A Note on Direct Investing in Private Equity

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Asset owners (e.g. pension funds, sovereign wealth funds) often want to invest in assets other than the traditional ones (e.g. bonds, public equity). The main reason is that they are seeking diversification benefits. The theory and logic behind diversification benefits are well understood. In practice, however, it is difficult to measure diversification benefits and it is also common to misjudge the costs of diversification. It is not rare to hear that diversification benefits are the only free lunch on financial markets, implying that it is free. Consider for example a US investor buying stocks traded in Africa. This is costly because of the trading costs (including and mainly price impact) and additional due diligence, compared to investing in US stocks. In addition, although it sounds like a clear diversifier, most of the large stocks traded in Africa are divisions of large multinational companies. It is thus unclear whether adding stocks traded in Africa would deliver significant portfolio diversification benefits. Similarly, compare the following two portfolios. Portfolio A contains only shares of a (unlevered) department store. Portfolio B contains some real estate (the walls of a department store), some private equity (equity in the leveraged buyout of a department store), some investment rated debt (that of the term loan A issued for the leveraged buyout of a department store), some speculative rated debt (that of the second lien debt issued for the leveraged buyout of a department store) and some mezzanine funds (those that provided the mezzanine tranche for the leveraged buyout of a department store). The point is: these two portfolios could very well be identical but portfolio B sounds much more diversified.

Another reason some asset owners want to invest in assets other than the traditional ones is that they have a lot of capital to deploy. This is increasingly the case with the emergence of extremely large asset owners in recent years. Consider the Norwegian Sovereign Wealth Fund – called GPFG – with asset under management of about $800 billion. This fund invests only in bonds (about 40%) and public equity (about 60%). For their public equity allocation they hold no less than 8000 stocks around the world and even though they spread their capital across so many stocks, they still end up owning on average close to 5% of the market capitalization. A similar Japanese fund – called GIPF – is almost twice as large and holds mainly Japanese government debt. This fund is now selling that debt to buy other types of assets. If they move a mere 1% of their fund from Japanese government bonds to say US listed equity, they need to sell a whopping $10 billion of Japanese government bonds and deploy $10 billion in US stocks. Such an investor faces major transaction costs if it does not consider a large universe of investment opportunities.

Another important reason why asset owners allocate capital to non-traditional asset classes is because they believe that returns are higher for non-traditional asset classes. Although the attractiveness of these returns depends critically on the chosen benchmark, non-traditional asset manager and consultants argue that returns have been undoubtedly superior. Note also that there are a few more elements to that belief. There is for example the widespread idea that if an asset is not traded (which is the case for non-traditional assets) then it will provide higher returns to compensate for the 'illiquidity'. This argument is a priori odd since any fund manager could buy a portfolio of stocks and prevents investors from trading the fund; this would be an illiquid investment but the return would be nothing more than those of the stocks in the portfolio.

Finally, some asset owners – mainly pension funds – may benefit from having non-traditional assets in their portfolio because the valuation of these assets tends to be much smoother over time than those of traditional assets (e.g. listed equity). This perceived lower volatility seems helpful from an accounting and regulatory point of view.

The bottom line is that for one reason or the other asset owners need/want to invest in various types of non-traditional assets. These assets are mainly made up of hedge funds and private equity funds. Private equity funds specialize in various types of assets including Leveraged Buy-Out (LBO), Real Estate, Infrastructure, Venture Capital, Natural Resources. Asset owners invest via specialized private equity funds and thereby deploy capital over non-traditional assets. For this financial intermediation private equity funds charge various fees, both fixed and performance dependent, to asset owners. These fees are quite complex and consist of many layers, making it difficult for asset owners to measure exactly the fee bill. Over the years, as asset owners became more familiar with the fee structure and data accumulated, it appeared that an average LBO fund charges about 7% per annum (returns are about 18% gross and 11% net on average). Such a fee level is by far the largest across all asset classes and it seems to have taken a number of investors by surprise. In addition, the breakdown of these fees raised some issues. In particular, about half of these fees are not directly dependent on performance (this means that large amounts of fees are paid even when relative performance is mild or even poor), and some fees are charged directly to the portfolio companies which generates some conflicts of interest for the fund managers. Finally, another issue is the potential divergence between the investment horizon of a private equity fund managers (5-8 years at most) and that of the asset owners which may be over 20-30 years.

The situation on the fee front, and maybe that on the return front, led some asset owners, in particular the large ones, to demand lower fees for their private equity fund investments. The industry is highly secretive but one could reasonably speculate that it was large asset owners who started to put pressure on funds in the early 2000s. Funds probably found best to grant fee reductions only to the large asset owners that were pressuring them rather than granting fee reductions to all investors. As it is difficult to give a different fee schedule to different investors in a fund, this was achieved via fee-free co-investments.

Co-investing means that a private equity fund (referred to as General Partner; GP) may invite a fund investor (referred to as Limited Partner; LP) to co-invest with the fund in a specific company, without charging additional fees (or charging much less). Engaging in co-investments is thus de-facto a reduction in the overall fee bill for the investor; although participating LPs do engage in extra and costly due diligence to screen co-investment opportunities. In addition, the GP may overweight the selected LPs in the best investments and therefore squeeze out the non-participating LPs. If so, the gross-of-fees performance would also be higher for participating LPs. Of course, it is also possible that GPs invest LPs to co-invest in their riskier deals, the deals they are less confident will be successful. In that case co-investments could have lower expected returns than funds. In addition, co-investments increase career concerns; e.g., an employee of a pension fund may decide to invest in a handful of co-investments and a handful of funds. The probability of five co-investments going wrong is much higher than that of five funds going wrong. You will not get fired for investing in KKR or Bain Capital but you will be if five co-investments go south. Hence, the drawbacks of co-investing are all 'agency stories'. After all, a co-investment is just an increase in an existing investment in a given company at no extra cost. Bared agency stories or career concerns there would not be a need for extra due diligence, it would be a no-brainer.

Co-investments have become an important aspect of private equity investing. Anecdotally, for example, a large investor told me that the reason why they invested in the buyout funds raised at the pick of the buyout boom (2005-2007) was because if they would not have participated, the large private equity firms would not have invited them to co-invest anymore. It thus looks like co-investment is a sizeable carrot used by GPs to reward or retaliate some of their investors. Yet, Fang, Ivashina, and Lerner (2015) find that co-investments have performed poorly for the investors in their sample.

As certain large asset owners increased their co-investment programs, other investors got increasingly aware of the practice and asked to be granted similar favours. It might also be the case that these other asset owners were concerned that the fund invested proportionately less in the best deals as the best deals may be have more co-investors.

A survey by DaRin and Phalippou (2014) finds that as of 2008, 80% of the investors have been invited at least once to co-invest. It means that even small and new investors get invited nowadays. They also find that the average invitee rejects a staggering 81% of the invitations. Finally, they report that the overall amount of co-investment in the private equity portfolio averages 10% among those investors who do co-invest. Hence co-investments are usually not that large compared to the universe of private equity investing but it is important to be aware of it given the recent strong growth in that practice.

Another consequence of the increased part of co-investments in asset owners portfolios is that asset owners grew an in-house team of individuals capable of judging the quality of a given private equity investments. But if a team has the capacity to select private equity investments, it may as well invest directly in private equity, thus bypassing private equity funds. Basically, an asset owner investing directly in private equity would improve its returns as long as it does not underperform private equity funds by more than 7% (if it is an average asset owner investing in an average fund). In addition, direct investments (sometimes called 'solo' investments) would avoid the other issues mentioned above such as the divergence in investment horizon.

For asset owners, bypassing specialized private equity funds is now at the very top of the agenda. The key challenge they face in doing this is probably is on the Human Capital (HC) front.

The most debated issue is whether asset owners can hire investment professionals away from private equity funds. Some argue that hiring the key professionals away would cost about as much as the fees charged by the funds, hence it is not worthwhile. The exception is when an asset owner has HC selection abilities, i.e. can distinguish between positive-alpha professionals (net of their compensation) and the rest. In fact, an asset owner could hire professionals who underperform the average private equity fund by, say, 4% per annum. As long as those professionals cost less than 3% of capital deployed, it is still better than paying the 7% average private equity fund fee. This illustrates that going direct – as it is often called – implies a belief that one can pick HC-alphas better than GPs. This is just like an asset owner investing in private equity funds when the average return is not attractive compared to traditional assets; the asset owner then believes that it has fund selection abilities.

An interesting argument for investing in private equity is that the private equity route may be a more effective route to deploy capital in a given country, company size or company type. For example, let us go back to the Africa equity case mentioned above. For most asset owners, especially the larger ones, deploying meaningful amount of capital in Africa equity cannot be done via the existing stock markets. The only route is to buy directly stakes in Africa based businesses. The asset owner can do this 'solo' (i.e. on its own), via co-investments with a private equity fund or via investing in a private equity fund. The choice of a route boils down to comparing the cost and benefits of each one of them. Going via specialized funds may generate higher gross of fees returns, but the returns net of fees may be lower than what could be achieved by an internal team (net of their compensation). In a situation where valuation is relatively easy (low asymmetric information etc.) and where the main motivation is to get a given exposure, then it is likely that the solo route will be preferred. In fact, asset owners typically start going direct in investments like real estate and infrastructure in developed markets, then move to similar investments in emerging markets, and then may move to leverage buyout investments in developed market etc. Seldom do they invest 'solo' in venture capital, or in emerging markets.

However, the key issue with going direct may be elsewhere. Asset owners need to be flexible with their allocation to specialized investments such as buyout in Latin America, or infrastructure in Africa. When they go direct, they lose flexibility. To illustrate, an asset owner wishing to go solo on infrastructure Africa will hire, say, two specialized professionals, and by doing so they tie their hands to one project per month (say). These two professionals cannot invest more than that and investing less would be tricky too. How many months would such specialized professional go without making a deal? Not many is the answer. Given the difficulty of hiring specialized people, it is also not possible to just hire and fire people as an allocation increases or decreases. Plus it would be difficult to hire in the first place if employment horizon is uncertain. Furthermore, once the LP has deployed its targeted amount in (say) infrastructure Africa. Then what happens next to that team? Needs to be fired? Need to exit some deals just because they need to invest in new ones to keep busy?

Some asset owners have teams of 100 in house professionals. This implies a tight asset allocation, i.e. an asset allocation that cannot be adjusted easily. A solution is to have an in-house team of professionals that generate more investment opportunities that their mother institution can deploy into and they 'sell' the surplus of investment opportunities to other asset owners (charging sourcing fees). The asset owner here is becoming a (cheaper) GP. Another solution is to keep the 'direct' investment program small and use the private equity fund commitments and co-investment opportunities as variables of adjustment.

A current trend, which contributes to blur frontiers and offers yet another route for asset owners is that some private equity fund managers offer exclusive vehicles for large asset owners in exchange of a sizeable allocation or full delegation of their entire non-traditional investment part of their portfolio. In that case the private equity fund is basically offering the asset owner to be its in-house investment team. The asset owner preserves some flexibility as it may stop its relationship but the private equity firms logically put some restrictions on that.

A route which I do not think has been investigated yet is a sort of passive direct investing. We know that there is not much diversification benefits beyond 30 well-chosen equity position. To be safe let's say it is 100. One could imagine that a fund such as the Norwegian Sovereign Wealth funds make 100 direct investments all around the world, for $5 billion on average. To source and structure these investments they could hire investment banks that specialize in these type of transactions. For monitoring they could hire specialized consultants and just hold these 100 companies forever (or so). In this case there is not much of a HC challenge, they remain diversified and pay relatively low cost for their investments. In fact, not having to invest in 8000 stocks probably saves a significant amount of money.

A number of private equity funds also operate on a deal by deal basis, meaning that they go to asset owners with one deal at a time to see if they are interested. These deal-by-deal private equity funds are in a sense a pool of co-investment opportunities.

In a nutshell, the private equity industry is in a sort of 'big bang' situation where frontiers disappear and asset owners are thinking hard about the best route to follow to at the top of the pack and ultimately best serve the stakeholders.

References

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Author's Bio

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A tenured Associate Professor of Finance at the Saïd Business School, University of Oxford, Ludovic has been named as one of "The 40 Most Outstanding Business School Profs Under 40 In The World" by the business education website Poets&Quants in 2014. Ludovic specializes in the areas of private equity that are of interest to investors and potential investors in that asset class, such as risk management, legal and corporate governance issues, liquidity and measurement of returns. His research papers have been widely cited in academia, in the press, in practitioner publications, and in regulatory circles; and have been published in leading academic journals such as the Journal of Finance, the Review of Financial Studies, the Journal of Financial Economics, the Journal of Economic Perspectives, the Journal of Financial and Quantitative Analysis, the Review of Finance and the Harvard Business Review. Ludovic has strong links with senior practitioners in the industry, routinely speaks at leading practitioner conferences, and works with a number of large institutional investors on their private equity investment decisions and benchmarking systems (e.g. Norway $900 billion sovereign wealth fund, APG $600 billion Dutch pension fund and PGGM $300 billion Dutch pension fund) and with government bodies (e.g. Dutch Ministry of Finance). Ludovic achieved a degree in Economics from Toulouse School of Economics; a Master in Economics and a Master in Mathematical Finance both from the University of Southern California; and a PhD in Finance from INSEAD.