Transparency and the PE industry

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BY

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Transparency in business bestows an aura of credibility and fidelity, whereas a lack of it breeds suspicion and lingering doubt – a notion the private equity (PE) industry is, or should be, well aware of.

To be sure, the PE industry, composed as it is of a multitude of funds, trusts and other financial vehicles, is a magnet for criticism when it comes to the level of transparency it sees fit to offer external parties. Such criticism has done nothing but escalate in the years since the financial crisis.

In the UK this is certainly an issue, with a recent report by the Private Equity Reporting Group (PERG) – the independent body established to monitor conformity with the 2007 Walker Guidelines on enhanced disclosure rules and to make recommendations to the British Private Equity and Venture Capital Association (BVCA) – finding that PE firms and their portfolio companies are somewhat lax when it comes to the transparency of their transactions.

In summary, the PERG report reveals that: (i) compliance with the Guidelines by portfolio companies fell from 95 percent in 2015 to 88 percent in 2016; (ii) the quality of disclosures fell substantially last year, with 57 percent (down from 95 percent in 2015) achieving a good or excellent "best in class" rating; and (iii) 20 percent of all portfolio companies had not published their audited report and accounts on their website at the time of the publication of the PERG report, with a greater percentage having not published their accounts within six months of year-end.

"Although compliance with the Guidelines in the sample reviewed this year was still high, at 88 percent, the issue is that the quality of compliance has declined, with a disappointing 57 percent of the sample achieving a 'good' or 'excellent' rating," explains Tom Allchorne, a director at the BVCA. "The primary reasons behind this fall are the higher standards of disclosure by FTSE350 companies, the benchmark the PERG uses for judging compliance, and the fact that nearly half of the companies are new to the process."

Samuel K. Won, founder and managing director of Global Risk Management Advisors, believes that the PERG report simply confirms what has been well known within the UK PE industry for some time: that the quality and quantity of the transparency supplied is limited and can vary substantially from firm to firm.

“The current breadth and depth of the transparency – such as profile data about a fund’s portfolio companies, performance metrics, progress towards exit of an investment and risk management data and analysis – that PE funds and their respective portfolio companies provide to external parties is still lacking, because these firms do not perceive the value of transparency as a business objective,” he says.

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Furthermore, the PERG analysis, while recognising the impact of the Walker Guidelines, also makes it abundantly clear that a significant amount of work remains to be done in terms of upping transparency levels across the UK-based PE industry. To achieve this, the PERG strongly encourages aspiring fund managers to reach standards of disclosure above the minimum requirements, meaning those observed in the FTSE 350. Simply put, the PERG is looking for the UK PE industry to get to grips with its shortcomings and make itself more accountable and culpable, and therefore, more transparent.

Transparency considerations

Alongside questioning the quantity and quality of UK PE industry transparency, it is important to recognise not only the improvements the industry has made in recent times, but also the context in which they were made. “The PERG report rightly highlights some weaknesses in firms reporting and these need to be resolved, but if the benchmark is the FTSE 350, containing firms which have far more dedicated resource and a higher obligation for compliance, then we should also naturally expect there to be some lag in adoption from private capital markets,” says Chris Ferguson, chief executive of Preqin Solutions. “Overall transparency in the PE industry could be a lot better, but the larger firms have generally led the way in terms of disclosure, and few of the findings would be particularly alarming to me as a stakeholder.”

In the view of Harry Nicholson, a partner at EY, since the publication of the Walker Guidelines, the UK-based PE industry has made great improvements to the way it conducts itself in terms of transparency and disclosure requirements. These include significant upgrades to annual reviews, description of governance, information on portfolio company investments, provision of data to industry bodies and portfolio company annual reporting.

“Much of this is well beyond the requirements of private companies, notably in the area of portfolio company annual reporting, where public company standards are used to judge private companies owned by PE firms,” opines Mr Nicholson. “The independent oversight of this process, by the PERG, also takes the view that the portfolio companies of several private-equity like investors should be subject to the same standards of transparency and disclosure. If there is any lack in transparency in the UK PE industry, then it lies here.”

In addition, EY's ninth 'Annual report on the performance of portfolio companies' (November 2016), which examines the economic impact of PE ownership of the largest UK businesses, found no systematic evidence of a reduction in jobs or investment that might merit further transparency or disclosure. "On the contrary, the findings show positive growth in productivity – as one of the main drivers of investment returns well above public equity benchmarks, as well as a long term approach," says Mr Nicholson.

Quality disclosure

Today, in a world which appears to advocate an ever-increasing focus on the conduct of large, privately-held businesses, the need for a UK PE industry that is transparent, with a level of disclosure that complies with industry parameters such as the Walker Guidelines, is increasingly acute. How the industry goes about achieving this of course varies, but there are a number of options available.

"Given the growing number of regulations and reporting requirements from investors, regulators and stakeholders, it is essential that firms commit the necessary dedicated resource and expertise to their compliance and data collection challenges," insists Mr Ferguson. "This resource can be in-house, but as requirements become more complicated and specialised, the market trend has been for firms to seek external help through a combination of consultants and software solutions."

One stumbling block in the quest for transparency worth noting is that compliance to the Walker Guidelines is voluntary. Some experts believe this should not be the case, reasoning that it is unrealistic to assume that PE funds and portfolio companies will provide transparency simply in order to be seen as good corporate citizens. "More effort should be made to ensure that, wherever possible, transparency is mandatory and in harmony with other major types of transparency initiatives such as AIFMD/Annex IV, Form PF, Open Protocol and leading due-diligence questionnaires from major industry groups such as the Alternative Investment Management Association (AIMA)," Mr Won recommends.

Another element of the transparency debate likely to continue to gain attention is the compensation philosophy and strategy that companies have in place, and how the mix of jobs is trending by compensation band. “This information is already being disclosed in aggregate by the portfolio companies,” confirms Mr Nicholson. “Public company standards are being applied to portfolio companies in areas such as gender diversity and human rights.”

Expected progress

With the PERG and the BVCA pledging their commitment to ensuring that compliance levels are raised among UK PE firms and their portfolio companies, a fair degree of progress is expected within the industry in 2017 and beyond. According to Mr Won, a number of major secular and regulatory trends, as well as evolving best practice standards, are beginning to have an impact on the transparency that funds are either required or willing to provide to their regulators or investors.

For example, there are recently enacted regulations such as the Alternative Investment Fund Directive (AIFMD) which sets a new and higher global standard for transparency and reporting. Under AIFMD, PE fund managers are required to provide, as part of the fund’s annual report, disclosures around the fixed and variable aspects of compensation including the carried interest for key employees and partners. At the same time, AIMFD has a number of risk management-related reporting and disclosure requirements which need to be observed. These include investment types and concentrations, valuation and stress test information that must be provided to comply with required transparency and reporting rules.

That said, Mr Won notes that, thus far, the Walker Guidelines have intentionally opted not to provide the level of granularity in the kinds of transparency that AIFMD/Annex IV requires. The danger in this, he suggests, is that the Guidelines risk being perceived as merely window dressing or not relevant, especially if it is felt there is a large gap between them and other kinds of transparency available to regulators and investors.

“If regulators and investors do not exert more pressure on PE funds to provide better transparency, it is unlikely that the participation rates as well as the quality of transparency that PE firms and portfolio companies provide will improve,” predicts Mr Won. “Some PE funds have begun to realise that enhanced transparency can directly and positively impact their ability to attract and retain investors and, in particular, from institutional investors such as pensions, foundations and endowments. Typically, most institutional investors now require a certain minimum level of transparency as a prerequisite for investing with a fund manager. In the future, more private equity funds may come to the realisation that their success in raising and retaining client assets is directly correlated to transparency; and, as a result, transparency may become a higher business priority for these fund managers.”

Given the growing institutional and private allocations to the asset class – in absolute terms and as a percentage of their portfolios – many commentators expect PE industry transparency demands and reporting requirements to grow. “Although the industry has been slow to adopt technology solutions to assist with these challenges, we expect this will change as the burden grows,” says Mr Ferguson. “The key point to solving the challenges will be standardisation – in how operating metrics are tracked and compared across investee companies, but also in the way that performance is calculated and reported to, and ultimately analysed by, investors and regulators.”

Embracing best practice

Given the role that the PE industry plays in providing funding for companies to develop into successful and sustainable businesses, it is essential for firms in this space to commit to an agenda that is as forthcoming and transparent as possible. Although it is true that a growing number of PE firms are embracing best practice standards in valuations, monitoring and reporting, there is still plenty of room for PE firms, especially those in the UK, to apply greater transparency to their structures and operations.