Straight to the source

Despite increasing commitments to private equity funds, institutional investors are increasingly evolving their approach to private equity investments, changing the dynamic in the relationships with fund managers

Oscar Geen
Senior reporter

LPs committed a record amount of money to European private equity firms in 2017, but with increasing competition and considerable fees levied to access the best funds, many are looking for alternative ways to gain exposure to the asset class.

This trend was highlighted in February with the news that a consortium comprising RPMI Railpen, Alaska Permanent Fund Corporation and the Public Institution for Social Security of Kuwait will launch a $1.5bn GP seeding programme (Capital Constellation) to be deployed over the next five years with an initial commitment of $700m. The venture will be advised by alternative asset manager Wafra Group.

The initiative will provide startup capital to 10 private equity firms. The seeded managers will operate independently and use standard fund structures with Constellation as their largest LP. However, Constellation will also share in the upside of the GP through revenue-sharing agreements, Daniel Adamson, Wafra managing director and president of Constellation, tells *Unquote*.

Investment consultant Ashby Monk first revealed the plans to the investment committee meeting of California State Teachers' Retirement System in February, saying: "With a billion dollars, they are going to put, in a single year, six new general partners in business, and they are pulling name-brand individuals out of name-brand general partners and getting aligned structures."

> "With a billion dollars, they are going to put six new general partners in business, and they are pulling name-brand individuals out of name-brand general partners and getting aligned structures"
> *Ashby Monk, California State Teachers' Retirement System*

Novel approach

The programme represents a novel way for LPs to structure their private equity allocations. It could offer an alternative to LPs that are unhappy with other options currently on the table, two of which are structuring investments into companies directly, or seeking co-investment alongside GPs. The past month has presented two high-profile examples of LPs pursuing both. In January, ▶

Blackstone announced its intention to acquire a 55% stake in the financial and risk division of Thomson Reuters in a deal worth $20bn. It took co-investment from the Canada Pension Plan Investment Board and Singaporean sovereign wealth fund (SWF) GIC to cover the $3bn equity ticket.

A week later, Blackstone's former parent, asset manager BlackRock, announced its intention to seek $10bn for its direct investment programme. BlackRock has previously structured its private equity investments as fund commitments and has backed at least six European private equity funds in the past two years, including commitments to brand-name GPs Livingbridge and EQT, according to *Unquote Data*.

Direct competition

All of this is symptomatic of a rapidly expanding pool of capital, and Vinay Ghai of investment bank Baird says he has observed an increase in the number and type of funds that are looking to do direct investments in European companies: "When we are constructing processes for European assets now, the list of parties we need to consider has increased. You have many of the established names plus a lot of new players in the direct investment universe, such as multi-family offices, pension funds, SWFs, Asian private equity funds, US private equity funds and others."

Some of the most active newcomers to this space are multi-family offices that have previously invested only in funds. According to data collected by Baird, family offices have improved their direct investment credentials significantly over the past five years. In 2012, family offices prevailed over other buyers in 4% of auctions; by 2017 this figure had increased to 7%, representing a 75% increase.

Vikash Gupta of Var Capital has observed this trend as well. Var works with 50 British and European families with net worth between €20m-10bn. Traditionally, he has advised them on their liquid investments but says they increasingly ask him for advice on private investments. "Most families have previously invested in the big-name funds in private equity but many of them have become disenchanted with private equity. The first reason is because fees are too high and they believe they can cut through by taking direct stakes," he says. It is not all about fees though; many of these families acquired their wealth by running successful businesses and value industry expertise highly, Gupta says. "Another issue that these families often mention is their perception that, in certain industries, their own experience is deeper than the experience or industry expertise of private equity teams."

Of course, direct investing is an industry of its own and, as the stats show, family offices have been building expertise in that industry. Gupta says they have had help from some quarters of the market: "Some investment banks now make an active effort to reach out to family offices and include them in their processes, such as Rothschild, Jeffries and Baird. Private equity funds are starting to respond to their presence as direct investors by offering more co-investment opportunities to keep their fund commitments." However, Gupta acknowledges that it can create difficulties as well. "As these families are often LPs in funds, it creates tension with their relationship managers when they start doing direct deals," he says. "But, for the most part, private equity funds just have to live with it."

Baird's Ghai says co-investment can often be an intermediary step for family offices that want to do directs, but do not have the capability: "A lot of family offices started out doing co-investment in other peoples' deals, but many now have the capability to compete for the assets directly. Examples of family offices that have institutionalised their approach in this way well before others are Cobepa and Bregal Investments."

> "You have many of the established names plus a lot of new players in the direct investment universe such as multi-family offices, pension funds, sovereign wealth funds and others"
> *Vinay Ghai, Baird*

Partnering up

This is a very different use of the co-investment mechanism than that generally associated with larger LPs such as SWFs and pension funds. Ghai describes the more traditional form of co-investment as a "partnership capital" approach. "Partnership capital is the most common form of capital deployment for pension funds. They partner with GPs in deals without participating as lead investor in the process. Ontario Teachers' Pension Plan's co-investment in BC Partners' acquisition of Ceramtec from Cinven is an example of this," says Ghai. "Pension funds are more active at the larger end of the market. They are trying to put at least €200m of equity into platform deals. Some of the SWFs are doing this as well."

PwC's head of global private equity and sovereign investment funds, Will Jackson-Moore, agrees with this as a general rule, but says there have been some issues: "Co-invest does not create a particular strain because it is a well-established feature of the GP-LP relationship. But when funds start to do direct investing it starts to create tension, and there have been instances where GPs restrict access to funds."

Jackson-Moore adds that, like family offices, some SWFs see co-investment as a stepping stone. "Lots of SWFs are now setting up teams and, at first, they will co-invest. As they get more experience they will do more early-stage co-investment rather than just syndication later on." For many SWFs just investing in private equity, or even alternatives in general, is quite a big step. Jackson-Moore explains the trajectory of a typical SWF looking to diversify: "Three fifths of SWFs derive a significant proportion of their wealth from hydrocarbons. Generally, they are selling oil for US dollars and then it is a question of how they invest those dollars. There is a maturity curve: at first, they buy US treasury bonds, then public equities and fixed income ▶

Beating the buyout funds

In order to expand their auction success rate from 4% to 7% since 2012, family offices have had to refine certain competencies and acquire others. The Ahluwaila family office, Dominvs Group, advised by Var Capital won out against private equity bidders to acquire Digraph Transport Supplies in September 2017.

The family already had sector experience, and its first business Euro Car Parts formed part of the Digraph transaction and expansion plans. Vinay Ghai of investment bank Baird says this is a common approach taken by family offices: "The families can also take an aggressive approach to due diligence and build a strong relationship with the management, especially if they have prior involvement and experience with their own businesses in the same industry." While they might be aggressive in one sense, they are unlikely to use as much debt as private equity funds, says Ghai. "Family offices generally lower leverage than private equity funds but they can be more aggressive on terms than traditional sponsors. They also have a longer investment horizon and are therefore more willing to support long-term growth initiatives, which can be attractive to vendors."

In the case of Digraph, Vikash Gupta of Var Capital explains how the family could put its bid together extremely quickly rather than spending time arranging financing: "When Dominvs bought Digraph it underwrote the entire value and structured part as a normal equity investment and part as a loan."

> "In general, there is a tension between people wanting to allocate to private equity and also a pushback on fee levels"
> *Will Jackson-Moore, PwC*

instruments, and then the most mature also look at alternatives, including private equity."

In general, though, SWFs have been slightly behind pension funds in allocating to alternatives. Between 2010-2016, SWFs increased their allocation from 19-23%, while pension funds increased it from 20-24%, according to a PwC report. Jackson-Moore offers an explanation: "Most of the larger sophisticated sovereign funds have big allocations to private equity, so in that sense it is counterintuitive that they have increased their allocation more slowly than pension funds. It could be because almost all pension funds will have at least some allocation to alternatives, whereas some of the more conservative SWFs have none."

Sourcing deals

Pension funds have been at the forefront of co-investment for a long time, and even when they do lead investments it is rarely in direct competition with their GPs. Baird's Ghai says: "Unlike family offices, with a few exceptions, pension funds do not really compete directly with private equity funds for assets. They identify assets or sectors they want to invest in directly and spend a lot of time on them and then partner with private equity in some form."

Unquote recently highlighted the trend of Canadian pension funds making inroads in France. Four of the five investments mentioned in the piece took the form of minority co-investments alongside a GP. The other was Omers Private Equity's (the direct investment arm of Ontario Municipal Employees Retirement Scheme) €670m acquisition of French calibration services specialist Trescal from Ardian.

Omers is one of the most sophisticated pension funds in this respect, with a team of 42 investment professionals based in London, New York and Toronto, and $12bn invested. However, sourcing is a common issue for LPs that decide to go the route of direct investment, which explains why its fund investments still outweigh its directs in Europe. "The sourcing problem is twofold," says Ghai. "First, it is having feet on the street, talking to sellers and management teams; the other thing is winning deals, which requires a lot of time and resources. That is why partnering with GPs makes sense for them; leveraging the GP's deal origination and execution capability."

Another type of LP that is naturally suited to using its GP connections for sourcing investment opportunities is the fund-of-funds. Quilvest is not quite a typical fund-of-funds, but has historically invested around 70% of its LPs' money in funds. Thomas Vatier is on the direct investment side of the business and explains part of the reason for its growing popularity: "Investors like direct exposure for the shorter duration and higher average returns, although this comes with greater volatility."

Quilvest is not generally active in direct investments in the same geographies and market segments as its GPs, but having a large network is always valuable, Vatier says: "We are not using our GPs for sourcing investment opportunities, but we do leverage the network. For example, if I meet a French CEO who is keen to explore expansion into a country where one of our GPs has expertise, we can use our relationship to share expertise."

Future innovation

This kind of extra value is representative of a wider trend of LPs asking for something beyond fund returns from their fund commitment. This can take the form of more co-investment opportunities, access to managed accounts or even support with leading investments, but PwC's Jackson-Moore does not think it represents a true threat to the LP fund model. "In general, there is a tension between people wanting to allocate to private equity and also a pushback on fee levels," he says. "This dynamic will continue to drive innovation, but the model of management fee and carry is fairly well ingrained. We will see innovation around it in terms of co-investments, managed accounts and so on, but the standard model will endure."

For the most part, these approaches will not be mutually exclusive. There may be isolated incidents of LPs being denied access to funds they previously invested in, but, generally, investors will either do enough to maintain GP relationships or institutionalise to the extent that they do not need them, at which point they start to look a lot like GPs themselves. ■