Should GPs Support the ILPA Private Equity Principles?

I have been fielding these same questions from my GP, LP and other industry colleagues:

- "What do you think about the ILPA Principles?" (soft voice)
- "How do you think it will affect my business?" (worried voice)
- "They don't matter – we go through this every ten years when LPs try to get the upper hand." (with bravado)

Others are either more certain in their opinion or not so sanguine and believe that this effort will have a long term (and dependent on your perspective) positive or deleterious impact on the industry. A few LPs, smaller ones and non-ILPA members are even cowed by the impact feeling that the "big dogs" are dictating their ability to enter into funding opportunities. I've been most surprised by the few on the record comments by industry members and in particular the lack of specific statements by GPs. So…I thought I'd relate some of the conversations I've had these past days and share my expressed opinion.

It's pretty hard to disagree with common sense. I see nothing offensively troubling in the document (http://www.ilpa.org/files/ILPA%20Private%20Equity%20Principles.pdf). In fact, it has offered a kind of first hand self-review opportunity for the industry. I know. I know. We GPs are supposed to rebel instinctively against any proposal by an LP that governs or restricts our ability to do business. Bull! We appeal to Pension Funds, endowments, banks and other institutions for fund capital and want as few restrictions as possible. After all, this is capitalism, no? Atlas will not shrug his great burden but rather heave the world as we know it if these so-called Principles become ubiquitous. Hardly.

OK, let's deal with the objection I most often hear when I mention my general support of the ILPA Principles, "But Mark, LPs are your clients. They give you the opportunity to triage or take over their troubled funds". True. But no less than they are the client of every other more traditional fund. They give us all the opportunity to use our skills to generate opportunity for entrepreneurs, jobs for citizens, innovation for the public and profits that we GPs and LPs hopefully get to share. Sure, Semaphore's fund turnaround and workout practice depends on good relationships with and performance for LPs (the same as the rest of my GP colleagues) but this is only part of our business. Fully half of our professionals are engaged in the conduct of diligence on people, products, markets, strategy and technology for GPs (yes, those that will never require our turnaround services) who value the independent review of an investment judgment before they risk LP capital and their own carry opportunity. It is this group of Semaphore clients that one expects has the most objections to the ILPA Principles. In truth, extended conversation suggests differently.

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Beyond the visceral reaction, there is need for deeper understanding of the moment in time in which we now conduct business than ever before. We must rise above initial response to see our industry at a watershed moment. And we can lose the moment if we settle for the usual ad hoc proprietary negotiations that will get us, collectively, nowhere. This is true of both PE and VC.

Somebody once said that people change when they see the light, others when they feel the heat. There has been plenty of heat with the roiling of the marketplace, constriction of fund formation activity, difficulty of capital access and restricted liquidity opportunity. Nevertheless I believe this is a moment of light more than fire.

I don't intend to take a point-by-point defense of the proposal. There may be one or two particular sentences that may seem to cross a long held and well trod line. But don't let your anathema to objectionable parts dismiss the value in the proposal as a whole. Take a breath then take a fresh read of the ILPA Best Practices enumerated. The Principles provide a "level setting" opportunity across the industry that will enable two things. One, a fair and open platform between LPs and GPs that will afford, even accelerate, profit opportunity for both parties. And two, the best chance to put what could be a years-long, fund-by-fund battle to change the so-called power relationship between LPs and GPs.

I'm not talking about GP surrender. Good fund formation lawyers will and should protect the interests of GPs in negotiating LPA's. Enlightened LPs know that there is elasticity in how the principles are memorialized in contract. However, if we cede no ground as GPs then disharmony and contention will become the hallmark of fundraising. Commitments and allocations will both diminish as performance inevitably dips during this unnecessary boxing match. We are all in a difficult enough environment that has too many of us suspect of "pay for play" fundraising and selfish exploitation of Limited Partner Agreements.

One thing I do know for certain: I am likely to have fewer turnaround and workout engagements upon the adoption of these Principles. A large proportion of the funds we take over are a consequence of governance sins committed by GPs and the lack of clarity in LPA's. I'd rather redirect my company's growth in future years to the prevention of troubled fund situations. After all, when LPs have problem children it keeps them from spending time and money on the good relationships in their portfolio. Selfishly, it might even help us grow our diligence and advisory practices.

Francis Picabia is not a richly rewarded GP or powerful LP. Rather he was an artist who famously said "Our heads are round so that thoughts can change direction." Run these Principles around your mind a few times. I believe you will see the bright and profitable path that LPs and GPs should walk together. I contend that general support of the ILPA initiative will reward the industry with long term - even decades long - "peace" between the parties, a more robust fundraising environment, and opportunity for larger profit sharing for each.

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