

LP-GP SURVEY

NOVEMBER 2011

KEY MESSAGES

As markets adjust to the new reality shaped by the global financial crisis and its aftermath, the time has come to assess the ongoing impact on the LP-GP relationship. The overarching question is: what lessons have LPs and GPs learnt from the crisis?

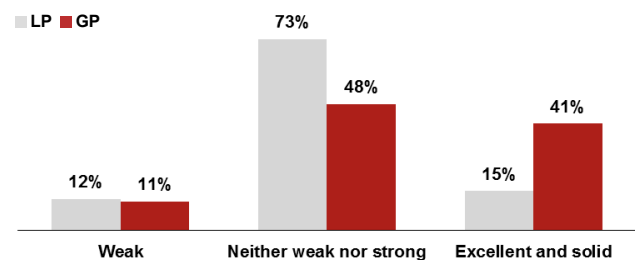
RELATIONS

The LP-GP relationship shows signs of stabilising at an intermediate level, with fewer LPs or GPs than in 2010 describing relations on many measures as either “good” or “bad”.

- **Relatively stable LP-GP relationship** – Just over a tenth of both GPs and LPs believed the relationship was weak, with 15% of LPs stating that the relationship had deteriorated over the last year. Most respondents however believe the relationship is relatively stable – around 65% of respondents, evenly split, believed the relationship had stayed the same over the last year with c.75% of LPs and nearly 50% of GPs describing the relationship as neither weak nor strong. A quarter of GPs do however believe the relationship has improved, although fewer LPs believe this to be the case (18%)
- **GPs are more positive on the whole** – 41% of GPs described the LP-GP relationship as excellent and solid while only 15% of LPs agree

- **The IR process has improved** – c.60% of LPs and c.40% of GPs believed that the IR process has improved in the last year, which continues last year’s trend. Only a small minority (c.5%) of either set of respondents believe the IR process has become less effective

How would you describe the LP-GP relationship?



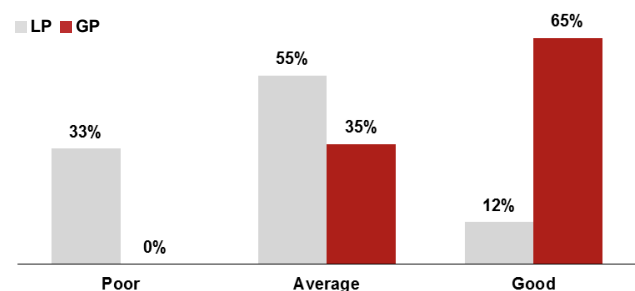
COMMUNICATIONS

Communications remain difficult.

In line with last year’s results, despite being in agreement on the importance of communication, both sets of partners disagree on the quality, with each partner overrating their own communications.

- **LPs and GPs agree that the quality of communication is very important** – 91% of LPs and 100% of GPs agree or tend to agree that communication is an important factor for an LP’s decision to invest in a fund
- **However, GPs continue to overestimate the quality of their communications with LPs** – LPs continue to rate GPs’ communications as average to poor, while a majority of GPs believe that it is strong
- **The need for clearer communication is not confined to GPs** – over a quarter of GP respondents believe that the level of feedback they receive from LPs is poor

In the last year, how would you rate GPs’ communications / your communication regarding underperforming investments?



TERMS

Terms remain an area of disagreement with strongly divergent views.

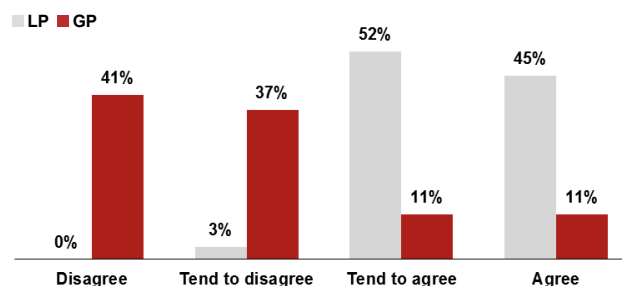
LPs continue to strongly believe that fee structures encourage imbalances between LPs and GPs, while GPs tend to believe the reverse.

- **Fee structures are generating more disagreement than ever before** – 97% of LPs believe that fee structures remained a problem to some degree compared to only 22% of GPs. LP sentiment on this point is growing stronger with nearly unanimous agreement this year compared to 89% last year. On the other hand, GPs appear to be gravitating in the other direction with 41% of GPs disagreeing fully that fee structures can cause divergence compared to only 28% last year
- **Views on investor protection clauses remain poles apart** – most LPs view these clauses as adequate to weak, with only 3% believing they are strong. This does represent an improvement on last year, where no LPs described investor protection clauses as strong, and 63% described them as weak. In contrast, the GP views on this subject are in line with last year, with the majority of GPs (78%) believing the clauses are adequate, and more GPs describing the clauses as strong rather than weak (15% vs. 7%)
- **Skin in the game is crucial** – 91% of LPs agree or tend to agree that GPs should invest more in their own funds – in line with last year. There are encouraging signs of consensus on this point with GPs increasingly

recognising the importance of their commitment as 85% of GPs agree or tend to agree compared to only 53% last year

- **As with last year, both LPs and GPs believe that advisory committees could be more codified** – 85% of LPs agree or tend to agree that the powers and duties of advisory committees need to be codified to ensure consistency and transparency. 74% of GPs agree or tend to agree. More LPs and GPs agree with this point to some extent this year compared to last year, suggesting that this continues to be an area for development

Current fee structures cause a divergence between LPs and GPs.



NOTE ABOUT METHODOLOGY

Acanthus interviewed senior personnel at LPs and GPs in Europe and the US, receiving 60 responses, of which 33 came from LPs and 27 from GPs.

The survey included 16 questions and statements, to which the recipients were asked to select the response which corresponded with their view. In addition, the recipients were also asked to respond to two open-ended questions.

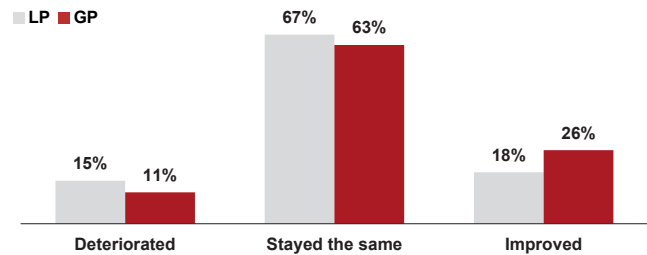
RELATIONS

1 In the last year, LP-GP relations have:

The majority of both LPs and GPs stated that LP-GP relations stayed the same over the last year. This indicates more stability over 2011 compared to 2010, when fewer LPs and GPs believed relations had stayed the same.

It is important to note that the relationship shows signs of stabilising at both ends of the spectrum – fewer LPs and GPs believe the relationship has either improved or deteriorated compared to 2010. In 2010, 35% of LPs believed relations

had improved over the last year – this has dropped to 18% in 2011. That said, only 15% of LPs this year vs. just over a quarter last year believed relations had deteriorated. GPs on the other end remain more optimistic – with over a quarter believing that relations had improved (higher than the 20% of GPs that answered the same last year) and only 11% believing that relations had deteriorated compared to nearly 30% in 2010.

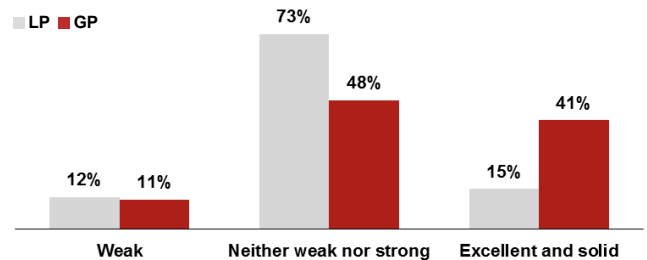


2 How would you describe the LP/GP relationship?

Nearly three quarters of LPs and half of GPs see their relationships as neither weak nor strong. 41% of GPs see relations as excellent and solid but only 15% of LPs agree.

Interestingly, more GPs

describe the relationship as weak this year (11%) compared to 5% last year. Fewer LPs describe the relationship as solid this year (15%) compared to 27% last year.

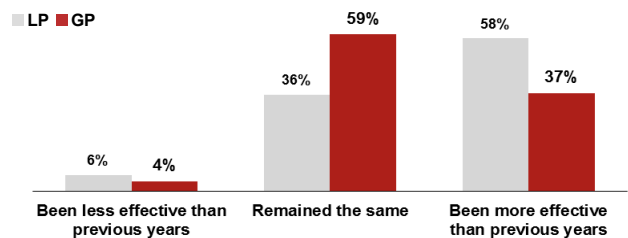


3 In the last year, the investor relations process has:

There is a general continued improvement in the investor relations process with 58% of LPs and 37% of GPs responding positively. Interestingly, as was the case last year, there are more LPs than GPs who say the investor relations process improved, perhaps a function of the fact that they are often

the recipient of the information flow.

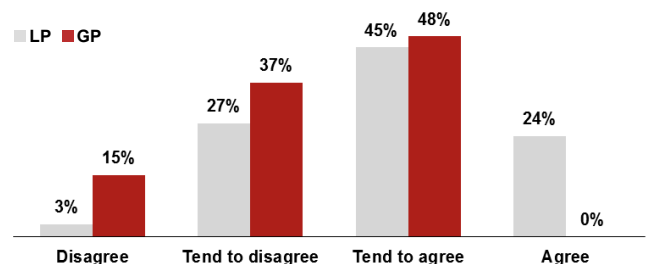
Some 36% of LPs and 59% of GPs saw no difference in the effectiveness of the investor relations process. Only a very small number of respondents saw the investor relations process as being less effective than in previous years.



4 LPs contribute significantly more than money:

70% of LPs and 48% of GPs agree or tend to agree, with the GPs showing more ambivalence as none fully agree. Over half the GPs disagreed or tended to disagree. Only 30% of

LPs disagreed or tended to disagree, which is a substantial decrease from 50% last year, showing that agreement amongst LPs on their non-fiscal contribution is growing.



TERMS & PROCESS

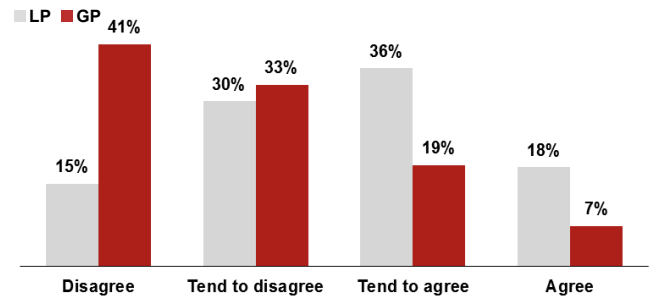
5 Should LPs involve themselves in key GP personnel issues?

Three quarters of GPs disagree that LPs should involve themselves in key GP personnel issues.

In contrast, LPs are almost evenly distributed between believing that they should be involved in key personnel

issues and those that believe the opposite.

This issue elicited a similar response last year, with the GPs overwhelmingly indicating resistance to LP involvement in personnel issues and LPs split roughly down the middle.



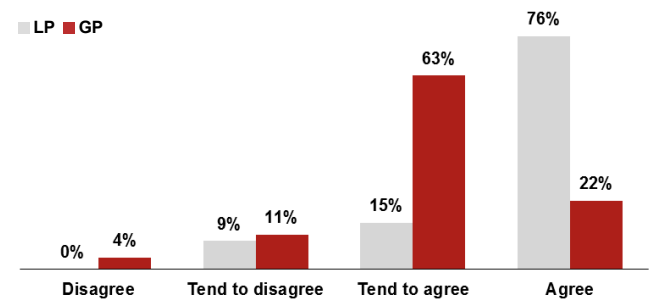
6 GPs should invest more in their own funds:

In line with the 2010 results, 91% of LPs agree or tend to agree that GPs should invest more in their own funds.

Interestingly, 76% of LPs agree fully (and none disagree), which is over three times higher than the proportion of GPs that fully agree. In essence, LPs hold far stronger views on the subject

than GPs.

However, GPs appear to be increasingly recognising this as an area of importance. Only 15% of GPs disagreed or tended to disagree in 2011 compared to nearly half in 2010, suggesting that while LPs continue to hold stronger views on this topic, there is evidence of convergence.

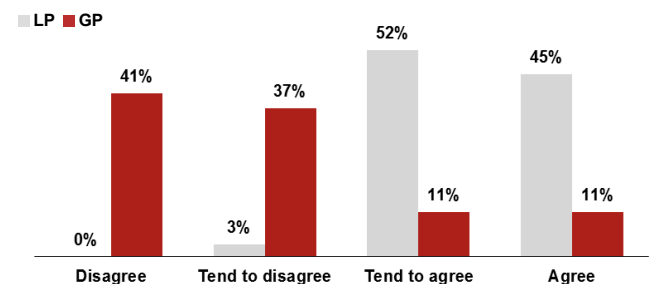


7 Current fee structures cause a divergence between LPs and GPs:

The overwhelming majority of LPs agree or tend to agree that current fee structures are a cause of divergence, as was the case in 2010. However, GPs do not share this view, with 78% of managers responding that they disagree or tend to

disagree that the fee structure causes a divergence of interest.

Interestingly, GP opinion on this matter has become more explicit, with 41% of managers disagreeing fully compared to only 28% last year.

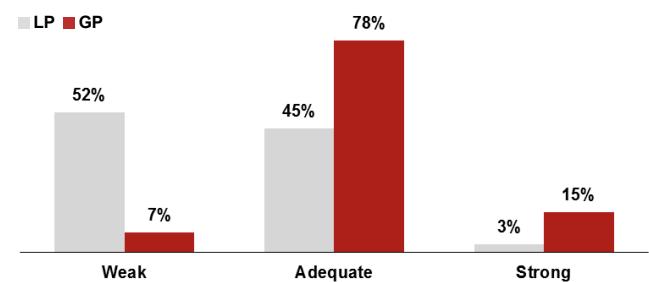


8 Investor protection clauses are generally:

Over half the LPs surveyed believe that protection clauses are too weak, whilst only 3% of the LPs asked believed that protection clauses were strong. Less than half the LPs surveyed believed that the clauses were adequate, indicating continuing perceived

vulnerability by LPs.

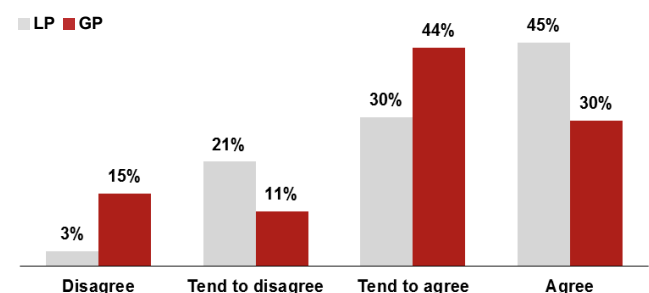
On the other hand, in line with last year, 93% of GPs believe that current protection clauses are adequate or strong, which indicates that the divergence between GPs and LPs over protection clauses has not been bridged.



9 The powers and duties of Advisory Committees need to be codified to ensure consistency and transparency:

The majority of LPs and GPs agree or tend to agree that the powers and duties of Advisory Committees need to be codified to ensure consistency

and transparency. GP opinion on this matter has intensified, with 30% of GPs this year fully agreeing compared to only 9% of GPs last year.



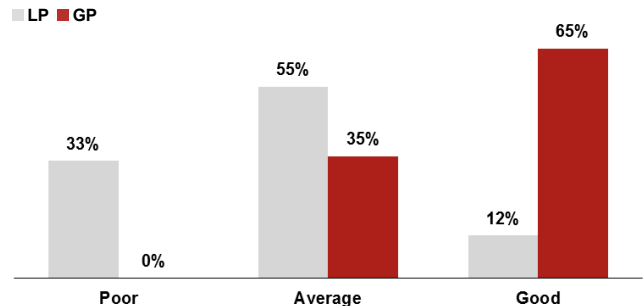
COMMUNICATIONS

10 In the last year, how would you rate GPs' communications/your communication regarding underperforming investments?

Only 12% of LPs thought that communications were good regarding underperforming investments, which is even lower than in 2010 (19%). Conversely, 65% of GPs believe that their communications on this topic have been good, clearly illustrating that GPs overestimate the quality of

their communications with LPs.

This message is a continuation of the findings in the 2010 survey. This year, 33% of LPs described the communications regarding underperforming investments as poor, which is marginally higher than the 27% of LPs that shared this view in 2010.

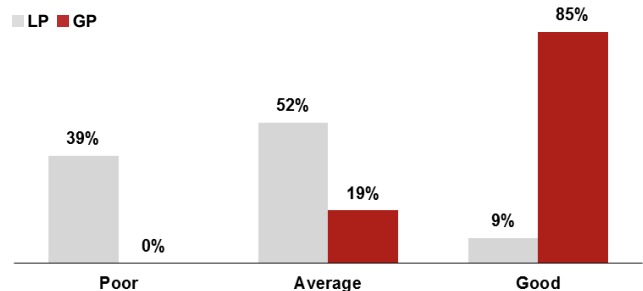


11 In the last year, how would you rate GPs' communications/your communications regarding changes in team size, new hires and departures?

The overwhelming majority of GPs responded that their communications regarding team changes were good, while only 9% of LPs agreed. This perception differential is even more pronounced this year compared to the last.

39% of LPs describe com-

munications on team changes as poor, while no GPs agreed. These results indicate a potential deterioration in communications on this topic compared to last year, when a smaller proportion of LPs (26%) described communications as poor and 5% of GPs agreed.

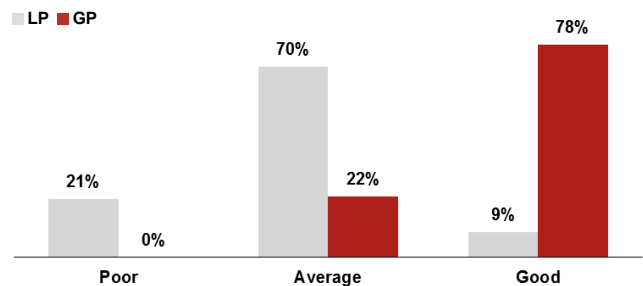


12 In the last year, how would you rate GPs' communications/your communications to LPs regarding changes in investment strategy?

Continuing the trend indicated in the previous questions regarding LP-GP communications, LP-GP beliefs regarding communications on changes in investment strategies also indicate a wide divide. 78% of

GPs believe communications are good but only 9% of LPs agree.

In contrast, 21% of LPs responded that communications are poor, with no GPs sharing their view.

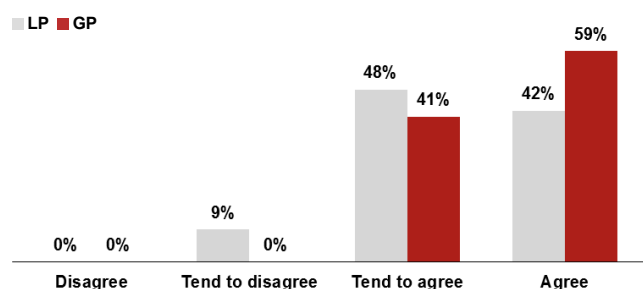


13 The quality of communications is an important factor in our/an LP's decision to invest in a GP's fund

Despite the apparent contradictory views on quality of communications, both sides are in agreement on their importance: 91% of LPs and 100% of GPs agree that the quality of communications is

an important factor in an LP's decision to invest in a GP's fund.

No LPs and GPs disagree with the comment, reinforcing the importance of open dialogue.

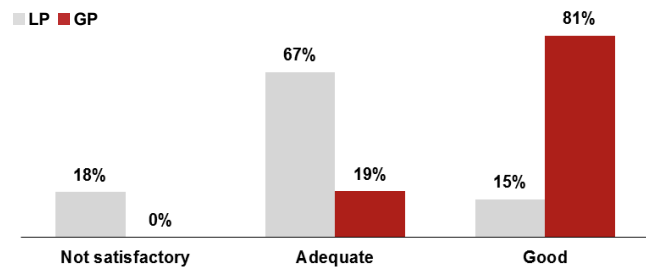


MARKET DISLOCATION

14 The level of reporting provided to LPs is:

Interestingly, 81% of GPs responded that the level of reporting they are providing to LPs is good, compared to only 15% of LPs. LPs largely believe

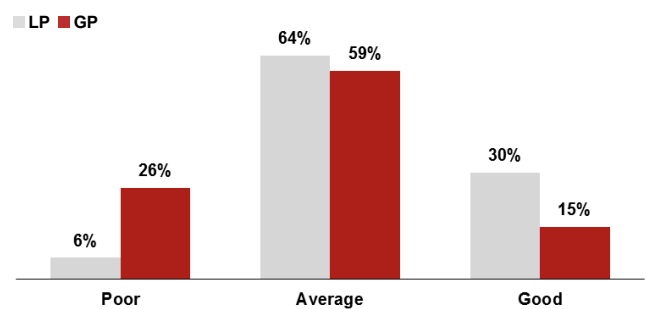
that reporting is adequate and a marginally higher proportion believe that it is not satisfactory rather than good.



15 In the last year, how would you rate the clarity and effectiveness of feedback from LPs to GPs?

LPs overestimate the quality of their own feedback to GPs, with double as many LPs than GPs rating their communications as good. At the other end of the spectrum, over a quarter of the GPs responded that LP feedback is poor, while only 6% of LPs agreed.

Considering the results when evaluating GP communications, this indicates that both parties appear to overrate the quality of their communications and reinforces the need for more candour from both sides given the bilateral nature of the relationship.



WHAT LPs ARE WORRIED ABOUT

This year's survey indicates that the area of greatest concern for LPs is whether GPs have in fact learnt and absorbed lessons from the global downturn or whether these have already been forgotten. The improvement in markets sustained over 2010 and the first half of 2011 has, in the eyes of some LPs, led to a recurrence of "top-of-the-market" behaviour from GPs, including highly priced and highly leveraged deals.

Moreover, many LPs worry that GPs act mainly out of self-interest and are rushing to "deploy capital" rather than "make good investments" so they can raise successor funds. There are concerns that the substantial and rapidly expiring dry powder in the market is damaging pricing discipline, with entry multiples in some markets reaching pre-crisis levels, and resulting in adverse deal selection.

Fees continue to be a major sticking point. Most LPs believe

that the current and historic fee structures produce misalignment on a fundamental level and are far too costly. As a result, we are seeing increased focus from LPs on direct and co-investments.

There is also a general recognition that some managers will not raise successor funds, and thus there are concerns about the instability this might cause. Amongst the managers that continue in the market, some LPs note that differentiation between fund propositions is often lacking. LPs may seek to remedy this by investing in newer markets, but equally there is trepidation that too much capital is being sought in emerging markets by teams with very limited prior experience.

WHAT GPs ARE WORRIED ABOUT

The greatest area of concern of GPs with their existing LPs is how they are reacting to the fall-out from this crisis. Many GPs note an increasing propensity of LPs to seek more control on internal processes

such as investment strategy and team issues, which can potentially paralyse managerial decision-making at the very times when decisiveness is required.

Perhaps the greatest worry overall is the perceived lack of funds from LPs including for re-ups, which can stem from a number of factors. For one, the trend towards portfolio consolidation will certainly mean that the numbers will simply not add up the way they used to. GPs also worry that LPs may choose to commit less to the asset class as a result of regulation that makes it less attractive to do so. Further, GPs are concerned that LPs are looking to move away from the traditional closed-end structures with many increasingly trying to access dealflow directly or through co-investing.

Overall, GPs feel that the decision-making and communication processes of LPs are too protracted, and result in more bureaucratic and less commercial investment decisions, especially given high risk averseness post-crisis.

CONCLUSION

To paraphrase the Bank of England Governor Mervyn King, 2011 has been the year of the “reluctant recovery”. There have been a number of very successful oversubscribed fundraisings which may have led some to believe that it is back to business as usual between LPs and GPs. However, it can be argued that these fundraisings took place in a specific window of time when a number of high quality managers returned to market and when LPs were under-allocated, many having abstained from investing over the crisis. The fact is that a far greater number of managers have struggled on the fundraising trail, and even more have yet to return to market.

The market dislocation caused by the global financial crisis over 2008-2009 has unearthed a number of uncomfortable realities about the LP-GP relationship and the limitations of historic arrangements. The movement towards greater transparency and alignment, spearheaded by the ILPA principles, is an irreversible trend that should result, if properly executed, in greater balance between both partners – we are already seeing evidence of this.

Overall, the two most important areas for improvement in terms of alignment appear to be GP commitment and fees.

The fee issue is most relevant to the larger end of the market where larger fund sizes may have produced fees that are substantially surplus to budgetary requirements. The GP commitment is relevant to all, although perhaps more so in the small-to-mid cap segment of the market, as it can enhance team retention and stability. GP commitment must always be commensurate to the wealth of the team, and there is little doubt that the historic standard must be raised for teams that have earned significant carry on previous funds. From the LP viewpoint, the GP commitment serves as an important safety valve – when times are good and the focus is on the upside, carried interest is a sufficient motivator and aligner. When times are tough and perhaps carried interest is no longer a prospect, the GP commitment can help ensure that all steps are taken to mitigate the downside and recover cost.

That said, a lot of emphasis is often placed on the areas where GPs can better align themselves, and not quite enough is said about the LPs. The LP-GP relationship is inherently bilateral and so optimal alignment can only be achieved through an iterative process of engagement and feedback from both sides.

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