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Feature: Institutional Investor Perspectives

Hemal Naran, Head of Investment & Actuarial at the GEPF gives his views on institutional appetite for private equity investment

What is the general appetite for investing in private equity?

The case for private equity within an institutional portfolio remains strong as a means of diversification across sectors and regions which are difficult to access via listed markets. However, the nature of deals have changed to focus on smaller size investments, higher equity contributions, more expensive and less attractive debt terms, and longer holding periods and hence lower IRRs. Nevertheless, the [positive] gap with public returns is expected to remain significant. Institutional investors are also focused on the impact of costs and aspire to do more direct deals, co-investments and secondary-market transactions.

What are your thoughts on the allocation by pension funds to private equity?

While only a few early adopters have meaningful exposures to private equity, many investors have committed to increase their allocations. Looking at private equity target allocation across regions, one observes a significant variation between European pension funds, with low single-digit allocations, and US pension funds, which have allocations in the mid-teens (CalPERS, for example, at 14%), to over 20% for various US endowment funds. Investors in other regions tend to have relatively immature portfolios with regard to private equity investments.

Is there distinction between the appetite for emerging markets versus developed markets?

Private equity in emerging markets is one of the few financing options available to growing businesses, hence a significant amount of private equity deals in these regions tend to be growth or venture capital. These deals tend to focus on top-line growth. By contrast, private equity in developed markets has a trend of secondary-market deals or “pass the parcel” between private equity firms. These deals tend to focus on cost-cutting and bottom-line growth.

Emerging markets remain appealing as a means to gain exposure to fast-growing regions, although the actual outperformance of private equity against more traditional assets remains to be seen. Private equity in developed markets is mature, with established players and clearly demonstrated outperformance. In emerging markets the number of general partners (GPs) is mushrooming while in developed markets the industry is consolidating with many larger players becoming multi-asset managers.

How would you describe the changing nature of the relationship between general partners and limited partners?

In my opinion, there is shift towards a “balancing of power”. Industry bodies, such as the Institutional Limited Partners Association (ILPA) have been instrumental in setting key terms and improving transparency within the industry. Some improvements in key terms include significant GP commitment (including affiliates), preferred return based on market segment or LP commitment, and management fees based on budgeted running costs.

What are your thoughts on the general partner selection process in various regions?

LPs allocating across various regions need to understand the intricacies of each market and not follow a “blanket” due-diligence process. In some markets, such as India and South-East Asia, the difficulty is identifying GPs that can gain access to fast-growing companies. In other markets, for example China, GPs need to demonstrate their value-add and operational improvements to portfolio companies. In developed market, like Europe, GPs need to demonstrate their ability to cost-cut and operate without financing. Exit strategies and track record are important when making private investments in African companies in the absence of little or no IPO market. Canny GPs need to demonstrate the ability to realise investments and return cash to investors.

What private equity areas are exciting at the moment?

In Africa, financial services, specifically insurance and consumer credit, real estate, agriculture and food, as well as healthcare, remain attractive. Infrastructure investing will always provide a decent risk and return trade-off if done correctly, particularly in usage-based sectors such as energy and transportation. This sector, with its long duration, monopolistic nature, and inflation linkage is a good match for long-term liabilities. Other assets such as farmland and timberland remain attractive. In recent years, investment in shopping has also become more attractive as price of physical vessels has fallen sharply following the credit crunch.

What are your thoughts on the regulatory environment for private equity?

Compliance with regulation remains a challenge for the industry. It has been one *annus horribilis* after another with too much regulation happening too fast to be fully digested. These include AIFMD, Solvency II and the Volcker Rule, and have had a negative effect on private equity where the cost of compliance makes investing not worth the effort.

What is expected of general partners and what is actually being done?

Private equity firms are expected to focus on their portfolios, with proactive involvement, significant cost and productivity improvements, and active liability management. In reality, many investors remain disappointed with GPs’ inability to manage the macro and micro-environment, and for incurring losses due to uncontrollable commodity prices or currency volatility.

Many GPs are more focused on the pace of investments and not enough on valuations and therefore entry prices. GPs need to be disciplined when investing, especially during market inflection points.

GPs need to be more innovative in seeking liquidity. Too often, GPs rely on “hot” equity markets to provide an exit – they should be developing multiple exit strategies that guarantee cash flows throughout the holding period, and provide downside protection.

Finally, LPs want length and breadth of returns. GPs should focus on longer investment horizons and also adopt a fiduciary mind-set.

What are your views on the future of private equity on the continent?

The future of private equity remains bright, although the discipline to invest in the right deals at the right time remains critical. Private equity has a role to play in developing the African continent, one characterised by numerous, larger, underpenetrated markets with long-term growth potential. Private equity will remain a preferred form of alternative investment on the continent.