IFSWF

International Forum of Sovereign Wealth Funds

Collaboration in Private Markets: Are Asset Owners Collaborating Enough?

May 2022

Background

On 29 March 2022, a panel of investors met to discuss the changing relationships among asset owners in private markets, focusing on collaborative approaches to private market investment. The speakers were:

- **Andreas Dische, New York State Common Retirement Fund**
- **Rebecca Manuel, CDPQ**
- **Steve Moseley, Alaska Permanent Fund Corp.**

The discussion was hosted by Duncan Bonfield, Chief Executive of the International Forum of Sovereign Wealth Funds.

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Introduction

Over recent decades, interest in private equity has surged, with investments reaching a record $1.6 trillion in investment globally as of December 2021, an increase of over 400% from $362 billion just a decade ago.[1] This interest has been driven in large part by institutional, long-term investors that can afford to pay the "liquidity premium" associated with the high returns for which private equity has historically been known. Indeed, private equity investors globally have enjoyed annualised returns of 17% over the last ten years compared to 13% for public markets over the same period.[2] The high returns associated with private equity is likely to be a primary factor behind investors' continued interest in the asset class.

However, the traditional private equity fund structure – wherein investors, known as limited partners (LPs), agree to commit capital to closed-end funds with lives of 10-12 years operated by managers known as general partners (GPs) – is no longer the only game in town. From changing relationships among private equity stakeholders, to the rise of technology in private equity, to shifting investor preferences, the private equity industry continues to evolve in the face of these changes.

We discuss several of these trends, drawing inspiration from a recent roundtable discussion sponsored by IFSWF, with input from Capital Constellation, a collaborative global asset owner network comprising leading institutional investors and advised by Wafra Inc., a leading global investment firm. In particular, we focus on the theme of collaboration in private markets, the benefits and challenges to collaborative approaches, and how other secular shifts – including the use of technology and the increasingly long-term focus of private equity investors – are impacting collaboration.

[1] Preqin Pro, last accessed April 8, 2022. Values include total investment globally across all PE strategies listed in Preqin, including venture capital (seed to late stage), buyout, balanced, and growth, among others.
[2] Preqin Pro, last accessed April 8, 2022. MSCI World Total Return Net index values used to calculate 10-year public market horizon return. PrEQIn Quarterly Index used to calculate 10-year PE horizon return.

Asset owner collaboration: Introduction and motivations

Historically, private equity funds were dominated by sovereign wealth funds, pension funds, endowments, and foundations that had the investment horizon, human and financial resources to make long-term investments at scale.

Increasingly, however, many of these same LPs have been working to sidestep the traditional fund model altogether. The motivations are clear: the classic 2 and 20 fee structure (2% management fee per year and 20% carried interest) has remained essentially fixed since the industry's inception.[3] These fees are significant. Research has shown that for buyout funds, total fees and carried interest payments amount to approximately $17 million per partner per fund. In VC, the amount is nearly double, at $33 million per partner per fund.[4]

As a result, there has been increased interest in co- and direct investing among LPs, particularly for larger institutional investors. A December 2021 survey found 54% of all LP respondents had active co-investment programmes, while 74% of large LPs (those with total PE commitments in excess of $500 million) did.[5] These numbers were up from 42% and 60%, respectively, just five years ago.[6] Similarly, for direct investments, 15% of all surveyed LPs had active programmes as of December 2021, while 26% of large LPs did. These numbers have increased over the last five years as well, jumping up from 12% for all surveyed LPs and just 8% for large LPs.

[3] Preqin Pro, last accessed April 8, 2022.
[4] Metrick, Andrew, and Ayako Yasuda. "The economics of private equity funds," *The Review of Financial Studies* 23, no. 6 (2010): 2303-2341.
[5] "Probitas Partners 2022 Institutional Investors Private Equity Survey." Probitas Partners. December 2021, https://3asstpm1ai412ap5q1o60dzh-wpengine.netdna-ssl.com/wp-content/uploads/2021/12/Private-Equity-Survey-2022_1203_2021_sm.pdf.
[6] "Private Equity Institutional Investor Trends for 2017 Survey." Probitas Partners. 2016, http://3asstpm1ai412ap5q1o60dzh-wpengine.netdna-ssl.com/wp-content/uploads/2015/12/probitas_partners_PE_Surveyfor_2016.pdf

Benefits to collaboration

Research has shown that these larger LPs have historically had the most success with these types of discretionary investments, particularly those LPs with prior track records of success.[7] Lerner et al. (2022) attribute this in part to access: they find top-tier LPs have over twice as much access to top-tier GPs as lower-tier LPs do. Unsurprisingly, this also translates to outperformance in terms of these discretionary investments: top LPs who have access to top GPs achieve returns that exceed those of lower-tier LPs investing with lower-tier GPs by 20% on a benchmark-adjusted basis.[8]

Along these lines, one of the contributors to the discussion noted the benefits of LPs working together to get access to top GPs. Partnership platforms, they noted, provide "the ability to fund managers with larger tickets, and therefore create a platform that is attractive to the most high-profile and promising deals."

In this way, collaboration by asset-owners may be thought of as a "virtuous cycle": as more successful LPs band together, access to top GPs increases, creating more success among LPs – and thus the cycle continues.

But more than this, partnerships can provide a broader geographic access to the most lucrative deals and best managers. For groups located outside of global financial hubs, partnerships with asset owners can enable access to expertise and talent that may not be as readily available nearby. Another participant in the session noted that, "for example, in areas of activity where deal flow drives outcomes (co-investments, secondaries, seeding businesses) … having geographical reach via partnerships is important." The panel noted that this was one of the reasons why structures like Capital Constellation work, as they can access global deal flow.

[7] Lerner, Josh, Jason Mao, Antoinette Schoar, and Nan R. Zhang. "Investing outside the box: Evidence from alternative vehicles in private equity." *Journal of Financial Economics* 143, no. 1 (2022): 359-380.

[8] In this calculation, the authors first calculated performance for investments using a "public market equivalent" (PME) metric, a ratio comparing actual PE returns to what equivalently timed investments into a public market index would have returned. A ratio greater (less) than 1.0 thus indicates outperformance (underperformance) of PE relative to public markets. The authors then calculated an "excess PME," or the PME of a given investment minus the average PME of the corresponding GP's fund.

Beyond access, partnerships can also facilitate knowledge transfer and provide learning opportunities. According to one panellist, "speaking with other asset owners who have different perspectives is a tremendous learning experience… we learn about current deal structuring ideas, fee terms, governance terms, and so when we put our thoughts together… we are just much more attractive partners to managers. We also become more effective in structuring terms which ultimately leads to stronger performance and stronger outcomes."

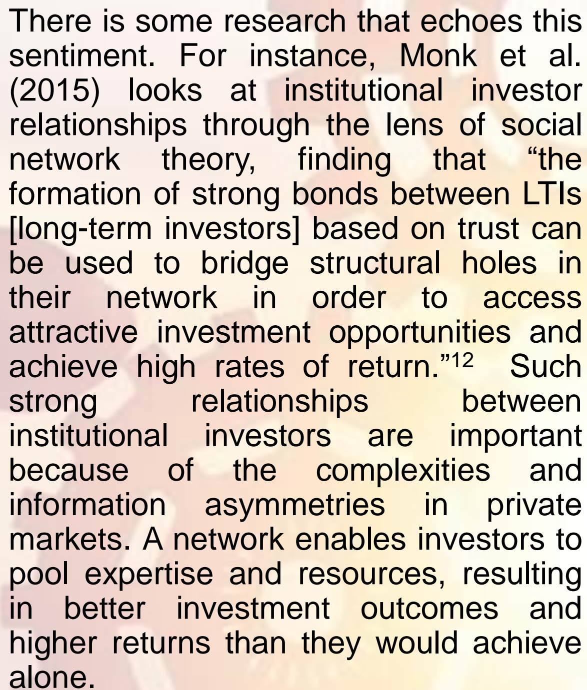
Indeed, research demonstrates the benefits of specialised knowledge and expertise in private markets. For instance, in venture capital, Gompers et al. (2009) showed that specialised venture firms outperform generalist firms.[9] Similarly, in private equity, industry analyses by AlpInvest[10] and Cambridge Associates[11] show specialists outperform generalists across sectors by around 15 – 20% on a return multiple (i.e., TVPI) basis.

It stands to reason, then, that similar specialisation on the part of LPs may pay dividends. When engaging in partnerships with other asset owners with specialised skills or relationships, a group is able to expand its reach while maintaining a focus on its own areas of competitive advantage. "It's like being a dual major in college…you can't do it alone, but you can do it with partners," one panellist said. "That's been the reason we joined with others and that's also been the source of returns for us as we've teamed up with others."

[9] Gompers, Paul, Anna Kovner, and Josh Lerner. "Specialization and Success: Evidence from Venture Capital." *Journal of Economics & Management Strategy* 18, no. 3 (September 2009): 817–44, https://doi.org/10.1111/j.1530-9134.2009.00230.x

[10] Cornelius, Peter, Eric Hanno, and Rutger Baauw. "Sector Exposure and Buyout Returns: A First Look at Chronograph Data." AlpInvest, May 2021.

[11] Zweig, Josh, Andrea Auerbach, and Jasmin Tabares. "Declaring a Major: Sector-Focused Private Investment Funds." Cambridge Associates, November 11, 2014, https://www.cambridgeassociates.com/insight/declaring-a-major-sector-focused-private-investment-funds/



There is some research that echoes this sentiment. For instance, Monk et al. (2015) looks at institutional investor relationships through the lens of social network theory, finding that "the formation of strong bonds between LTIs [long-term investors] based on trust can be used to bridge structural holes in their network in order to access attractive investment opportunities and achieve high rates of return."[12] Such strong relationships between institutional investors are important because of the complexities and information asymmetries in private markets. A network enables investors to pool expertise and resources, resulting in better investment outcomes and higher returns than they would achieve alone.

> *"Partnerships enable investors to expand their reach while maintaining focus on their own areas of competitive advantage."*
>
> — Steve Moseley, Alaska Permanent Fund Corp.

[12] Monk, Ashby, Rajiv Sharma, and Wen Feng. "Social Capital and Building an Institutional Investor's Collaborative Network," (2015), https://dx.doi.org/10.2139/ssrn.2698178

Challenges to collaboration

Despite the many benefits to taking a collaborative approach to private markets investing, challenges still remain. First, there are still "practical" issues to consider. As another panellist pointed out, "Asset owner partnerships offer scale or complexity that can be leveraged …the flipside is that not every organisation is set up structurally or has the legal framework to enable them to collaborate peer-to-peer."

And at a higher level, there is the key question of interest alignment generally. "Interest alignment is core to anything we do in terms of thinking about who we want to partner with. Part of that is alignment around what we are trying to achieve with the underlying asset, do we have the same growth-oriented mentality, are we prepared to support the company over the long-term. To us, that is critical," said the panellist. On a purely deal-by-deal basis, assessing alignment between partners – for instance, in the case of a single co-investment – is perhaps more straightforward. As one discussant noted, "in a worst-case scenario, one could always exit." But the challenge is much greater when the scope of the partnership is deeper, as is the case with partnership platforms, wherein relationships are longer-term, and involve deeper considerations around secular shifts, macroeconomic trends, and geopolitical factors.

So, the question becomes how to navigate these challenges and successfully capitalise on the many potential benefits partnerships have to offer?

> *"Speaking with other asset owners is tremendously helpful as we share insights not only on current market opportunities, but also about structuring insights, such as on creating bespoke evergreen or co-investment vehicles."*
>
> — Andreas Dische, New York State Common Retirement Fund

The evolution of private equity: Trends underscoring the potential for increased collaboration

There are a number of secular changes already underway that may spark collaboration among asset owners. One clear theme is the deepening LP-GP relationship. Not only is this clear from the rise in discretionary vehicle offerings from GPs (such as co-investments), but from other shifts as well.

One example of this is the increasingly long-term focus of LPs and GPs alike. In private equity, research shows that holding periods have been trending upwards, reaching an average of 5.4 years as of 2020, up from 3.8 years in 2010.[13] The same is true in VC: for instance, when considering unicorns (companies with valuations of at least $1 billion), the time from founding to IPO increased from seven years in 2015 to nearly 11 as of 2020.[14] These statistics likely stem, in part, from the fact that many GPs are increasingly using operational improvements to create value in portfolio companies. Historically, operating improvements were found to drive about a third of private equity returns,[15] but their importance is increasing.

These trends may also reflect the increasingly long-term orientation of private market investors. Some groups have gone so far as to raise dedicated long-term private capital funds. These funds represent opportunities to build durable relationships, and often align better with the horizons of institutional investors seeking "patient capital" solutions. These LPs can forge deeper connections with select GPs and gain access to investment products that better align with their objectives, while GPs benefit from having reliable pools of long-term capital, are not subject to short-term pressures to generate immediate returns. GPs also benefit from the expertise and access offered by institutional investors.

[13] "Exit Environment in 2020 and Evolution of Holding Periods." eFront: a part of BlackRock, n.d.
[14] Brown, Keith C., Wiles, Kenneth W., "The Growing Blessing of Unicorns: The Changing Nature of the Market for Privately Funded Companies," *Journal of Applied Corporate Finance*, (2020).
[15] Acharya, Viral V. Oliver Gottschalg, Moritz Hahn, and Conor Kehoe. "Corporate Governance and Value Creation: Evidence from Private Equity." *The Review of Financial Studies* 26, no. 2 (February 2013): 368–402, https://www.jstor.org/stable/23356858.; Guo, Shorun, Edith Hotchkiss, and Weihong Song. "Do Buyouts (Still) Create Value?" The Journal of Finance LXVI, no. 2 (April 2021): 479–517, https://www.jstor.org/stable/29789787

Another trend underscoring the potential for future collaboration comes in the form of GP stakes deals: where GPs sell stakes in their management companies, often to other LPs or GPs. Since 2011, fundraising for GP stakes deals has increased at an annualised rate of 11% per year, exceeding $70 billion in 2021.[16] Moreover, 42% of large GPs (those with fund sizes of over $15 billion) have sold stakes over the last decade. In fact, one of the primary motivations for these types of arrangements is interest alignment.[17] From early examples such as CalPERS' investment in Carlyle[18] to more recent examples – including investments by Wafra and Capital Constellation – there are clearly tailwinds already blowing in the direction of increased collaboration in private markets.

A final shift worth noting is the rise in secondary market activity. Over the last three years, GP-led secondary transaction volume – that is, secondaries structured and offered by GPs as products to LPs – has nearly tripled, reaching $68 billion in 2021.[19] At the same time, fundraising for these products has become increasingly specialised, with the proportion of funds with "broad secondaries" mandates decreasing from 86% to just 46% from 2020 to 2021.[20] These findings suggest GPs are increasingly attuned to the changing preferences of LPs, and adapting their product offerings to the needs of their investors. Some of the traditional barriers to collaboration – including information asymmetries, misalignment of interests, etc. – may be starting to dissolve.

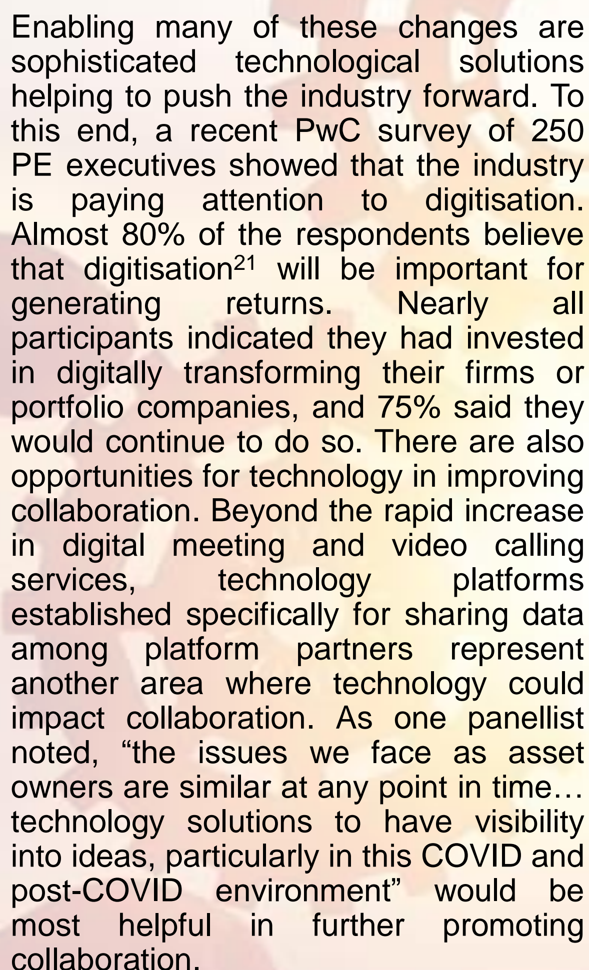
[16] Pitchbook data cited in "The GP Stakes Market Outlook for 2H 2021" Eaton Partners. 4 August 2021 https://www.stifel.com/Newsletters/InvestmentBanking/BAL/Marketing/StifelSays/2021/GP%20Stakes%20Market%20Outlook%20August%202021.pdf

[17] Ibid.

[18] See, for instance, Scannell, Kara. "Deal Makers: CalPERS Buys 5% Stake in Carlyle Group for $175 Million, Invests in Some Funds." *Wall Street Journal*. February 2, 2001.

[19] "Global Secondary Market Review: January 2022." Jefferies. January 2022.

[20] "PJT Secondary Roadmap Series: 2022 Deployment Blueprint Q1 2022." PJT Park Hill. 2022.



Enabling many of these changes are sophisticated technological solutions helping to push the industry forward. To this end, a recent PwC survey of 250 PE executives showed that the industry is paying attention to digitisation. Almost 80% of the respondents believe that digitisation[21] will be important for generating returns. Nearly all participants indicated they had invested in digitally transforming their firms or portfolio companies, and 75% said they would continue to do so. There are also opportunities for technology in improving collaboration. Beyond the rapid increase in digital meeting and video calling services, technology platforms established specifically for sharing data among platform partners represent another area where technology could impact collaboration. As one panellist noted, “the issues we face as asset owners are similar at any point in time… technology solutions to have visibility into ideas, particularly in this COVID and post-COVID environment” would be most helpful in further promoting collaboration.

[21] Steve Roberts and Elena Naydenova, “Private Equity Trend Report 2019: Powering through uncertainty”, PwC, February 2019, https://www.pwc.de/de/finanzinvestoren/pwc-private-equity-trend-report-2019.pdf

Closing thoughts

The private equity industry has continued to evolve in fundamental ways, responding both to changing macroeconomic conditions as well as broader secular changes. As the industry evolves, however, so too must market participants. As the panellists noted, collaboration among asset owners will be a powerful way to catalyse further growth and success in private markets. In the words of one participant "partnerships are essential tools applied differently in different markets." In view of benefits including access to deals, knowledge sharing, and returns, there are many compelling reasons for collaboration.

"Interest alignment is core to anything we do… Part of that is about what we want to achieve with the asset. Do we have the same growth-oriented mentality? Are we prepared to support the company over the long-term? To us, that is critical."

— Rebecca Manuel, CDPQ

Although challenges still remain in implementing such partnerships, industry tailwinds are helping to make these partnership models more effective. From closer relationships among LPs and GPs to an increasingly long-term orientation for investors generally, there are ample opportunities – and technologies – making collaborative platforms in private markets a successful reality. These efforts certainly require work on the part of LPs, but as one of our discussants said, "we think partnership is worth it. We roll up the sleeves and we do it. Sometimes it takes weeks and sometimes it takes months, but at the end of the day we think the returns will be stronger and the knowledge transfer will be stronger. So, we're all for this."

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