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‘Honest re-appraisal’ needed of GP-LP alignment of interests

General partners have to ‘open their minds’ to investor concerns about fees, control and transparency while limited partners have to move away from the ‘who’s to blame’ conversations, according to David Hodes and Doug Weill.

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Private equity real estate fund structures need to evolve if they stand any chance of survival – with both GPs and LPs taking part in an "honest re-appraisal" of their alignment of interests.

A paper from advisors David Hodes and Doug Weill warns that just like open-ended funds being forced to adapt in the crisis of the late 1980s, so too must the commingled fund model change, particularly in relation to fee levels, control, transparency and effective governance.

The duo, who left Credit Suisse's placement group to set up their own advisory business, Hodes Weill & Associates, said fund managers "need to open their minds to LP concerns", but insisted it wasn't a "one-way street".

"LPs cannot view this solely as an exercise in reducing fees and neutering management," the paper added. "[There needs to be] an honest re-appraisal of the alignment of interest that underpins the private fund structure.

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The paper said LPs were concerned that a minority of GPs were making investment decisions based on the ability to generate fund fees, perpetuate fees "or worst of all, survival" rather than a decision based on what was best for all the assets and, ultimately, investors.

"LPs have expressed concern that their managers may be incentivised to pursue portfolio re-capitalisations in order to perpetuate a fee stream from a portfolio that might be insolvent. Other LPs have expressed concern that some GPs are not looking for investments because they are unable to fund their co-investment capital."

The paper, which was published ahead of the fall conference of the US Pension Real Estate Association gathering in Los Angeles next week, insisted that LPs also had to engage more constructively.

"We need a transformation of the content of GP/LP communications away from 'who's to blame' and focused toward 'what happens now'." It would, Hodes and Weill said, require "transparency and realism on all sides.

"We have all learned many new lessons - painfully - about how misalignments can arise, so the funds of the future will inevitably reflect the greater experience we have gained during this period of extreme market stress."

The paper said, though, those lessons could only be learned through "constructive engagement rather than a prolonged cycle of mutual recrimination".