SECTION I
GP–LP Relationships

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One of the competitive advantages we have is we have a large balance sheet, and economies of scale allow us to build big internal teams. We also have very long term time periods, so we never have to sell an asset unless it's at our choosing. We don't need the liquidity. Why aren't we looking for opportunities to invest higher up the capital stack and take advantage of that?

—**Gordon J. Fyfe,** CEO and Chief Investment Officer, British Columbia Investment Management Corp. (bcIMC) and INSEAD Alumnus

CASE

1 BERONI GROUP

MANAGING GP–LP RELATIONSHIPS

SYNOPSIS

This case follows Jack Draper, Managing Director of the Beroni Group, a private equity family of funds, as he manages his growing business and tries to satisfy his investor base. It deals with the issues arising in private equity firms once multiple funds have been raised from various limited partners and are being managed by a related set of general partners. Beroni has just closed its third fund successfully and has started to explore investment opportunities as the financial crisis of 2008–2009 reaches its apex and changes some of the fundamental assumptions for its investor base.

The case is set in a difficult economic environment, which raises some very interesting investment possibilities as well as problems. Jack strives to manage two competing groups of investors seeking exposure to these possibilities, as well as the cash flow problem at one of his leading investors.

The case highlights the different motivations of existing investors: some of them invested in both Funds II and III, others in only one or the other. As Jack starts to address the issue of the composition of the advisory committee (AC), queries regarding overlapping staff resources for both funds and pressure for a reduction in management fees, he is faced with a potentially critical issue: one of his investors is in serious financial distress and has asked to be given preferential treatment to avoid default.

PEDAGOGICAL OBJECTIVE OF THE CASE

The case explains the importance of a professional relationship between investors and managers in a private equity fund and discusses possible solutions that managers can offer to investors facing financial difficulties.

It sets the scene to critically debate investor demands and expectations with regard to the time managers allocate to individual funds and their overall commitment to managing a family of funds.

SUGGESTED ASSIGNMENT QUESTIONS

1. How should Jack handle the allocation of deal flow between the different funds that have overlapping mandates, and/or between one of his current funds and an eventual successor fund? Should allocations be fixed or discretionary? In addition, regarding the impending deal, which AC should he approach first, and with what sort of proposal, to minimize potential tension among the various investors.
2. How should he deal with downward pressure on his management fees as more assets come under management, since some costs (e.g., rental costs, back office

staff) are fairly steady regardless of how much capital is under management? How could he rebut investor demands to lower management fees?
3. Since the senior Beroni principals serve on the deal teams and investment committees of more than one fund, how could he help his investors feel comfortable that the principals (and staff) would allocate their time appropriately between the respective funds?
4. How could he help his investors be comfortable with the prospect of *de facto* cross-liability—that is, if one of his funds were to run into difficulty, how could he "ring fence" other unrelated funds to ensure there were no negative financial or time effects on the managers?
5. How could Jack balance the needs and requests of EUBank, one of his oldest and largest investors, with the legitimate expectation of other investors in BAF II and BAF III that EUBank not be shown any favoritism, and that a portion of EUBank's interest be forfeited and distributed to them? Would he be faced with a flood of defaults and withdrawal requests if he were to treat EUBank gently? What fiduciary duty did he have to the nondefaulting investors in BAF II and BAF III that have managed their finances more prudently than EUBank? Would the managers risk breaching the investment fund agreements to implement EUBank's proposal?

ADDITIONAL RESOURCES

To make the most of this case study, we suggest the following additional sources to provide context and background information:

- In particular, we recommend the following chapters from *Mastering Private Equity—Transformation via Venture Capital, Minority Investments & Buyouts*
  - Chapter 1 Private Equity Essentials
  - Chapter 16 Fund Formation
  - Chapter 17 Fundraising
  - Chapter 19 Performance Reporting
- You may also refer to the book website for further material: www.masteringprivateequity.com.

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Beroni Group:

Managing GP-LP Relationships

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Introduction

Jack Draper had just completed the initial close of his third private equity fund for the Beroni Group, a family of funds based in Hong Kong and investing across Asia. As Managing Director, Jack had been with the group for nine years since its founding in 2000, and with his two partners had successfully steered the Beroni Asia Fund (BAF I) to a successful conclusion, creating the opportunity to establish follow-on funds in the same mould. BAF II was approaching the end of its investment period, after which remaining capital could only be invested in follow-on investments. BAF III had received US$500 million in commitments from its limited partners (LPs) by late summer 2008, before the fundraising environment for private equity funds became difficult. Notwithstanding these difficult conditions, Jack was able to get to a first closing, and expected to raise an additional US$300 million by the final close. He took pride in their ability to hit fundraising targets despite the difficult fundraising environment. It was typical of what he and the other principals who managed the fund on a day-to-day basis had achieved over the years.

With success, however, had come some unexpected issues. While managing each fund in isolation required essentially the same skills and processes, he was discovering that managing a group of funds required careful strategic (and sometimes political) manoeuvring. Just the day before, he had received final information about a proposed deal that he planned to present to the investment committee the following week. BAF II still had US$135 million in remaining capital that could be deployed (and another year left on the investment period), and BAF III's funds were now available. The seller in the proposed deal was in deep distress and the investment committee felt that the pricing on the deal was exceptionally attractive – it was likely to be one of the most successful deals ever sourced by the Beroni Group. But there were a number of other complications:

- Some LPs had invested in both BAF II and BAF III, while others had invested in one but not the other. LPs sometimes co-invested directly in companies with the fund in which they had invested.
- Each fund had its own advisory committee (AC), and the make-up of each AC was a reflection of LP participation. Hence there was not identical membership across the ACs.
- General partner (GP) resources were sometimes thinly spread across multiple funds since the same team managed all three funds.
- LPs participating in multiple funds were making noises about a reduction in management fees for the latest fund, since many of the costs associated with managing it were essentially fixed (rent, salaries, etc.). In difficult economic times, LPs were looking for any way to cut their costs.
- Finally, in any co-investment situation, the approval of the relevant ACs would be necessary in order to execute.

Jack knew he would end up doing the deal one way or another – he just needed to resolve some of these issues first in order to avoid creating future problems with the LPs.

Another problem facing Jack was that EUBank, one of the Beroni Group's earliest and largest investors, was (as with many financial institutions) having cash flow problems of its own, and was unable to fund its capital commitments to BAF II and BAF III.

As is common in the private equity industry, the limited partnership agreements for BAF II and BAF III had extremely severe penalties for a defaulting limited partner, including forfeiture of half of its interest in the fund. EUBank had proposed to the Beroni Group that it be allowed to suspend making any further capital contributions to BAF II, that its capital commitment to BAF III be reduced from US$120 million to US$60 million, and that none of its interest in either BAF II or BAF III be forfeited. The GP of BAF II had some discretion over enforcement of the forfeiture provision, but there was no mechanism in the limited partnership agreement for BAF III to reduce capital commitments in this way. Nonetheless, in light of the long and otherwise happy history of EUBank and the Beroni Group (and in the hope that EUBank would recover and be a large investor in BAF IV when it was raised), Beroni Group wanted to be as accommodating as possible.

Group History

Jack and his partners had founded Beroni in 2000, closing BAF I with US$250 million contributed by three LPs (see Appendix A). Over the following four years, Beroni successfully deployed all of the capital and went on to exit all portfolio companies in a relatively short six-year timeframe from closing, achieving a remarkable 42% IRR over the period. Shortly after fully investing BAF I's assets, and with a few credible exits under their belts, the Beroni GPs successfully closed BAF II in 2004 at US$350 million. All of the original LPs participated to some extent, and a further two LPs came on board (see Appendix B).

The firm had been less able to deploy BAF II's capital due to a dearth of quality deals, with only approximately US$215 million invested as of the initial close of BAF III. The deals in which the company had invested, however, had again generated spectacular returns, estimated to be around 30% IRR (including unrealised gains) – which in turn had further attracted LPs to BAF III. Prior to the meltdown of the financial industry in late 2008, LPs committed US$500 million to BAF III at the first closing. Even though the fundraising environment had become exceptionally difficult, Jack and his partners believed they could secure an additional US$300 million in further commitments by the final close of the fund (see Appendix C), largely because a number of liquid and savvy LPs believed that there were historically good buying opportunities in the market.

Key Issues

Jack now found himself with two active funds and several issues to manage:

- Disparate LPs

  Because one of the LPs participating in BAF II had elected not to participate in BAF III, and because a number of first-time LPs had subscribed to BAF III, the LP structures of the two funds were significantly different. Jack knew the LP that had opted out of BAF III (Gulf Developments, a sovereign wealth fund with considerable assets and influence which he could not afford to upset) wanted BAF II to fully invest its remaining assets before BAF III began to deploy its capital (particularly because they believed that asset values were now at an all-time low), and would therefore

vehemently oppose any investment by BAF III before that time. On the other hand, the BAF III LPs were eagerly looking forward to their first deal in this attractively repriced market, so if a very attractive opportunity went to BAF II in preference to BAF III, Jack risked upsetting his new partners.

- Differing AC compositions

  Because the investor that had not subscribed to BAF III was on the advisory committee of BAF II but not on the AC of BAF III, and because some of the first-time LPs were on the AC of BAF III but not BAF II, Jack had different ACs to manage. Complicating matters was the fact that for the upcoming deal, Jack would have to engineer approval from both committees in order to receive the go-ahead on a co-investment – and this would generate tension depending on which LPs participated in each AC.

- Overlapping human capital

  Like many families of funds, Beroni employed the same staff across all three funds. The same senior staff, investment managers and associates that had executed deals for BAF I and who were currently working on BAF II would also manage BAF III; the synergies of information and experience were obvious, and utilising his staff in this way allowed Jack to generate higher management fees per headcount. Of course, each fund's LPs preferred staff to be 100% focused on their fund to the exclusion of the other, whether it was BAF II or BAF III.

- Reduction in management fees

  Because some of the LPs had invested in all three funds, they felt that Jack should reduce Beroni's management fees in some way to reflect the fact that the group as a whole was able to utilise the same staff to manage each successive fund. In addition, because each successive fund required neither additional office space nor additional administrative staff, the LPs felt certain that costs could be cut – providing additional justification for a reduction in management fees. Moreover, because of the difficult economic context, a number of LPs felt that the Beroni Group should "tighten its belt" and pass some of the cost savings along to LPs.

- EUBank default

  Beroni was faced with an imminent default by one of its largest and oldest investors, which would not only create cash flow problems for BAF II and BAF III (and might even jeopardise the ability of these funds to consummate the investment they were currently considering), but would also create some embarrassment for EUBank and for the Beroni Group. EUBank had put a proposal on the table that would mitigate some of these problems (and yet not leave EUBank in a good position), but accepting the proposal would not only anger other non-defaulting LPs (since they would not receive the forfeited interest to which they had a legitimate claim), but also create a moral hazard should other LPs try to extract a similar deal from the fund GPs. Also, it was not clear whether granting EUBank's requests would violate the GPs' fiduciary duty or even breach the limited partner agreements themselves.

Appendix A
Table of LPs (BAF I)

LP Entity	Amount Invested (US$ million)	Advisory Committee Seat (Yes/No)
Gulf Developments	100	Yes
EUBank	80	Yes
La Famiglia Inc.	70	Yes

Appendix B
Table of LPs (BAF II)

LP Entity	Amount Invested (US$ million)	Advisory Committee Seat (Yes/No)
Gulf Developments	120	Yes
EUBank	70	Yes
La Famiglia Inc.	40	Yes
Pensions-R-Us	70	No
StateFund	50	Yes

Appendix C
Table of LPs (BAF III)

LP Entity	Amount Invested (US$ million)	Advisory Committee Seat (Yes/No)
EUBank	120	Yes
La Famiglia Inc.	30	Yes
Pensions-R-Us	100	No
StateFund	80	Yes
New LP 1	90	No
New LP 2	80	Yes
*New LP 3	75	No
*New LP 4	75	Yes
*New LP 5	75	No
*New LP 6	75	No

*Denotes anticipated funding as of the final close of the fund.

Source: Fictitious data