The New Paradigm
A study into the GP perspective on the rise of direct investing
As the private equity industry continues to evolve year on year, influenced by its growing regulation, Limited Partners’ (“LPs”) developments, and ever changing economies, MVision’s annual survey gathers opinions on the dynamics of the leading global investors in the asset class. This year, discussion has focused on the ‘Mega LP’, i.e. institutional investors with the capital to invest directly in transactions usually reserved for private equity funds or strategics, and on co-investment. Will Mega LPs have a long-term effect on competition both in terms of acquisitions and LP commitments to funds? Very little analysis has been done to date on General Partners (“GPs”) reaction to this growing trend, so this year MVision’s survey collates the views of over 60 International GPs.

Foreword by Mounir Guen,
Founder and CEO of MVision

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For us, this trend hasn’t really affected the mid-market players… but the trend has an impact on some of the larger players. Right now these are like small waves which can turn into a tsunami in the long term.

Asian-focused mid-market private equity manager

To date, a third of GPs we spoke to in our research have come up against direct investment from an LP in an auction process over the last 12 months and almost half (47 per cent) expect to do so increasingly in the future. The Canadian Pension Plan Investment Board’s winning bid for General Electric Co.’s private equity lending business last year was a high profile example of this, as the pension board beat Apollo Global Management LLC and KKR & Co., amongst others, at auction with a bid of $12 billion. Crucially, only 25 per cent of GPs think direct investing is just a phase, suggesting that they need to be prepared for this trend to continue.

LPs are definitely more present. Some are sometimes seen as competitors.

Mid-market private equity manager, based in Western Europe

Have you come up against direct LP investors in auction processes over the last 12 months?

- Yes
- No
The threat to private equity: if there continues to be a rise in direct investing from LPs will it be harder to secure commitment from them for future large funds? And why?

GPs have some concerns about the emergence of the Mega LP for three main reasons. Firstly, they see them as competing with private equity firms in auction processes. Almost half of the GPs we spoke to now perceive Mega LPs as direct competitors when it comes to deal origination. Secondly, their increased participation in deals is thought to potentially inflate prices as the LPs have a different set of targets. Around 40 per cent of GPs think the higher valuations currently in the market place are a consequence of the arrival of Mega LPs in the bidding process. Thirdly, some are concerned that GPs may find it harder to secure fund commitments in the future. An increase in direct investing from LPs is viewed as an uncertain future for some private equity firms, with 45 per cent of GPs admitting that they have yet to understand exactly how much the direct investing of Mega LPs will affect their ability to access commitments to their future fundraises.

What do you think is driving the increase in direct LP investment?

It is vital that GPs understand what is driving the trend of direct LP investment. Why would LPs look to bypass or supplement private equity firms if they have historically produced above average returns for their investors? Our research shows that this is not a question of performance, but one of fund terms. Almost half of the GPs we discussed the trend with think that concern over industry fees is driving LPs to invest directly. Indeed, only four per cent think the shift is because LPs believe they can outperform GPs on returns. While investors’ pursuit of reduced fees is not a new phenomenon, it is only recently that the numbers of those venturing out on their own has increased enough to make a significant impact on the investment community. Looking to the future, GPs will need to examine the way that their fees are communicated and justified to investors, and work harder to demonstrate the value that their expertise brings and the returns they can achieve.
Co-investment: Do you currently offer co-investment to LPs?

Some LPs however are not ready to go it alone and instead are demanding that as a part of their commitment to a fund, they also have the option to co-invest. It is an undeniable and permanent feature of the market; 86 per cent of firms surveyed offer it, however GPs are still opting to do this on a selective basis. The majority of GPs offering co-investment (83 per cent) make this option available for just 25 per cent of their deals or less. Sixty per cent do not charge a co-investment fee and 32 per cent do so on a case-by-case basis.

What are your reasons for offering co-investment opportunities to your LPs?

We experience a high level of demand for co-investment. It’s the easiest meeting to get, teams will listen fast, intermediaries (Fund of Funds, Consultants) and end LPs (particularly the larger, Mega ones) are all staffed and more importantly focused on doing this.

Partner of Asian-focused debt and equity firm

What to expect: Which types of LPs are generally more involved in direct investments?

In the nascent period of direct investment, the investors had understandably looked to target investments with longer-term, lower-risk assets. Limited industry knowledge and operational expertise may dictate the types of deals LPs were involved in, however, as we have seen, it will not exclude them entirely going forward. GPs expect to see increased competition for deals in infrastructure and real estate, as their predictable cash flows and lower operational demands make them the ideal purchase for direct investors. According to feedback in our survey, GPs also expect heightened demand in the mid-market, with LPs focusing on transactions between $150 – 500 million.

Most GPs (73 per cent) have noticed increased direct investment interest from Mega LPs, especially from North America and Europe. This can be attributed to familiarity with developed economies, strong institutions and ease of deal origination. Sovereign Wealth Funds and Pension Funds have been identified as particularly active direct investors, however GPs have also come to expect increased rivalry from Funds of Funds and High Net Worth Investors, making for a highly competitive market place. The Canadian consortium of Pension Funds that succeeded against stiff opposition in a £2 billion bid for London City Airport last year is indicative of the types of deals we can expect in years to come.
Are there any significant barriers to entry for LPs?

(1 = most important, 5 = least important)

Although it is clear this trend of both direct and co-investing from Mega LPs is not a phase, there are still a number of barriers for LPs which works to the advantage of the private equity firm. Our survey shows that this includes: limited industry knowledge (23 per cent), lack of transaction experience (22 per cent) and speed of due diligence (20 per cent).

However, with many of the large buyout funds not reducing their fees and increasingly adapting fund terms to their own favour, such as no longer having a hurdle rate, how long will investors with substantial liquidity to invest continue to work with these funds? Note that some LPs are hiring top transaction personnel from private equity firms to take charge of investment teams, which will quickly level the playing field in the industry. The closer the Mega LP comes to filling the skills gaps, the quicker they become a very real alternative to the GP.

As the market develops the LPs continue to seek to produce returns and manage their growing deployment. Direct investing is key as long as LPs trust their own ability to complete a transaction and that they have sufficient industry expertise to grow or transform an investment. The perceived experience gap is exactly what many GPs hope will keep them ahead of their competitors in a very crowded market place. This ‘trend’ may not have an immediate impact at this moment in time, but as LPs build their confidence and their transaction teams, they will be a real presence.

Methodology

We collected responses from 62 private equity firms, including large buyouts and mid-market firms to gauge current sentiment among GPs towards the developing trend of institutional LPs foraying into direct investment and co-investment. We focused on funds investing across all geographies but the majority of the respondents were mid-market funds investing in North America, Europe and Asia with an AUM between $1 billion to $5 billion.

This report was developed in collaboration with London Business School.

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