from private equity due to regulatory pressures (Volcker Rule) or cost of capital (Basel III);
ii) a thirst for income from distributors of products;
iii) a lack of simple products yielding sufficient income for clients, both for the intermediary and for the product provider.

However, few players know how to address the retail market. The US, UK and France could be mature enough: US BDCs (business development companies), UK VCTs (venture capital trusts) and French FCPI/ FIPs (fonds commun de placement dans l'innovation/ fonds d'investissement de proximité) may be ill-adapted – they're too risky, too 'sticky' and too keen to register losses – but they have educated local retail clients about private equity.

The second strategy is opportunistic growth, i.e. acquisitions of structures or portfolios, combined with economies of scale and a verticalisation of the value chain – as evidenced by the Blackstone Group's acquisition of Credit Suisse Strategic Partners, or the Carlyle Group's acquisition of Alpinvest.

European and North American GPs (who dominate the market in terms of number of GPs and average assets under management, as well as the degree of diversification of the offering) have deployed significant efforts along these lines. Asian GPs are rather close to Europe in terms of years of experience and degree of diversification, but manage less than half the average amount of assets as their counterparts in Europe/ North America. They could be the next consolidators, particularly as they deal with a regional slowdown.

The Middle East, Africa and Latin America are potential target areas: the number of years of manager experience in these regions is rather limited (one to two business cycles, versus three to four for Europe and North America) and their level of assets under management is low – although this could be compensated by a rather high level of diversification, particularly in MENA.

ARTIFICIAL DIAMONDS: PRODUCT STRUCTURING

Although maturing, the private equity market in effect demonstrates a traditional polarisation between niche GPs (high expertise, limited assets under management) and very large GPs (large offering, significant assets under management). Actors in the middle of the spectrum can only rely on differentiation: the degree of diversification of their offering is a determining factor of their future. Positioning innovative products and solutions is their way out of the standardisation squeeze.

The third strategy, therefore, is to tailor products so that they meet the increasingly diversified needs of potential clients. This requires expertise in product structuring. Few players have the clout to offer exposure to niche geographic markets or strategies (e.g. venture lending, turnaround/distressed debt in Europe/Asia, or high yield). The focus is hence on institutional clients' need to deal with solvency and prudential issues (AIFMD, FATCA, Basel III, Solvency II, EIORPA II etc.). Thus far, this has been a missed opportunity for GPs to lobby for greater recognition of their risk diversification benefits. But product structuring has the potential to get around this by using financial instruments to meet LP needs (via guaranteed capital, for example).

So the field of experimentation is clear. In the fund of funds industry, the stage is set for the next evolution of the private equity market – which will be all about consolidation and innovation.

Hence the two main parameters are risk (largely defined by regulations, with different emphases such as liquidity, market, currency and feeding formulas through value-at-risk reasoning); and return (defined by liabilities, as for pensions, or by cost of equity). Secondary parameters are costs (a function of declining marginal returns in private equity); and illiquidity (a function of risk analysis and regulatory models that are ill-adapted to private equity). Product structuring can partially solve some of these questions by using leverage to enhance fund of funds returns. ■

TABLE 1: GENERAL PARTNERS OF PRIVATE EQUITY FUNDS OF FUNDS

REGION OF GP HEADQUARTERS	NUMBER OF GPS	AVERAGE YEARS OF ACTIVITY	TOTAL ASSETS UNDER MANAGEMENT ($BN)	AVERAGE ASSETS UNDER MANAGEMENT	AVERAGE DEGREE OF DIVERSIFICATION OF OFFERING*
Asia-Pacific	15	12.4	29.3	2.0	2.9
Europe	67	13.7	374.9	5.6	3.1
Latin America	2	4.5	0.6	0.3	2.0
Middle East Africa	4	8	2	0.5	3.8
North America	69	16.6	411.5	6.0	3.0
TOTAL	157	14.6	818.2	5.2	3.0

* Counts as a degree of diversification: PE FoF primaries, PE FoF secondaries, co/direct investments, gatekeeping/advisory, wealth management advisory, other investments capacity.

Source: AltAssets, Preqin, Thomson Reuters, FindTheBest, Towers Watson, company websites, Author (2013).

> **The most pressing [issues] are a lack of critical mass of assets under management; and/or a lack of international reach**

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