LP's Going Direct: Beyond Co-Investing to Direct Investing

On May 27 the INSEAD Alumni Association Switzerland's Zürich Chapter hosted an evening conference entitled, "LP's Going Direct: Beyond Co-Investing to Direct Investing" at the historic Zunfthaus zur Saffran in the city centre. INSEAD's Professor Claudia Zeisberger and Michael Prahl, who together lead the School's six year old Global Private Equity Centre, spoke to an audience of more than 40 private equity professionals, as well as attendees from investment banks, corporate finance, family offices and law firms, about the latest trend amongst institutional investors to bypass private equity funds and invest directly into businesses in their search for above average returns.

Zeisberger has identified a Canadian pension fund that is a frontrunner in direct investing by Limited Partners (LPs), and developed it as a case for INSEAD. By analysing its approach and research data, comparing it over time with other institutional investors' direct and co-investments, she and Prahl found certain success factors, challenges, and best practises which they shared. There is no rule that says direct investing is good or bad, but there are ways to do it right and many ways to get it wrong. LP have several options, such as pooling capital and working together with other LPs, sharing or outsourcing the work, or they can build the capability in-house, knowing that there is a need to dedicate resources and go up the learning curve, or find another solution that fits the LPs goals and capabilities. The presentation slides are available on the INSEAD Alumni Association Switzerland's website here.

(ZUERICH, June 23, 2014) After Blackstone went public in 2007, its CFO who now oversees the company's USD 272 billion asset management and advisory business spent his first years on the job explaining his employer's business model to stock market analysts who did not understand it. Even today, as he recently told Bloomberg, he believes the share price remains under-valued because private equity is not well understood. And yet the private equity business model is "remarkably simple", according to INSEAD Professor Claudia Zeisberger who teaches a core elective on private equity at INSEAD's Singapore campus, in addition to her leadership role at INSEAD's Global Private Equity Initiative.

"Private equity professionals invest in companies, improve the company over a period of three to five years, and then sell the stake, ideally at a profit. What is done in between may vary. It could be venture capital style or distressed, but it is still a simple business model," she told those gathered at an INSEAD Alumni Association Switzerland event.

Simple Business Model

For the benefit of the handful of people in the audience who came from fields unrelated to private equity, Zeisberger (pictured right) explained that private capital for investments and buyouts are typically drawn from a fund that is managed by General Partners (GPs). The fund is backed by institutional investors, or limited partners (LPs). The GPs invest the fund, select the companies, grow them, and sell them. The LPs can be pension funds, family offices, endowment funds, and occasionally high net worth individuals. The LP typically invests in funds advised by GPs.

Understanding LP motivation for investment in this asset class is important and Zeisberger uses insight gained from speaking to LPs in her classes. At the moment, the LP's classic model of investing through funds is evolving and now increasingly includes direct and co-investment strategies. One of the frontrunners in direct investment is Ontario Teachers' Pension Plan (OTPP) and Teachers' Private Capital, which was headed until recently by Jim Leech. "Even after considering risk, OTPP's private equity allocation has delivered superior returns compared to benchmarks of other asset classes at OTPP," said Zeisberger who originated the OTPP case for INSEAD and has analysed and compared returns over time and against other asset classes held by OTPP.

For the longest time, Yale endowment's approach was the model for the industry and *the* LP case used for teaching the LP perspective. It was written by Harvard. "At INSEAD we wanted to teach private equity using only INSEAD cases. I had originated all the cases I needed for my courses, except for the LP case," said Zeisberger recounting how it was a chance meeting at an Alumni networking event that she was able to find a connection to Jim Leech at OTPP and learn more about its unusual three pronged approach to private equity.

Direct Deals: Returns and Rationales

Co-investment and direct investment activity had a modest start, rising to the low single digit billions in about 2004 and 2005, to dramatically climbing in 2007. "It peaked in 2007, mainly as a result of mega-sized buyouts. Then fell [as a result of the bank debt crisis in 2008]. Pretty strong anecdotal evidence suggests that the figure is back up now to levels reached during the last cycle," said Michael Prahl.

"It is not rocket science to understand why LPs are attracted to direct investments. They think returns are better, that the management fees are lower, and they will have more control over their investments, which some find preferable to the blind pools of most PE funds," commented Michael Prahl (pictured right).

There is a long-standing desire to cut out intermediaries and reduce fees paid for PE investments. "Some LPs would rather have lower returns and lower fees. It is not exactly rational but some of the LPs find it easier to get approval for lower fee investments from boards," explained Prahl.

When LPs were surveyed by Preqin, the majority reported that the returns on their co-investments were delivering better returns than their fund investments. But academic research on such investments found evidence to be more mixed.

"A study by INSEAD and Harvard researchers found that there was a very wide spread in performance of LP co-investments. There was some evidence of direct investments performing well relative to fund investments yet, co-investments actually underperformed funds," said Prahl. The dataset in the study consisted of about 400 direct investments made by a set of large US institutions between 1991 and 2011.

This is not to say LPs cannot be successful in co-investing and direct investing. In fact, OTPP has an enviable track record in direct investments. Why some LPs are more successful than others is a topic that Zeisberger and Prahl have researched, and they have identified several barriers or challenges to LP success. One of the reasons is negative selection bias. "While GPs are more willing to consider co-investors, there is a potential for a negative selection bias in the sub-set of deals offered for co-investment, which can be explicit or implicit," said Prahl. That means that GPs tend to show deals that are larger in size, and not necessarily the best deals overall, to potential co-investors.

On the LP side there may be a tendency to choose brand name deals, ignoring fundamentals. They invest without considering risk of concentrating their "bets" in certain types of deals or industries when making co-investments.

LPs can also make the mistake of not realizing that they have to invest in human resources to support the strategy. It is also difficult to match the "selecting and stewarding" culture of the LP with that of the GP culture. The GP culture is not passive. It is typically closer to day to day business operations, requiring deep knowledge of an industry or type of business, being able to orchestrate M&A activity, and execute other growth strategies.

There is also an issue with being able to attract and incentivize professionals to carry out co-investment and direct investment programmes, according to Prahl. A pension fund does not typically compensate professionals in the same way as a PE fund does. "People that are competent in direct investing can earn a share in profit while collecting fees in a GP structure and they are obviously not going to go work for an institutional investor, unless it has a broadly similar compensation structure," said Zeisberger.

Success Factors

The research shows not only what will ensure poor returns in private equity and direct investing, it also reveals factors affecting success. One success factor is ensuring scale. OTPP set a PE target allocation and maintained it between 5% and 10%.

Another success factor is perseverance. "Don't dabble," said Zeisberger. The board needs to understand the risks and returns in direct & co-investments and know that PE returns have to be evaluated over a long period of time. Clearly, the governance model has to support private equity and it has to be able to accommodate learning lessons. "Teachers' success was based on the patience to move up the learning curve slowly," said Zeisberger, pointing out that OTPP uses 4-year rolling returns to evaluate its success. When its direct investments outperformed the performance of the GPs in its portfolio, it generated greater trust.

Another success factor identified is that the LP has to develop a compensation package and structure to attract top talent. And it has to stick to its strategy in order to justify the investment in expanding its capabilities. Furthermore, the direct investment team has to be protected from "political" interference of the investment committee. In turn, the team itself has to be able to attract dealflow, be able to perform due diligence on targets, and execute and that takes time. "It is only now that Teachers' is getting calls from businesses asking if it wants to invest. It has taken more than a decade to build a brand as an attractive private capital provider," said Zeisberger.

Focus and humility are important. "Be clear about what you do and don't do. Key to OTPP's success is that it understands its strengths and limitations. OTPP defines itself as a good 'overseer' of investments," said Zeisberger. It refrains from managing assets, and exercises caution when going abroad.

That same focus and humility means that some deals do not get done. These days a competitive advantage in private equity is to be able to execute on "operational excellence", as opposed to financial engineering. It is a wide-ranging trend caused by scarcity of debt and macroeconomic trends, so such deals are not suitable for passive investors. A pension fund or the like is wise not to do that sort of investment as a direct deal.

Easy in Theory, Hard in Practise

"The Private Equity Fund model looks easy enough," commented a member of the audience before he asked why some LPs are struggling to outperform benchmarks. "It looks easy. Yes. Identify the top quartile performers in private equity, and invest accordingly," agreed Zeisberger, who then explained why it is not as easy as it looks. One of the challenges is that LPs are always looking at historical data. Past performance is not necessarily indicative of future results.

Another reason it is challenging to identify the winners is scarcity of information. "Private equity fund performance is not as well researched over time as mutual funds. We know that mutual fund performance data shows that there is a convergence to a mean as time passes," said Zeisberger. Higher performers come down to the mean and the lower performers come up to the mean. There is not enough research available to show if this is also the case with PE.

The existing private equity research shows that especially on the buyout side there is a "kind of stickiness to top quartile performance". A while ago a "reasonable argument" could be made that over a fifteen year period, the benchmark outperformers stayed top. "This was correct data and it was good research," asserted Zeisberger. But recently this performance persistence has been weakening. "We need about another five years of data to get a final answer and to know if top quartile performance persists over periods of time greater than 15 years or if there is a regression," she added.

By way of an explanation, she referred to the ongoing trend that sees successful GPs growing larger asset pools, adding new strategies, and raising more funds. They are going global. They might raise a European fund and an Asian fund too. It is not necessarily the case that the top quartile performance will persist with a wider focus, according to Zeisberger. "Just because you have done well in the past in the US market, does not mean that you will do well if investment activity grows internationally," she said.

Furthermore for the fund investing model in some strategies such as venture capital, access to top quartile funds is scarce. "It has been said that Yale has been successful in a large part due to its longevity in PE/ VC and its longstanding relationships with GPs," commented Zeisberger. Therefore the Yale model is not easy to replicate for new entrants to private equity.

Alternatives and Rules

To summarize on key aspects of direct investment and co-investment strategies, Prahl suggested there are in broad strokes three alternatives. 1) Don't do it at all if you don't have the resources and long term mind set to do it right. 2) Take the time to build up an in-house capacity for more active investment activity with a focus on direct and co-investments. or 3) create or invest in a pool managed by a platform jointly financed by several LPs, thereby outsourcing the ability to make direct and co-investments.

Zeisberger had the last word. "Just as can happen in the M&A world where CEO's become irrationally competitive, LPs are subject to emotion. There is a need to be prudent. "Don't get caught up in the deal frenzy," she said. Be aware that due diligence on a fund or a GP is not the same as due diligence on individual deals. Selection has to fit the risk profile of the overall portfolio. Furthermore, understand that the decision making process is quick moving and the LP has to build the capability to become speedier. "There is no rule that say co-investments are good or bad. Can you get it right? Yes. But you have to add the capabilities and the processes to support it," concluded Zeisberger.

About the Speakers

Professor Claudia Zeisberger's Private Equity research includes GP/ LP relationships, Emergin Strategies (such as turnarounds and restructuring), financial market dynamics (data-driven topi funds and PE, trading simulation & Game theory and Risk Management. She received the "Dea Commendation for Excellence in MBA Teaching" for the last 5 years running. Working in Asia fo co-founded the Financial Women's Association. She advises clients and regulatory bodies in As Middle East.

Michael Prahl is Executive Director, Global Private Equity Initiative (GPEI). An INSEAD alumnu years with Apax Partners, working on high profile retail and consumer investments for Apax in E US including buyouts, public to privates, PIPE's, minority investments and privatizations. He mo Kong beginning of 2006 to help set up Apax Partners' Asian operations. He continues to advise establishment, fundraising, business and investment strategy.

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