PRIVATELY SPEAKING

What families want

As head of the private equity team at Stonehage Fleming, Richard Clarke-Jervoise knows a thing or two about how to attract private wealth to the asset class. By **Isobel Markham** and **Toby Mitchenall**

PHOTOGRAPHY BY PETER SEARLE

You can't get away from the fact that it's an expensive asset class to access

If you're keen to entice family office capital into your latest fund, a coffee with Richard Clarke-Jervoise would be time well spent. As head of the private capital investment team at multi-family office Stonehage Fleming, he is acutely attuned to what makes an investment proposition 'family-friendly'.

While institutions think in terms of assets and liabilities, families think in terms of wealth creation and wealth preservation; private equity fits squarely into 'wealth creation'.

"Private equity is very intuitive for a family, because for most families, that's where their wealth came from, it was created by a private company of one sort or another, so they get that. And they understand risk completely from that point of view."

The 'wealth creation' approach translates into a strong bias towards growth; in the past year Stonehage Fleming has invested with Abry Partners, Summit Partners, Centerbridge Partners, HgCapital, Insight Venture Partners and New Mountain Capital, among others.

No two families are the same, Clarke-Jervoise points out. But they are often extremely long-term in thinking, yet impatient to see results; considered in investment decisions, yet willing to take risks well beyond an institutional investor. Above all, they are their own masters.

The exact number of family offices out there – and the exact amount of capital at their disposal – is, for obvious reasons, hard to pin down, but recent estimates have put their wealth at around $4 trillion.

And they are becoming increasingly interested in alternatives. Respondents to the UBS/Campden Wealth *Global Family Office Report 2016*, a survey of 242 family offices, indicated on average 22.1 percent of their assets is allocated to private equity, up from 19.8 percent the previous year. Between 2010 and 2015, the proportion of capital raised globally for private equity from family offices grew from 4 percent to 6 percent, according to the Alternative Investment Council and Preqin.

Family offices are becoming too big for general partners to ignore.

And these investors are good people to have in your fund. Having some key family offices among your LP base can act as "external validation", says Bracken White, a managing director at Probitas Partners. "These are people that invested with you because they chose to, whereas certain institutional investors may invest with you because they have an allocation they need to get out the door."

If a family office well-known for being thoughtful and highly disciplined in assessing investments is an LP in your fund, "that can tell other investors that smart money is investing in you", White adds.

FAMILY AFFAIRS

Stonehage Fleming looks after more than 250 families with anything from millions to billions, providing a wide range of services, including the fiduciary side of asset management, legal advice from its in-house law firm, investment management, property management and art management. The families range from first generation to third generation and way beyond, and include chief executives of banks, supermarkets, industrial firms – and private equity general partners.

"We've got a lot of GPs as clients," Clarke-Jervoise says, "and that's a growing portion of our client base."

About 30 of these families invest in private equity through Stonehage Fleming. The firm has three teams covering the asset class: the funds team; the corporate finance team, which helps clients make direct investments; and FPE Capital, a private equity firm with which Stonehage Fleming has an affiliate relationship and which manages funds on behalf of its clients and third-party clients.

Whether families choose to access private equity through Stonehage Fleming is not simply a matter of size, Clarke-Jervoise says.

"The thing that determines whether they do [private equity] with us or potentially with someone else is really whether »

» they want to invest in the resource to do it themselves," he says.

"One of the things that characterises PE compared with all the other asset classes is it is very resource-intensive. People who work in the industry take that for granted and the larger investors typically have dedicated teams covering not only the investing but the reporting, the tax administration, the capital calls and distributions."

HOW MUCH WILL IT COST?

Families, Clarke-Jervoise says, don't consider the cost in terms of basis points on assets under management. "They look at 'how much is this costing me? Is it costing me a couple of hundred thousand or is it costing me millions to administer?'"

The easiest way for wealthy individuals and families to invest in private equity is through feeder funds offered by banks, but "a lot of them say they get a pretty rough deal from the banks who are notoriously hungry for fees", Clarke-Jervoise says.

Stonehage Fleming charges its clients a flat fee based on the assets it manages for them, regardless of the types of financial products they're investing in. The private equity programme charges on the basis of NAV and invested capital, rather than committed capital.

"You can't get away from the fact that it's an expensive asset class to access," Clarke-Jervoise concedes. "Of course we charge for our services, but we try and avoid the adverse selection you get with a lot of the banks which push product because it's very profitable for them to do that."

There is no performance fee. "Philosophically, it was just something the firm felt the clients would struggle to understand and they're quite resistant to," Clarke-Jervoise says.

By charging fees only on invested capital Stonehage Fleming is certainly ahead of the pack; despite prominent members of the industry such as Terra Firma's Guy Hands speaking out against the practice of charging fees on committed capital, it remains the norm for more than 90 percent of buyout funds and close to 90 percent of growth funds according to recent data from Preqin.

Of course, applying these management fees is to account for the initial costs of a fund that will only call its capital in increments over a number of years. Nevertheless, Clarke-Jervoise doesn't see this remaining universally accepted.

"I would be very surprised if in 10 years' time much more than 50 percent of the asset class was charging on the basis of committed capital," Clarke-Jervoise predicts.

"It's just such an anomaly within investment management as an industry. There are very good reasons for it, but I just think people will eventually say 'we're not prepared to pay for that.'"

EVERY LAST DROP

Another element eating into the overall returns for family offices – and one which particularly displeases them – is the way fund managers, having raised a fund, often fail to invest all of it.

For example, the idea that, having committed $10 million to a private equity fund, only $8 million or even $5 million ends up being invested is extremely unappealing.

"Our clients look at all the performance numbers that come through private equity managers, and they're good, but they are typically internal rates of return; and that IRR is on potentially only 50 percent of invested capital rather than the full amount of an investor's commitment," Clarke-Jervoise explains.

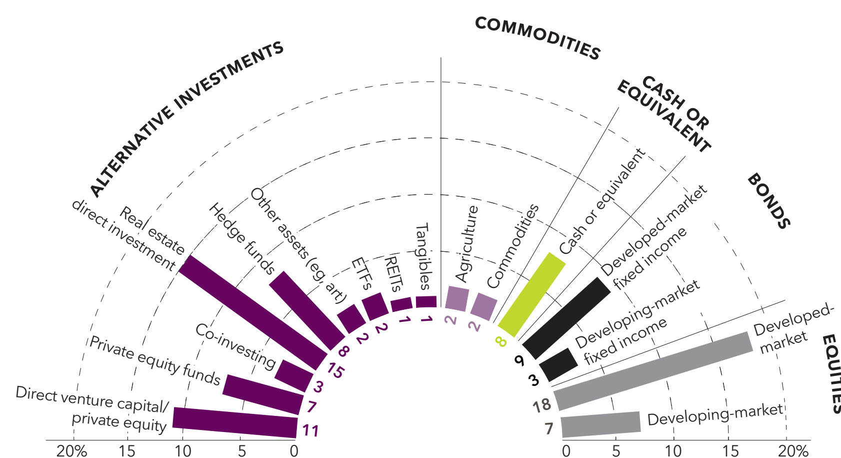
Family offices would know if they had been getting a 15 percent return on the 10 percent they have allocated to private equity, he says; in reality, the allocation ends up returning only around 7.5 percent.

"Trying to be fully invested is what families find really hard," he says. "Why do they find that harder than institutions? Because institutions have entire teams whose job it is to do cashflow modelling and asset allocation to ensure that at all times they are fully invested. Certainly, the families we look after don't have those resources."

Stonehage Fleming pushes fund managers hard to be as close to fully invested

A GOOD ALTERNATIVE

The average family office portfolio



Source: UBS/Campden Wealth Global Family Office Report 2016

> *[GPs] are great investors, they're not very good fund managers*

as possible. And it calls the capital in its own private equity programmes to a fixed schedule – and fast.

"We give our clients a very clear capital call schedule. We say: 'we'll call this on day one, this a year later, and this two years later', so they know 100 percent of their capital will be called within a fixed period of time and can plan what they do with their cash around that."

Stonehage Fleming's 2016 private equity programme made its first capital call in September 2016 and its second in January 2017, at which point more than 80 percent had been called. The full programme has been deployed into underlying managers, who in turn have called only around 10 percent of capital. The 2016 programme is currently sitting at around 5 percent IRR.

"We use a permanent capital vehicle which we invest a significant portion of the fund in to reduce the cash drag," Clarke-Jervoise explains. "It's similar to using a significant secondaries portfolio at the start of a fund and allows you to get money in the ground working in private equity assets."

WANTED: BETTER FUND MANAGERS

Tied into concerns over fees and capital efficiency is the issue of gross-to-net spread, something to which the majority of GPs are only just starting to pay attention.

"They're great investors, they're not very good fund managers," Clarke-Jervoise says of GPs. "The IR guy or the finance guy really understands the component parts of net performance, quite often the »

» deal-doers have got no clue about net performance."

The data on this are stark. Across the last 15 years the median spread between gross and net for all buyout funds is 8.59 percent, based on a net IRR of 16.01 percent, according to CEPRES, a tech platform that allows GPs and LPs to exchange confidential performance data. Interestingly once you include private debt, venture capital and infrastructure funds in the sample, the average spread comes down to 6.32 percent; there are clearly more efficient managers in those asset classes.

LEVERING LEVERAGE

Aside from slashing fees – which, in today's environment, is not on the agenda for most GPs – there are several levers that can be pulled to narrow the spread between gross and net returns.

One is a credit facility. Clarke-Jervoise sees the benefits of such facilities for managing out the J-curve and simplifying capital calls; however, he is cautious about "the more egregious versions" in which capital is only called once a year.

"In some cases, it's ending up really as fund leverage," he says.

Annual capital calls can also challenge LPs – having up to 25 percent of your fund commitment called in the space of a day pushes both families and institutions to keep more money in cash.

"People talk about Swiss and German institutions who will keep all their unfunded commitments in cash. It means they've got a hell of a lot of cash, particularly in what has been up until quite recently a negative interest rate environment; they're actually paying to keep it in cash."

Another lever is the use of cross-fund investment, mopping up the tail-end capacity of one fund with a portion of one of the next fund's deals. Both can be viewed with suspicion by investors, but both have their uses from a capital-efficiency perspective.

THINKING OUTSIDE THE BOX

One of the biggest shifts Clarke-Jervoise expects to see within the private equity industry is adjustments to the standard 10-year fund structure.

"You're beginning to see tweaks around that, whether it's long-dated funds, whether it's evergreen funds, whether it's shorter-dated funds," he says.

This change, he predicts, will "slightly redistribute the cards" among fund managers.

"People who can really embrace demand for different durations of funds and things, and investments and different models have a chance to take a market position as the industry evolves."

And family offices are just the sort of LPs which can help fund managers make the shift into a slightly different model. Devoid of constraints around investment 'buckets', family offices can assess new strategies purely on their own merits.

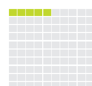
"Family offices with established programmes are willing to entertain things that are slightly different than normal," says Probitas's White.

"You need people like that if you've got a strategy that makes a lot of sense but isn't very common." ■

$1.6bn

Invested in private equity since 2001

5%



IRR of Stonehage Fleming Global Private Capital Fund 2016 fund as at 31 July

>250

Number of families Stonehage Fleming looks after globally

£9.5bn/$12bn

Group assets under investment management

Although positive about the resilience and potential for innovation within the industry, Clarke-Jervoise does have his concerns, particularly with regards to how private equity will navigate the next downturn.

"I worry about what will happen to the industry post the next crash. Everyone says private equity had quite a good crisis, and I do worry that the next one won't be quite as good," he says.

"I worry about the complacency within parts of industry that you saw within hedge funds previously, and you saw what happened to the hedge fund industry."

Clarke-Jervoise notes a tendency for those within the industry to talk "to themselves in a kind of echo-chamber that can lead to them becoming disconnected with the outside world".

"I just worry there is a perception – and we definitely see it with clients – that private equity managers are quite greedy. The industry needs to be quite wary of that."

Fund managers should take note of Clarke-Jervoise's warning; what family offices think of private equity managers will only become more influential. ■