# Private equity – allocations and commitments

## Addressee

This paper is addressed to the Officers and Pensions Committee of Suffolk County Council as administering authority for the Suffolk County Council Pension Fund ("the Fund"). It should not be released or otherwise disclosed to any third party except with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have especially accepted such liability in writing.

The paper considers the Fund's private equity allocation and proposal to make further commitments to this asset class.

## Background

The Fund currently has a strategic target allocation of 5% to private equity. The Fund employs two private equity managers who invest on a fund of funds basis; Pantheon and Wilshire. Both managers have recently put forward proposals for further commitments. The proceeds of private equity investments are returned to investors. This means that the Committee needs to review the progress of existing commitments periodically and consider options in relation to new commitments in order to achieve and maintain the target allocation.

In this paper we provide a brief summary of how private equity investments work, some of the challenges faced by private equity investors in the current market environment and our views on the recent proposals from the Fund's private equity managers.

## Private equity investing

Private equity involves the provision of finance for business development or buyouts. In return for providing finance, investors purchase a share of the business. These businesses are unquoted; their value (both at the time of investment and subsequently) is hard to determine. The worth of the business that has been acquired can only be established accurately when it is sold (either through a trade sale or by floating the company on a stock market) on average 4-6 years after the private equity investment is initially made.

In its pure form, the intention of private equity is to provide finance to allow businesses to develop; this is more in the nature of venture capital. In practice, a very large proportion of private equity investment relates to buyouts.

Buyouts of quoted companies are akin to a corporate takeover. The reason for the buyout may be because the share price is considered low (on a medium term view). A company may also consider an approach from a private equity manager for the buyout of a subsidiary company. It is common for the buyer to acquire the company with a view to changing the management, re-financing the balance sheet perhaps with a significant increase in gearing, and running the company aggressively to generate cash flow with a view to selling the business on, or obtaining a stock market quotation again, within 3-4 years. The purpose of buyouts is therefore wealth creation for the general partners, their investors and the executive management of the businesses being bought out.

There is more detail on the different types of private equity investment in the Appendix to this paper.

Private equity is still a form of equity; therefore, investment in private equity does not offer strong diversification from quoted equity exposure. The value of individual investments is usually released by trade sales or stock market flotations. Returns are delivered in a different pattern of returns from quoted equity but its attraction also depends heavily on the achievement of an excess skill-based return.

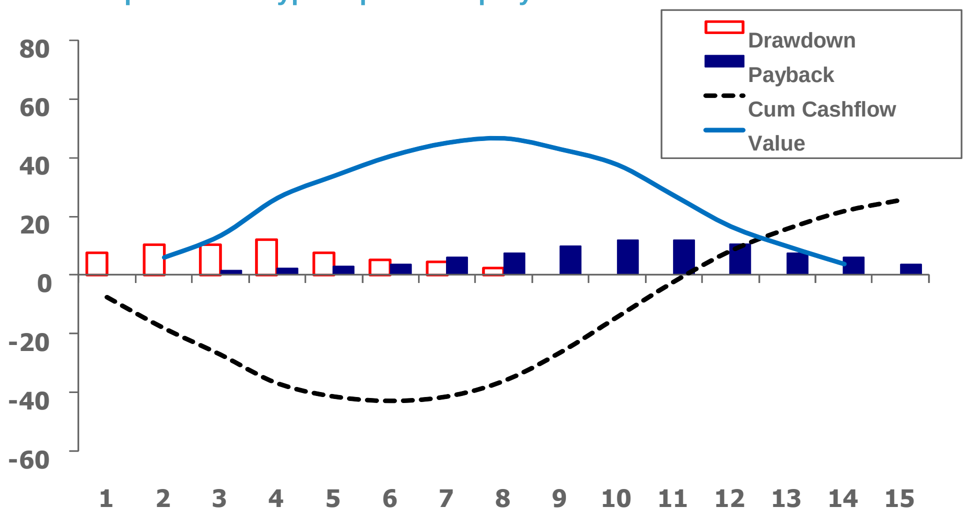
### Getting invested in private equity

One of the challenges of investing in private equity as an asset class is managing the amount of money actually invested at any point in time. When the Fund selects and commits to a fund of funds product or products, the manager will typically make commitments to primary private equity limited partnerships over a period of one to three years. The General Partners (managers) of the primary private equity limited partnerships will in turn typically commit investments to companies over a further one to three year period. Money is only ever drawn down in this asset class on a "just in time" basis, so it may be that the Fund is still paying capital calls (i.e. fulfilling investment commitments) to the fund of funds manager four or five years after the initial commitment.

By this time, it is not unreasonable to expect that some of the earliest investments will be beginning to yield returns. As investments are realised, cash proceeds of sales (including realised gains or losses) are returned through the investment chain to the original investor. Because investments are returned to the investor, further commitments to the asset class are required in subsequent years to top up the strategic allocation to the asset class. Consequently, the investor who takes the strategic asset allocation decision to invest 5% of the fund in private equity, but does not commit more than 5% to private equity products, is unlikely ever to achieve their full exposure in actual money terms, and will remain underinvested in private equity. Without continued new commitments, the self-liquidating nature of the asset class means that exposure will eventually return to zero.

This feature of the asset class is illustrated in the chart below.

### Cash flow profile of a typical private equity Fund-of-Funds




In this example, cash is drawn down from the investor (the red bars) over a period of 6-7 years. Distributions of profits (the blue bars) can begin as early as year 3 but will peak in years 8-13. The actual amount of money invested in the asset class is shown by the blue line, peaking at £50m in this example around years 6-10 and declining thereafter.

Making projections such as this for specific funds is difficult as the exact pace of investment and distributions will depend on the underlying economic climate, as will the value of investments at any point in time. However, it is important to have some broad view on how future cash flows will develop in order to plan commitments which may need to be made now. The managers tend to be best placed for making these forecasts.

## The challenges of private equity investing

At the most recent Committee meeting, we gave a summary of the objectives of the Fund and the way that the investments are structured in order to achieve those objectives. When looking at the investment structure we separated the assets into four groups: return seekers, diversifiers, stabilisers and insurance assets. Private equity sits firmly in the return-seeking group alongside quoted equities.

Some of the challenges of investing in private equity are as follows:

- private equity is still equity and therefore, does not diversify away from equity. Indeed, to the extent that it applies leverage, it adds to equity concentration
- it requires a long period of investment, over which time it is essentially lacking in transparency
- performance is measured by Internal Rate of Return (IRR) which makes it extremely difficult to assess performance or make return comparisons with listed assets, such as equities or bonds
- Comparisons with listed equity may be possible, albeit a bit tricky, through shadowing the drawdowns and distributions of a single private equity fund using index tracking listed equities (of equivalent region) in order to create a listed equity IRR that can be compared with a private equity IRR. However it will take about 8 years following fund launch before the distributions are sufficiently meaningful to make the comparison

One of the key reasons for investing in private equity is that we expect it to return 4-5% p.a. outperformance of listed equity (in a fund of funds). To achieve this level of return we need to be invested with a top quartile manager – both Pantheon and Wilshire have been in the past. The question is whether this excess return is sufficient. There are reasons why it might not be sufficient:

- You should receive an illiquidity premium because your capital is locked up. LGPS funds can tolerate this illiquidity but we need to be aware of other illiquid asset opportunities which might be more suitable.
- Private equity is more highly geared than listed equity so you should be compensated for the higher risk (or you could take the excess risk elsewhere).
- Most private equity is in smaller companies with strong cash flows – you could invest passively in smaller companies and these have significantly outperformed the mainstream equity indices which are essentially large cap – at least part of the private equity excess return is likely to be due to the small cap bias you could gain elsewhere.
- Fund of fund fees are egregious. The fee is paid on the amount committed rather than the amount that has been invested (at the level of the fund of fund manager and also the underlying manager).

This last point on fees is one that we believe needs careful consideration. Are the expected returns more than compensating for the fees we are paying to private equity managers? If we assume that, on average, only half of the committed amount is invested at any time, the fixed fees you pay are about twice the quoted level as a percentage of the amount actually invested. You will also pay performance fees. Further, there will be other costs paid to various providers along the way (arrangement fees, etc.).

Crudely, assume you pay a commitment fee of ½% to the fund of fund manager and around 1½% to the underlying manager and we double these. That amounts to 4% p.a. You will pay away performance fees to the underlying manager which might be another 2% p.a. and perhaps some performance fee to the fund of fund manager. With other costs, this can easily amount to an aggregate fee of 7% p.a. If we assume that an individual participation is acquired, held for 4 years and sold at double its original cost, that translates to a 19% p.a. return which, after 7% p.a. fees and costs, reduces to 11% p.a. return to the investor. This would typically equate to a 4% p.a. excess return over what you might expect from listed equity markets.

Clearly, operating with secondaries and co-investments is likely to avoid a reasonable amount of double charging of fees so should produce better returns net of all costs.

If listed markets are going through difficulties, it is likely that private equity exits will also be difficult, holding periods will rise (depressing IRRs) and exit prices might be lower. Essentially, private equity will probably be able to maintain a 4% p.a. premium return against a lower return from listed equities, but only if it is managed well.

Questions that need to be asked about a number of aspects of private equity are:

- Is excessive leverage being employed – we suspect that there could be in some areas, particularly mega-buyouts, but mid-scale buyouts are probably OK
- We know there are dividend extraction systems, where a manager will increase debt within an entity and then pay some of that as a cash dividend, further increasing risk. Again, this is more likely in the mega buyout category
- We know that some high profile underlying private equity funds have folded, because their old fashioned models won't work anymore or they cannot get funding
- We can envisage that, in a lacklustre growth environment, private equity might need to depend on management expertise rather than financial engineering. Many private equity firms relied (lazily) on the latter and may not have the skill (or the perseverance) to undertake the former
- If firms need to hold onto participations for longer, it damages the IRR. It may also damage their internal management and profitability model (how they remunerate staff). They may as a result be incentivised to accept lower exit prices. This will diminish returns
- In a world that is short of organic growth, there may well be stronger competition from companies (balance sheets are quite strong) to make bolt-on acquisitions. This would raise entry prices for private equity firms.

When considering new commitments and whether the current allocation to private equity should be maintained, we need to be comfortable with the way in which the investment is being structured, the level of fees and the outlook for the market it is targeting. This review process would currently lead us to favour secondaries and co-investments over primary private equity. However, each proposal should be evaluated on its own merits.

## Current manager proposals

### Wilshire

Wilshire have proposed that the Fund invest in Wilshire Fund IX. This is a single global fund rather than the separately managed funds for US, Europe and Asia which the manager has previously offered. Fund IX is a rather small fund, with a funding target of $150m. Wilshire are seeing a lot of investors asking for separate accounts and much of their new capital will be in that form. The target portfolio of Fund IX is 45% US, 30% Europe and 25% Asia, which looks reasonable given the global opportunity set. Up to 33% of the fund will be allocated to opportunistic transactions, such as secondaries and directs. Wilshire have offered attractive fee terms for investors in first close.

According to Wilshire's projections, Suffolk's private equity programme with Wilshire will turn significantly cash flow positive in 2014 and remain so (distributions are expected to be between £7.5m and £9.5m in 2014, with expected capital calls of just £2.5m). This means that the exposure to Wilshire will start to decline rapidly unless new commitments are made.

We are reasonably comfortable with Wilshire as an organisation. They have kept the European team essentially intact and rebuilt the US and Asia teams with quality individuals. However, we have concerns about their ability to raise new capital for Fund IX. The amalgamation of the three regional funds into one (small) global fund is an indication that they too have similar concerns.

We would feel more comfortable with other private equity managers such as the Fund's other manager Pantheon. They have continued to successfully raise large funds since the crisis, at the expense of the smaller firms.

As we stated above, Wilshire Private Equity have been raising capital in separate accounts so we are confident that they can continue to operate as a healthy business. They also have a very strong parent in Wilshire Associates Inc. However, given problems experienced at Wilshire in the past and some concerns over the fund being proposed, we are happy with the gradual reduction in the exposure to Wilshire as we experience what are expected to be reasonably strong distributions over the period 2014-2018.

## Pantheon

**Current private equity commitments**

The Fund first started investing in private equity with Pantheon in 2003. Since then, there have been a number of new commitments to a range of funds which has helped to build up a diversified exposure to private equity across regions, types of investment and vintage years. The table below summarises the existing commitments.

| Vintage year | Commitment (£m) | Fund | Drawn (£m) | NAV + distributions (£m) | Net multiple | Net IRR (%) |
|---|---|---|---|---|---|---|
| 2003 | 4.5 | USA Fund V | 3.9 | 6.4 | 1.6 | 10.9 |
| 2004 | 5.5 | Europe Fund IV | 4.7 | 6.1 | 1.3 | 7.4 |
| 2004 | 2.4 | Global Secondary Fund II | 2.1 | 2.9 | 1.3 | 9.4 |
| 2005 | 2.0 | Asia Fund IV | 1.6 | 2.4 | 1.6 | 13.4 |
| 2006 | 4.6 | Europe Fund V "A" | 3.4 | 3.8 | 1.1 | 3.8 |
| 2006 | 2.0 | Global Secondary Fund III | 1.7 | 2.1 | 1.2 | 4.8 |
| 2006 | 4.2 | USA Fund VII | 2.9 | 3.7 | 1.3 | 7.8 |
| 2007 | 3.2 | Europe Fund VI | 1.8 | 1.9 | 1.1 | 3.0 |
| 2007 | 3.1 | USA Fund VIII | 1.9 | 2.1 | 1.1 | 5.8 |
| 2010 | 5.4 | Global Secondary Fund IV | 2.3 | 3.0 | 1.3 | 22.7 |

The table shows the importance of building a private equity programme that gives the Fund diversification, particularly in terms of vintage years. The performance variation by vintage is evident in the difference in the IRRs of the funds raising capital pre credit crunch where it has been harder to recover from what in many cases were over-priced valuations. However, the crisis also created opportunities for funds such as those focussing on secondary deals where, while it is still early in the lifetime of the fund, returns are looking strong.

As we have highlighted earlier in this paper, direct performance comparison with equities is difficult due to the calculation methodology. However, since its inception, the aggregate Pantheon portfolio exposure has produced a net IRR of 8.4% which is ahead of what we might expect from equities.

**New commitments**

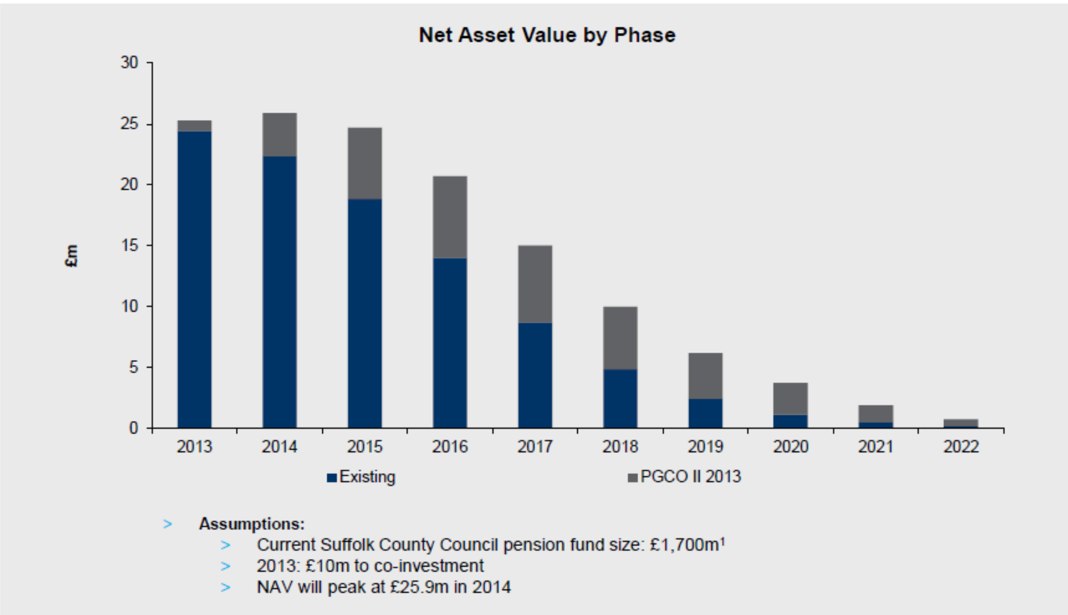
Pantheon have proposed that the Fund make a commitment to the Pantheon Global Co-Investment II Fund (PGCO II). This will be a co-investment fund comprising minority equity and equity-like investments in private companies primarily in leveraged buyout and growth equity transactions. Pantheon will seek to build a balanced portfolio with limits on individual investment size, and diversification across companies, geographies, sectors, stages, vintage years and private equity fund managers. The target allocation split on a regional basis will be 15-25% Asia, 20-30% Europe and 50-60% United States.

As the name implies, the proposed fund is focussed specifically on co-investment opportunities. Pantheon believe that the current market environment is favourable for co-investments as, post credit crisis, the market environment for fund raising and debt availability has led many highly rated private equity providers to look for reliable co-investors in some of their investments. Pantheon's activity within the co-investment part of the market in recent years has been significant. The size and depth of their team means they are well placed to source co-investment opportunities.

As set out earlier in this paper, we need to be confident that we are investing with a top quartile manager and that we are using a cost effective way of accessing the asset class, to achieve the level of returns we are seeking from private equity to compensate for the illiquidity and the high fee levels,. We are supportive of the Pantheon proposal for the following reasons:

- To date, they have performed consistently well; we believe they will continue to be one of the better performing managers
- They have a strong record of being able to raise new capital and invest it in the market
- The proposed co-investment route will result in a lower overall level of fees and therefore improve the expected level of net net returns
- They have significant experience in investing on a co-investment basis across the globe
- The route to investing with Pantheon should also allow the funds to be drawn down faster and reduce some of the impact of the J-curve (the J-curve reflects the initial reduction in value of an investment due to the impact of acquisition and re-organisation costs, before investment returns become positive).

Pantheon will present in more detail to the Committee in relation to the PGCO II and their capabilities in this area of the private equity market. Subject to the Committee being supportive of investment in the proposed fund, we would also need to determine how much money to commit. Pantheon have provided the following estimate of the expected commitment and distribution profile of the existing private equity programme and with a £10m commitment to the new PGCO II fund.




The pattern and timing of cash flows in private equity are unpredictable and will depend, inter alia, on general economic conditions and the example above represents only one of a large number of possibilities. The example above is based on Pantheon's experience. This example is not intended to represent forecasts of performance and should not be used for that purpose. For illustrative purposes only.
Annual projections as at December
[1]Source:Preqin 24.06.2013

Source: Pantheon

From the blue bars in the chart we can see that, without any further commitments, the exposure to private equity through Pantheon is expected to reduce steadily over the next 5 years. The grey bars demonstrate that a commitment of £10m to PGCO II is projected to broadly maintain the exposure for the next couple of years, reflecting the pace at which the co-investments are expected to be drawn down. At that time, we will again see net distributions. We believe this proposed commitment would allow the Fund to maintain a reasonable allocation to private equity, with a manager we rate highly, and to do so in a cost effective manner.

The nature of private equity means that we would then be able to review the position in 12-18 months' time to consider if future commitments are required and to examine the most attractive areas of the market at that point.

**Summary**

We believe that private equity should be retained as a part of the Fund's return seeking asset allocation. However, some of the challenges faced when investing in private equity such as a lack of transparency, high fee hurdles and difficult market conditions mean that the Committee should carefully consider how to allocate to the asset class. We are supportive of the proposal from Pantheon on PGCO II and believe that a commitment of £10m allows the Fund to maintain a reasonable allocation to the asset class in an efficient manner.

We look forward to discussing this paper with the Committee.

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**Risk Warning**

# Appendix: Private equity - the opportunity set

An important aspect of successful investing in private equity is to secure proper diversification by geography, financing stage and time, while avoiding over-diversification that might simply lead to a return outcome that was equal to the mean returns from the asset class. Mean returns from private equity do not generally provide any additional reward for illiquidity and the extra risks taken by investing in the asset class relative to quoted equity. In selecting managers to execute their private equity strategy, investors should be conscious of the opportunity set available to them and be aware when their selection strategy excludes particular opportunities.

The following text describes each of the opportunities in turn, first by geography and then by financing stage.

## Geographical Opportunities

### North America

The North American, and particularly the US private equity markets, are the most developed and sophisticated in the world. The investment infrastructure is more developed and returns from these markets have generally been better than elsewhere. We would normally expect that a very significant proportion (possibly 50% or more) of any properly diversified private equity portfolio would be invested in North America.

### Europe

Europe, including the UK, is the next important block of geographic investment opportunity sets. For this purpose Europe is broadly taken to be Western Europe but can include Israel. Although Eastern Europe could still be considered as a developing market it is increasingly seen as being part of this opportunity set. The European private equity market is gaining rapidly on North America in terms of the investment infrastructure and in recent years returns have been comparable. Indeed, many believe that the small and mid-market buy-out funds of Europe may provide better returns going forward than the more developed North American markets. Within Europe, individual markets are at different phases of their development and the UK is usually regarded as the most advanced of these markets. We would normally expect a significant proportion (up to 50%) of any properly diversified strategy to be invested in the European private equity markets.

### Asia

These markets, which have become the growth engine of the world, potentially offer great opportunity, but they have a less developed private equity infrastructure than western markets. Again, individual markets vary greatly in their sophistication and development, with perhaps even greater divergence than in Western Europe. Very few general partnerships have raised more than one or two funds, and so track records can be difficult to assess. We would expect investment in Asia to play an increasingly significant part (10-15%) of a diversified strategy at this time.

### Rest of the World

For this purpose the Rest of the World would include Latin America and Africa. These markets are very underdeveloped and are probably not well suited to pension fund investing at this time, apart perhaps, from the occasional opportunistic deal. These markets will mature, at different rates, over time and investment managers will need to be researching them. However, we would not expect to see investments in these markets feature to any significant extent, if at all, in investment vehicles available to pension fund investors at this time.

## Financing Stage Opportunities

### Venture Capital

In many ways Venture Capital is the best known of the various private equity strategies available and many have confused it with the entire opportunity set. For this purpose the term Venture Capital may be taken to mean equity or equity-like investments in companies that have underdeveloped or developing products or revenue. Venture capital investing can embrace start-up companies and/or development finance where the investor is participating in later stages of fund-raising for existing companies.

### Expansion Capital

Expansion Capital refers to equity or equity-like investments in public or private companies that have been operating for a sufficient amount of time to develop a sustainable business. The investment will be used to expand the operations of the company. Managers that specialise in what is known as "early-stage finance" often combine both Venture and Expansion Capital investing in their fund strategies.

### Buyouts

Equity investments in public or private companies that result in the purchase of a significant portion or majority control of the company. Very often this includes the use of debt (leveraged buyouts). The buyout market is generally split by deal size into small, medium and large capitalisation deals and some managers will attempt to specialise in one or more segments of the buy-out market depending on where they perceive their strengths and relative advantages to lie.

### Mezzanine

Investment in the subordinated debt (i.e. ranking above equity but below senior debt) and/or equity in privately owned companies. The debt holder participates in equity appreciation through conversion features such as rights, warrants or options. Returns are pitched between bond returns and the expected equity return.

### Distressed/Restructuring

Radical restructuring of a business with severe economic difficulties (also called Burn-out Turnaround). The new third party funds are brought in and stakes of existing shareholders are diluted.

### Others (Special Situations)

Usually has a special component related to geographic, economic or social issues (economically targeted investments) but may also include investments in the exploration for oil and/or gas reserves or in the development of proven reserves. It may also include investments in farmland or timberland.

### Secondaries

Investors in private equity usually invest in the knowledge that such investments are illiquid and that there is no easy way to realise the value of the investment before the full cycle has matured. However, for a variety of reasons, investors sometimes seek to exit their commitments to private equity funds by selling them (usually at a discount) in the secondary market. Such secondary investments can be very attractive, not only because of the discount that usually accompanies them, but because they will have already experienced some write-down of the less successful investments (lemons ripen first!) and because they can bring earlier returns to investor’s private equity strategies. This market place is sometimes divided between mature (or “financial”) secondaries (i.e. those where substantial commitments have been made) and those where substantial commitments require to be made (immature or “manager” secondaries). Whereas the dominant evaluation factor in “mature” secondaries is the price or discount involved in the purchase, immature or “manager” secondaries require greater judgement and deeper knowledge of the General Partners involved.

### Co-investments

Co investment opportunities are opportunities to invest in underlying portfolio companies without having to do so through the General Partner's limited partnership vehicle. This has the advantage of saving fees and carried interest which lowers the cost of investing and ought to improve returns.