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The Private Capital Research Institute

The Disintermediation of Financial Markets: Direct Investing in Private Equity

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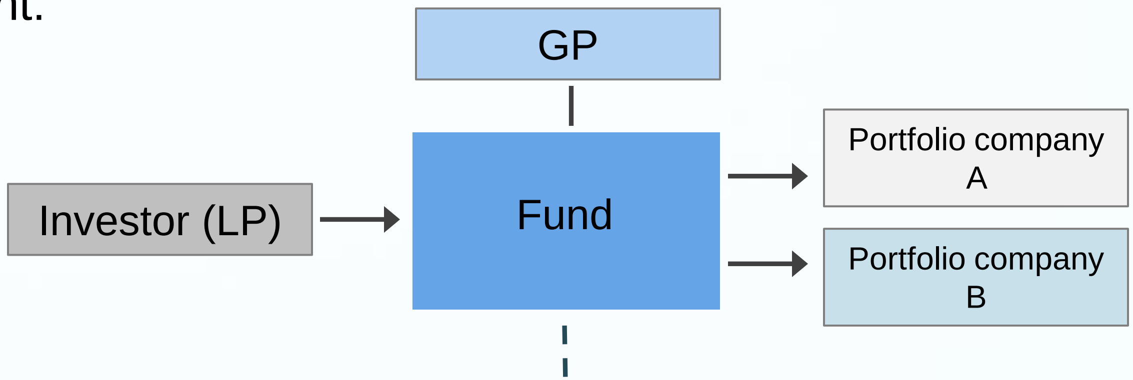
Increasing trend of direct investing in PE:

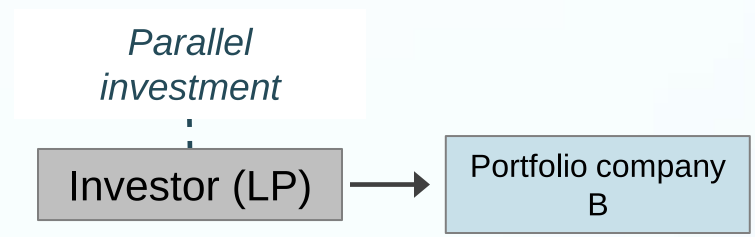
- Enormous interest on part of LPs:
  - Sovereign funds, funds-of-funds, endowments, pension funds, and even family offices…
    - Preqin, 2013:
      - 43% of LPs are actively seeking co-investment rights, 11% of LPs are strongly considering.
      - 65% of investors expect to increase their allocations to co-investments (9% expect to reduce).
  - More broadly, there many assertions but little evidence.

Some basics:

1. Traditional PE investment:

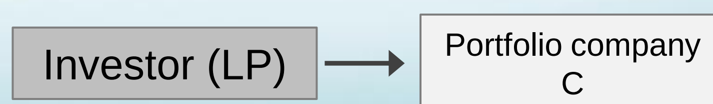


2. Direct investment: Co-investment



- ✓ Reduced fee and carry
- ✓ Quasi-independent investment decision (decision over the pre-selected set and no control over exit)

3. Direct investment: "Solo" investment



- ✓ No fee and carry (but higher in-house costs)
- ✓ Fully independent investment decision

Data:

- The data is proprietary: Collaboration of 7 large LPs.
- Complete cash flows for 391 direct investments made by a set of large institutions between 1991 and 2011:
  - $23 B capital invested ($14B (61%) co-investments, $9B solo investments).
  - Cash flows are net of fees (relevant for co-investments).
  - In some analyses, back out also estimated costs of running programs.
- Seven investors are younger and larger than typical LP; probably more sophisticated.
- Distribution of outcomes of deals (e.g., IPO, bankruptcy) look similar to direct deals in CapitalIQ.

Comparing Public Market Equivalents (PMEs):

- “Best” measure: performance relative to public markets.
- Good news: direct investments beat public market.
- But so do PE funds.
- Better to compare direct investment PMEs to funds’:
  - Direct buyouts outperform funds in 1990s, but not after.
  - Direct venture capital underperforms in 1990s; and even more in 2000s.

Comparing IRRs and Multiples:

- Similar to PMEs:
  - Little evidence of outperformance relative to funds.
  - Sharp deterioration of relative performance in 200s.
  - Venture capital directs do particularly poorly.

- Also, better performance by solo investments than co-investments.

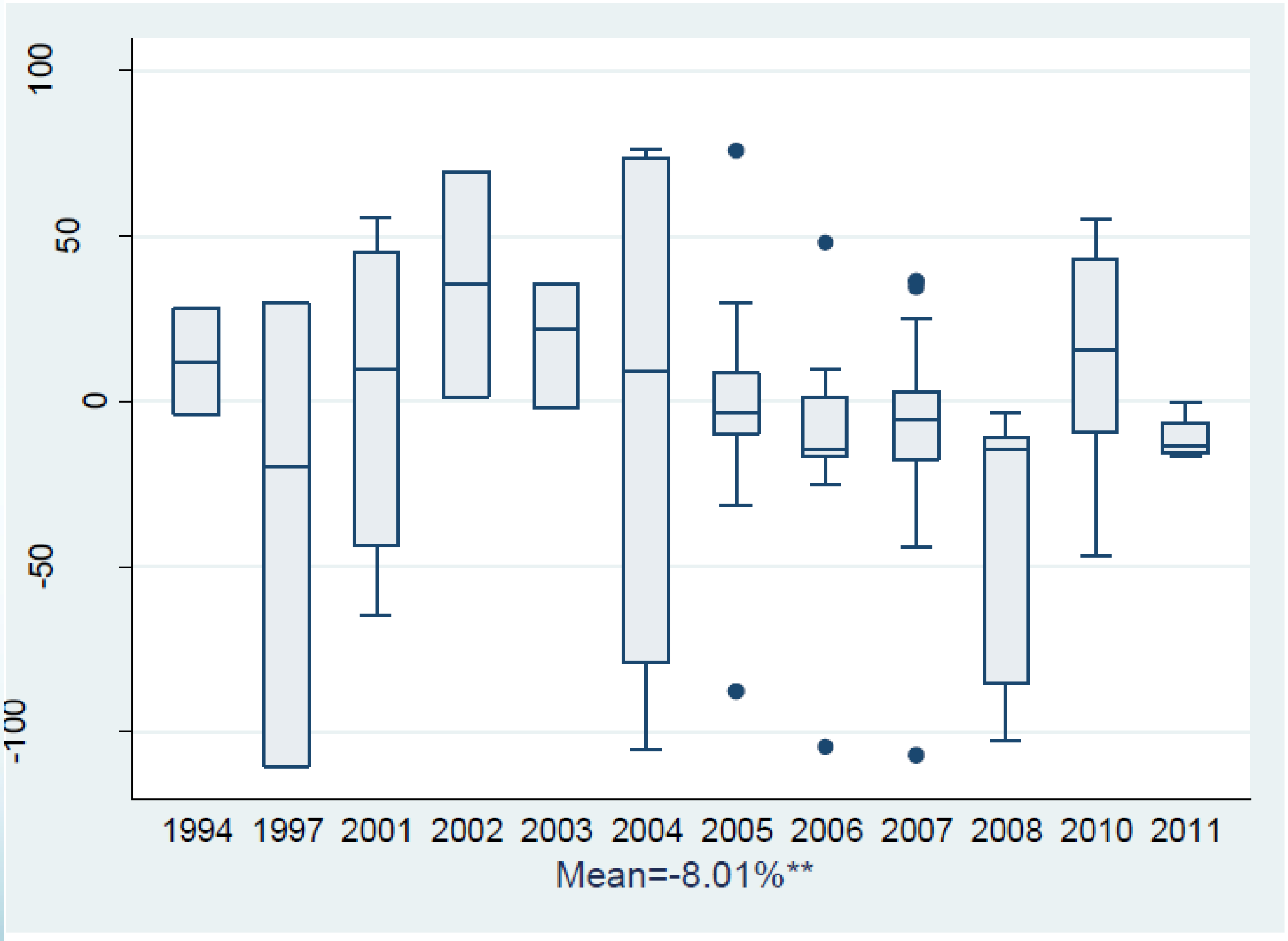
Why poor co-investment performance?

- Bad timing:
  - Concentrated in hot markets about to turn down.

- Big deals:
  - Median deal is 3x the size of the deals done by same GPs around the same time.

- Bad deals.

Comparing co-investments to the same fund performance:



When do solo deals do well?

- Local deals.
- Buyout deals.
- Deals when economy is relatively robust (less need for intervention?).

→ "Plain vanilla" transactions when better information, less need for special skills?

In summary:

- This is the first large sample insight on performance of direct investments:
  - We collect a proprietary data set with detailed CF information from seven large LPs.
- Co-investments do (relatively) poorly, solo investments do OK:
  - Substantial difference 1990s vs. 2000s.
  - Weak performance of co-investments appears to be connected to poor selection (“lemons problem”).
  - Solo investments perform better in settings with less information, implementation problems.

Final thoughts:

- Warning: This is a backwards-looking sample!

- But numerous cautions to LPs considering such initiatives:
  - Deterioration of performance in 2000s.
  - Success focused in place where information advantage:
    - Suggests limits to scaling.
  - Relatively limited evidence of success, even among most sophisticated.

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