CMS Funds Market Study 2021

June 2021

Table of Contents

CMS Funds Market Study 2021

Periodically, CMS takes soundings on the state of the market from our funds-related clients. Given the unprecedented nature of the last 12 months we thought this was an opportune time to look back over the last few years. This study analyses the key market trends in fund documentation of over 300 funds established in Europe, Asia, USA and offshore jurisdictions advised on by CMS offices throughout 2017 to 2020. We have also conducted client interviews, which are highlighted in this report, and conducted a selective survey of our international client base.

I trust this CMS Funds Market Study will be a useful guide for both managers and investors this year. The size of our deal sample and the range of countries involved means that the study should be a uniquely valuable and rich resource for managers and investors. Our research indicates that funds industry players are clear on how to move forward and that, while strategies may have shifted, there are reasons for optimism and bullishness, unlike the gloom that descended after the global financial crisis in 2008.

Looking forward we see an active funds market, with Luxembourg being the jurisdiction of choice for European funds. ESG is now a key focus for investors. This market impetus and regulatory drivers are moving sustainable investment from a niche focus into the mainstream for investors and managers alike. We also see managers increasingly looking at the benefits and impact of AI and technology with the tokenisation of assets and the use of blockchain. We see this pace of change accelerating.

If you have any feedback or questions, we would love to hear from you.

Amanda Howard
Partner, Head of CMS Funds Group
T +44 20 7524 6342
E amanda.howard@cms-cmno.com

> We've communicated extensively with investors. That was a lesson the smarter players in the industry learned through the financial crisis.
>
> *Edmund Craston, Head of Fund Management, PATRIZIA*

Summary of study findings

The study focuses on over 300 private, institutional, alternative, illiquid funds (the "**Sample Funds**") on which CMS advised between 2017 – 2020 (the "**Review Period**"). The Sample Funds cover a range of geographies and asset classes, over 2/3 are focused on European strategies, approximately 1/3 are real estate, 1/3 are private equity ("**PE**") and 1/3 are infrastructure, debt and other strategies. Our study has been informed by interviews with leading industry participants and over 100 survey responses (both undertaken at the end of 2020). As Sir Ronald Cohen, the international venture capitalist and PE investor, said *"The first bounce of the ball everyone can see. To anticipate the second, you need a really deep understanding of the market."* A lot has happened in the recent past, very little of which was predictable, and what happens next may be even more surprising. We now wonder where the uncertain second bounce of the market will be. We set out below some key findings of the study.

Key findings

- Overall **fund raising volume reduced in 2020** off the highwater mark years of 2017 and 2018;
- Although 2020 saw fewer funds established, there was **a lot of transaction activity** as institutional investors continued their programmes and made new allocations in light of the risks, opportunities and challenges that arose out of Covid;
- In private equity a **strong secondaries market** continued to develop as institutional investors looked to streamline their holdings and take an active approach to portfolio management;
- When material uncertainty over commercial real estate values made it necessary to **suspend daily dealing in some open-ended property funds**, fund managers worked with the regulators to make this happen quickly and safely; we expect further regulation in this area;
- 2020 saw investors sell off what they perceived to be higher-risk investments and purchase safer investments in perceived Covid winners (principally **technology and distribution related assets**);
- **Luxembourg continues to be the most popular fund jurisdiction for European fund launches**, particularly in light of Brexit, with Dublin also starting to garner additional popularity in relation to funds marketed throughout the EEA;
- Funds with no commitment from managers are becoming less common with **increasing manager commitments in closed-ended funds**;
- A **hurdle rate of 8% remains standard** for closed ended funds across real estate and private equity;
- Managers in the upper quartile (in terms of performance) kept their **management fees steady** but there is some evidence that new managers are offering fee reductions or other incentives in order to raise capital; and
- The **demand for ESG products grows** with indications that investors see ESG as a value driver as well as a risk mitigator.

Sample Funds

Jurisdictions

Figure 1 shows the breakdown by jurisdiction for the Sample Funds, with Luxembourg dominant for European funds and Delaware dominant for funds aimed at US investors. Most of the funds in the sample were marketed at European investors and therefore Luxembourg funds are common in the sample.

Figure 1

Fund location

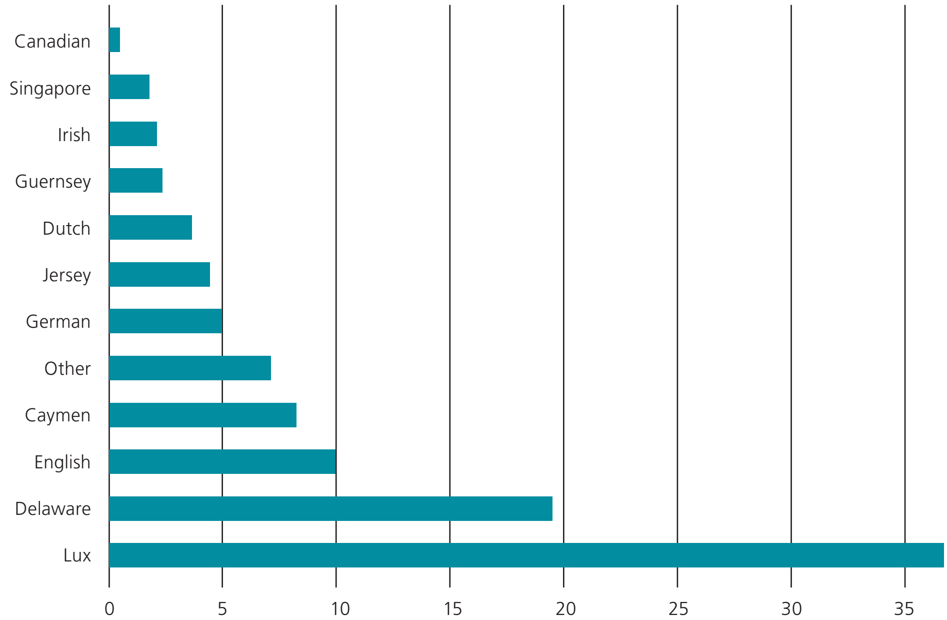


Figure 2 shows the types of funds that have been advised on by our Asian offices. Cayman, Delaware and Luxembourg are the most popular structures.

Figure 2

Sample Funds advised on in Asia

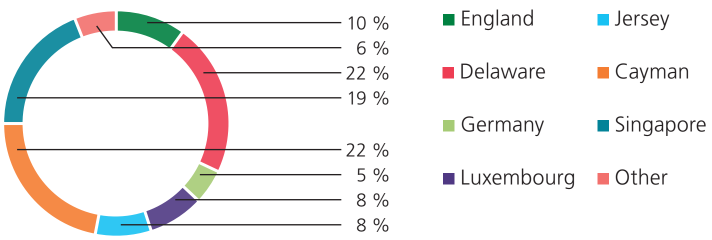


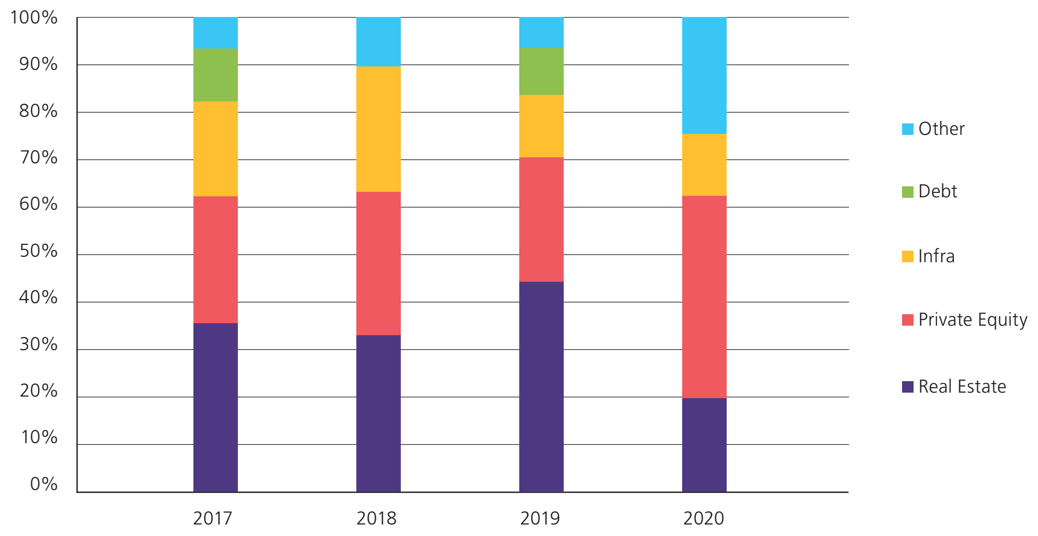
Figure 2 is based on a sample size of 61 funds. Delaware was common in this sample as these funds were also available to US investors.

Funds in the sample

The Sample Funds covered a range of asset classes with a majority focused on real estate and private equity (See Figure 3)

Figure 3

Types of Sample Funds



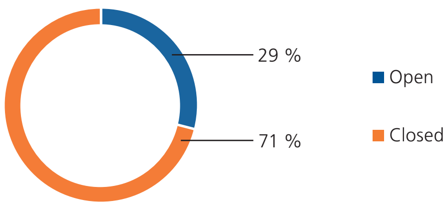
Includes: funds focused on hedge funds strategy; passive; Long/Short Equity; Market Neutral; Merger Arbitrage; Convertible Arbitrage; Event-Driven; Credit; Fixed-Income Arbitrage; Global Macro; Agriculture; Technology.

Structures of the Sample Funds

The majority of the Sample Funds are closed-ended whilst those classed as open-ended funds typically allow redemptions on a limited basis as they hold illiquid assets.

Figure 4

Open Ended/Close Ended Funds Sample Funds



In 2020, several UK open-ended property funds in the retail sector needed to suspend redemptions (none of which feature in this study). Although few semi-open-ended private funds have suspended redemptions, some investors now question the extent to which allowing redemptions in funds investing in illiquid assets ought to be permitted. Anne Breen, Head of Investment Strategy (Real Estate) at Aberdeen Standard Investments remarks: *"So the recent environment hasn't been positive for open-ended funds, because obviously for investors it is fairly challenging when the funds are suspended."* Our research indicates that even though the Covid crisis has highlighted difficulties with valuation methods and redemption gates in times of stress, there is still demand for funds offering periodic redemptions.

Anne Breen

Head of Investment Strategy (Real Estate)

Aberdeen Standard Investments

How do you see the future of office space, the working environment and sustainability?

Covid has accelerated the move towards flexible working by maybe five to ten years. And that's partly about technology and businesses having to raise their technology offering, but also partly about attitudes and the old school view of presenteeism. We're starting to see that happen in terms of what is required from an occupier perspective. The wellness theme, the technology, the flexibility, the service provision, all of those factors were already happening but now have accelerated. And we've researched into what we call future-fit offices based on flexibility, amenity, connectivity, technology and sustainability.

What do you see as the safe havens for real estate investment in 2021?

I think urban logistics, the last-mile logistics space, is a safe haven, but also the private residential sector. In the UK, for example, residential is still a very underappreciated part of the market and affordability still remains an issue.

The UK has consistently dominated the private equity deal market in Europe over the last decade and even the ambiguity around its future relationship with the EU has not diminished its standing. Moreover, any crisis often tends to push investors and dealmakers towards mature and established markets, meaning the UK should stand up better than other jurisdictions during the Covid pandemic.

What are investors looking for from an ESG perspective?

There's been a massive increase in focus on ESG across the offer. There's much more focus on social impacts in the built environment. We're now talking about purpose built residential schemes that are actually designed with that fully integrated approach to ESG.

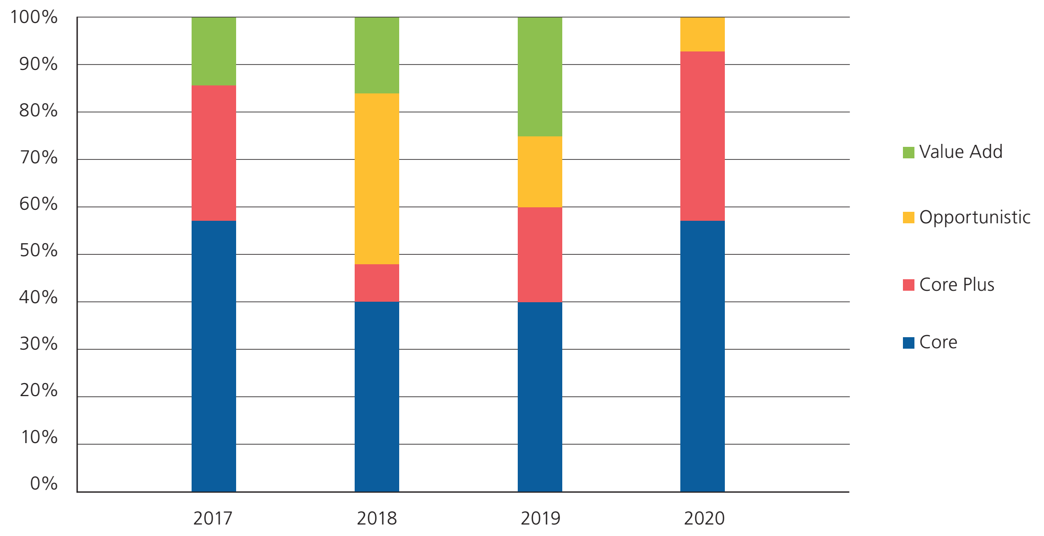
Strategies

The real estate funds covered by the Sample Funds focused on a range of strategies with a majority in Europe.

Real Estate Strategies

Figure 5

Real Estate Sample Funds: Strategies



Our study indicates investors selling off what they perceived to be higher-risk investments and seeking to purchase perceived Covid winners (e.g. technology and distribution related assets). Accordingly, it is not surprising to see evidence of a heavier weighting towards core strategies in 2020.

Our survey reveals that ESG principles (environmental, social and governance) are becoming increasingly important. A result of increased demand for more sustainable investment approaches, investment managers are now "following the money" and making ESG products available to investors.

Fund managers will continue to be subjected to increasing regulation, for example, non-financial reporting requirements which include disclosing their ESG impact. This, when coupled with increasing investor demand, is likely to affect non-green companies' ability to raise capital. We expect ESG will become a core investment theme going forward.

Fund terms

Following the 2008-2009 global financial crisis, investors were initially reluctant to commit to funds and this tended to lead to more investor-friendly terms. However, from the end of the global financial crisis until the arrival of Covid, investors invested large amounts into private funds searching for yield as well as capital growth. For many managers this tipped the balance of power back in favour of fund managers.

Post-Covid there are signs the balance of power has started to tip back in favour of the investor as our survey indicates that investors are willing to occasionally walk away from funds if terms are unattractive. In our survey, 71% said investors occasionally walk away for this reason. Clearly, fund terms and conditions are critical to an LP's decision-making process and commitments can fall through because the manager and investor cannot agree terms.

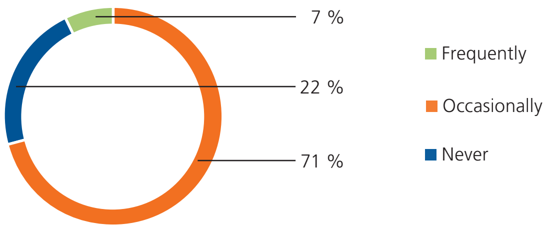
Many interviewees felt that fund terms have not significantly changed, but there is a theme of market conditions becoming more challenging for managers to achieve terms in their favour compared to the 2019 high point.

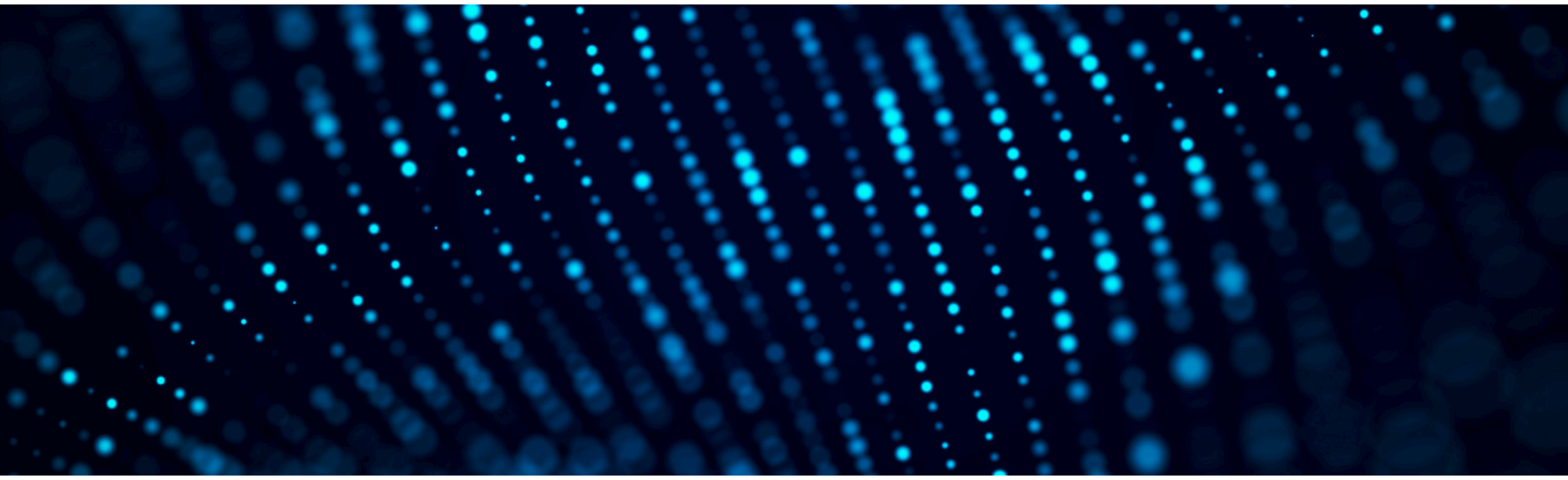
Covid has had a negative impact on fundraising in some sectors such as real estate. Given current market conditions, fund managers may, as in 2009-2011, look to attract investors by offering more investor-friendly terms.

However, there is evidence of the emergence of increasing polarisation in the market with respect to the balance of power between managers and investors. The best managers continue to have sufficient demand to obtain GP-friendly terms and fees. At the other end of the market, lesser performing or new market entrants face more competition to raise capital and therefore investors are able to dictate LP-friendly terms and fee discounts.

Figure 6

The chart below shows the response to our survey question: Have you decided, or had a potential investor decide, not to invest in a Fund due to the proposed Fund terms and conditions?





Edmund Craston

Head of Fund Management

PATRIZIA

How has the pandemic affected your relationship with investors?

We've communicated extensively with investors. That was a lesson the smarter players in the industry learned through the financial crisis.

How might fund managers prepare for future shock events, following the Covid crisis?

Fund managers are often asked to think about business continuity planning and disaster recovery planning. I think most will have passed the test with flying colours. We can function without going into the office. We've established resilience to physical inconvenience.

What investment strategies are likely to dominate in 2021?

I think that definitely there will be a number of people following core strategies, but not every type of core strategy. There is capital available for core strategies in certain sectors and countries. Residential and logistics are popular and likely to stay that way. Some people may be nervous about pricing in residential and logistics, but there is still value in and capital for both these categories.

What are the main challenges for investors in the UK and Europe in terms of availability of suitable products, costs and current market conditions?

The principal challenge is uncertainty. Economies have been hit hard by Covid and still everyone wants to work out what the outlook is economically. We might see riskier capital being deployed in 2021 when people see areas that have been affected priced down and there is an opportunity for recovery.

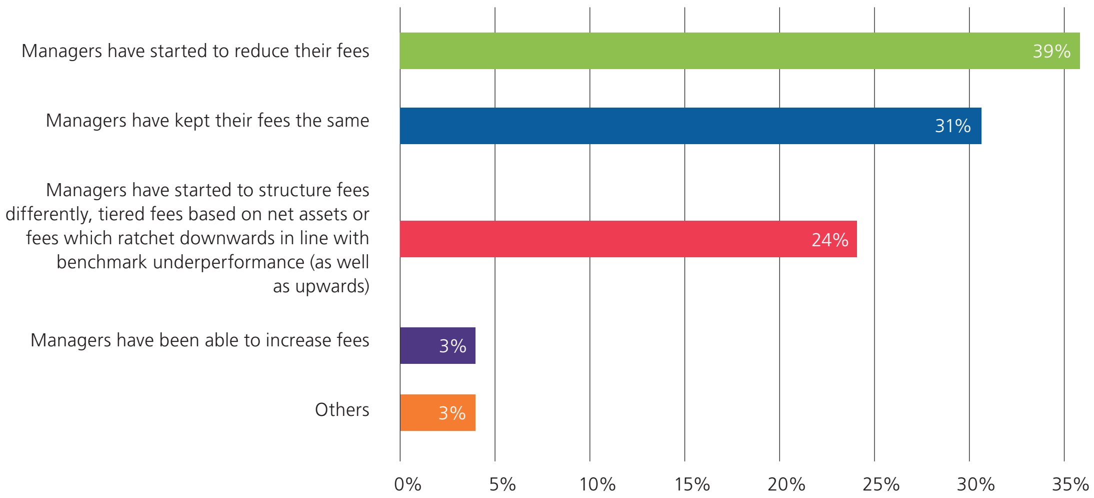
What will be the true impact of Brexit now that we have some certainty about the relationship with the EU?

The underlying feeling is that while some people predicted from the start that lots of businesses would move away from the UK and others that predicted it will be fine and dandy, the reality will be somewhere in the middle.

Management fees

Figure 7

Survey Responses: Management Fees for closed-ended private funds



Among investors and managers we surveyed, 39% believe that managers have started to cut their fees, while 31% think fees are stable. Where our study reveals there is some downward pressure on fees, this not true in all cases.

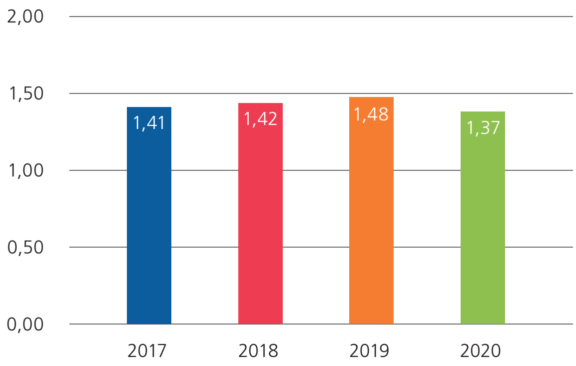
Our research suggests that fees charged by managers (in 2020 compared to 2019) have not materially changed – in contrast to the period after the 2008 financial crisis. Market forces and some regulatory pressure have led some fund managers to reassess their positions, but where funds are oversubscribed or where a manager inhabits a niche or underserved market, fees have largely remained stable. Eric Byrne, Head of Multi-Managers, REPM at UBS Asset Management, says it's simply a case of supply and demand: "*Where you have a situation where you've got good performing or reasonably performing private market funds, that have capacity constraints, and demand is in excess of supply, then managers are able to keep their fees at the same level that they planned. And quite simply, if someone doesn't want to pay those fees, they don't go into the fund.*" Austin Mitchell, Head of International Housing and Global Strategy at Nuveen agrees: "*Investors are happy to pay for performance, especially with operationally intensive and alternative real estate sectors when there is material demand*".

For investment strategies and geographies that are occupied by a number of competing funds, there is greater downward pressure on fees as managers compete for capital. "*There are some pockets of downward fee pressure but this is more prevalent in parts of the industry where 1) there are options and choice for investors, and 2) fees represent a greater proportion of forecast performance i.e. core*", Austin Mitchell comments.

Our data indicates that some managers are adopting different tiered fees based on net assets or fees tied to key metrics such as performance and ESG impact.

Figure 8

Real Estate Sample Funds – Investment Period Average Management Fee by Vintage Year



From our real estate Sample Funds 2020 shows a slight dip in management fees, but this is small and not statistically significant. The data from our Sample Funds is consistent with our survey, which suggests that management fees have remained stable for funds that are performing well in the right sectors.

Our Sample Funds show typical closed-ended real estate funds charge a Management Fee with a range of about 1.3%–1.5%. Private equity funds typically receive slightly higher fees up to a maximum of circa 2%. However, discounts for cornerstone or first close investors are common. Venture capital funds' management fees are typically in the region of 2.25% to 2.5%.

Austin Mitchell

Head of International Housing and Global Strategy

Nuveen

How do you view the current climate for fees and the ranges that you are seeing?

The real estate industry is immature in terms of market share concentration, so where you have more supply and more choice you would expect downward fee pressure on fees. There is some evidence of that. But it is polarised between those with an established track record and product, and those doing things for the first time. There are some pockets of downward fee pressure but this is more prevalent in parts of the industry where there are options and choice for investors, and fees represent a greater proportion of forecast performance. Investors are happy to pay for performance, especially with operationally intensive and alternative real estate sectors, where there is material demand.

Due diligence must be challenging in the current climate. How is this affecting the industry's willingness to invest?

Allocations to real estate are rising every year, but the levels of deployment have left a gap. The issue now is about pivoting strategies towards areas where you have the highest level of conviction. In real estate, traditionally the highest allocations were to retail and office, but that is where the most questions are right now. We have strong conviction around strategies in more 'alternative' sectors as well as housing, logistics and debt.

How is the funds sector responding to or likely to respond to the Covid crisis?

More 'alternatives', more operational real estate, more impact investing and more consolidation. Plus the transition of rental housing to a branded consumer product.

What priorities are investors seeking from fund managers right now?

There is investor demand for a positive social and environmental impact. We've seen a huge sea change with investors changing the way they make decisions. One of the biggest areas is the affordability challenge in cities. Where strategies specifically targeting social mobility and accessibility objectives can help with housing for people with certain income thresholds and ensuring access for people with certain roles, including key workers. We are spending an increasing amount of time developing additional impact investment strategies for our clients, and have been an active impact investor for over a decade.

Management fee step down rates

In closed-ended funds, once the investment period ends, there is a shift from origination to managing and preparing for exit. This change in work, depending on the type of fund, may lead to changes in the fees. This might include:

— The same rate as before, but charged on invested capital instead of total commitments (**same rate on invested capital**);

— No change at all on the fees charged (**no change**);

— A reduced rate charged on invested capital (**reduced rate on capital**);

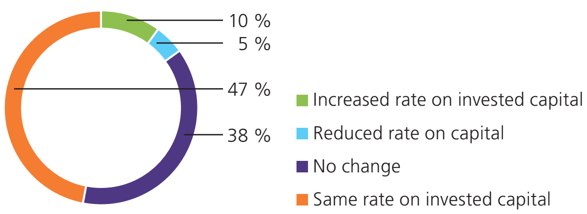
— A reduced rate on commitments during the investment period with a higher rate on invested capital (**increased rate on invested capital**).

Which of these applies depends on the type of fund. For real estate funds, management fees are usually on committed capital during the investment period and then the same rate, but on invested capital, after the investment period.

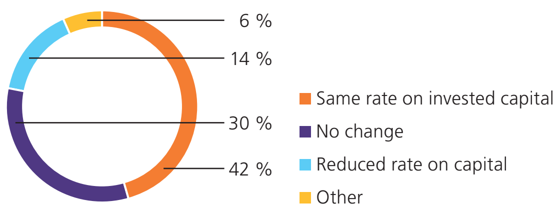
In debt funds management fees on invested capital are more common and fixed rate management fees are common for venture capital funds.

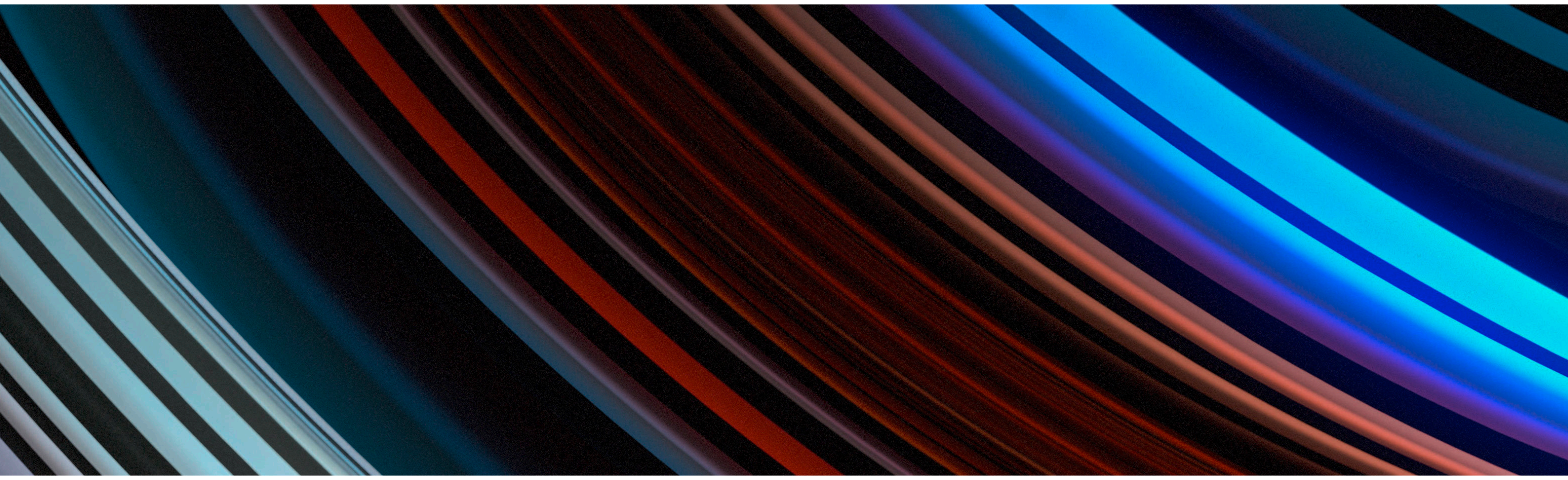
Figure 9

Real Estate Sample Funds



Venture Capital Sample Funds





Carried interest

For closed-ended funds carry remains anchored around 20% of fund profits after return of principal and hurdle across the asset classes. However, we have seen some alternatives including:

High Carry
A new trend seems to be emerging where a small number of top managers who perform very well in the resilient sectors (such as technology and distribution) can demand higher carry.

For technology-focussed venture capital funds, there is some evidence of a developing market normal for a second tier of 25% carry above a 3x return. For some managers with a strong track record there is even higher carry for outstanding returns.

Ratchet-based Carry
Where the manager has a higher carry percentage as the fund achieves additional benchmarks.

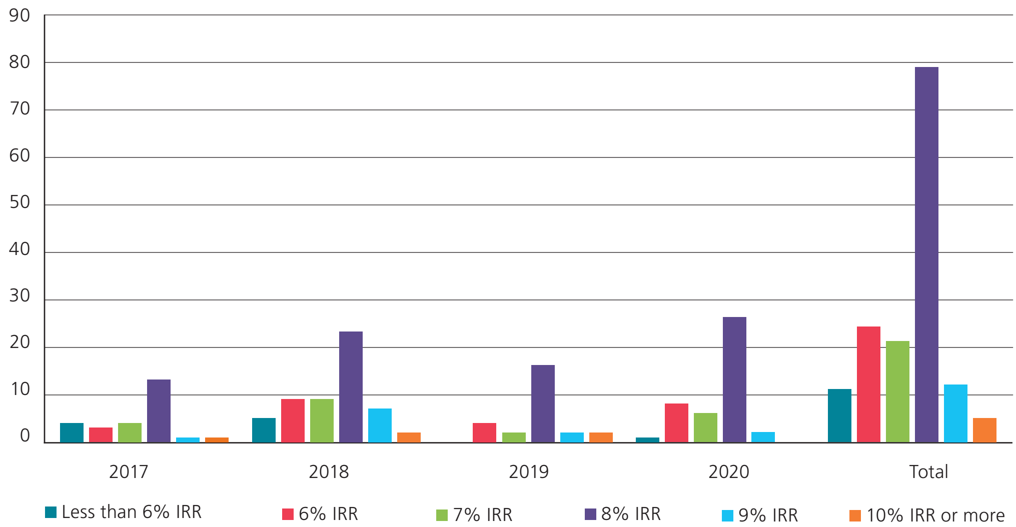
Different combinations of Carry/fees
Where a higher fee attracts lower carry and vice versa.

Hurdle Rate

An 8% hurdle rate remains the most common across all asset classes.

Figure 10

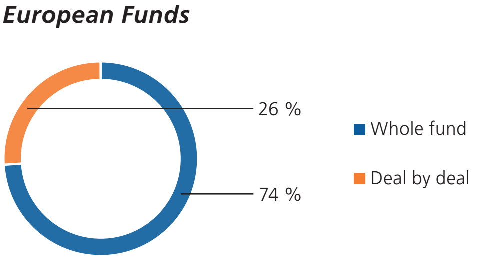
Sample Funds Promote: Hurdle

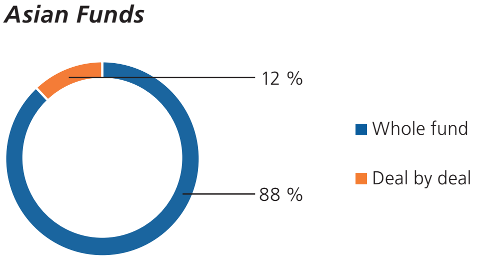


Basis for distribution: Whole Fund vs Deal-by-Deal

Whole fund waterfall is the predominant model for Europe and Asia in our Sample Funds.

Figure 11



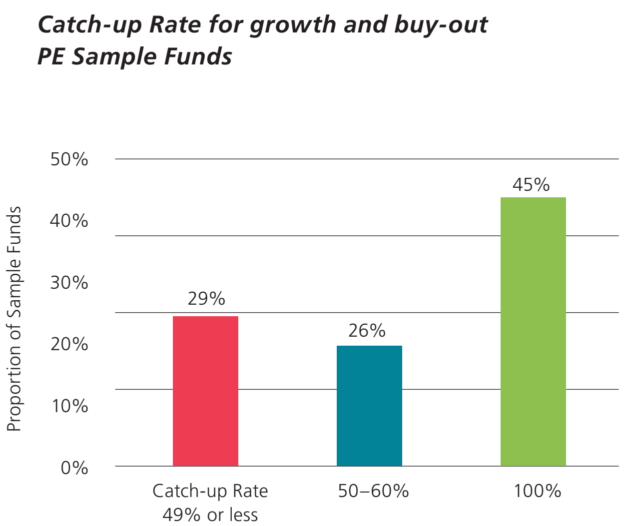


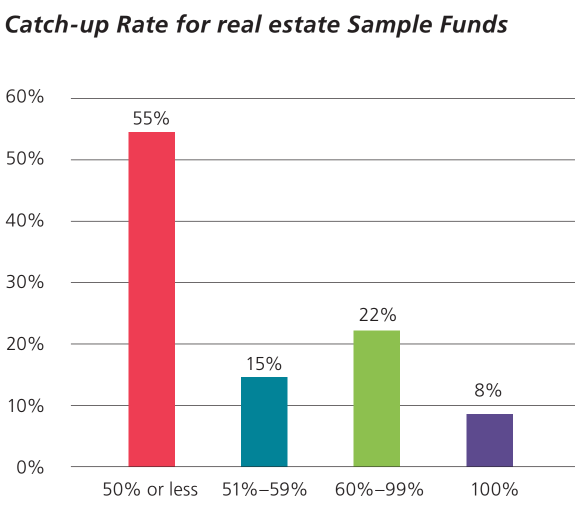
Catch-up Rate

Once investors have received profits equal to the hurdle, typically the carry holders are entitled to receive a percentage of the pre-hurdle profits to catch-up with the investors. Historically, carry holders received 100% of catch-up distributions to catch-up to the position of investors.

Whilst this remains common for private equity funds, a lower rate of catch-up is more common for real estate funds, typically around 50%, with no catch-up in some instances (although hurdle rates may be lower or ratcheted in these situations).

Figure 12





Escrow, Claw-Back and Guarantees

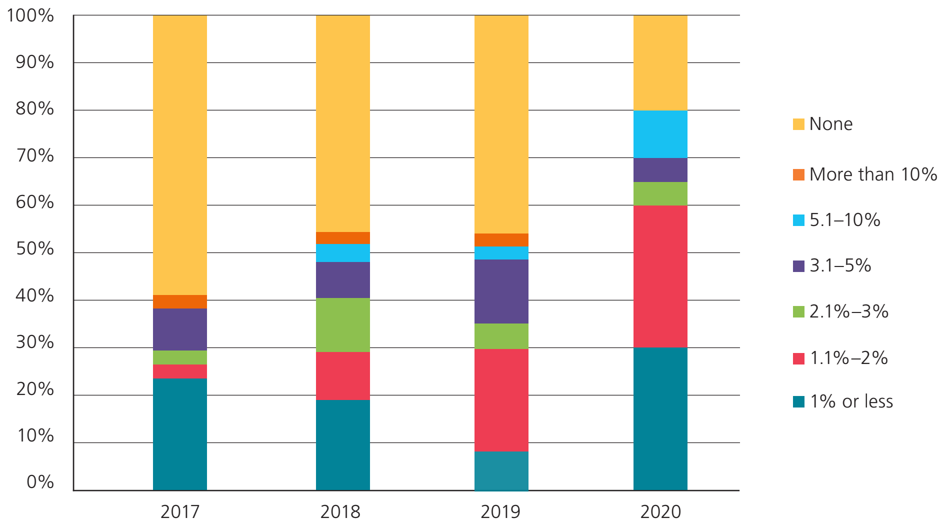
It is common for carry to be subject to a clawback on termination of the fund (including both Deal-by-deal and Whole fund waterfalls), with escrows continuing to be common in Deal-by-deal funds. We are also starting to see a growing request for fund manager guarantees although these are still generally resisted.

GP commitment

For closed-ended funds, the traditional benchmark GP Commitment is 1-2%, but the average has been increasing in recent years. Some funds have a GP Commitment of 5% or greater. Our study shows that managers establishing their first closed-ended funds are statistically likely to have higher GP Commitments.

Figure 13

GP Commitment in closed-ended Sample Funds



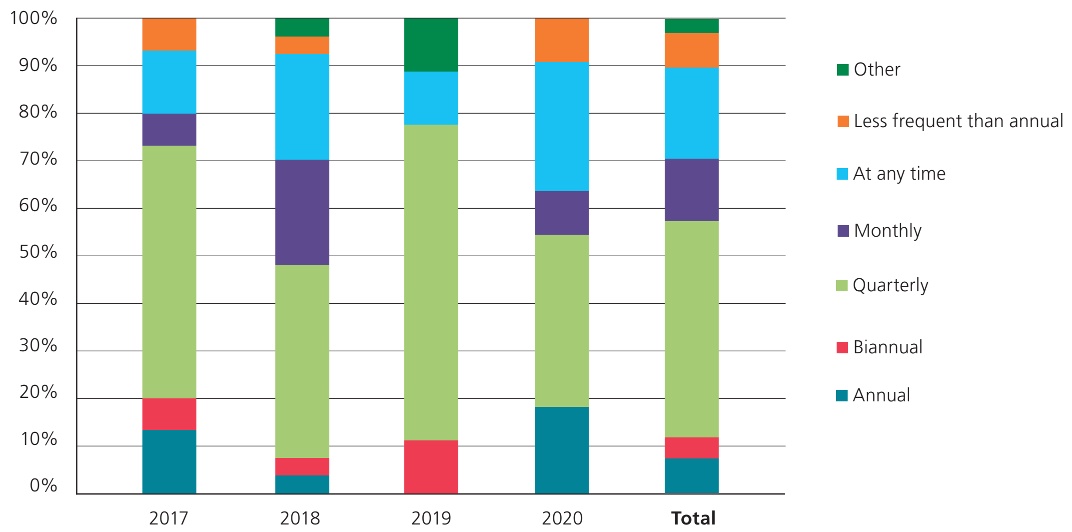
Redemptions and limits on liquidity

Covid resulted in a liquidity crisis in March 2020, though not to the same level as occurred after the 2008 global financial crisis. Of course, market illiquidity can also offer opportunities, with the potential for investors that have sufficient financial resources to enter the market and buy distressed assets with greater fundamental value than their fire-sale pricing. At the start of 2021, transaction activity was slow. "*Exit activity is still lagging,*" says Matthias Reicherter, Managing Partner and CIO, Golding Capital. "*Liquidity out of the private market has been reduced. We hope that 2021 exit activity will bounce back.*"

For open-ended and semi-open-ended funds, quarterly redemptions are the most popular redemption periods.

Figure 14

Redemption Frequency in Sample Funds



NAV suspensions have brought into focus how managers deal with redemptions in private funds investing in illiquid assets.

Many of the Sample Funds do not need to hold high levels of cash as they do not have regular redemption dealing dates. However, for those funds which offer regular redemptions, managers have had to manage liquidity by a number of methods including carrying large amounts of cash (and near cash) and in a low interest rate environment, they have found themselves under pressure for returns..

In some cases, even funds with cash / near cash in the region of 20% struggled to meet redemptions and gated nonetheless when under stress. The UK's FCA has consulted on possible ways of addressing this structural mismatch including a proposal to require investors to give longer notice periods before their investment is redeemed.

The regulator argues that this could deliver an increase in returns to property fund investors due to the funds operating in a more stable and sustainable way, with more assets invested in property and less in cash.

Matthias Reicherter

Managing Partner and CIO

Golding Capital

What investment strategies are likely to dominate in 2021? What sectors are likely to be most attractive?

My belief is that the alternative investment side, where we are part of the private equity, private debt and infrastructure investment sectors, will benefit from the crisis. The volatility is so severe on the public markets side, that institutions are shifting allocations towards the private markets.

I can see longer dated funds and longer holds in private equity. Rolling an asset into another vehicle and having another five years of managing that asset, people are happy to keep their exposure to various asset classes for longer.

How do you view the level of competition for deals in the market and how is this affecting valuations?

There is a move towards more complex and more greenfield deals to earlier in the investment's lifecycle. There are interesting return profiles when you pay for complexity and bring it to clarity. You need to avoid the brutal competition for plain vanilla deals.

Investors are reallocating from the traditional to the alternative. The secondary market is going through the roof with people buying into portfolio exposure and building out that exposure across sectors.

How do you see the relationship between GPs and LPs in 2020 and how is this likely to change in 2021?

We have reported to and communicated intensively with our LPs. At the beginning of the Covid outbreak we communicated what it meant for the portfolio or what it could mean for the portfolio. There was a continuous flow of information and more intense than normal years.

What effect has Covid had on fundraising?

Our job is to find new opportunities and new fund managers and this is challenging as you don't want to write a EUR 50m cheque without having seen each other. That is another Covid theme. A virtual meeting is a good way of doing a lot, but it needs to be somehow supported by a physical meeting as well.

What is the ongoing impact of Brexit on investment strategies and where funds are domiciled?

The UK is still a very important market. The number of players in the UK market is significant so if you are building a European private equity, private debt or infrastructure portfolio, you can't ignore the UK.

Governance

For many it is a distant memory when the Alternative Investment Fund Managers Directive ("AIFMD") was introduced in Europe and introduced new standards in areas such as risk management and oversight. It also introduced the fund depositary to oversee the operation of many private funds that were not used to such a concept.

Capacity, independence and competence of directors seem to be prominent themes with investors, and managers are under regulatory pressure to raise their own internal governance standards. More emphasis is now given to the environmental and social consequences of investments and how managers run their operations. Against that background, we look at key-person clauses and removal of the manager in closed-ended funds.

Key-Person Clause (in closed-ended funds): If the key-person provision is triggered there is often an automatic suspension of the investment period. The vast majority of the Sample Funds had some form of automatic suspension. How management activity is reinstated varies from a vote of investors holding 75% of commitments, through to fixed periods (e.g. 180 days) for automatic restoration of the investment period, unless there is a vote against restoration.

Removal of GP (in closed-ended funds): The fund provisions allowing investors to remove the GP/manager are frequently negotiated but rarely used. The majority of funds surveyed included a right for investors to remove the GP/manager for cause, with a simple majority investor vote being the market standard. While the right for investors to force a no fault-removal was only seen in around 50% of funds, where it was included a 75% investor vote threshold was most common.

Figure 15

Cause removal of GP / manager in Sample Funds

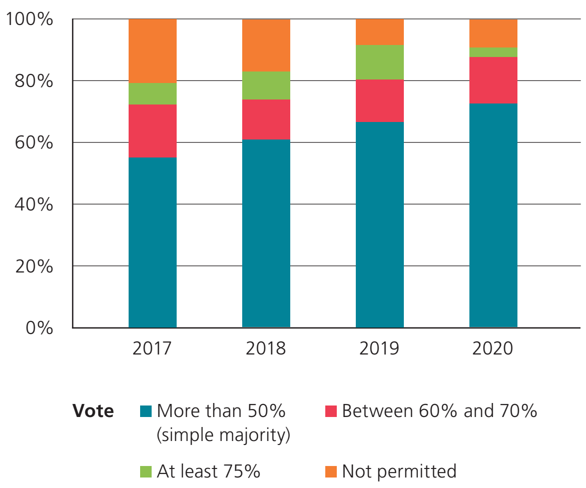
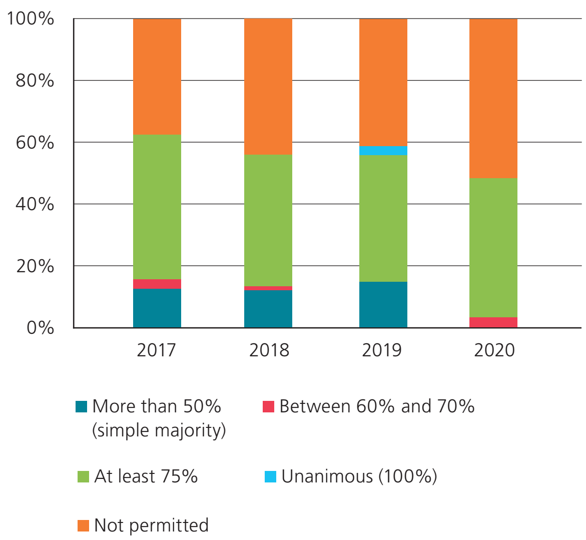


Figure 16

No-cause removal of GP / manager in Sample Funds



Eric Byrne
Head of Multi-Managers, REPM
UBS

What changes have you seen in the actual interaction between GPs and LPs, particularly in agreeing terms? Has there been more pushback from LPs?

There was a rebalancing between the GP and the LP that occurred after the financial crisis in 2008/2009. So pre-financial crisis, the GP was in the ascendancy and sort of set the terms and the LP could either take these terms or choose not to. That then evolved quite a bit, from really 2010 onwards to a position pre-Covid where I would say there was the right balance between the GP and LP with regard to fund terms and transparency in the majority of cases. Covid hasn't really changed that, but GPs have become very attuned to transparency requirements during Covid, particularly if you're invested in assets that have been under stress.

What trends are you seeing in GPs' fee structures and what LPs are willing to accept?

It's a case of supply and demand. Some large or unique funds can hold their fee levels, while in areas of strong competition fees are falling.

If there's a fund that is quite unique and it's investing, for example in life sciences, where everyone wants to get into, then people are willing to pay the fees because they can't find another alternative to get into life sciences. But if there are ten other life sciences funds that are offering the same thing and lower fees, then of course you've got that extra optionality and ability to negotiate a lower fee.

How do you view the difficulties experienced with valuations?

When Covid hit no one really knew what retail, hotel or even office assets were worth, because there simply were very few transactions occurring to find a fair value. The Royal Institute of Chartered Surveyors quite rightly recommended at the time to put a material uncertainty clause in place, however this was inconsistently applied around the globe by the valuers and managers with some funds suspending trading while others did not. As the impact of Covid has become better understood and transaction volumes have picked up, the material uncertainty clause has been lifted in almost all cases now.

How attractive is the secondary market right now?

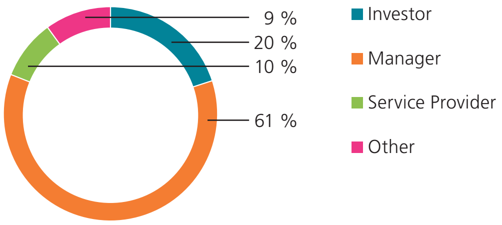
We've seen over the last 15 years, there's been different points in the cycle which have created better opportunities for secondaries. And of course, the best opportunity was post the last financial crisis really. The secondary vintages around 2011 to 2013 were very good as there were a significant amount of distressed sellers willing to sell at quite a significant discount.

The secondary market has now evolved where there is more tactical LP led secondary transactions at less distressed prices. The growth area we have seen is in GP-led recapitalisations which is playing a much larger part in the secondaries space today.

Predicted fund trends

Looking to the near future, we surveyed over a hundred managers, investors and service providers to reveal the state of the market and where it is headed. The respondents comprised:

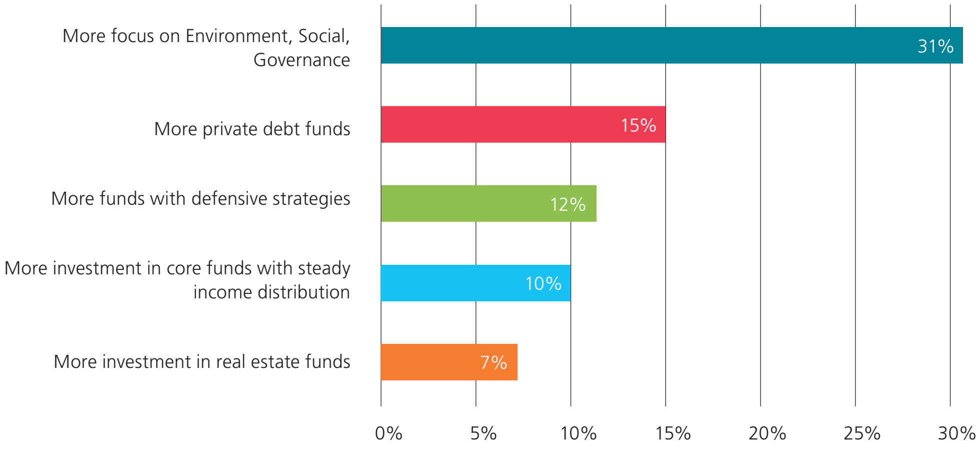
Figure 17



Developing trends: Strategy

Survey respondents were asked to select three emerging trends in funds' strategy they anticipate over the next year. The table below shows the top five results.

Figure 18

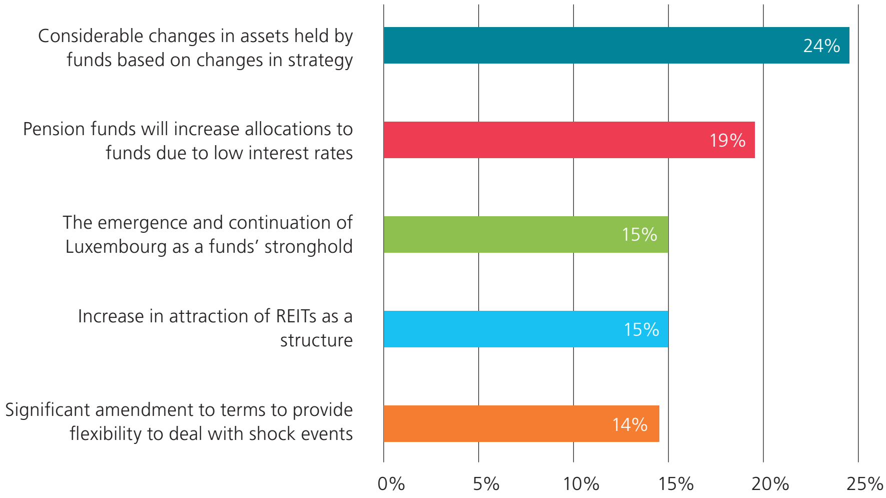


ESG will inevitably be a greater focus for managers and investors alike going forward as this moves from an alternative strategy to the mainstream.

Developing trends: Investment Sector

Survey respondents were asked to select three trends they anticipate in the investment sector over the next year (concerning the matters set out below). The table shows the top five trends.

Figure 19

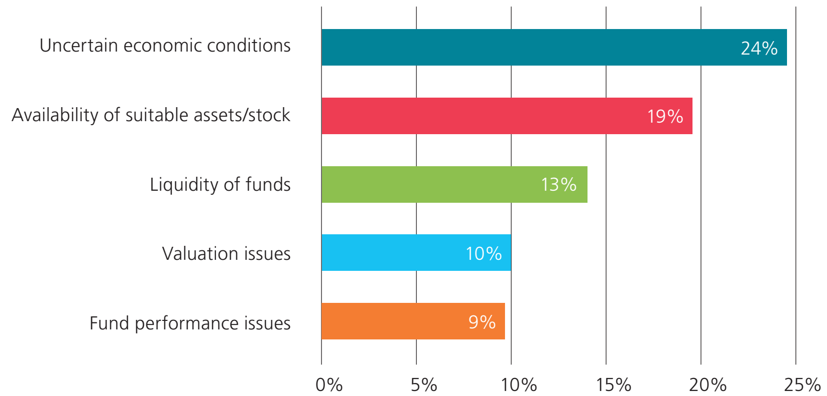


Portfolio balance is unlikely to remain static. Respondents were of the view that there will be changes in investment strategy as managers focus on better performing classes.

Biggest challenges

We asked survey respondents to select the biggest challenge(s) that they consider the funds industry is facing over the next year. The table shows the top five challenges.

Figure 20



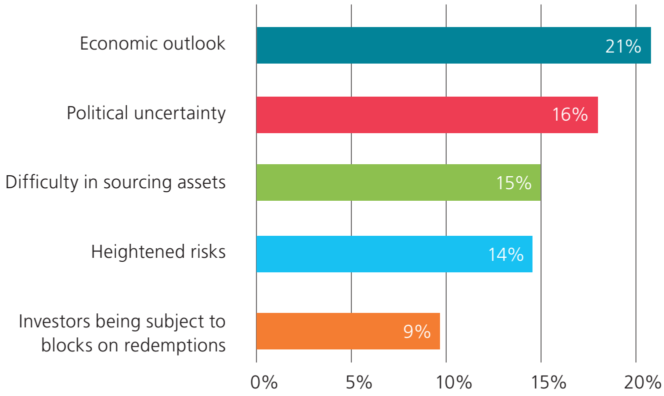
The economic outlook and difficulties in sourcing assets are thought to have the biggest impact on raising funds.

Raising Funds

We asked survey respondents to select the factor(s) that they think will have the greatest impact on fund managers' ability to raise capital over the next year.

The table shows the top five factors.

Figure 21

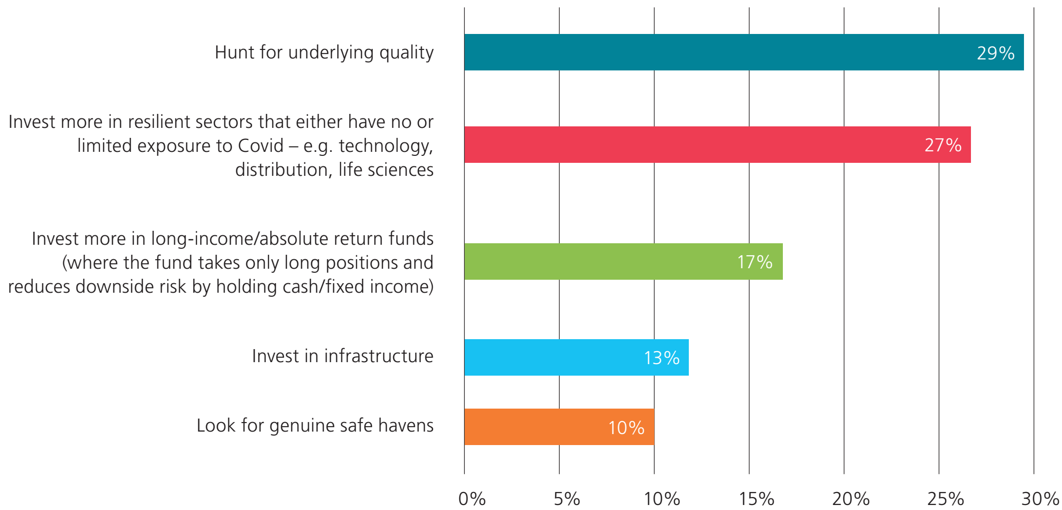


Although Covid has given rise to uncertainties, many managers plan to take advantage of opportunistic strategies. Eric Byrne, Head of Multi-Managers, REPM, UBS Asset Management, believes that the negative impacts will be slight in comparison to what happened after the 2008 global financial crisis: "*The lessons have been learned from the financial crisis. LPs are more diversified, they're more careful on their use of leverage, and therefore, there are far fewer distressed sales now in private equity, real estate and infrastructure, than during the financial crisis.*"

Preserving asset value

We asked survey respondents about the best way to preserve asset value in 2021. The table shows the top five responses.

Figure 22



Sustainability and ESG

Our survey respondents point to a continued focus on ESG, particularly as investors see this as a primary factor in choosing between funds.

It is now impossible to consider the future of funds and fund terms without considering sustainable investment. Over the course of the last two years, sustainable investment has moved from being a relatively niche area of the investment universe to the mainstream – all types of fund and asset class now need to consider ESG: either as a result of regulatory need or market impetus.

Level 1 of the Sustainable Finance Disclosure Regulation came into force on 10 March and has crystallised these changes in EU fund processes and documents, but this is only the beginning of the story. Over the course of the next year (and beyond) the shift towards sustainable investment as an imperative for managers will continue to pick up speed. From the EU, we will have Level 2 of SFDR, which brings with it a significant and onerous reporting burden for managers, as well as the EU Taxonomy.

In the UK, there are numerous sustainable investment related initiatives from the FCA and the PRA, covering the UK's own proposed climate related disclosure regime, guiding principles for the design of ESG products, stress testing and a separate taxonomy: all of these will see material change for the industry over the course of the next year. The main disclosure regime is expected to apply to large asset managers in 2022 and to smaller asset managers in 2023. On top of this, both the EU and the UK are pursuing additional requirements for corporates; as such, fund managers will be affected at every level.

Artificial intelligence (AI) and Technology

Fund managers and investors are increasingly looking at the potential impact and benefits of AI and Technology and Fintech in the funds sector. Whilst not yet in this study's top developing trends, our discussions with managers and others reveal a growing opportunity to innovate, differentiate and to create new products. Tokenisation of assets is a way to increase how and what investors can invest in and to increase the investor base. We are seeing this trend begin to pick up across our CMS offices with security token offerings for a wide range of assets from Europe to SE Asia. There is a global opportunity to attract a new generation of investors both in existing and fast growing new regions. Investors will also increasingly look to technology to determine how they invest and monitor their portfolios.

Digitalisation of operations and use of computing is also an accelerating trend. This includes the use of distributed ledger technology (DLT) such as Blockchain. It may be used, as we are now seeing in some cases, for fund raising and onboarding. DLT can also be used to gather data, for reporting and for trading tokens on a platform. It is likely to support compliance for accounting and ESG and generally create value for investors in terms of the governance of a fund and data about its investments. Technology will also be an opportunity to drive down costs or increase performance through cost savings or investment and asset management benefits.

This is a period of exciting change. Digital currencies and tokens for payments are becoming a theme alongside legal and regulatory changes and sand boxes to facilitate growth. Change is also likely to bring disruption and change the shape of the funds sector. We expect our next study to confirm this.

Glossary of terms

AUM: Assets under management.

Catch-up Rate: An accelerated rate of return paid to the manager after investors have received the Hurdle Rate and before payment of the Carried Interest share, which ensures that the manager's total share of profits (taking into account payment of the Hurdle Rate to investors) equals the Carried Interest share.

Carried Interest or Carry: A share of fund profits paid to the manager after the investors have received back their invested capital plus the hurdle return on that capital.

Deal-by-deal: Where the Carried Interest (and Hurdle Rate) is calculated separately in respect of each individual investment of the fund. Often combined with other mechanisms (such as escrows, clawbacks and guarantees) designed to protect investors from an overpayment of Carried Interest to the manager.

ESG: Environmental, Social, and Corporate Governance refers to the three central factors in measuring the sustainability and societal impact of an investment.

GP Commitments: The amount of capital invested in the fund by the GP/manager, with the purpose of aligning the interests of the GP/manager with investors.

Hurdle Rate: The rate of return to which the investors are entitled before the manager earns its Carried Interest. Also commonly known as the 'preferred return'.

Investment Period: In respect of closed-ended funds, the period during which the manager is entitled to draw down investors' commitments for the purposes of making new investments. Also commonly known as the "Commitment Period".

Key-person Provisions: The requirement for key people of the manager to devote time to the fund's business and the consequences should they not do so.

Management Fees: The fee paid to the manager to compensate it for its management of the fund and its investments. This may be determined by reference to different bases (such as fund commitments, invested capital, net asset value or gross asset value) and at different rates, depending on the nature and strategy of the fund.

No-fault Divorce: The removal of the GP/manager from the fund without cause.

Redemption Gates: A restriction on the volume of total redemptions permitted from a fund in a given period.

Termination or Removal for Cause: Removal of the GP/manager by vote of the investors in instances where the GP/manager has through its actions or omissions given rise to cause for removal (for example, fraud, gross negligence, wilful misconduct, material breach of agreement).

Whole Fund: Where the Carried Interest (and Hurdle Rate) is calculated on an aggregate basis in respect of the entire investment portfolio of the fund.

Thanks

A very warm thank you to our clients for their participation in the debate particularly:

- Anne Breen, Head of Investment Strategy (Real Estate), Aberdeen Standard Investments
- Austin Mitchell, Head of International Housing and Global Strategy, Nuveen
- Edmund Craston, Head of Fund Management, PATRIZIA
- Eric Byrne, Head of Multi-Managers, REPM, UBS Asset Management
- Matthias Reicherter, Managing Partner and CIO, Golding Capital

Methodology

In this study we look at samples from transactions on which CMS offices advised. All data has been anonymised and any outlier results have been removed. The majority of the Sample Funds reviewed are closed-ended private funds although some funds do have open-ended features and have been classified as semi-open-ended.

CMS Funds Group: Global Reach

Our funds lawyers are embedded in their local markets and have extensive industry connections. But we are also well known for our specialist expertise in international fund structuring and cross-border mandates.

From our global team of over 130 professionals, we can mobilise the right people quickly to create the best team for every mandate. Our experts are based across our international offices including:

- Austria
- Belgium
- Bulgaria
- France
- Germany
- Hungary
- Italy
- Luxembourg
- Netherlands
- Poland
- Romania
- Singapore
- Spain
- South Africa
- Switzerland
- UK
- Ukraine
- US (Regulatory support)

Wherever you operate and do business, we can put the experience and resources of one of the world's largest law firms to work for you.

CMS Law-Now™

Your free online legal information service.

A subscription service for legal articles on a variety of topics delivered by email.
cms-lawnow.com

CMS locations:
Aberdeen, Abu Dhabi, Algiers, Amsterdam, Antwerp, Barcelona, Beijing, Beirut, Belgrade, Berlin, Bogotá, Bratislava, Bristol, Brussels, Bucharest, Budapest, Casablanca, Cologne, Dubai, Duesseldorf, Edinburgh, Frankfurt, Funchal, Geneva, Glasgow, Hamburg, Hong Kong, Istanbul, Johannesburg, Kyiv, Leipzig, Lima, Lisbon, Ljubljana, London, Luanda, Luxembourg, Lyon, Madrid, Manchester, Mexico City, Milan, Mombasa, Monaco, Moscow, Munich, Muscat, Nairobi, Paris, Podgorica, Poznan, Prague, Reading, Rio de Janeiro, Rome, Santiago de Chile, Sarajevo, Shanghai, Sheffield, Singapore, Skopje, Sofia, Strasbourg, Stuttgart, Tirana, Utrecht, Vienna, Warsaw, Zagreb and Zurich.

cms.law