Changing Methods of Accessing Private Equity

Institutional investors in private equity are now able to access private equity investments through a variety of methods, including separately managed accounts offered by some GPs. To what extent is this a growing phenomenon amongst LPs? Emma Dineen investigates.

The private equity industry has evolved considerably over the past two decades. As the asset class has grown and financial markets have changed, a host of private equity strategies have developed alongside traditional buyout and venture capital funds, including growth, mezzanine, distressed private equity and secondaries funds. In 2000, a significant 65% of all private equity funds were buyout or venture capital vehicles, whereas this fell to 37% by 2010, as many new approaches have emerged. Furthermore, private equity has diversified out of its traditional markets of North America and Europe as opportunities to invest outside these regions have become more accessible and appealing to investors worldwide. At present, 72% of institutional investors in private equity currently invest, or are considering investing, in emerging markets. Of those that do, none expect to reduce their exposure to these regions in the longer term.

Clearly the private equity industry has evolved over this period, but what does the future hold? Are investors satisfied with their private equity portfolios? The results of Preqin's annual study of public and private sector pension fund returns show that private equity has been the best-performing asset class for these investors over five-year and ten-year time horizons. As a result, investors remain broadly satisfied with the performance of their private equity portfolios, and intend to continue allocating capital to the asset class. A substantial 79% of a sample of 100 global institutional investors interviewed by Preqin for a study in June 2012 noted that their private equity investments had met or exceeded their expectations (see Fig. 1), and 91% expect to increase or maintain their exposure to the asset class in the longer term.

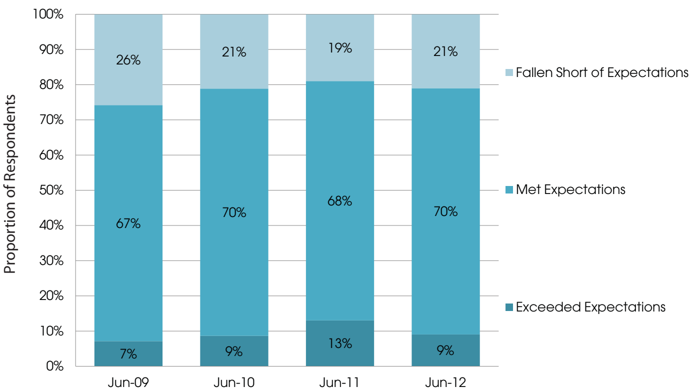
The private equity industry has not stood still, however, and is continuing to mature and adapt to wider economic realities. Historically, the only method for institutional investors to access private equity investments was via commitments to closed-end limited partnership structures, which remain the most common route to market for the vast majority of investors. LPs are, however, becoming increasingly savvy when it comes to private equity investing and many are exploring new ways to access the asset class in order to extract value from their portfolios. These new approaches include secondary market purchases, direct and co-investments, awarding separate account mandates and tapping into listed private equity. The opportunities and performance offered by the listed private equity market are explored in more detail in our recent Preqin / LPX Special Report: Listed Private Equity - Opportunities for Institutional Investors.

LP Appetite for Separate Accounts

In recent months there have been a number of reports of large institutional investors allocating capital to separate accounts. These arrangements can benefit LPs by enabling them to solidify relationships with their fund managers, negotiate better terms, and allow increased exposure to particular market sectors.

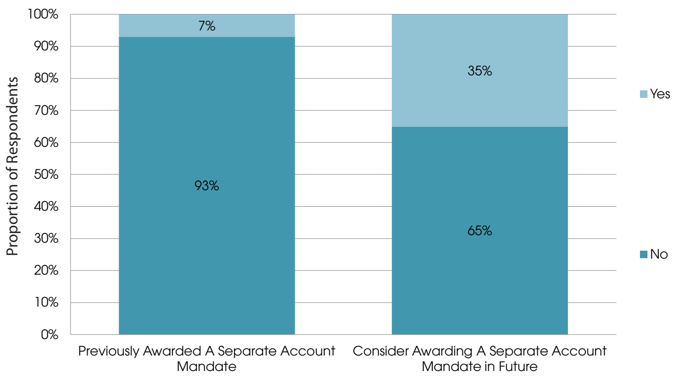
California State Teachers' Retirement System, for example, recently committed $250mn to CalSTRS New and Next Generation Manager Fund III, a separate account vehicle managed by Invesco Private Capital. The fund targets managers that are raising their first, second, or third vehicles, increasing the pension

Fig. 1: Proportion of Investors That Feel Their Private Equity Fund Investments Have Lived Up to Expectations



Source: Preqin

Fig. 2: Institutional Investor Appetite For Private Equity Separate Accounts



Source: Preqin

fund's exposure to emerging managers. Similarly New York State Common Retirement Fund recently established a separate account managed by 57 Stars, targeting mid-market funds and co-investment opportunities in European markets.

Is the practice of setting up separately managed accounts on the rise? In a recent study of 100 global investors' attitudes to the private equity market, we asked LPs whether they invest in private equity via separately managed accounts. Just 7% of investors interviewed told us they have previously awarded a separate account mandate, indicating that it is not always possible for LPs to access private equity via this route (see Fig. 2). One US endowment that does not invest in separate accounts noted: "We are too small for separate accounts; typically [we] only invest $2mn to $5mn per fund so a separate account would be pointless." Portfolio size was mentioned by several investors as a reason for not investing in separate accounts.

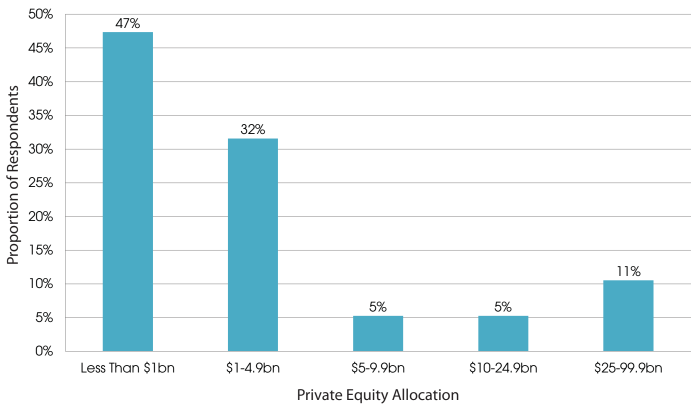
More than a third of LPs (35%) interviewed advised that they would consider allocating capital to a separate account in the future. As the private equity industry continues to mature, we expect that more LPs will seek to invest in separately managed accounts.

Fig. 3 Illustrates the make-up of institutional investors that would consider investing in a separate account split by size. Almost half of LPs with an appetite for separate accounts have less than $1bn in assets under management. A further 32% have between $1bn and $4.5bn under management, suggesting that smaller investors are looking to separate accounts as a way to access private equity. Ten percent of investors with an interest in separate accounts manage between $5bn and $25bn, while a significant 11% of LPs manage more than $25bn.

Direct, Co-Investments and Secondary Market Purchases

We have seen an increasing number of investors seeking to gain direct exposure to private equity over recent months, particularly since the onset of the financial crisis. Additionally, many LPs have looked to the secondary market as a way of accessing funds they may not have been able to access during the initial fundraise, often at discounted rates to NAV. A family office we spoke to told us "[we have] been buying and selling on the secondary market for the past five years, but only for portfolio management reasons and to take advantage of pricing opportunities." Purchasing fund interests on the secondary market can benefit investors in a number of ways, including mitigation of the J-curve and creating portfolio diversity by giving LPs access to funds across a range of vintage years.

Fig. 3: Make-Up of LPs That Would Consider Awarding a Separate Account Mandate by Assets under Management



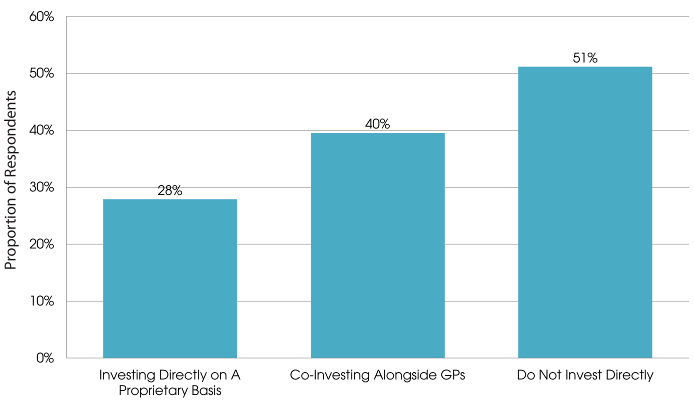
Source: Preqin

Some investors have used separate accounts mandates to increase their exposure to direct or co-investments as well as to the secondary market, while other LPs look to manage such investments themselves. In February 2012, North Carolina Department of State Treasurer revealed plans to form a co-investment program, for which it would consider awarding a separate account mandate to a fund of funds manager.

As Fig. 4 illustrates, almost half (49%) of investors interviewed by Preqin invest directly in private equity opportunities. Twenty-eight percent of LPs seek direct investments on a proprietary basis, including one Swiss foundation that has ceased investing in funds in order to pursue more direct investment opportunities. Investing directly in companies has been particularly prevalent among the Canadian LP community in recent years, with many Canadian public pension funds shifting their investments away from fund investments. Many of these larger LPs have the necessary internal resources to bid against established private equity firms and participate directly in deals; however, there has been little evidence of this occurring across the wider institutional investor community.

A higher proportion (40%) of investors look to gain exposure to direct investments by co-investing alongside their fund managers in portfolio companies. Although they increase risk, co-investments offer investors the potential to access higher returns. Further benefits include building knowledge of private equity by getting closer to deals, building stronger relationships with fund managers and potentially negotiating better terms on their commitments to funds. Co-investments are becoming an increasingly common occurrence in many LPs' portfolios, and offering co-investment rights can be a useful tool for GPs hoping to attract LPs to commit to their funds. Indeed, some LPs now consider not being offered co-investment rights a dealbreaker when choosing whether to invest in fund. When asked what a GP can do to stand out from the

Fig. 4: Institutional Investors' Preferred Method of Investing Directly in Companies

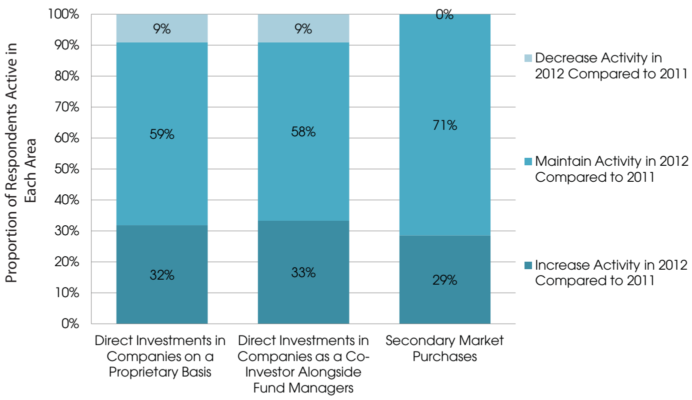


Source: Preqin

crowd one US-based investment company noted: "Track record and opportunity to co-invest are important," while a US family office also commented that to secure a commitment, a GP "must be globally diversified, have a strong operating background and must present good co-investment opportunities."

These methods of accessing the asset class look set to continue to be popular, as Fig. 5 illustrates. One-third of investors already active in the co-investment space expect to increase their co-investment activity over the course of 2012 compared to 2011, and 59% plan to maintain their exposure. Similarly, 91% of investors plan to increase or maintain their direct investment activity in 2012 compared to 2011. Of the investors that currently participate as buyers on the secondary market there are none that expect to reduce their exposure to such investments in 2012 compared to 2011.

Fig. 5: Institutional Investors' Expectations of Their Direct Investment Activity and Secondary Market Activity in 2012



Source: Preqin

Outlook

As new investment opportunities arise in new markets, the private equity industry is likely to continue to evolve. Both fund managers and investors will continue to strive to find the best methods of accessing private equity and tap into high returns. Since the financial crisis, LPs have become more prudent when investing in funds, and are more aware than ever before about the opportunities and potential drawbacks of investing in private equity. Consequently many LPs are now looking to take advantage of the different ways of accessing private equity, working more closely with managers in order to build more enduring relationships and get closer to deals.

As investors take a more 'hands-on' approach to investing in the asset class and portfolios mature, a key concern for many LPs is finding the best methods of extracting value from their investments, be it gaining direct exposure to deals, participating in the secondary market, or awarding separate account mandates. With fundraising conditions so challenging, private equity fund managers hoping to attract institutional capital must be keenly aware of the changing needs of the investor universe, and accommodate new requirements as the industry continues to evolve.