IFSWF
International Forum of Sovereign Wealth Funds

Investing outside the box

Lessons for sovereign wealth funds from direct private equity investments

March 2022

In partnership with

STATE STREET

Introduction

In February 2022, IFSWF partnered with State Street Associates to host an online roundtable for sovereign wealth funds assessing the benefits of principal private equity investments over co-investments or fund allocations. Professor Josh Lerner, Head of the Entrepreneurial Management unit at the Harvard Business School and academic partner of State Street Associates, shared some research insights in conversation with Alison Tarditi, Chief Investment Officer at Commonwealth Superannuation Corporation.

In this wide-ranging discussion, Prof Lerner and Ms Tarditi, covered a range of subjects, including:

- **The role of private equity in portfolio construction;**
- **Disruption to the original investment thesis;**
- **Faster fundraising, faster distribution of capital?**
- **Decreasing alignment of interests;**
- **The importance of human capital.**

Prof Josh Lerner, Head, Entrepreneurial Management unit, Harvard Business School; academic partner of State Street Associates

Alison Tarditi, Chief Investment Officer, Commonwealth Superannuation Corporation

The role of private equity in portfolio construction

The COVID-19 pandemic underlined that long-term investing has become more complex. Investors now perceive a wider range of risks including ensuring the quality of growth of their assets, the equitable distribution of dividends, as well as the cost of mitigating environmental, social and governance risks and their portfolio construction needs to reflect these circumstances.

As investors take a wider and more nuanced approach to risk, they need to ensure that their governance and decision-making processes are orientated towards the long term, tuned more keenly into structural changes in the value of investments, rather than temporary price dynamics and are capable of supporting financial capability, strategic capacity and cultural attitude for real-time decision making.

Private equity plays an important role in a long-term portfolio, as it enables the investor to leverage ownership to create new sources of durable value rather than simply recycling existing wealth. As such, private equity enables long-term investors to access the equity risk premium and grow long-term cash flows and net real returns. However, there are still challenges. Although private markets have matured and grown over the past two decades, and the secondary private equity market has become more liquid, there is still inconsistency in the quality and availability of underlying portfolio company data, which makes it more difficult for the LP to fully evaluate the underlying asset in which they are investing.

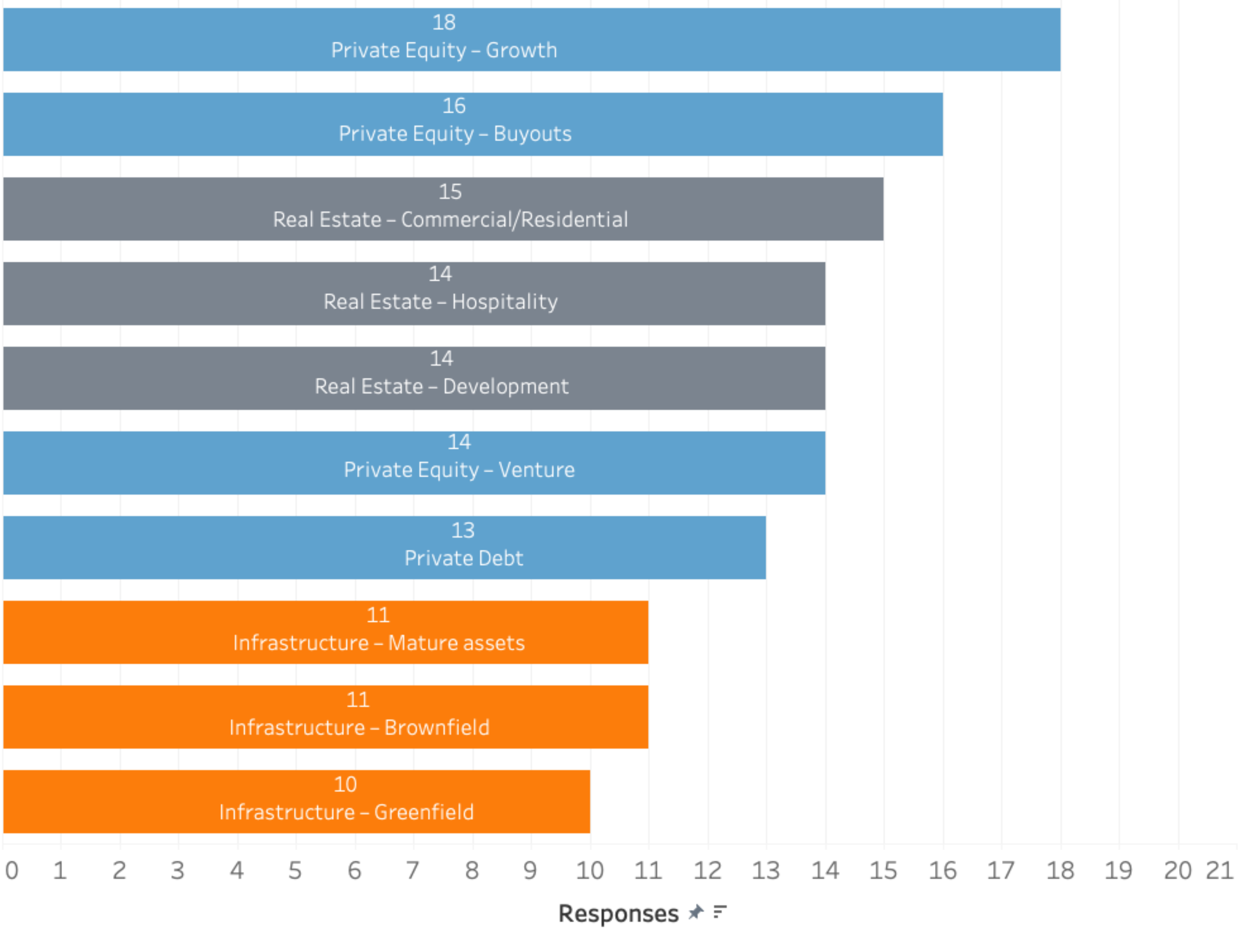
Disruption to the original investment thesis

Regardless of an investor's private equity experience, general partners (GPs) are still an important element of a successful private equity programme. It is, therefore, important for sovereign wealth funds to identify and select GPs and co-investors that can provide strategic capital and operational insights to support the execution of their investee companies' strategic plans. The provision of operational expertise is one of the main reasons why many companies have started to stay private for longer, rather than pursuing a listing.

The accelerating pace of technological disruption and its intersection with the increasing value of strategic capital means that long-term investors have to become more adept at evaluating risks and opportunities on an ongoing basis to ensure that their original investment theses remain intact. For example, renewable energy transition and policy risks are evolving very quickly and regulatory changes might undermine an investment case. Similarly, the long-term value of core office properties may well be shaped by post-pandemic work-from-home trends. As a result, long-term investment and management decisions have become more complex, or, at least, less forecastable today.

Innovation is a common source of additional complexity. New technologies can increase a business's or sector's efficiency but may give rise to unforeseen risks, for which investors are not compensated. Consequently, asset owners have largely been recipients of the benefits of innovation, rather than helping to initiate it. However, over the last decade, the growth of asset owners' financial resources and knowledge have begun to re-calibrate that balance and more of them are financing early-stage innovative companies.

Figure 1: Do you allocate to the following assets in private markets?



Source: IFSWF/PwC Partnership Survey, 2021

Faster fundraising, faster distribution of capital?

Competition for sourcing venture capital ideas has increased over the past decade, as has the amount of capital available to both GPs and companies raising equity. Yet, despite the growth in scale and sophistication of asset owners, the model for private equity investments still largely relies on external managers, and GPs remain the dominant access routes to unlisted assets. The challenge is to get the balance right so that portfolios are efficient, but maximise risk-adjusted returns. The volume of capital available to GPs has ballooned and fundraising cycles have contracted over the past decade, according to data from Prof Lerner. However, the pace of growth is not necessarily being matched by faster distributions by GPs, which has liquidity implications for the investors as they have to find the cash to satisfy capital calls from the new funds without having received distributions from previous funds.

Tensions around liquidity are not just related to exiting investments. Limited partners became aware of the importance of liquidity management during capital calls in the 2008 financial crisis; when the credit markets froze, and GPs were unable to exit any investments for over a year, but they could deploy capital very fast as there was a surfeit of distressed opportunities. However, some GPs were unable to take advantage of counter-cyclical opportunities because some of their large investors (limited partners, LPs) were liquidity-constrained.

Evergreen fund structures, open-ended fund structures that carry on investing indefinitely, have been suggested as a potential solution to the liquidity mismatch between LPs and GPs, but these structures are often seen by investors as an attempt by the GP to charge unearned fees by repackaging existing portfolio companies. Evergreen structures can also create conflict between existing and incoming investors, which can be challenging to reconcile around entry pricing and valuations as the same private equity manager would be valuing the asset as a seller (as manager of the legacy fund) and as a buyer (as manager of the new vehicle) and thus creating doubts about a fair valuation.

Another solution to the liquidity discrepancy between investors and managers are continuation funds or GP-led secondary funds. These structures aim to create liquidity by buying their own portfolio companies. The concept has been around for more than a decade, but its share of the market has increased significantly in recent years. According to the investment bank, Greenhill, there were approximately $62 billion in GP-led secondary transactions in 2021, or 46% of a record $134 billion in total secondary volume last year. GP secondary volume in 2016 was just $9 billion or 24% of the total volume.

The proliferation of continuation funds or evergreen fund structures has several implications for investors. On the whole, LPs are aware that a GP would hold a portfolio company for longer during times of public-market correction or volatility. However, GPs tend to use continuation funds as a route to hold preferred, better-understood assets, to capture value, rather than originate new investments. The absence of independent market testing (as the asset isn't sold to a third party) is a challenge for LPs, who often can't allocate for portfolio construction or concentration reasons, as they would end up owning some assets several times via different vehicles.

However, there is investor demand for vehicles to extend the holding period of private equity funds to generate durable growth, or just for rent extraction. Private equity companies often continue to hold equity in companies after they go public. For the LPs, in this case, the issue is continuing to pay high fees for exposures to listed companies that could be easily achieved at a much lower cost.

The traditional way GPs used to exit some assets, is the so-called pass-the-parcel model, where one private equity group sells a portfolio company to another, often where they have a similar investor base. This is not a particularly attractive model from an investor's point of view, as a large sovereign wealth fund is likely to end up paying additional fees for the privilege of holding the same company, but across different private equity funds.

Decreasing alignment of interests

The easy money – the first half of the 1990s, when private market returns were often 50% higher than public markets – have long gone. As a result, choosing good managers is more important. According to recent research, it is more difficult to predict if a fund will outperform or underperform the market, as even the best performing (top-quartile) funds are no longer as sticky as they used to be, and do not repeat the outperformance in successive vintages.

In the past, GPs made most of their money through carried interest, which required them to add value to a portfolio company, rather than from management fees. This aligned their interests with the long-term investment horizon of their LPs. However, as GPs are raising funds much quicker than in the past, it makes them less reliant on creating durable growth, and more on earning fees that were originally charged to cover basic business expenses. According to a study from Wharton University and Hamilton Lane, which quantified the net present value of payments per partner per fund looking at 250 biggest venture and buyout funds raised during the 1990s, returns from those years were not replicated in the following decade. As a result, the investment horizons of investors and managers have come unaligned and, while fundraising has increased, asset owners are putting more capital into special purpose vehicles (SPVs) and direct investments rather than into funds. By 2017, 40% of cash went into alternative vehicles for private equity, a surge after the global financial crisis.

These alternative vehicles were thought to have better net returns, because of a low-fee no-carry basis or at low cost. But research from Prof Lerner and State Street Associates using proprietary data from State Street based on 1,500 vehicles, reveals that the median performance of discretionary and GP-directed vehicles is identical. This apparently counter-intuitive situation, according to Prof Lerner, is largely a result of bad timing. These investments were made at problematic times, generally right before a fall in markets, moreover, they also tend to be large deals. Consequently, the performance of LPs' direct investment varies considerably. If LPs were good at selecting high-performance private equity funds, they also tended to be good at selecting good co-investment opportunities. Indeed, co-investments seem to magnify the disparity across the returns of limited partners essentially rewarding the sophisticated but making it harder for others.

The Importance of Human Capital

Human capital, skills and experience in private equity are, therefore, key to ensuring that an LP's principal investment programme performs well. As such, an established investment team, with shared battle scars is a competitive advantage, as they can lean against institutional risk aversion and can innovate. As such, long-term investors should build their private-market teams by looking across a wide universe of candidates, for experience, character and clarity of purpose.

Conclusion

In an increasingly complex long-term investment environment, private market allocations still provide much-needed access to the equity risk premium, long-term cash flows and net real returns. They are also an important channel to tap into innovation and direct industry contacts and knowledge. However, there are challenges. While the private markets have grown and matured over the past two decades it is increasingly difficult to pick a consistently outperforming manager. Research has shown that in the last twenty years even top-quartile funds are not always able to repeat their previous performance in successive funds or vehicles. Consequently, co-investing has become even more difficult as it magnifies the risk of not choosing the appropriate GP.

Furthermore, evergreen vehicles, continuation funds, or the increasing custom of managers holding portfolio companies after they list on public markets, pose a fundamental conflict of interest between GPs and LPs as the latter is often asked to still pay full private equity fees for an asset that could easily buy on the public market, or for one that the GP has already owned for several years.

Cash management and liquidity are of utmost importance for the LPs as general partners are becoming much quicker at raising new funds. However, they are not as fast to redistribute capital from their previous funds and, in some cases, seek to profit from “rent-seeking” by not redistributing capital under the guise of aligning investment horizons with their investors.

In short, sovereign wealth funds and other long-term investors that have been good fund pickers, are also better at choosing co-investments and SPVs. Co-investments aren’t the solution to improve performance. They may well benefit the most sophisticated investors, but they are not a panacea for those asset owners with less institutional knowledge and skill. In fact, they may end up being counterproductive in terms of returns for these institutions.

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