Be Direct with Me, Please!

Original Article: "Direct Investments" by Paul Kenny, *AIAR Volume 8, Issue 3*
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The full article may be accessed here.

Central Issue of the Paper

In an effort to decrease fees and increase access to attractive opportunities in the private markets, allocators are getting more creative with their private market allocations, opting for co-investing opportunities or even directly investing in portfolio companies. While seemingly attractive in some ways, direct investing comes with other complications for consideration. In this Viewpoint, we discuss some of the takeaways from Paul Kenny's article, "Direct Investments", which as published in Volume 8, Issue 3 of the *Alternative Investment Analyst Review.*

Approach Employed by Paper

According to Cerulli Associates, approximately 67% of HNW-focused practices expect to increase their allocations to direct investments over the next few years. Of this same group, only 22% expect to allocate to *indirect* investments through private equity or other third-party managers over the same period. While these statistics may appear staggering, Kenny offers some historical context around flows into direct investing. In fact, direct investing flows have fluctuated over many cycles over the past few decades, which can be separated into four distinct categories:

- 1960 – 1977: Conglomerate Venture Capital
- 1978 – 1994: Silicon Valley
- 1995 – 2001: Irrational Exuberance
- 2002 – Present: Unicorn Era

This could suggest that this recent surge in demand for direct investing is a normal part of the cycle, but private markets have never been larger. With such a large opportunity set, due diligence becomes crucial.

Why Direct Investing?

Kenny argues that one of the most obvious reasons for direct investing is to decrease fees paid to fund managers and intermediaries. However, fees may only be one dimension behind the rationale for more direct investing. For example, family offices who participate in direct investing allows them to concentrate their dollars into more high

conviction investments and/or capitalize on family domain expertise (e.g., perhaps a family has deep knowledge of software and wants to apply that knowledge for venture capital projects). Other reasons might be for the investor to maintain greater control and transparency over their underlying investments, customize their risk exposures, and better align their portfolio with non-financial values (ESG/SRI).

Institutional investors, such as endowments/foundations, healthcare systems, corporations, are also engaged in direct investing, and have significantly ramped up their allocation efforts. Corporations, especially, have ramped up their allocations to direct venture capital, known as corporate venture capital (CVC). Rationales for institutions often include monetization of intellectual property, professional development, and enhanced investment reputation.

What Are the Tradeoffs?

Direct investing is difficult, arguably more difficult than investing with a general partner. By attempting to invest directly in portfolio companies, family offices and institutions are making the following three trade-offs:

1. Performance: Kenny notes that direct investments have not necessarily added significant value relative to third-party funds. By going direct, an investor is not guaranteed to outperform what they might experience with a manager.
2. Costs: It's expensive to implement an internal program. It may seem like a less costly way to gain exposure due to lower third-party expenses but running a direct investment program will increase internal costs. The process of investing directly in a company is far more complex than selecting a general partner.
3. Expertise: By going direct, instead of investing with a manager, investors are potentially losing valuable investment expertise from the professional investors that manage the funds.

Findings of the Paper

Kenny offers some important considerations for an investor looking to implement a direct investment program, including:

- Direct *and* GP-led investments: these should not be viewed as mutually exclusive, and investors might even want to consider co-investing alongside other investors. This not only improves the due diligence process, but also increases diversification potential.
- Know where you have expertise: Some sectors require more technical expertise than others. Some sectors, such as health care, should only be part of a direct investment program if the team has expertise in the sector. Know your strengths and play into them.
- Due Diligence: Due diligence is extremely important in private markets, and especially with direct investments. There are additional levels of complexities in this space, so the importance of risk management and domain knowledge is magnified even more.

As investors continue to invest more aggressively in private markets, direct investments are likely to gain more traction and only get more complicated. As always, it's important to know your area of expertise and to know what you own.