NEWS ANALYSIS: STATESIDE

A separate piece

Amid the furor for institutional co-investment programmes, LPs should ask themselves whether they are outfitted to be 'seekers' of deals, or merely 'takers'

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Strapped to the much-discussed "pendulum of power" that swings cyclically between LP and GP is what might be called the "pendulum of DIY". The more in-demand that GP services become, the more contented LPs are to stay within their "limited" role in the partnership. By contrast, as the demand for private equity funds subsides, the more likely LPs are to say: "I should do it myself."

From an institutional investment perspective, doing it yourself means directly investing in assets that are otherwise accessed indirectly through limited partnerships, via co-investing, direct investing unsponsored by GPs, and separate accounts. Almost no private equity LPs are talking about abandoning funds and solely investing directly, but many are hoping to create substantial allocations that will not be committed through traditional fund structures.

The desire to reduce the fees of partnership investing among institutional investors is intense

The attractions of doing it yourself are clear and have been generating much attention and study of late, with the pendulum of power stuck firmly on the LP side. Direct (or co-) investing means largely bypassing the fund, with its management and carried interest fees. In a lower-return environment, as is expected going forward, a lower overall fee burden can mean the difference between private equity falling short of, and exceeding, return assumptions.

Like many tidy systems of thought, the institutional co-investment programme looks great on paper and in spreadsheets. But when the rubber hits the road, these programmes can go in unanticipated directions. Unless they have the right resources, LPs with co-investment programmes may find these separate allocations become overexposed to the largest deals in their portfolio. This may have the effect of pushing their private equity portfolio more toward an "index" performance, albeit with lower fees. In other words, the benefit of lower fees may be negated by a move toward average performance.

The mere ability to do direct deals does not confer an expertise in the selection and underwriting of direct deals – LPs with limited resources in this area must decide if they want to be "takers" of deals passed down by the GPs, or whether they want to be fully fledged "seekers" of the best direct investments.

The "takers" versus "seekers" analogy was created by Satyan Malhotra, president of New York-based Caspian Capital Management, as he looked through the statistics of dozens of GP-sponsored co-investment deals offered to his firm and other prominent LPs. Malhotra found that the vast majority of co-investment deals made available to limited partners – either directly from GPs or through third-party co-investment ➛

programme administrators – were in what he defines as the "mega/large" size category. This is perhaps not surprising – large deals require more equity, and therefore GPs are more likely to "give LPs the opportunity" to pony up additional cash. But there is at least one problem with this from the LP's point of view. If it is accepted that the largest deals will tend to be the ones that are offered to LPs as co-investment opportunities, LPs should not necessarily want to inject further capital into deals to which they are already highly exposed. It could be that the benefit of reduced average fees for ownership of an asset is offset by the effect that increased ownership of the asset has on the diversity of the larger portfolio.

The ideal LP co-investment/direct programme would resemble an ideal private equity firm – staffed by highly incentivised experts who vet a large number of opportunities before deciding which, if any, to back. And because an LP co-invest programme will usually sit alongside a larger fund-investment programme, the direct team should probably play a different role than merely plowing further capital into deals done on the fund side. Maybe LP direct deals should have very different characteristics than those taking up the bulk of the fund portfolio – smaller companies, a different mix of industries, different risk profiles, mezzanine, distress.

Malhotra says he's found that blindly allocating to all excess capital can actually reduce return and increase the probability of loss.

The desire to reduce the fees of partnership investing among institutional investors is intense, and out of this era of realignment will come a new set of market terms for how GPs and LPs work together. But one wonders whether several of the experiments in DIY among limited partners will eventually be scrapped when it becomes clear that the expense and hassle of running such a programme is not, in fact, yielding the desired benefits. A true direct investment programme is expensive – that's what GP fees are (supposed to be) for. A present, there aren't many LPs that can afford the expense of becoming a "seeker". ■