KEYNOTE INTERVIEW

Democracy in action

Managers looking to diversify their AUM should renew their focus on democratised structures, say Travers Smith's Will Normand and Leigh Stockey

Q What developments are you currently witnessing around the democratisation of private equity?

Will Normand: We are seeing democratisation driven by demand from both investors and managers. This is manifesting in a number of ways, but one key theme is that, on the investor side, wealth management platforms – particularly the largest pan-European platforms – are pushing for evergreen, semi-liquid structures. On the manager side, these structures also appeal because of the potential to tap into an expanded investor base.

It's worth noting, however, that generally (with some significant exceptions) alternatives managers launching these products are focused on wealth management platforms. These managers then aggregate their underlying client subscriptions, rather than the management houses marketing directly to retail investors themselves.

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All this is not to say that wealth management platforms' clients (broadly high-net-worth investors) have not previously had some form of access to private equity vehicles – they certainly have, but this tends to be through feeders for mainstream products. These can prove difficult in terms of things like managing capital calls, which can be complex to administer. They also frequently don't like being tied into 10-year products, but that has been their only means to get exposure to these assets.

We are now at an inflection point where we are talking about so much capital in this space that it is worth managers designing products specifically for these clients.

Leigh Stockey: As well as the volume of available capital in this space, which Will has mentioned, the wider economic backdrop is also playing a part. Managers are looking for different ways to diversify their assets under management, while investors are considering current pressures to balance allocations between public and private markets as the public market valuations are challenged.

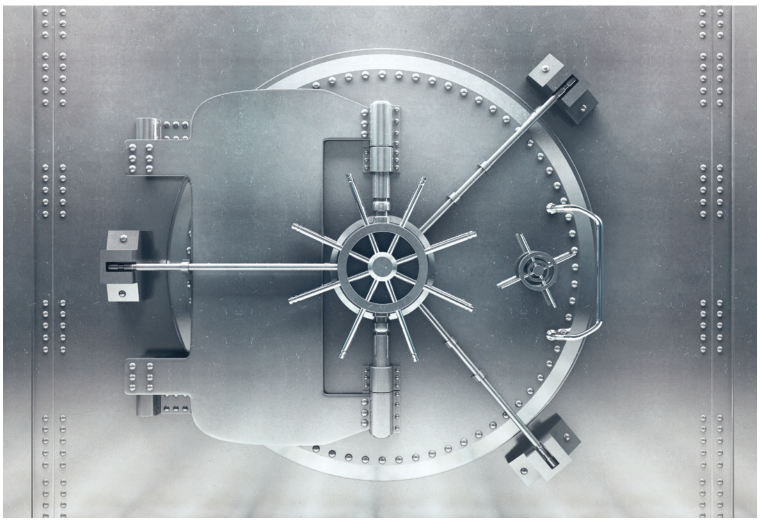
At the same time, the European market is trying to catch up with what has been going on in North America and Southeast Asia for some time, where these types of structures are more embedded – particularly in the US, where the broadening of access to private equity by company-sponsored employee retirement plans proved to be a strong catalyst for new products. So, unsurprisingly, we're seeing a selection of the largest global alternatives managers pursuing these kinds of structures, responding to requests from some of the largest global wealth platforms.

Q What is happening in the broader industry that will affect the democratisation trend?

Will Normand: There has been a lot of focus recently on the Blackstone Real Estate Income Trust (REIT), which is essentially the US equivalent of the semi-liquid evergreen structures Leigh has described. The $69 billion unlisted REIT makes up a material percentage of Blackstone's global earnings, and its success and scale has been held out as a model that other managers are keen to replicate. However, the decision by Blackstone in December to apply a cap on withdrawals after a surge in redemption requests raised questions about the structure.

The Blackstone REIT lets investors out up to a cap of 5 percent of quarterly net asset value, which means it can take up to five years to fully exit. Up until now, the fund has seen such significant inflows that redemption has not been a problem.

Leigh Stockey: It has always been clear that the Blackstone REIT is not a daily dealing fund with a full right to immediate redemption – it is a real estate fund with illiquid property holdings, so to suggest that there is something wrong with the assets simply because people are redeeming is entirely wrong. This is all very different to your traditional open-end fund, which tends to shut the gates entirely and stop anyone from redeeming if too many requests are received. As such, the fund is doing what it says on the tin; some of the commentary around this seems to be happy to ignore that. It is, though, a lesson for investors in these products: understand that you are coming into a limited liquidity product, which is the trade-off for exposure to a primarily illiquid strategy.



Q How do you see the democratisation trend evolving over the next 12 to 18 months?

WN: There is certainly space in this market and in these products for democratisation to percolate further; it may trickle down to managers that are perhaps not the size of the global top 20 by AUM, but are nevertheless very substantial players in the geographies in which they operate. Equally, on the demand side, we will probably see more localised wealth managers beginning to consider these products, because they need to generate returns for their investors by getting them access. Those regional players see their larger competitors getting into these, and they want to understand and get involved.

There is a natural floor to the use of these structures, however; this is predominantly based around resources and pipeline. Managers looking at them have to understand they are potentially getting monthly subscriptions that are paid in full, rather than contractual commitments to draw cash when required. That means they have quite a lot of capital to deploy, potentially on a continuous basis, and of course, any delay in deployment will impact performance. While it is always possible to stop accepting subscriptions, that is not going to be popular.

So that need for dealflow has to be factored in versus keeping returns in your institutional funds up at a level that keeps investors happy. Coller Capital's winter 2022-2023 Global Private Equity Barometer survey asked institutional investors if they were concerned about returns being impacted by these structures. They said yes, they were worried about pipelines being spread too thin. These vehicles really only lend themselves to houses of scale.

These are also quite complicated products, and wealth management platforms need to fully understand what they are signing their clients up to. That suits the larger players, but not independent financial advisers on the high street. These products also won't be appropriate for all investors. Distributors especially, but also manufacturers, need to take their product governance obligations seriously. So there is a natural limit to how far this can – and, indeed, should – go.

Q Is there an ESG angle to these structures?

LS: That is an evolving area. With the recent incorporation of sustainability preferences into the MiFID II suitability assessment, we think managers will come under pressure from the investor side to actively consider ESG issues in the construction of these funds. Wealth managers are likely to push for fund managers to badge their products as Article 8+ with some minimum commitment to sustainable investments, or, for impact strategies, Article 9 to avoid their clients being precluded from products as a result of their sustainability preferences.

Even that may not be sufficient: there may also be pressure on managers to opt into consideration of Sustainable Finance Disclosure Regulation 'principal adverse impacts' and to commit to at least some level of taxonomy alignment. However, such pressures are likely to be less intense – and more easily resisted – in private fund strategies than they are in public funds.

Q What developments do you see in other retail products?

WN: Managers need to remember that this isn't the only way to get these investors into a fund, even if it is the most likely way they will do it at scale. There are still traditional master-feeder and listed investment company structures, and there are other routes to diversification of the investor base.

Recent amendments to the European Long-Term Investment Fund (ELTIF) regime are likely to make those vehicles more attractive, for example. The ELTIF is an alternative investment fund with a full retail European marketing passport. It is not open-ended, but there is some ability to put limited liquidity features into it.

The new rules will broaden the scope of eligible investments, relax some of the restrictions on borrowing, clarify the conflict rules and set out a framework for fund of funds strategies. Still, managers have to pick and choose the right strategy and the right underlying asset mix to make the structure work.

There are some jurisdictions where wealth management prefers the lower subscription level that an ELTIF can offer – for example, in Spain or Italy – so we might see more ELTIFs being launched with a specific focus on clients in jurisdictions such as these.

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LEIGH STOCKEY

LS: The other development is the UK's Long-Term Asset Fund (LTAF), which was primarily designed to encourage UK defined contribution pension fund investment into UK infrastructure assets. So far, that has not lived up to what was hoped, in part because of the hurdles for both managers – many of whom would need to apply for additional FCA licences – and the DC pension scheme industry as a whole, whose platforms rely on daily pricing. There is also an ongoing consultation with the UK government around removing the charge cap restriction for "well-designed" performance fees, which will need to be addressed to make the LTAF viable.

Ultimately, the impediments are being removed, but there is still something of a mindset shift required before that capital starts flowing in any significant way into alternatives. In particular, notwithstanding the proposed changes to pension funds' charge cap rules, DC scheme allocators may still be unwilling to pay carry or performance fees at a level that is typically acceptable to the wider institutional investor market.

You then have a degree of repurposing of the LTAF to allow for retail distribution, subject to certain limitations. We will see some fund managers that already have a fund range based around retail distribution branching out into LTAFs. That said, our sense is that very few traditional alternatives managers want to invest in the required infrastructure and authorisations to directly target truly 'retail' investors. ■

Will Normand is a partner and Leigh Stockey is a senior counsel in the funds department at Travers Smith