IFSWF
International Forum of Sovereign Wealth Funds

Partnering for Success: Sovereign Wealth Fund Investments in Private Markets

pwc

Introduction

For almost a decade, institutional investors have been discussing the impact of “lower for longer” interest rates, resulting from the monetary policy response to the 2009 Global Financial Crisis, on their portfolio allocation and investment strategy. Until the GFC, many long-term investors, like pension funds and sovereign wealth funds, had traditionally allocated large proportions of their portfolios to government bonds and securities such as Treasury Inflation-Protected Securities (TIPS), which had generated relatively low-risk, high-single-digit returns, and enabled them to meet the needs of citizens and beneficiaries for generations to come.

In the wake of the crisis, many institutional investors fundamentally changed the way they allocated capital. They could no longer rely on government bonds to generate a healthy return and, consequently, during the 2010s, many institutional, long-term investors took inspiration from the Endowment Model of asset allocation conceived by the late David Swensen, to boost returns in a low-interest-rate environment. The key aspect of this model is increasing exposure to so-called alternative assets such as private equity, real estate and infrastructure. In the years immediately preceding the GFC, some sovereign wealth funds, such as the Abu Dhabi Investment Authority (ADIA) and Singapore’s GIC, had already set up wide-ranging private markets departments to diversify their soaring inflows deriving from record-high oil prices and burgeoning global trade.

Raising allocations to unlisted assets required pension funds and sovereign wealth funds to reassess the way they think about and embrace risk. To do so they have had to hire smart people to design and implement a new investment policy. They have also needed to transform their governance structures to enable their investment teams to act swiftly and make decisions without interference. Such independence, which is hard-baked into the Santiago Principles, may be partly due to the experience of ADIA and GIC, which were the first sovereign wealth funds approached to start the Santiago Principles consultation process and took a leading role in their creation. IFSWF members discussed both these topics extensively in April 2021 during a Chatham House Rule discussion on the challenges of making the right decisions of how and where to use external managers, particularly in private markets.

IFSWF first examined sovereign wealth funds’ increasing allocations to private assets in 2016. At the time, sovereign wealth funds had rapidly increased their allocations but wanted to consolidate their position and build their teams’ skills. However, over the past five years, sovereign wealth funds have continued to allocate more of their portfolios to unlisted assets. This trend appears to have been accelerated by the COVID-19 pandemic.

For example, in its 2020 annual report, ADIA disclosed that its allocation range for private equity rose to 5%-10% from 2%-8%, at the same time increasing infrastructure to 2%-7% from 1%-5%. As a result of this increased allocation, ADIA's private equity department committed more capital than ever before in 2020, with 24 investments, up from 18 in 2019. Direct investments and co-investments represented 55% of its overall deployment for 2020, up from 45% in 2019.[1]

One prominent aspect of sovereign wealth funds' increasing allocations to private equity is a tendency to build partnerships with private equity general partners (GPs), commercial partners and, sometimes, their peers. We wanted to understand more about this trend, why it came to be and how these partnerships worked. To do so IFSWF collaborated with PwC to learn more about what unlisted asset classes sovereign wealth funds favour, how they partner in private markets and how they integrate these considerations into their investment and governance decision-making processes.

We circulated a survey to all IFSWF members and asked them about their unlisted asset strategies, as well as their approach to partnerships to provide the first in-depth insight into this diverse investor group's activities in private markets. We also spoke to five IFSWF members with different approaches to private equity investment to gain some context for the findings. We also spoke to a major private equity GP with a large number of relationships with sovereign wealth funds to gain insight into their perspective.

[1] ADIA Annual Review 2020

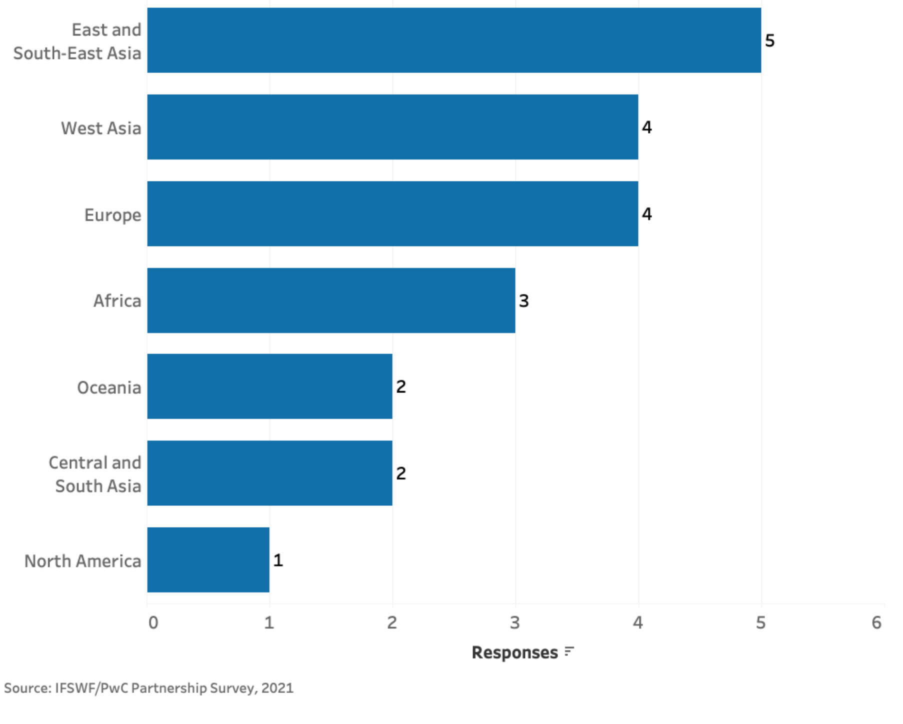
About the Survey

For this project, we distributed the first comprehensive survey that specifically examined sovereign wealth funds' attitudes to partnership in private markets and how they integrate these considerations into their investment and governance decision-making processes. We believe that these results represent a decisive and accurate view[2] of how this investor group approaches direct investments and co-investments.

We distributed the survey to the total membership of IFSWF. Twenty-one institutions responded.

The respondents were those members that invest in private markets, which explains the small sample (20% of the world's 82 sovereign wealth funds). Globally, only a relatively small number of sovereign wealth funds invest in private markets, so this sample likely represents the majority of those institutions. as shown in the chart below. Of these respondents, two-thirds currently allocate more than 25% of their portfolios to private markets

Chart 1: Sample Geographical Distribution of Survey Respondents

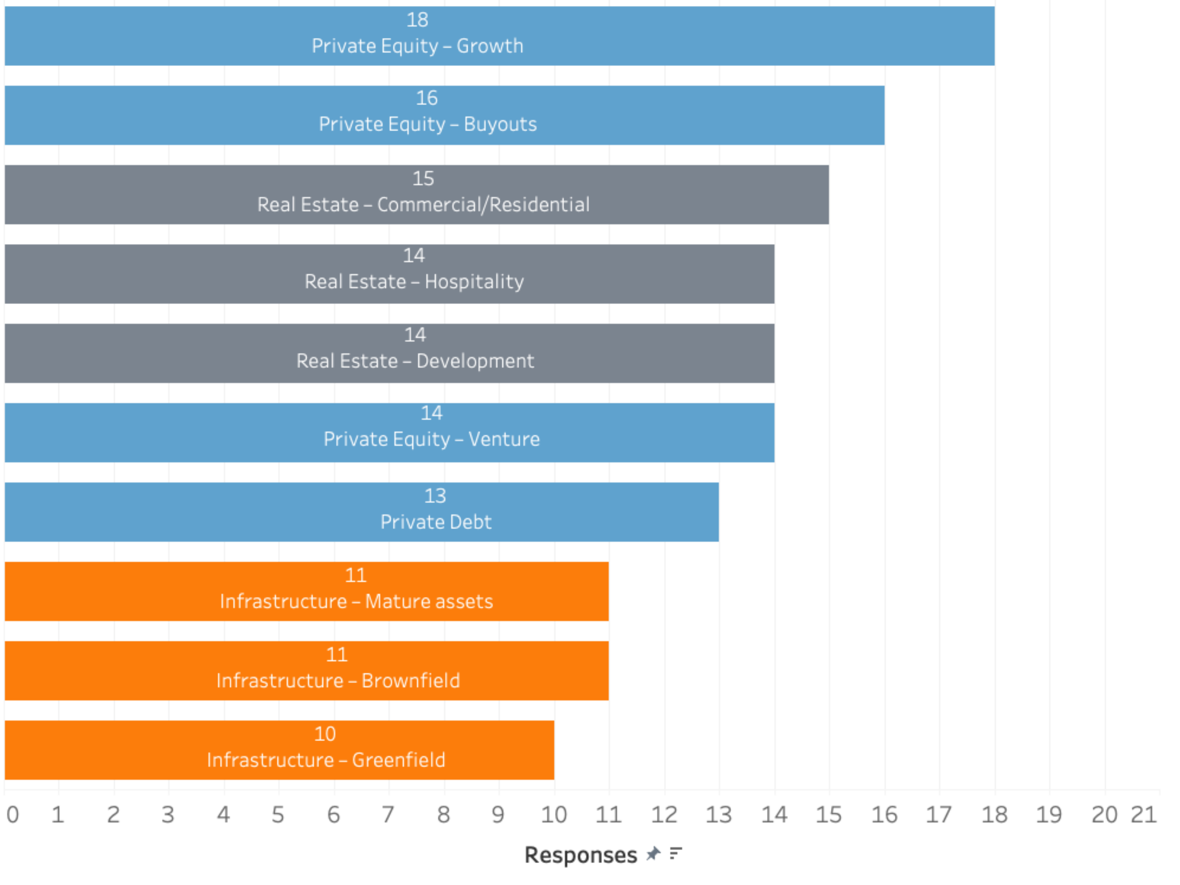


[2] As with all primary research, some methodologies used in the questionnaires aren't perfect and might result in collecting some answers with bias. For instance, Likert scales are subject to distortion from several causes: Avoidance of using extreme response categories (central tendency bias); Agreeing with statements as presented (acquiescence bias); Attempt to portray the respondent's organisation in a more favourable light (social desirability bias).

How Sovereign Wealth Funds Allocate to Private Markets

The survey revealed that, perhaps surprisingly, the most popular unlisted asset class for sovereign wealth funds is growth equity (Chart 2.1). From our interviews, it appears that for most sovereign wealth funds this sector of the private markets offers not only higher returns but also more opportunities for co-investments than large buyout funds.

Chart 2.1: Which unlisted asset classes do you allocate to?

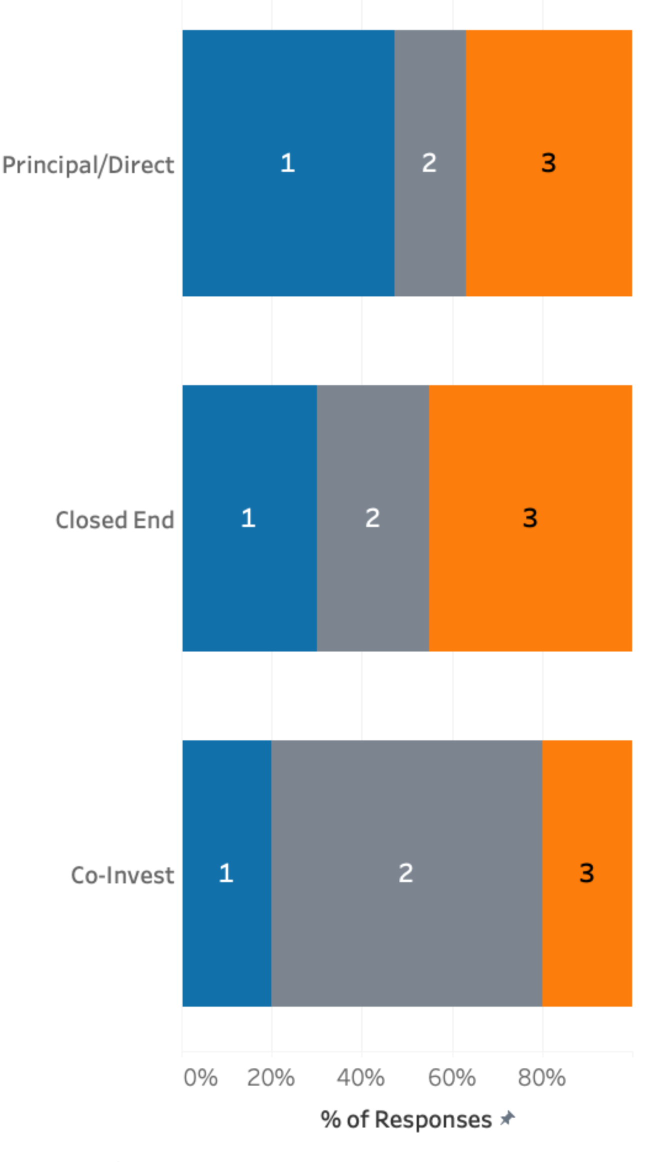


Source: IFSWF/PwC Partnership Survey, 2021

Traditional buyout funds often have to accommodate many limited partners (LPs) that would like co-investment opportunities, and will give priority to their largest and longest-standing. Conversely, growth strategies often have smaller funds with fewer investors, so developing expertise in this strategy opens up the opportunity for more co-investments with potentially higher returns than buyout funds.

Our survey also revealed that sovereign wealth funds are continuing to develop direct investment capabilities. Over 45% of institutions favoured directly investing in private markets, while 30% of respondents still prefer the use of closed-end funds (Chart 2.2).

Chart 2.2: What type of instrument do you prefer in private markets? (Please rank 1-3 where 1 is your most favoured.)

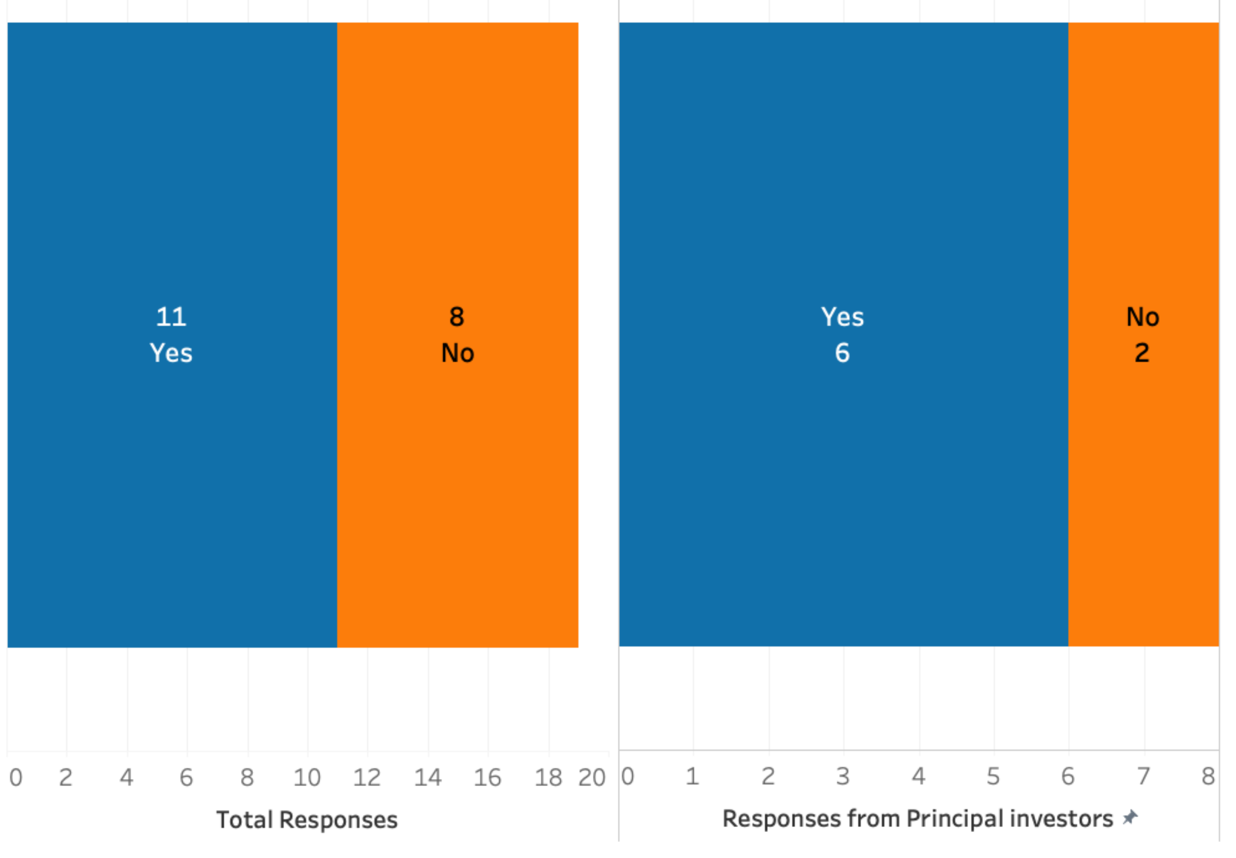


Source: IFSWF/PwC Partnership Survey, 2021

Co-investments were the second choice for 60% of respondents, suggesting it is the most popular second choice for both direct investors and fund investors. However, these co-investments are likely to look different. Direct investors usually require more influence over the co-invest and fund investors often prefer smaller stakes, or standard side-car vehicles.

Indeed, those respondents that preferred direct investing, were unlikely to invest in a fund without co-investment rights. (Chart 2.3)

Chart 2.3: Do you only invest as an LP in a private equity fund if offered co-investment opportunities?

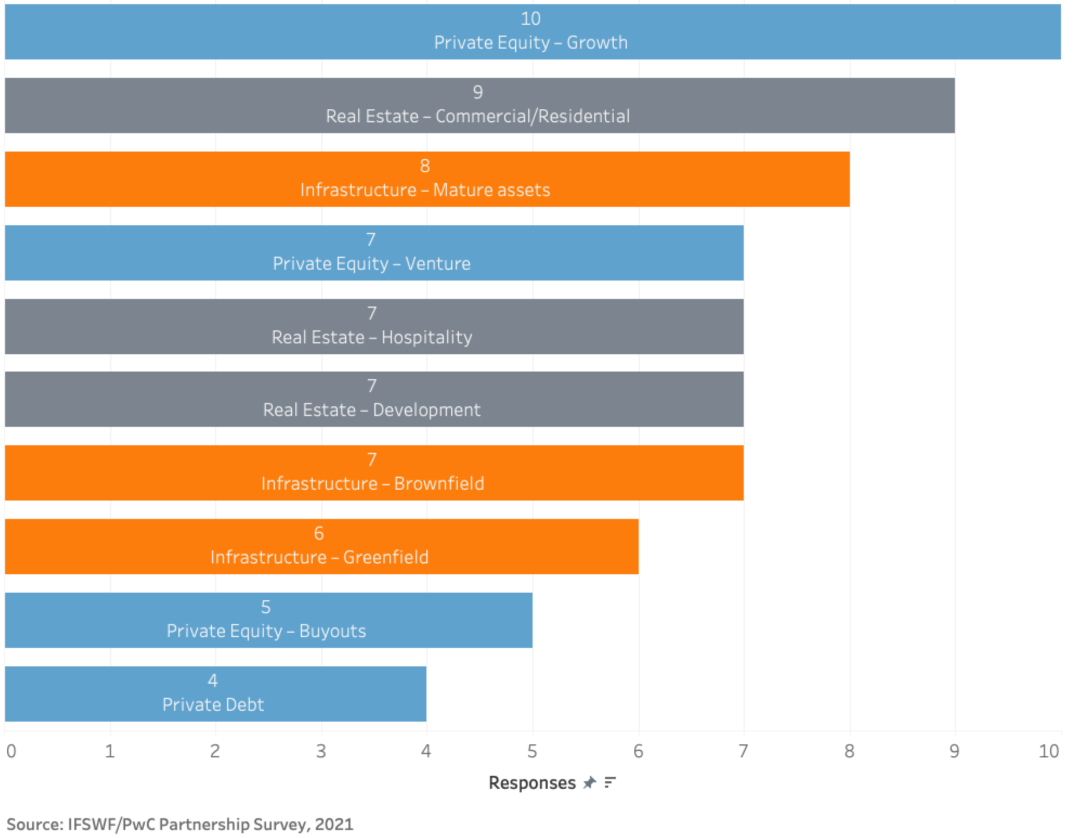


Source: IFSWF/PwC Partnership Survey, 2021

While 84% of respondents make direct investments, outside of growth equity, these are largely concentrated in relatively straightforward asset classes such as commercial real estate and mature infrastructure assets in developed markets (Chart 2.4).

This trend suggests that, rather than competing with major GPs for buyout deals, sovereign wealth funds are concentrating on building specific expertise in growth equity, and to a slightly lesser extent, venture capital – the next most popular private equity sector for respondents that invest directly.

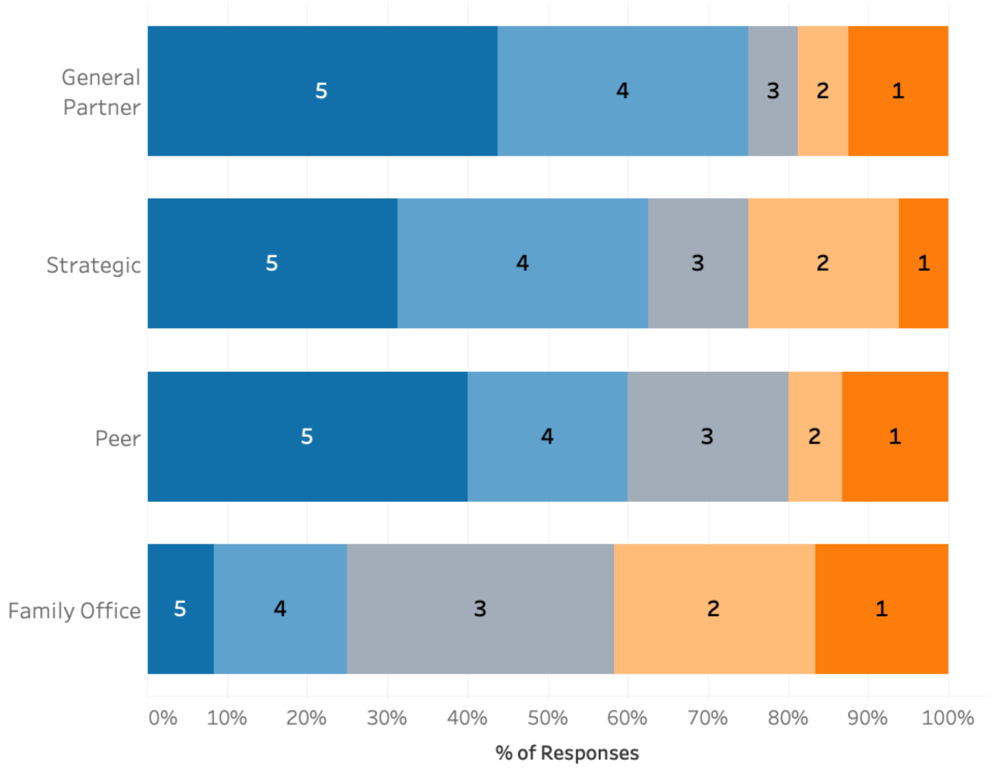
Chart 2.4: In which asset classes do you invest directly?



Source: IFSWF/PwC Partnership Survey, 2021

Indeed, private equity buyouts were the second least popular asset class for sovereign wealth funds to invest directly, with the more niche private debt being the least likely. Rather, sovereign wealth funds prefer to co-invest alongside GPs in these assets. This conclusion is supported by the fact that GPs, with specific expertise and highly developed networks, are the most favoured partners for sovereign wealth funds (Chart 2.5).

Chart 2.5: What type of partners do you prefer to invest alongside? (Please rank 1-5 where 5 is the most attractive)

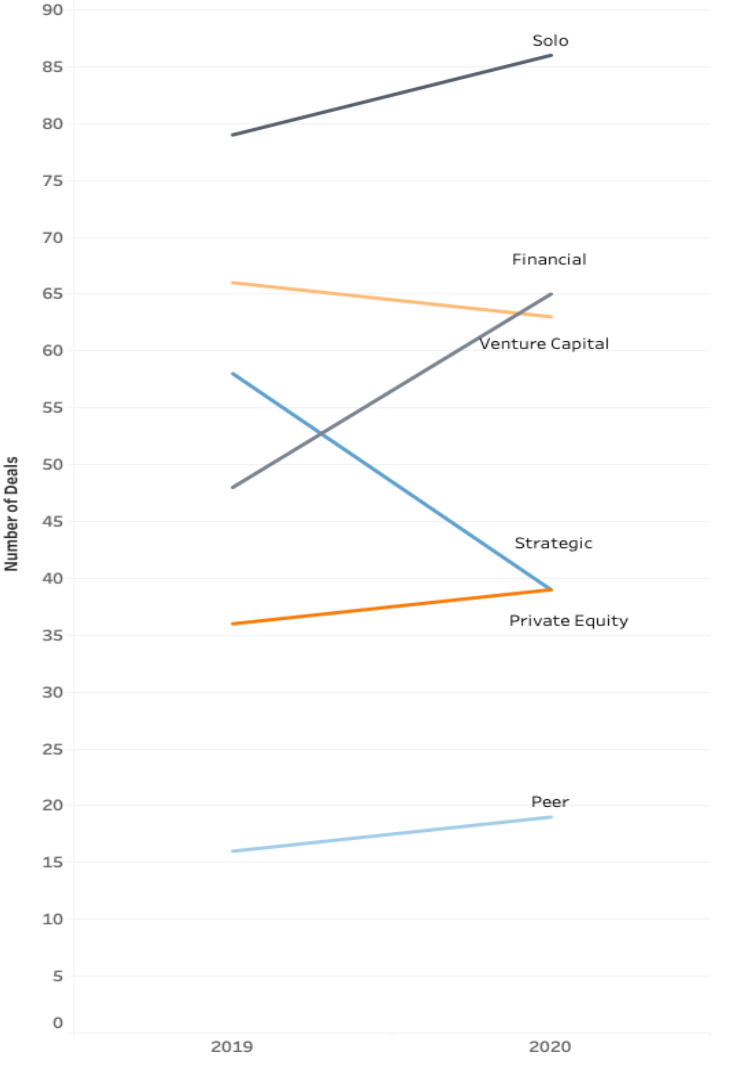


Source: IFSWF/PwC Partnership Survey, 2021

However, sovereign wealth funds also favour strategic partners, who have access to differentiated deal flow and strong expertise in their sectors. Other institutional investors are less popular co-investors for sovereign wealth funds as they often view them as competitors and have less confidence in the value-add they bring to a deal. Indeed, several sovereign wealth funds noted that they actively avoided competing with other sovereign wealth funds, and instead developed their own niche of expertise, particularly in early-stage private equity investments.

These findings are in line with the last IFSWF's Annual Review of sovereign wealth fund direct investments in which we highlighted how sovereign wealth fund co-investments with private equity and venture capital firms were becoming more popular, while co-investing with industrial, strategic partners and peers had stalled. In 2020, there were only 39 transactions in strategic partnerships, a 30% drop compared to the previous year. While sovereign wealth funds invested in 19 deals with peers, in line with the low of 2019 (Chart 2.6). This decline might be due to sovereign funds investing less in real estate, traditionally a sector where they preferred partners.

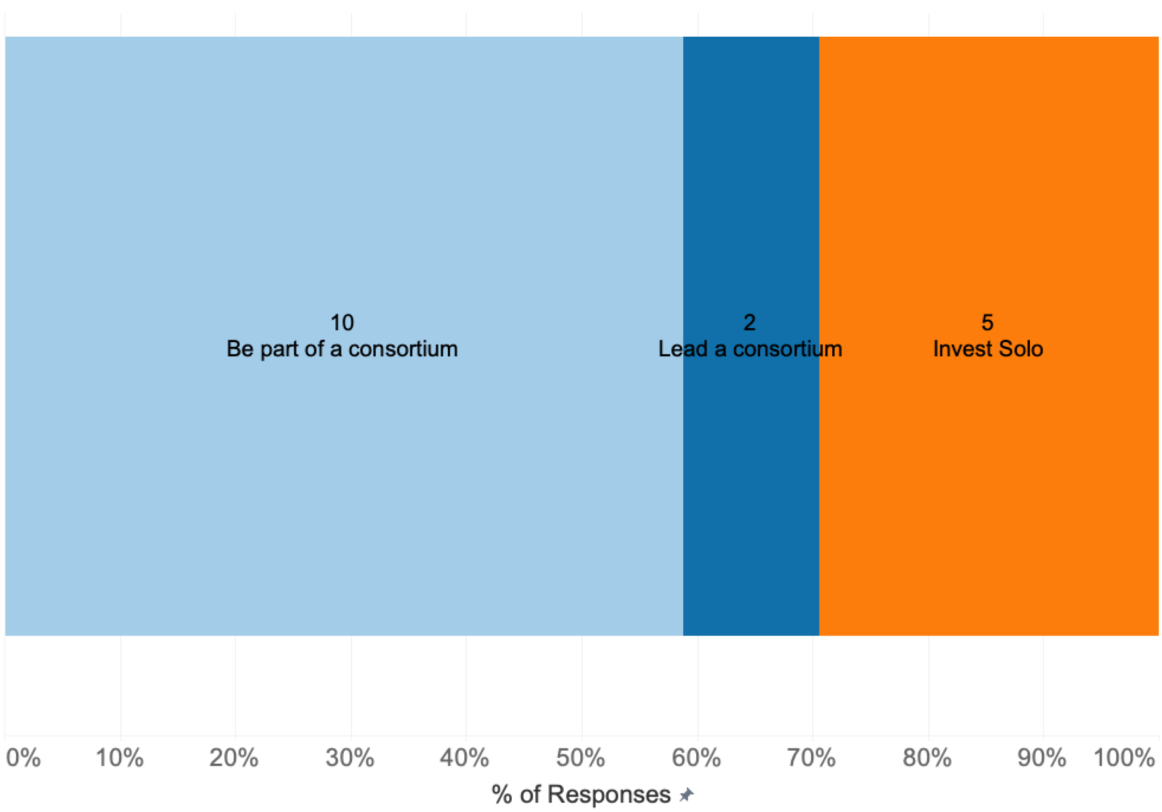
Chart 2.6: Sovereign wealth fund investments with partners 2019-2020



Source: IFSWF 2020 Annual Review

In recent years, sovereign wealth funds have developed the in-house expertise to invest directly in unlisted assets, but the majority do not yet have the resources or expertise to lead a consortium or go it alone and prefer to be part of a consortium (58%) rather than lead a consortium or invest solo (Chart 2.7). Consequently, GPs play a key role in the private-equity ecosystem, given their access to differentiated deal flow, expertise in due diligence and managing the assets.

Chart 2.7: When you invest directly do you prefer to?



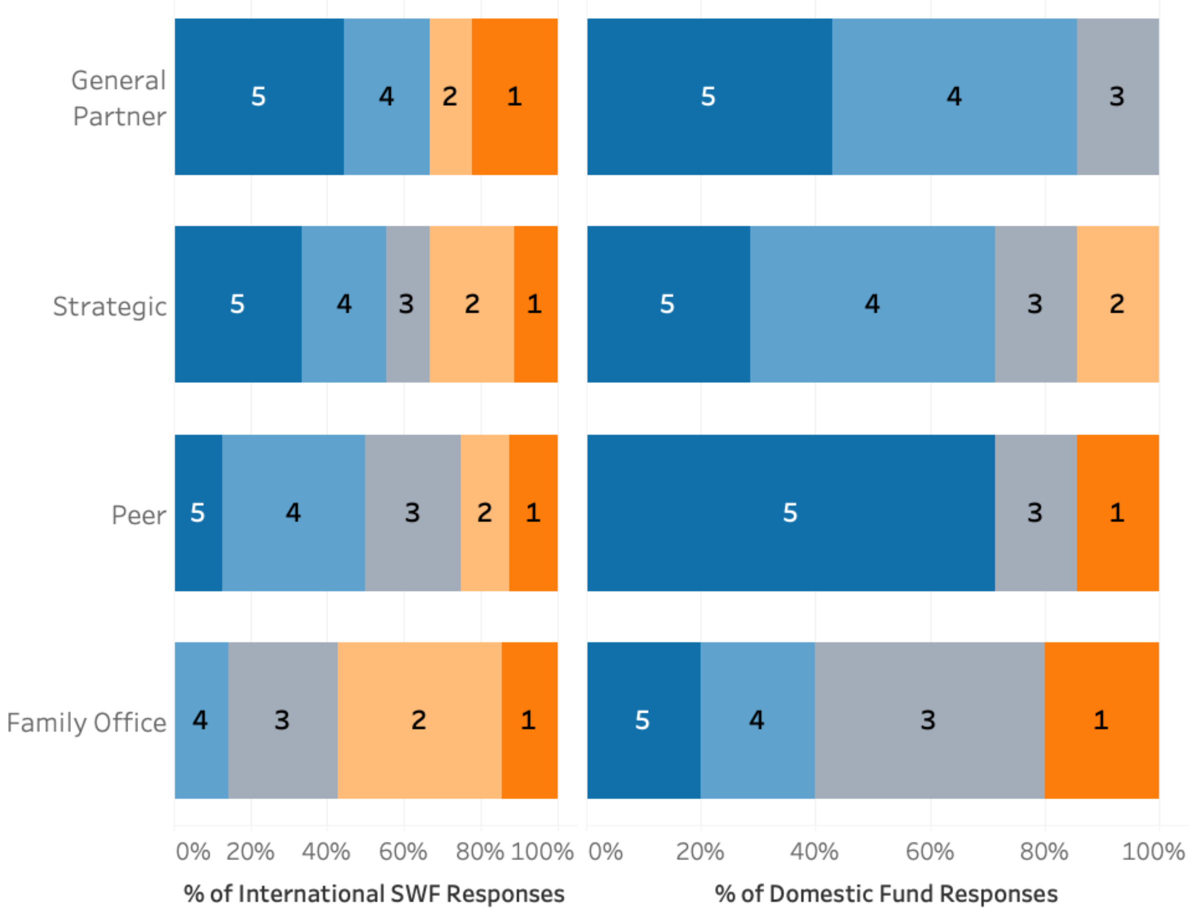
Source: IFSWF/PwC Partnership Survey, 2021

Domestic Sovereign Wealth Funds

The 39% of respondents that had a domestically focused mandate were more likely to invest in greenfield infrastructure, real estate development and hospitality-focused real estate than the full sample as these sectors are often key to spurring sustainable growth and job creation in their communities.

Similarly, domestic sovereign wealth funds are also much more likely to prefer to invest alongside peers than their international counterparts (Chart 2.8). For domestic funds, peers have aligned interests and expertise and can help scale projects with substantial cheque sizes, as well as reputations and networks that will help crowd in capital into their major projects.

Chart 2.8: What type of partners do you prefer to invest alongside? (Please rank 1-5 where 5 is the most attractive).



Source: IFSWF/PwC Partnership Survey, 2021

Conclusion

Since the last time IFSWF examined sovereign wealth funds' allocations to private markets in 2016, they have become more sophisticated investors, understanding where their strengths and weaknesses lie, and how best they can leverage partners to provide the exact exposure to private markets that they want in their portfolio. This is most obvious in their disinclination to invest directly in buyouts where commercial GPs have the advantage, and instead, build expertise in specific niches in growth and venture capital, where they can hire teams to build expertise as well as new and differentiated networks for deal origination.

As a result, we can observe that sovereign wealth funds are looking to partner with investors with complementary expertise, rather than their peers. The exceptions are those funds with domestic mandates that seek to attract those sovereign wealth funds that invest overseas into their projects to provide long-term, patient capital aligned with their interests, as they are able to provide the on-the-ground expertise that their peers would value in a partner.

Partnerships have, therefore, become central to sovereign wealth funds' private equity and real assets strategies, as they enable them to access a range of sectors and geographies that they would otherwise be unable to tap. Depending on the approach of sovereign wealth funds – either from a director or fund investment perspective – these partnerships will be structured differently, with sovereign wealth funds requesting more or less influence and involvement in individual investments. These relationships may also depend on the cheque size that the sovereign wealth fund has available to them. That said, that doesn't mean that partnerships are less important to fund-focused private equity investments, indeed, the opportunity to gain access to deals for a lower fee is very valuable to these investors, as is the opportunity to learn about managing these investments from their managers, and upskill their teams.

In short, over the past decade private equity has become an important component of sovereign wealth funds' portfolios, and partners have and will continue to play an important role in developing and managing these investments.

Acknowledgements

The International Forum of Sovereign Wealth Funds and PwC would like to thank the investment practitioners from the following organisations who gave their time to contribute to this report:

- Abu Dhabi Investment Authority
- BPIFrance
- CVC Capital Partners
- GIC
- Ireland Strategic Investment Fund
- Khazanah Nasional Berhad
- Mubadala Investment Company
- Nigerian Investment Authority
- Qatar Investment Authority

We would also like to thank Dr Victoria Barbary, Director of Strategy and Communications at the IFSWF, for preparing the text and to Tarek Shoukri, Director and Will Jackson-Moore, Partner, at PwC for their assistance and support in undertaking interviews and for their insight..

We would also like to thank Duncan Bonfield, Chief Executive of IFSWF for his support in getting the report completed and Enrico Soddu, Head of Data and Analytics at IFSWF, for his assistance with analysing the survey data.

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