

FINANCIAL NEWS

Monday, 24 March 2014

Private equity firms tap into new investor sources

[Alec Macfarlane](#)

24 Mar 2014

The universe of private equity investors has changed dramatically in the past few years. So much so that previous dominant players in the area – such as banks, insurers and public pension schemes – are no longer the most significant investors in terms of the overall amount of capital they invest.



Last orders: small private equity providers are challenging the big players

investors.

Funds of funds, private sector pension funds, high-net-worth individuals, insurance firms, government agencies, corporate investors and family offices all make up a greater proportion of capital in a normal private equity fund in 2011 to 2013 than they did in 2008 to 2010, according to Preqin.

The proportion of aggregate capital invested in private equity by sovereign wealth funds, for instance, has doubled from 5% in January 2009 to 10% in January 2014, according to Preqin. The aggregate amount of capital invested in private equity by family offices and foundations as a group has also more than doubled during the same period, from 6% to 14%, while the proportion provided by endowment plans has only increased from 7% to 8%.

While it is well known that banks and insurers were forced to limit their exposure to the asset class following post-financial crisis regulation, the proportion of capital provided by public pension funds in the average private equity fund has halved in recent years. Just 13% of capital committed to funds that closed between 2011 and 2013 came from public pension funds, according to data provider Preqin, less than half the 27% that they committed to a typical fund between 2008 and 2010.

But this is not because such investors have decreased allocations to private equity. The average allocation to private equity by public pension funds has barely moved, from 6.3% last year to 6.2% this year. Instead, there is increasing appetite for private equity from other types of

Antoine Dréan, chairman of advisory firm Triago, said the greater diversity among investors in private equity was amplifying. He said: “On the fund manager side, the trend is driven by a relatively new priority to create uncorrelated investor bases that can withstand localised financial crises. On the investor side, the principal catalysts are concentration of capital in emerging markets and a relative dearth of investment options, other than private equity, that can credibly offer double-digit annual returns.”

Further change may also be on the cards. Just half of sovereign wealth funds are known to invest in the asset class, suggesting that others could follow suit. This could open up billions of dollars in additional capital for fund managers, further reducing their dependence on investors such as banks that have reduced their exposure to private equity amid new regulations such as Basel III and the Volcker Rule.

Scott Church, a partner at advisory firm Rede Partners, said: “Private equity and other alternatives can provide a big boost to the paltry returns on offer in high-grade fixed income and government bonds. Another trend we are seeing in sovereign wealth funds is the increasing appeal of exchange-traded funds and other indexed approaches to public equities, while concentrating more of the active portion of equities in favour of private markets and private equity.”

Family matters

Meanwhile, family offices have also been increasing their exposure to the asset class. These investors provide 7% of aggregate capital globally, compared with just 3% three years ago, and put a greater percentage of their assets, 28%, into private equity than any other.

Peter McKellar, chief investment officer at private equity investor SL Capital Partners, said: “In many instances, family offices are focused more on absolute returns and often have a multi-generational time horizon. Accordingly, they can take on more illiquidity and potential risk.”

Industry figures also believe that the emergence of a new private equity investor group, the mass affluent – defined as households that have at least \$100,000 in investible assets or annual household income of more than \$125,000, giving them the ability to make smaller investments of \$5,000 to \$10,000 – will play an increasingly important role.

Some buyout firms are building the necessary infrastructure to address this trend. The Carlyle Group let some investors into its latest fund with as little as \$50,000. The minimum for entry into the US firm’s funds was previously between \$5 million and \$20 million, according to a securities filing for the fund.

A managing director in the investor relations team at a large private equity firm said: “A lot of people think, ultimately, the mass affluent will come into private equity investments, because as defined benefit pension schemes close, decline or reduce in popularity, people are going to look at longer-term savings plans for their retirement that they manage, and the only way that they’re going to get the returns they need to build a potential retirement pot is to have alternatives, and a lot of plans today you can’t put alternatives in them.”

Along with increases from those areas, many insurance firms are also increasing their exposure to private equity, despite Solvency II regulation requiring them to hold capital against private equity investments, making it uneconomical.

One such investor type is Swedish insurers. In 2007, Swedish insurer Skandia decided to increase its 1% allocation in private equity to 10%, and now has about 8% of its Skr320 billion (\$50 billion) portfolio invested in the asset class. Jonas Nyquist, head of buyout fund investments at Skandia, said that long-standing solvency rules in Sweden are strict on private equity, allowing insurers to use

their private equity holdings to hedge up to 10% of the value of the liabilities.

He said: "It's punished very aggressively, which doesn't really make sense because we have such a long-term liability so it doesn't make sense to put such a burden on private equity. But the Solvency II framework will actually make it easier for us because the Solvency II will be less punitive on private equity compared with the current Swedish regulations."

But although the increasing appetite for private equity by larger investors such as sovereign wealth funds is opening up huge pockets of capital for fund managers, the rise of such investors has brought some discontent to smaller investors. Some have been squeezed out of the best funds by investors who are able to offer larger tickets, many of whom are also offered preferential terms for investing over a certain amount.

Equal opportunities

McKellar said: "Private equity was an asset class where traditionally all investors were treated alike regardless of the quantum of their investment. This has changed over the last few years, with larger investors increasingly seeking more value-add and a differentiated position. That translates into fee breaks, co-investment opportunities and other preferential terms."

Co-investment, a luxury afforded by investors with the capital to do so, is also creating an unfair playing field among investors, according to one consultant, who suggested that the current co-investment craze is distorting alignment in the limited partner/general partner relationship and amongst investors themselves.

He said: "Rather than outsourcing strictly to general partners, many more limited partners are taking a half-way house approach to outsourcing, while bringing direct investment in-house in the form of general partner co-invest. Since this co-invest is typically granted free of fees and carry, it is a massive benefit to the largest takers of it, and one could argue that smaller investors who do not have the resources to manage a co-invest programme are, in effect, subsidising those larger investors who do."

[US banks take chunk out of Europe's flowmonsters - Financial News](#)

[Goldman Sachs partner Jeffrey Currie goes against the flow - Financial News](#)

[Citigroup alternative assets head departs - Financial News](#)

[Viswas Raghavan: A JP Morgan career that started in the headmaster's study - Financial News](#)

Recommended by

