January 2019

Alpha

The Next Generation Private Equity Investor

1. The Private Equity Evolution

The Private Equity ("PE") industry has evolved enormously from its humble beginnings in the 1940s to an industry worth more than £3 trillion today. The industry expanded rapidly in the 1980s and its journey since is illustrated in Figure 1. More recently, the percentage of PE houses raising new funds in the UK continues to grow rapidly, representing 44% in 2016, compared to 24% in 2015 and 12% in 2014.[1] From 2005 to 2015, the UK accounted for about one-third of private equity deals worldwide and one-quarter of deal value across Europe. Traditionally, PE firms have attracted clients such as sovereign wealth funds, institutional investors and a few pension funds, but falling yields in traditional asset classes and changes to pension regulations have led to the creation of the 'Next Generation' of PE investors. This 'Next Generation' includes family offices, retail investors and a larger number of pension funds. This paper will assess the impact of these investors on the industry.

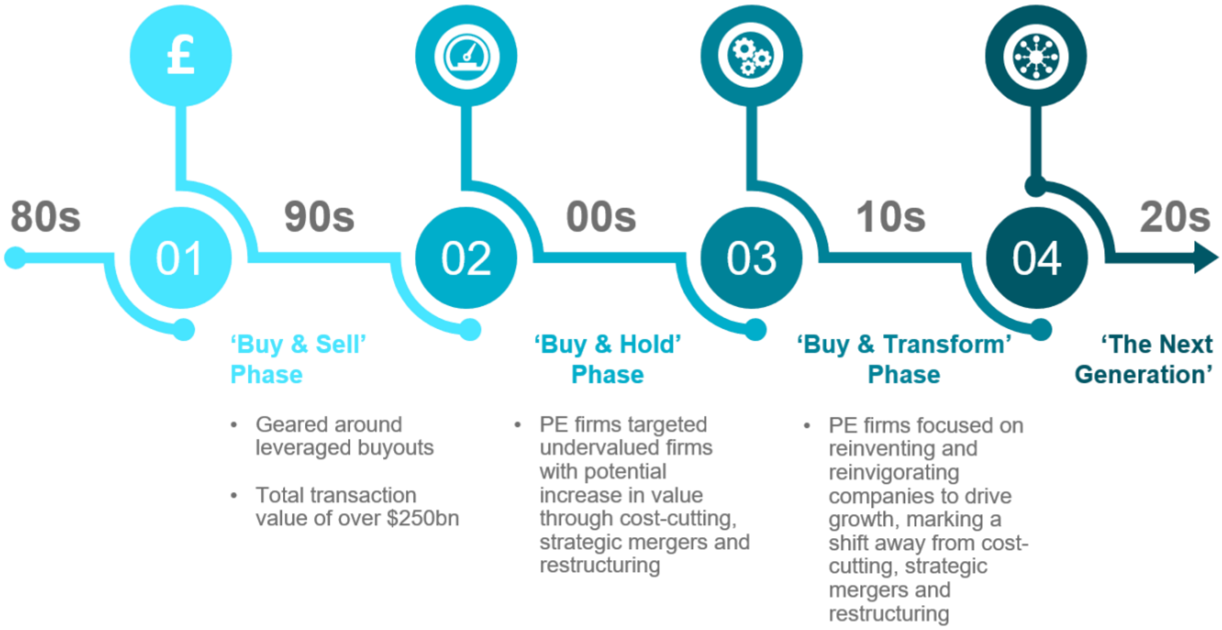

Figure 1: The Private Equity Evolution

2. Why Invest in Private Equity?

Interest in PE is driven by its enhanced risk-adjusted return potential alongside concerns of low yield and high current public valuations. PE is characterised by its long investment period, relative illiquidity and returns that are expected to turn positive in the medium to long run. Investors are compensated for illiquidity risk with a higher return, with some well-managed PE funds generating returns of 4-5% more than public equities in the long run[2]. The following are PE's attractions:

- **Diversification:** PE offers investors access to private companies that are otherwise hard to gain exposure to via other asset classes (where most investment is in public companies). The companies PE firms invest in are often smaller businesses with the potential to grow or improve once changes have been implemented. Although exit multiples will somewhat be a result of the market conditions (which is why not many portfolio companies were sold between 2008-2013) PE investments have a low correlation with stock markets. As a result, intrinsic value is not necessarily impacted by factors that typically affect listed companies

- **Alignment of interests:** PE results in a different value creation model from public equity markets, as investors have a meaningful (often a majority) stake in the company they are investing in. Investors can enjoy a high degree of co-determination and can influence the company's strategy by holding a valuable place on company boards where they are better able to influence company direction and change. These larger company positions are also harder to liquidate; especially as these companies are not listed. PE fund managers have a stake in the result and a greater vested interest in the company's performance than in public equity firms, where the shareholder base is passive and highly dispersed. They're also able

[1] Thomson Reuters. (2017). Private Equity in UK (England and Wales): market and regulatory overview [online]. Available at: https://uk.practicallaw.thomsonreuters.com/4-500-5750?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1
[2] JP Morgan. (2018). Investing in Private Equity. *JP Morgan* [online] p.1. Available at: https://am.jpmorgan.com/blobcontent/1383531120699/83456/PI_PE_INVESTING.pdf

to implement longer-term strategies without short term public investor pressure. Companies receiving investment from PE firms benefit from an experienced management team, leading to organisational growth and tend to be more successful, leading to higher investor returns

- **Compensation for Illiquidity:** PE provides an investment opportunity for investors willing to lock-up their capital, allowing managers to follow strategies otherwise unavailable and compensating investors for the associated illiquidity. This feature is attractive to longer-duration pension funds looking for return enhancement in response to persistent asset-liability gaps

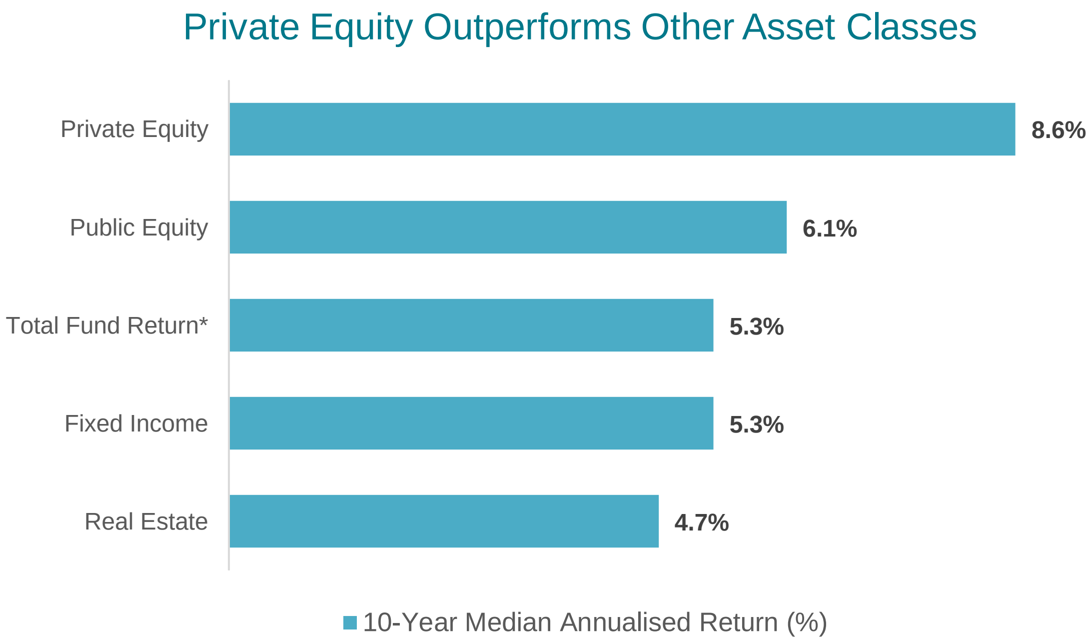

Figure 2: Private Equity Outperforms Other Asset Classes[3]

3. Drivers for Increased Capital

The evolution of the 'Next Generation' PE investor can be seen as a consequence of the financial crisis and the subsequent pressure for alpha generation across traditional asset classes. Following the crisis, every asset class saw systemic re-evaluation by investment boards, resulting in stricter regulation and scrutiny of investments - yields were expected to be lower. Low-interest rates have also led to an influx of money from sovereign wealth funds, family offices and high-net-worth individuals.

Growth in PE has also been driven by a government-incentivised shift from public to individual pension plans particularly in the UK and US - the shift from Defined Benefit ("DB") to Defined Contribution ("DC") continues, due to a massive pension liability gap alongside institutions not wanting these liabilities nor the associated risk on their balance sheet. In the UK pension liabilities continue to grow at pace – total gross pension liabilities increased by £1 trillion between 2010 and 2015. By adding social security payments to workplace pensions, total liabilities were over 400% of GDP in 2015 (Fig 3).

Numerous factors have further widened the liability gap, though two are most prominent. First, though most pensions have sizable exposure to equities, many recognised significant losses at the time of the financial downturn and did not reallocate with sufficient alacrity to take full advantage of the past decade's bull run. Second is the UK's ageing population which has led to the revision in actuarial assumptions when modelling liabilities including an increase in life expectancy for example. It is estimated that the number of workers paying for the pensions of those in retirement will fall from eight workers today to four per retiree in 2050[4].

[3] American Investment Council. (2018). Public Pension Study.
*Asset class return are based on pension funds that reported 10-year annualised returns
[4] Office for Budget Responsibility. (2018). Ageing population. *OBR* [online]. Available at: http://obr.uk/cross_cutting/ageing-population/

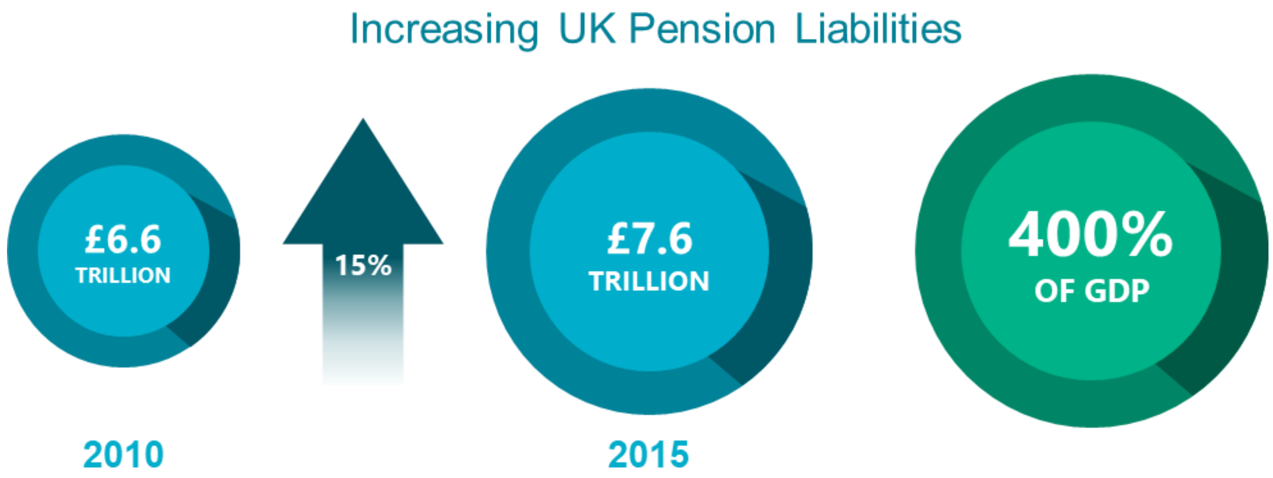

Figure 3: Increasing UK Pension Liabilities[5]

The liability shortfall alongside the growing need to address the financial concerns of ageing populations is pushing public pension funds towards PE. Research by OECD suggests that by 2020, pension funds' investment in PE is projected to reach $7.4tn, up significantly from $1tn in 2004. [6]

Resulting from the shift from DB to DC pensions, employees are enjoying greater pensions flexibility, however coming at the cost of increased responsibility. Employees have a wider range of investment opportunities, providing pension fund providers with the opportunity to offer a wider range of investments, including greater access to PE. Global private pension funds' assets are projected to increase to $56.6tn by 2020, from $21.3tn in 2004 (Fig 4). The shift is creating the 'Next Generation' of the private equity investor.

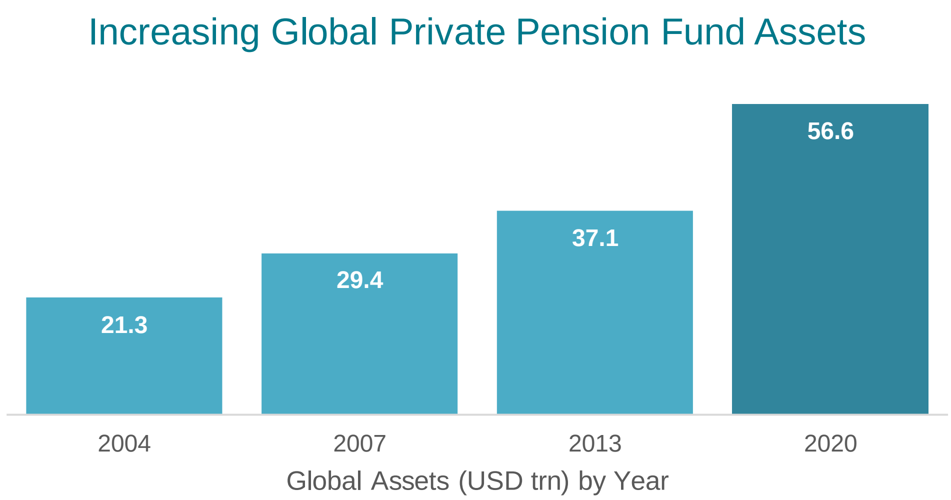

Figure 4: Global Private Pension Fund Assets[4]

PE firms are looking at the potential of utilising the new growing market of retail investors. Traditionally retail investors have bought exposure to PE through a fund of funds ("FoF") offered by their wealth manager, as current regulations and minimum investment thresholds prevent retail investors from investing in PE directly. The obvious disadvantage of a FoF approach is the extra layer of fees on top of those charged by the PE firms, but there are signs that the landscape is changing.

Currently, in the US, the SEC law states investment in PE is only open to "accredited investors" – those with an income of more than $200,000 per year and a net worth of more than $1 million. However, in 2017, the House passed legislation widening the definition of accredited investors to include those licensed as brokers or investment advisors by the SEC, with the appropriate knowledge of the investment area. In addition, in the EU the Packaged Retail Investment and Insurance-based Products Regulation ("PRIIPs") requires that when an investment product is marketed to a retail investor, it must be accompanied by a Key Information Document ("KID"). Producing a KID

[5] Office for National Statistics. (2018).
[6] OECD. (2018). Pension Markets in Focus. *OECD* [online]. Available at: http://www.oecd.org/pensions/private-pensions/pensionmarketsinfocus.htm

has been made easier as firms leverage new performance, risk and workflow tools alongside emerging technology platforms that facilitate the extensive paperwork, client tracking and communication specific to private investment.

As a result, access to private equity for retail investors is increasing, and some financial advisors are using this as a point of differentiation for their practices. PE firms are starting to understand how to package deals for accredited retail clients. The Carlyle Group has introduced a product that allows investors direct access to their funds for as little as $50,000 and KKR followed soon after, by making a regulatory filing which suggested a minimum investment of just $10,000[7].

A more orthodox alternative solution for retail investors is to invest in shares of publicly listed PE firms. ETFs also now exist containing a range of PE firms' shares, such as the ProShares Global Listed Private Equity ETF, however, so far it has been a poor proxy for directly investing in PE. As PE firms pay a large proportion of deal profits (driven by performance fees) to their employees, it is the management fee revenue that is primarily used to value PE firms. The correlation between AUM, which drives the management fees, and the share price of Blackstone and KKR is 0.93 and 0.94 (1 representing a perfect correlation) respectively[8]. Investing in these ETFs is arguably, therefore, equivalent to getting exposure to the size of the pot, rather than the pot itself.

4. Impact of the 'Next Generation' of PE Investors

Dry Powder at the ready

In today's low-interest rate environment, a combination of accommodating credit markets and a growing investor appetite for higher returns has resulted in more capital chasing fewer targets, driving up operating costs for PE firms. Hence, with competition rising, deals are becoming harder to find and rising investment by limited partners ("LP's") means that PE firms' stock of dry powder has been increasing, having reached over $1tn worldwide in 2017[9].

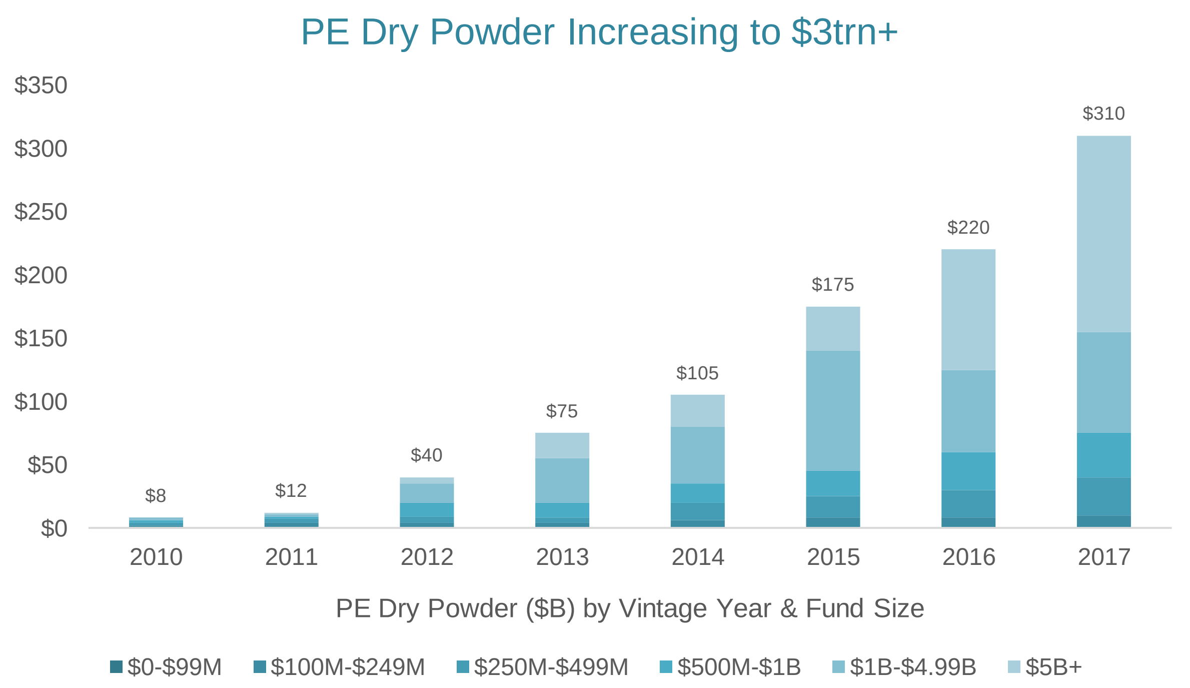

Figure 5: Dry Powder held by US Private Equity firms[10]

PE firms now hold more dry powder than any other alternative asset class, especially concentrated in larger $5Bn+ funds, with smaller funds not experiencing as great of an increase. Greater investment by family offices (such investment increased 29% between 2015 and 2016 to $1.8tn - Fig 5)[11], retail clients and pension funds in PE have

[7] Alden, W. (2014). K.K.R Seeks to Attract Investments as Small as $10,000. *DealBook,* [online]. Available at: https://dealbook.nytimes.com/2014/05/01/k-k-r-seeks-to-attract-investments-as-small-as-10000/
[8] Nextvest. (2016). Why Investing In Private Equity ETFs Is Like Chewing On The Bones. *Seeking Alpha*, [online]. Available at: https://seekingalpha.com/article/3965217-investing-private-equity-etfs-like-chewing-bones
[9] McKinsey&Company. (2018). The rise and rise of private markets. [online]. Available at: https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/the%20rise%20and%20rise%20of%20private%20equity/the-rise-and-rise-of-private-markets-mckinsey-global-private-markets-review-2018.ashx
[10] Black, G. (2018). The trillion-dollar question: What does record dry powder mean for PE & VC fund managers? *PitchBook* [online]. Available at: https://pitchbook.com/news/articles/the-trillion-dollar-question-what-does-record-dry-powder-mean-for-pe-vc-fund-managers
[11] Bill, T. (2018). Family offices evolving investment strategies in hunt for better returns. *Knight Frank* [online]. Available at: http://www.knightfrank.com/wealthreport/2018/property/family-offices-wealth-growth

increased the pool of funds available to PE firms and it has allowed additional deal participation and leverage 'as a whole' (i.e. the size of the overall credit is larger).

The 'Next Generation' of investors are exacerbating this and may reduce long-term returns, as deals are becoming more expensive and harder to source; for example, the average PE deal multiple paid in 2007 was 8.9x EBITDA but is approaching closer to 11x in 2018[12]. Hence, the current PE model is to pay a higher premium for an asset and earn it back later through value creation driven by in-house expertise.

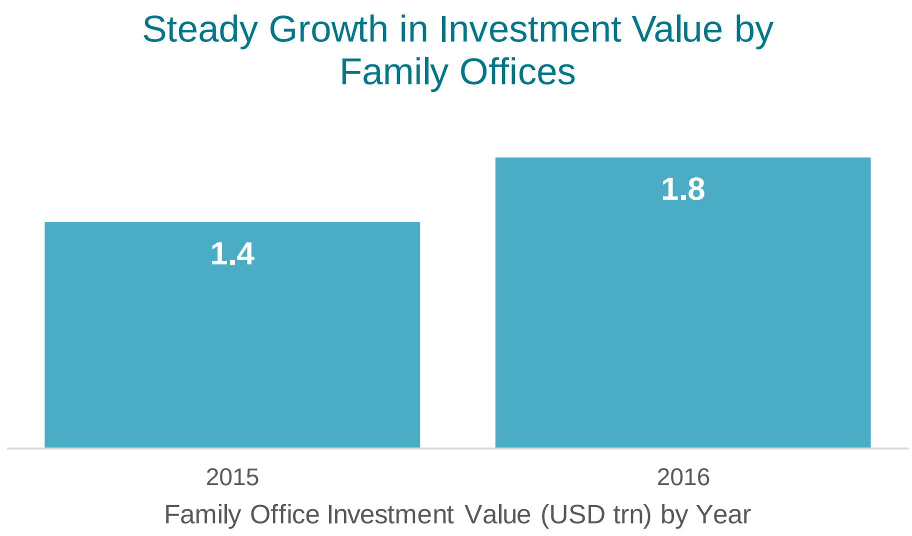

Figure 6: Change in Investment by Family Offices - Adapted from Knight Frank[11]

Lower Fees

The number of PE firms has also increased from 4,700 in 2008 to over 7,000 today[13] - potential targets are being approached by several PE firms and investors have an increasing number of PE firms to choose from, so PE firms are being forced to innovate and differentiate themselves.

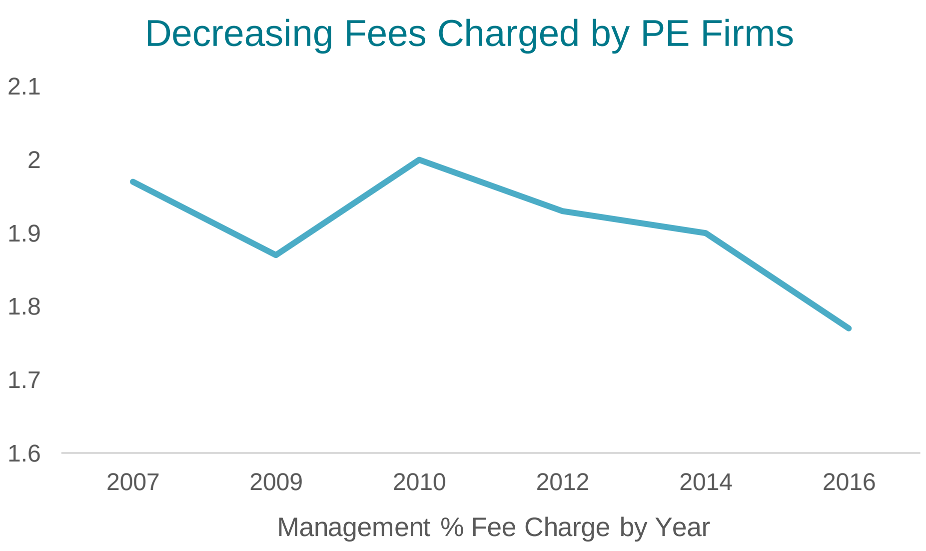

Figure 7: Average Fees Charged by PE Firms - Adapted from FT[16]

The increasing number of investors means that PE firms have faced scrutiny over fees and transparency and investors are becoming more demanding in terms of the information they seek. Up to 73% of PE firms are experiencing significant pressure from investors to reduce management fees. PE firms have typically operated a '2 and 20'[14] fee model in the past, by charging a management fee of circa 2% and an additional 20% of the profits earned above a specified hurdle rate. Average fees, however, have been falling (Fig 7) - PE investors such as pension funds are being squeezed from the bottom by their investors to reduce their fees, and this has trickled up to PE firms, resulting in lower net returns. Pension funds and family offices are increasingly looking to run their

[12] Stepek, J. (2018). Steer clear of private equity. *MoneyWeek* [online]. Available at: https://moneyweek.com/steer-clear-of-private-equity/
[13] Espinoza, J. (2018). Private equity funds active in market reach all-time high. *Financial Times [online]. Available at:* https://www.ft.com/content/c74e10c6-47d2-11e8-8ae9-4b5ddcca99b3
[14] Flood, C. (2016). Private equity clings to a '2 and 20' fee model. *Financial Times* [online]. Available at: https://www.ft.com/content/f7dc242c-58a9-11e6-9f70-badea1b336d4

portfolios internally and invest directly to lower their fees, and these direct investors are posing further competition to PE firms. Hence, the review of the end to end operating model, such the implementation of new digital workflow tools designed to reduce costs for PE firms is becoming an important prerequisite to the reduction of fees whilst also sustaining profits.

Pension funds are also increasingly using co-investment, investing alongside private equity managers directly into companies: a cost-effective way of investing given lower or no management fees by the underlying private equity manager.

New Market Entrants

There is increased competition, from both new fund managers looking to put capital to work and corporates seeking inorganic growth. The number of new corporate venture capital firms ("CVC") making first-time investments reached record levels in 2017. 186 new corporate VC units globally made their first investment in 2017, including stock exchange Nasdaq Ventures, and life insurance provider Northwestern Mutual, among others.

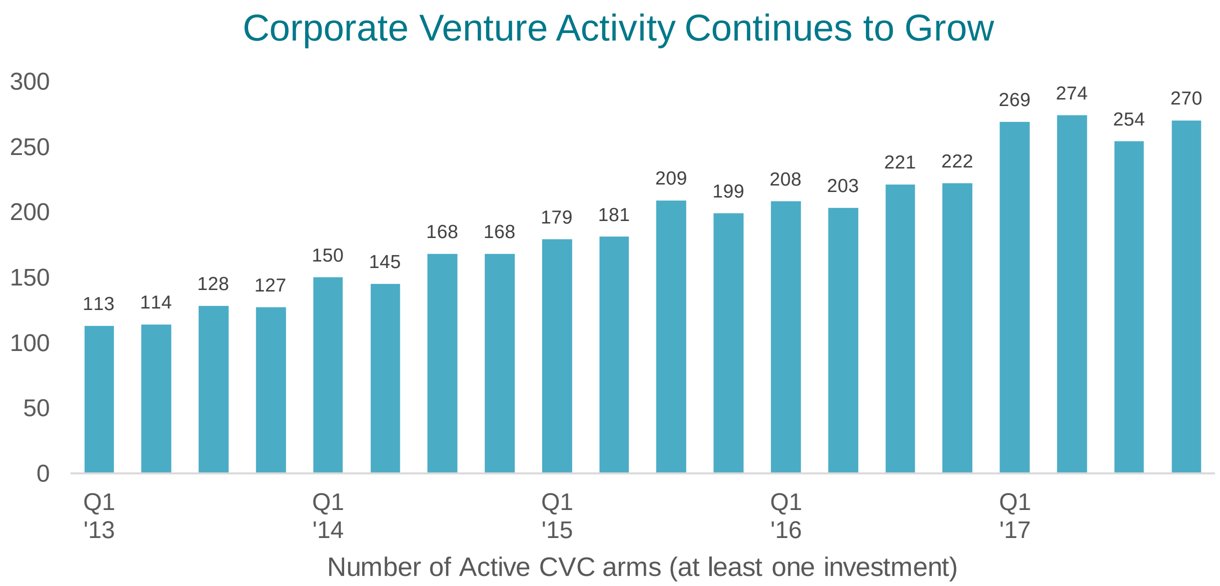

Figure 8: Corporate Venture Activity continues to grow[15]

Legislative Change

More diverse investors are likely to lead to increased legislative pressure – amongst others, directives such as the Dodd-Frank Act, the Compliance Act and money laundering regulations have created mounting pressures on PE firms to deliver greater transparency, better reporting and tighter accounting controls.

[15] CB Insights. (2018). The Most Active Corporate VC Firms Globally. *CB Insights* [online]. Available at: https://www.cbinsights.com/research/corporate-venture-capital-active-2014/

5. Market Reactions

Among other things, PE firms are now looking at their end to end operating model efficiency; formalising succession plans; better integrating analytics, digital, and big data tools; and rethinking recruitment of analysts and associates. Many are also sharpening their risk-management processes, which can protect firms from macroeconomic downside, including a possible slowdown of global growth as well as rising interest rates.

Furthermore, a higher number of investors mean that PE firms can no longer rely on manually-intensive spreadsheets and small-business software to manage high volumes of capital, so PE firms are reviewing their operating models to ensure they are scalable.

PE firms are looking to be more efficient in the way they track their investments and more effective in identifying value creation opportunities and synergies. CRM tools are helping firms revolutionise their deal origination processes and helping to manage client relations more effectively. Vendor tools are being used to help more easily visualise the relative performance of alternative funds against peer funds or public indices as PE firms grow in size (e.g. Burgiss' Private iQ and Prequin). These tools allow customisation of sets of metrics unlocking improved understanding of portfolio performance by having more live data points linked to the business as well as the industry peers.

Investor Relation portals can help manage smaller pots of funds with growing numbers of investors (Limited Partners, LPs). An example of this is InvestCloud which further allows investor visualisation instead of using existing excel methods. End to end vendor tools such as eFront and FIS Investran support portfolio and deal flow management through to accounting and investment administration. They offer robust workflow tools and dashboard/reporting capabilities, as well as allocation, accounting, cash management and performance measurement capabilities.

PE firms are building more scalable and flexible models by using third-party administrators, outsourcing non-core activities so that they can concentrate on core investment activities. All major global administrators are developing their private asset administration propositions alongside a number of more niche providers such as Aztec, Colmore and SEI.

In summary, there is significant innovation in the market in terms of vendor solutions and outsourced services that can help PE firms transform their operating model in a challenging environment.

To make themselves more attractive to the increasing number of new investors, there have been structural changes in the way that PE firms operate. Terra Firma, for example, is putting €1 billion of its own money into its investments, showing investors that it has "skin in the game" and increasing the link between fund managers' performance and reward to remain competitive.[16] Blackstone, the world's largest Private Equity firm, has announced plans to double assets under management over the next five years. It also wants individual investors to get a greater slice of the action by trying to cut out the middle man - namely, the brokers at big money-management units at large banks.[17]

With this in mind, PE firms need more compelling value propositions to ensure that they can not only unlock greater operational post-acquisition value behind more expensive deals but can also look towards alternative sources of new money to continue their success – exploring retail channels and new products.

[16] McDermott Will & Emery. (2018). The impact of regulatory changes on private equity firms. *Lexology* [online]. Available at: https://www.lexology.com/library/detail.aspx?g=d661821d-c89e-4fc1-a242-11b278ebb3d7
[17] Perlberg, H. (2018). Blackstone Group's Assets Jump 22% to Record $450 Billion. *Bloomberg* [online]. Available at: https://www.bloomberg.com/news/articles/2018-04-19/blackstone-group-s-assets-advance-22-to-record-450-billion

6. How can Alpha help?

- **Alternatives Expertise:** Alpha has a wealth of industry experience, having been involved in multiple Alternative Investment projects across all alternative asset classes, including private equity. Alpha is well-placed to offer strategic & operational advice following recent regulatory and industry changes

- **Identifying Opportunity:** Alpha can identify potential opportunities in response to market trends and assist with meeting the demands of the 'Next Generation' of investors, and help PE firms remain competitive

- **Business & Technology Implementation:** Alpha has selected and implemented many of the Alternatives vendor solutions, integrating their existing business systems whilst helping firms to innovate and differentiate themselves. Alpha can assist with improving operating models, i.e. move away from manually-intensive spreadsheets to improve efficiency and productivity, thereby delivering cost savings

- **Operational Excellence:** We have run numerous successful strategic operational reviews and target operating model initiatives for private equity clients - we understand the related complexities, challenges and opportunities, and can reduce cost, time and risk

- **Outsource Provider Selection:** Over the last 10 years Alpha has outsourced over $1.5tn of Assets Under Administration ("AUA") on behalf of our clients; as such, we have a deep understanding of outsourcing providers, vendors and target states, enabling us to effectively support strategy, advisory, selection and implementation outsourcing initiatives

- **Value Creation:** Alpha has assisted in driving value creation for numerous acquired firms. This has involved:
  - **Market analysis** & **target acquisition** Identification
  - Commercial **due diligence**
  - **Research** & **project management** Support
  - Portfolio company **strategy & advisory**
  - End-to-end functional **understanding of market**
  - Proprietary methodology of **opportunity assessment**
  - **Fintech capability** assessment
  - Proprietary operational and cost **benchmarking** data

Should you have any further questions, please contact:

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