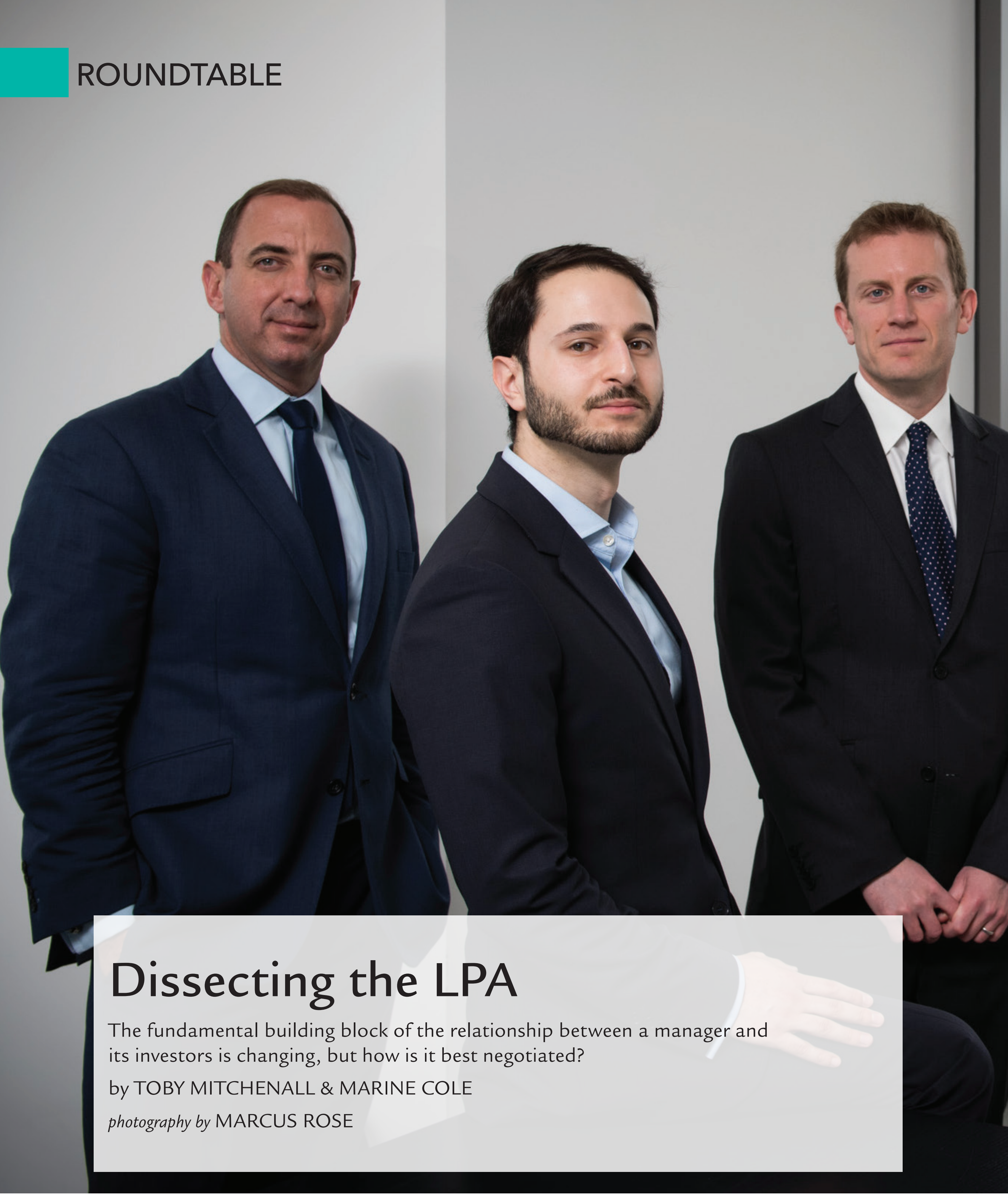


Dissecting the LPA

The fundamental building block of the relationship between a manager and its investors is changing, but how is it best negotiated?

by TOBY MITCHENALL & MARINE COLE

photography by MARCUS ROSE

From left: Nigel van Zyl, Proskauer; **Andrew Panayides,** Duke Street **Michael Lampshire,** Actis

The limited partnership agreement is not a static document. It has evolved since the early days of private equity, adapting to general partners' changing practices and limited partners' demands.

Whether it's because of the ubiquity of subscription lines of finance, the rise of co-investments, the impact of the secondaries market on funds' lives or the consequences of regulatory oversight, the LPA has changed.

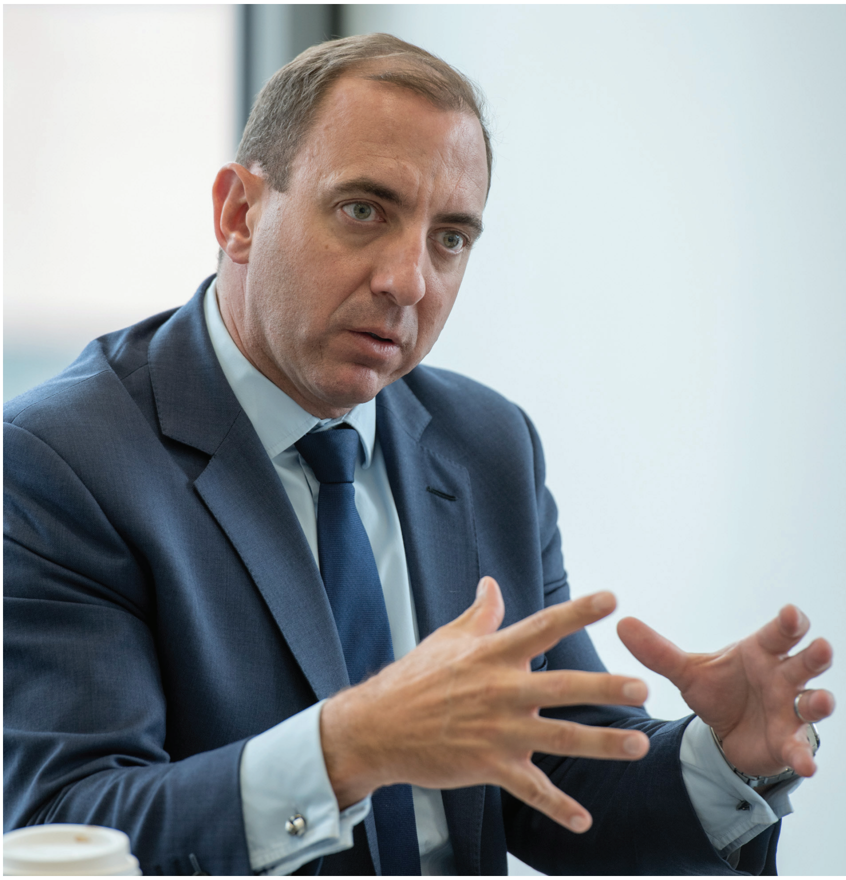
In April, *pfm* gathered an attorney and two GPs in London to discuss how different parties negotiate the document that has become the foundation for fundraising and dictates the relationship between GPs and LPs.

They all agreed the most successful situations are those in which the document isn't imposed on anyone, where it makes sense from a commercial sense to all parties and where the GP clearly explains the intention behind any changes.

"If you're sending a red-lined copy of the previous LPA to an LP, that should be preceded by a note explaining what the changes are and why you're making them," says Andrew Panayides, general counsel at Duke Street.

"It is important to inform your LPs what your objectives are. If you manage that process correctly and you're speaking to your LPs, you should find less aversion to your proposals."

Nigel van Zyl, a partner at Proskauer, admits different external counsels have different approaches to how they



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Nigel van Zyl

guide their clients through an LPA negotiation process.

"I think the view that I take personally is the negotiation process on a fund will last a couple of weeks or a couple of months, but what we are building is a 10-year relationship. We have seen occasions – we act for both LPs and GPs – where the external counsels have conducted the negotiation process in such a bruising way that it's damaged the LP/GP relationship."

"We want our GP clients and investors to come out of a process thinking that it was fair, transparent and well-run," he says. "I think external counsels can often help set that tone or damage that tone."

One area where negotiations have significantly evolved in recent years is fund finance.

An increasing number of GPs use subscription lines of credit for diverse reasons, including bridging capital calls or boosting performance.

Actis, for one, uses lines of credit. One of the reasons they are important to the firm is their ability to limit the number of capital calls, particularly in relation to investment strategies that deploy capital incrementally over a long period of time such as its real estate development and its energy buy-and-build strategies.

"A bridge facility can be a helpful way to reduce the number of capital calls on LPs and ease their administrative burden," says Michael Lampshire, director of funds legal at Actis. "During the closing period of a fund, a bridge facility can also be helpful to avoid multiple equalization drawdowns and distributions as new LPs come into the fund."

Duke Street on the other hand doesn't typically use subscription lines of credit. "Our LPs prefer to avoid using bridge facilities but we do have flexibility to use them in certain circumstances," Panayides says.

There's a great divide on the topic, not only between GPs and LPs, but also among LPs.

Some LPs embrace the increased internal rates of return, particularly if their compensation is IRR-based, while others vehemently oppose it, see it as a risk issue and think it artificially accelerates the carry point. The latter type typically cares more about money multiples – which are slightly eroded by the use of credit facilities – than IRRs, which are slightly boosted.

The proliferation of credit lines among private funds has prompted a dramatic expansion in the number of provisions in the LPA covering borrowing.

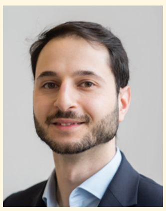
"Your borrowing provisions in the LPA in some cases are almost a page long now," says van Zyl, attributing it to more complex security packages, larger borrowed amounts and longer durations, but also to banks and private lenders becoming more sophisticated in how they determine the credit rating of each investor.

He explains that as lenders are requesting more information to identify investors' creditworthiness, "a lot of investors are pushing back against that, so now you have provisions in the LPA that say you can't give information that's not in the public domain. The drafting on all of that is becoming longer, more fulsome."

AROUND THE TABLE

Nigel van Zyl Partner – Proskauer
Van Zyl advises GPs on all aspects of their fund business, including the formation, raising, maintenance and ongoing operation and compliance. He also represents institutional investors such as funds of funds, sovereign wealth funds and global asset managers, and buyers and sellers of secondaries fund interests.

Michael Lampshire Director, funds legal – Actis
Lampshire joined Actis in 2015 and previously served as legal counsel at Campbell Lutyens and as an associate at Clifford Chance. Actis, which was founded in 2004, is a leading investor in growth markets in Africa, Asia and Latin America across several asset classes including private equity, energy, infrastructure and real estate. It has raised around $13 billion since inception and has deployed over $7 billion in more than 40 countries across its markets.



Andrew Panayides General counsel – Duke Street Private Equity
Panayides joined Duke Street in 2015 from law firm King & Wood Mallesons, where he specialized in funds and corporate acquisitions. He also has experience implementing fund structures, structuring investment management platforms, advising on and forming joint ventures among others. Duke Street was founded in 1988 to focus on the European mid-market buyout space.

Impact of secondaries

The secondaries market is also affecting LPA drafting and negotiation. More LPs are transacting fund interests while GPs are becoming more proactive in addressing end-of-fund-life issues and in dealing with portfolio and fund management.

Several funds from 2003-07 vintages have undergone significant GP restructurings in the past few years, explains van Zyl, although the initial LPAs didn't deal with such scenarios.

Should today's LPAs contain wording to account for solutions for the end of the fund's life? Van Zyl advises not to "draft prescriptively for an event eight to 10 years down the line in what's a rapidly evolving market."

Instead, "draft conceptually and then allow the market to determine what the transaction would look like as opposed to trying to draft prescriptively. I think if you're trying to draft prescriptively, you're probably going to do it wrong." Concepts to take into account include the percentage of votes required to allow a process or the governance of fund extensions.

Lampshire notes that Actis has had discussions on the topic in the context of its longer life products. "We thought about it, but less in terms of GP-led restructuring and more about liquidity," he says. "Some investors such as funds of funds who are restricted by their own holding periods will look for enhanced liquidity provisions or extension provisions in documents for longer life funds. Our view is that less is more in this area. Secondary markets are very sophisticated, so provided the fund documents fundamentally and mechanically allow the process to happen, there is limited advantage in drafting detailed provisions on day one that invariably will need adapting to meet market dynamics at a future point in time."

In terms of straightforward stake sales, GPs can exercise control in the LPA through its consent right over potential buyers and over provision of confidential fund information by sellers to third parties.

Allowing sales of fund interests remains more of a commercial decision on the GP's part than a legal issue. "As much as possible we will be helpful to an LP wishing to sell down its exposure to one of our funds, although we will consider long-term relationships with potential buyers as part of the process," says Lampshire.

"There may be valid reasons for objecting to a request, but in most cases it makes sense for the GP to be amenable to the request of the transferring LP and commencing a relationship with a new LP," adds Panayides. "We've seen some of our LPs asking in side-letter requests to be informed of any potential LP transfer and for the right to participate in the transfer process."

Addressing falling returns

A small group of GPs has been able to either reduce their hurdle rate in recent years or do away with it altogether.

This has prompted discussions between fund managers and external counsel around how LPA terms – in particular the hurdle rate – should be adjusted to the current market. So far it hasn't resulted in a wave of firms following suit.

"We often have this debate with our clients, because I think there's probably a broad recognition that returns and profits in private equity are lowering," says van Zyl.

"The question becomes: do you think you're going to get to such a point where you're not going to be able to outperform 8 percent? And if you are at that point, then are LPs going to pay the 20 percent carry? It's a double-edged sword."

"We spend a lot of time thinking about management fee and co-investment incentives but historically we have tended to avoid incentives around the hurdle," says Lampshire.

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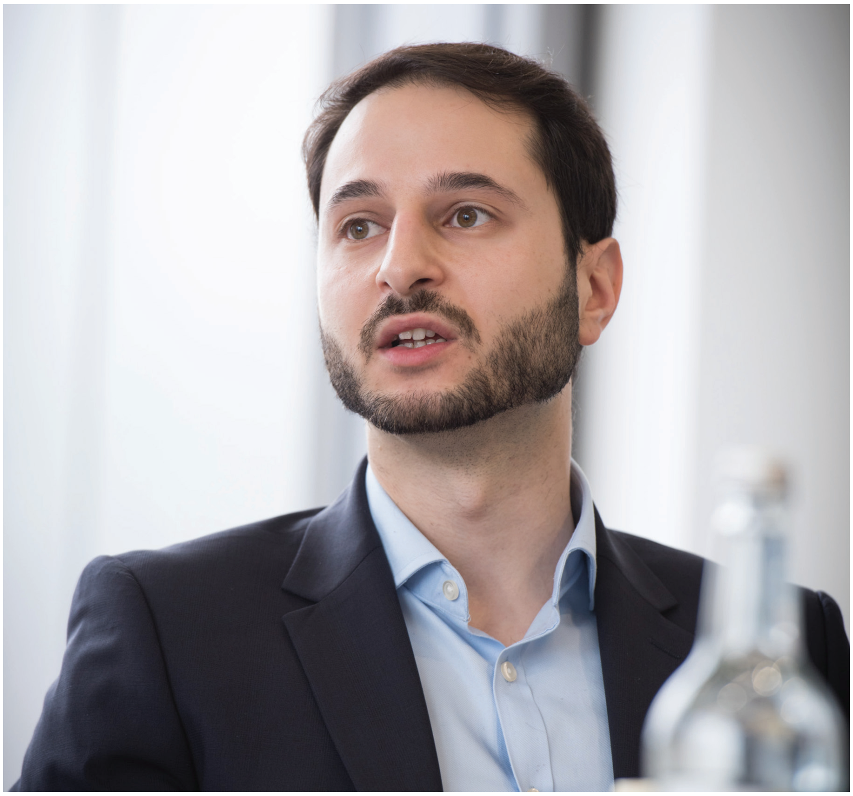

The Securities and Exchange Commission has played a significant part in the development of the LPA. Enforcement actions and hefty fines against high-profile firms like KKR and Apollo Global Management have pushed GPs to sharpen their agreements and to remove uncertainty and ambiguity in certain areas.

These actions have revolved around the need for more thorough transparency and disclosure, especially in the realm of fee and expense allocation. The SEC has paid special attention to portfolio monitoring fees and co-investment costs for example, and LPAs have been adjusted accordingly.

"I think interestingly the SEC – in terms of a non GP/LP institution – has had the biggest influence on LPA terms in the long term because of some of the actions that they have taken against some of the GPs," says van Zyl. "The SEC wants LPAs, PPMs to be more granular and transparent so investors are aware of what the arrangements are going in."

This is particularly true of co-investment expenses and their allocation, he adds.

Co-operation on co-investment

Broadly speaking, the higher demand for co-investments from investors has also expanded LPAs and LPA negotiations, sometimes with new separate documents reflecting the arrangements.

"The impact of co-investment on fund documentation is probably the topic that has evolved most since I've been working in the sector," Lampshire says. "Co-investment arrangements can take many forms, requiring more negotiation, bespoke documentation and more focus on disclosure."

While the LPA has changed throughout the years, it is no longer the last word on fund terms and conditions. Increasingly, the bulk of negotiations happens outside of the LPA in side-letter agreements, which have multiplied in recent years in part due to greater disclosure demands and other supplemental compliance requirements applicable to specific investors.

Lampshire explains that Actis's latest energy fund has 40-50 LPs and as many side letters. Some of these side letters end up being somewhat standardized because they reflect common concerns and requests from LPs.

"Other than key commercial points which are addressed mainly at business level, most of the legal negotiation I would say these days is not done on the LPA, it's done on the side letters," he adds. ■

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>
> **Andrew Panayides**