PRIVCAP BRIEFING/

The Voice of the LP

Thought leadership on an evolving asset class

Featuring Experts from:

Zurich Alternative Asset Management • Ardian • Korea Investment Corporation • Washington University Investment Management Co. • Performance Equity • MVision Private Equity Advisers

Sponsored by

MVISION

'Increasingly Sophisticated' Investors

One oft-repeated observation in today's market is that investors are becoming increasingly sophisticated in their approach to private equity investing. You'll see evidence of this sophistication in the interviews presented in this report.

That limited partners take a much more rigorous approach to setting portfolio allocations and vetting potential partners is not universally welcomed among general partners, although this is not admitted openly. In truth, the "old days" were easier; too many LPs were more likely to build a portfolio via years of responding to incoming PPMs.

Today, LPs and their advisors are much more likely to set targets related to underlying exposures—U.S. oil and gas, Chinese retail—and then proactively search for managers who have a track record of executing an investment plan in those areas. The bad news is that this bottom-up approach to allocation means many GPs with strong track records are being told "no" because their expertise is not needed in the portfolio. The good news is that the diversity of the global LP community means someone out there has a "yes" waiting for a credible GP team.

At the same time a U.S. public pension fund might be "full up" on energy exposure, an Asian sovereign wealth fund might be looking to make a $500M commitment.

The interviews we've assembled offer a broad diversity of views, but a unified message: Long-term capital commitments require much more up-front analysis than has historically been the case. GPs about to hit the fundraising trail are advised to brace themselves for this new normal.

David Snow
CEO & Co-founder
Privcap
@SnowsNotes

In This Report

Click to watch this video at privcap.com

Changing Dynamics of LP-GP Contact

Even if an LP isn't in a GP's pool of investors from past fundraisings, they may maintain periodic contact for a variety of reasons. Mounir Guen, founder of MVision Private Equity Advisers, discusses these reasons, and why LPs and GPs are meeting more frequently.

Mounir Guen, MVision

Bio

Mounir Guen founded MVision Private Equity Advisers in 2001. Previously, he was a managing director at Merrill Lynch. He received degrees from Georgetown University and the London School of Economics.

CONTINUES ON NEXT PAGE

Privcap: How does board-level pressure on the investment staff at LPs affect their relationships with GPs?

Guen: The first thing that boards look at is their fiduciary responsibilities—and actuarial responsibilities, if applicable. Within that context, they need to decide what exposures they're going to have on a geographic front, from a performance and a risk perspective, to try to ensure the type of return profile that they want to target. We're seeing a number of trends in private equity that are becoming more prominent. One of them is "more with less," where there are instructions and concepts in place of putting more capital with fewer general partners. The next step is that your selection has to be more forward-thinking and preparation-oriented. So there's a directional push coming where the investors are spending a lot of time identifying who they will want to build their portfolio with, looking at who's coming to market in the next couple of years, and trying to understand whether that short list is the right combination and the right candidates. And that then entails quite extensive further diligence and getting to know your general partners, which is new to the market. What are some of the filters that they're using? It gets more complex as the program ages, because if I have 200 general partners in my portfolio and my ideal number is 60, there has to be restructuring that takes place. There's also encouragement from the boards to allow enhancing, repositioning, and freshening of the potential performance of the portfolio through the mix of GPs.

Are LPs being more proactive in approaching GPs to get a meeting?

Guen: They can be meeting quarterly [even if there's no fund in the market], and in a way, it can cause some confusion, because the general partner views the communication as a commitment when it's just educational or trying to manage an open dialogue.

So the trigger mechanisms for an LP commitment are not there the way that we were used to. It's interesting today, consulting a general partner who is going to come to market, that they don't need to do introductory meetings and that they can actually go into diligence. But the people they believed were interested in their fund aren't really interested. And then the question is: Who is interested in my fund, and how do I get their commitment?

For what reasons might certain investors maintain regular contact with a GP?

Guen: A number of investors are in touch with varying degrees of interest, trying to understand a particular general partner, and are doing some market surveys. Some are trying to get their heads around particular types of strategies. Some are trying to justify that their current relationship is the best by meeting others that are using a similar type of strategy. They all have different agendas, but you could argue that the general partners are supposed to be spending all of their time on the portfolio, and this is a whole new wave of unexpected contact that takes place. That's why, some first time, smaller GPs are hiring investor-relations people, because somebody has to respond to the questions. And the performance of their portfolio is everything.

Are these internal IR pros almost like matchmakers?

Guen: Not quite, but I do know a few GPs who basically say that if you're my existing investor, it's fine. If you're not, we'll talk to you nearer the time [of fundraising], because our focus is the portfolio. But on the whole, if you're looking over the long term and open, transparent dialogue is necessary, you need to meet these investors. The question is: Who do you meet? How do you use your time? We work with general partners, not only to select for them who to meet with, but create a model, a system by which they can continue focusing on their portfolio but still maintain a certain presence in the marketplace. ■

"We work with general partners, not only to select for them who to meet with, but create a model, a system by which then they can continue focusing on their portfolio but still maintain a certain presence in the marketplace."

–Mounir Guen, MVision

Click to read the article at privcap.com

Former KIC Exec on Sovereign Wealth Fund Investing

Don Lee served as CIO of the Korea Investment Corporation until early 2014. He shares how he made his way into alternative investing and where he sees opportunity.

Don Lee, former CIO of Korea Investment Corporation

Bio

Don Lee was chief investment officer at Korea Investment Corporation from 2012 until early 2014, and was previously head of the private markets group at KIC. Previously, he was head of investments at Korean private equity firm STIC Investments, head of overseas investments at Samsung Life Insurance, and an emerging equity market analyst at International Finance Corporation.

CONTINUES ON NEXT PAGE

Privcap: Don, you've had an interesting career. You've been a banker, you've been in finance, and, most recently, CIO of a major sovereign wealth fund. Tell us how you got involved in alternative investing.

Lee: I started my career as an analyst [at IFC] back in the '80s and '90s and moved back to Korea in '97. I became the head of overseas investments for Samsung Life Insurance Company, then worked for a private equity fund in Korea for five years. In 2008, I became the head of private markets investment for KIC; then, for the last two years, I was serving as the CIO. The private market was not that well-known back in the '80s, '90s, in Korea, but I had a chance to expose [the market to] overseas investments, meeting and working with the many groups in this area.

So you were a pioneer?

Lee: I was. At that time it was just a lot of chances and opportunities. I got to work with many good groups on a global basis.

So you have developed in your career. You've seen different patterns, ups and downs. What would you say are some of the key lessons that you have learned, particularly as it relates to deploying private capital?

Lee: You have to be patient. This is a long-term business, so you cannot be happy and unhappy; you have to be steady and stable. So you have to believe in the long-term cycle, no? It's not easy timing the market in this business. It's not like equities or bonds.

So you're not looking at your terminal every five minutes.

Lee: I mean, that's affected by the public market; everybody knows that. But if you stick to the basics, like buying at good valuations and moving through all these difficulties, eventually it turns out to be a workable outcome.

What do you see as the performance differential between public markets and private markets? What are you looking for in terms of an equivalent return against the public markets?

Lee: Well, those were some debates when we started the program. How are you going to measure against that sort of thing? When you do those public markets, then you have to adopt some kind of benchmark approach which is a global benchmark; it depends on the asset class. Still, in private markets, we have to go against the equity market benchmark. But the bottom line is we always look for absolute return. How you measure that cost of capital and, in this case, probably the inflation plus some premium.

So how did you think about maintaining flexibility [at KIC]? You had kind of a long-term plan, but also you have dislocations that arise. How were you able to stay nimble to take advantage of the dislocations?

Lee: Well, all institutions are different, based on their strategy and the approach and format system. In our case, we still have to go by a certain kind of allocation model. So you look at a five-year or seven-year span and the market movements we can see. Then you can make adjustments. You try to be as nimble as you can.

What are some of the energy sectors that you find interesting on a global basis?

Lee: Well, some sovereigns may see those sectors, especially energy and resources, as a national agenda. At KIC, it is purely a risk-return-driven case. But at that time, there was a boom in energy. There are a lot of opportunities in that area. But now KIC is trying to diversify to other sectors as well.

> **"Still, in private markets, we have to go against the equity market benchmark. But the bottom line is we always look for absolute return."**
>
> –Don Lee, former CIO of Korea Investment Corporation

What about infrastructure and those types of investments that have a little less absolute return but a safer profile?

Lee: Well, infrastructure depends on how you categorize it, because the public sector is always dealing with this kind of capitalization. Sometimes it could be shown in some real estate type of ingredient and also some private equity type, so it's kind of in between. But by definition, infrastructure could be a very long-term, but hopefully steady, return, so these days there's no low-risk environment. Not only for sovereign, but maybe pension funds, insurance companies, are more interested in that area because they can match their existing liabilities. But sovereign funds could play a little bit more, taking more risk. So in terms of appetite, maybe relatively speaking, pension funds and insurance companies have probably more of it.

You've seen a lot of GPs. You've seen a lot of pitch-book presentations. When you think about selecting a

CONTINUES ON NEXT PAGE

"You have to be patient. This is a long-term business, so you cannot be happy and unhappy; you have to be steady and stable."

–Don Lee, former CIO of Korea Investment Corporation

GP, what are some of the key factors that go into your evaluation?

Lee: When I used to work for KIC, there were a lot of questions like that, but we are no different. We have a certain process of selecting; I need to find good managers. There's no exact equation. You have to have some kind of a judgment or guts, so in that sense it's always looking at the people and team. But all in all, I think chemistry, leadership—those are very important. So maybe, in some cases, it comes down to meeting people, and the chemistry you feel about them.

So the people factor is big.

Lee: Absolutely.

If you're a big player and you have power in the marketplace, what about trying to drive a bargain on terms? Is that something you see as important?

Lee: Well, big is not always power, so you have to look at some special terms or preferential terms. But another aspect is, as more sovereigns like KIC get more experienced and sophisticated, maybe they are demanding some kind of special payload structure. This is getting more and more common.
The research consistently shows that LPs believe that outperformance in the mid-fund size and the small fund size will outperform the larger funds. And yet when you look at the statistics on where the capital is going, 75 percent or 80 percent is going to the large funds.

What is your feeling about fund size and performance? And if LPs believe that the outperformance and alpha can be found in the mid-size and the small size, why is all of the capital going to the larger funds?

Lee: In the case of KIC, it's still a young program, so we don't have enough data showing that. But instinctively, I think it is going to be important. The universe is so large in the mid-cap space, it's all completely different; there are so many players. But in larger spaces [there are] very well-known big players out there, so it could be safer for big institutions. So that kind of answers the question. More so, what we believe is even with those big guys, there's a lot of fund flow there, but still there should be winners and losers.

What's your outlook? Are you positive about private capital, going forward?

Lee: I'm positive, no question. More because I'm seeing the Korean space. A lot of new emerging institutions are following that trend. Key terms are going global, and alternatives, so there are a lot of followers, and so there will definitely be more and more allocation, regardless of whether it goes to big funds or small funds.

And you see that among Korean institutions specifically?

Lee: Absolutely, yes. ■

Click to watch this video at privcap.com

Inside Endowment Investing

Daniel Feder of Washington University Investment Management Company discusses how endowments invest in private equity

Daniel Feder, Washington University Investment Management Co.

Bio

Daniel Feder is managing director of private markets at Washington University Investment Management Co. Previously, he was a senior investment manager in endowment services at TIAA-CREF, managing director of private markets for the Sequoia Capital Heritage Fund, and managing director of PE and VC with the investment office for Princeton University's endowment. He received degrees from the University of Massachusetts, Boston University, and Trinity College.

CONTINUES ON NEXT PAGE

"For us, the hardest decisions are not what to do but what not to do. Because returns for the asset classes are so dispersed, by definition, the decisions at the margin are the ones that will drive whether they have a good portfolio, a mediocre portfolio, or even a poor portfolio."

–Daniel Feder, Washington University Investment Management Co.

Privcap: Can you give some brief background on the Washington University program and where it's headed?

Feder, Washington University Investment Management Co.: The endowment overall is just under $6.5B, and we also manage an additional $700M of operating assets, so overall we're managing about $7B.

We have an office with a dozen or so investment professionals and an investment management company structure with its own board. Although not a separate legal entity, the board oversees our activities, and the investment staff have delegate authority to make decisions about implementation, including hiring and firing of managers.

Concentration is a big theme in endowment investing, in terms of liquid holdings and even illiquid holdings. Is that a principle that still makes sense?

Feder: When we look at portfolio construction and what we're trying to do within the private capital area, we pull the tape all the way back to what we're trying to get exposure to and those underlying companies and investments. If we look over a period of 15 or 20 years, what becomes evident in private equity and venture capital is an 80/20 rule, meaning that 80 percent of all the profits that have come out of private equity and venture capital over a long period are accounted for by about 20 percent of the funds.

If we look at venture capital, that rule becomes 90/10; early-stage venture capital becomes 100/10, meaning that 10 percent of all the funds over essentially a 20-year period account for all the profit in real estate venture capital. Everything else is essentially a wash, meaning there are some winners, but the losers offset those completely.

It means we need to be concentrated in the funds, and the managers of those funds, in order for this to make sense for us, because the penalty for being outside the bounds of that 20 percent or 10 percent, depending on private equity versus venture, is fairly high.

In terms of selecting this ideal group to be in the portfolio, what does it take to select the winners and avoid the losers?

Feder: For us, the hardest decisions are not what to do but what not to do. Because returns for the asset classes are so dispersed, by definition, the decisions at the margin are the ones that will drive whether they have a good portfolio, a mediocre portfolio, or even a poor portfolio. In that process, we try to isolate the two or three issues at the margin that are going to make the difference between an investment being ranked in the upper strata of the universe or below.

Have endowment investment committees changed their long-term view in the aftermath of the financial crisis?

Feder: There is still the notion that you have to have intergenerational equity within an endowment, so it's not an unbounded, infinite time horizon. The endowment is intended to last forever, and that ought to mean that if there are not very high demands on the return liquidity, that endowment ought to have the advantage of weathering near-term or immediate-term volatility.

In the case of private equity and venture, that means endowments ought to be excellent partners for a private equity fund manager or a venture fund manager, because they can support the idea that those investors can invest when it makes sense to invest, and they can exit investments when it makes sense to exit and not be forced to participate in every single environment. ■

Click to watch this video at privcap.com

Ardian's Independence Day

Vladimir Colas of Ardian describes the Paris-based firm's move away from AXA Group, its European middle-market roots, and trends in the PE secondary market

Vladimir Colas, Ardian

Bio

Vladimir Colas is a managing director at Ardian. He joined AXA Private Equity in 2003 and previously worked in BNP Paribas' sell-side equity research department.

Privcap: How would you describe Ardian's business as it's transformed from AXA private equity? What's changed and what's the same?

Colas: We were founded in 1996 with $100M under management. Now we're close to $50B. Becoming independent was a natural evolution for us. What's changed is the ownership of the management company. Out of the 320 employees, almost 300 of them participated in the spinouts. AXA hasn't sold its private equity holdings—they're still our number one clients. More than two-thirds of the capital that we manage is third-party: pension funds, sovereign wealth funds, insurance companies around the world. Nothing has changed with the investment process, the investment committees, the funds we manage.

How would you describe the value that Ardian brings to GPs in the co-investment context?

Colas: It's an important aspect of our investments. When we make primary commitments with a private equity manager, we hope to build a broader relationship. We like to provide private debt in some cases to make secondary acquisitions or help a manager open doors for add-on acquisitions in industries or countries where we have specific knowledge. On the co-investment side, we have strong positioning because we're a direct group, but we're also a fund-of-funds group.

You mentioned secondary activity. What are the underlying trends driving that market?

Colas: Through our fund-to-fund platform, we deploy roughly $2B a year on the secondary side and about $1B on the primary side. Both are strong legs to our platform. Regulation is making it more expensive for banks and financial institutions to hold private equity. You have strategic shifts; some pension funds deciding to go direct will want to sell some fund portfolios. More generally, private equity is no longer an alternative asset class. It's a several-trillion-dollar industry and needs a robust secondary market.

What innovations to the secondary market do you see coming down the pike?

Colas: We've seen more secondary demand from LPs for new assets classes like energy, real estate, and infrastructure. A lot of that demand is from LPs who have exposure to those programs and want to increase it. We've seen more GP restructurings, but have been cautious on that side of the secondary market.

Earlier you talked about Ardian's roots in Europe's middle market. Can you talk about what you see as the opportunities there in this post–Great Recession environment?

Colas: Historically, we've done well with country-specific companies. Our roots were in France, taking French companies and making them European leaders. Now we have an established practice in Germany and Italy. On the direct side, the strategy is taking smaller companies and helping them become European or world leaders. It's a good time for us to be putting capital to work in Europe. ■

Click to watch this video at privcap.com

Breaking Down GP Selection

Frank Brenninkmeyer of Performance Equity talks about what the firm looks for in a GP manager and how its history with GM's pension group informs strategy

Frank Brenninkmeyer, Performance Equity

Bio

Frank Brenninkmeyer is a managing director at Performance Equity. Prior to joining the firm, he was a vice president at GE Asset Management and also held various operational positions at one of Europe's largest retailing organizations. Brenninkmeyer received degrees from the University of Notre Dame and UCLA Anderson School of Management.

Privcap: We're here to talk about GP manager selection. Things change, markets change; what worked in the past may not work in the future. How does that impact your deciding whether to commit to a manager?

Brenninkmeyer: I'd start by saying that the core levers of value creation are pretty well known. You have financial engineering, cost restructuring, top-line improvements, and expansion strategies. Those will remain relevant for a period. Then there's the skill that managers need to implement value-creation strategies. Do they have the ability to repeat this over time? Do they have the skills in-house to do that? Do they have the ability to create and craft a portfolio? That's what we're looking for.

As you think about the analysis you have done internally on managers, do you find that there is persistence, or does performance degrade over time?

Brenninkmeyer: We've been studying persistence carefully in conjunction with Josh Lerner and others, but also with our own data sets, which reach back to the early 1980s. What we've found is, persistence in private equity is relative to the public markets. If a manager has a first-quartile fund, there's a 36 percent chance that a subsequent fund will also be top-quarter. This is the persistence that many people refer to when they talk about private equity. We took it one step further and asked what the likelihood is that the third fund in the series would also be top-quartile, and that declined substantially to 21 percent. There is a degradation, which means that relying on a track record as your sole methodology for evaluation of managers is difficult.

Performance Equity is recognized as one of the more experienced fund-of-fund advisory organizations. The firm's history is connected to the General Motors Pension Group. How does that affect your thinking today?

Brenninkmeyer: Our heritage coming from the world's largest corporate pension certainly influences us in a number of ways. The most important is our mindset, which comes from managing an asset class within a broader portfolio with the explicit goal of alpha generation and to assist the organization in achieving its return hurdles. I would contrast that with a more benchmark-driven type of approach where relative performance is a larger driver of portfolio construction and investment mindset.

In terms of evaluation of managers, do you see a lot of research on the individual partner? Is it the firm franchise that drives performance, or is it dumb luck? How do you sort those factors?

Brenninkmeyer: That's a complicated question. It's talent and luck. Luck plays a pretty important role in investing, but many people are not that interested in admitting that, or even estimating what percentage of their return was attributable to luck. ■

Click to watch this video at privcap.com

A Global Insurance Group's Bet on PE

Private equity's ability to generate alpha won it a role in Zurich Alternative's portfolio despite its illiquidity, says the firm's Ferdinand Seibert. He also discusses choosing an operating partner and the benefits of co-investment.

Ferdinand Seibert, Zurich Alternative

Bio

Ferdinand Seibert is a senior vice president at Zurich Alternative Asset Management. He previously was investment principal at Swiss Life Private Equity Partners and has worked in M&A at CSFB and BNP Paribas. Seibert received degrees from Frankfurt University of Applied Sciences, University of St. Gallen, and EM Lyon.

Privcap: From your perspective at a global insurance company, what role does private capital play in the portfolio?

Seibert: As with most insurance companies, our portfolio is dominated by fixed-income instruments and publicly traded securities. Hedge funds, private equity, and private debt take a backseat to these fixed instruments. They're in favor because they're expected to generate alpha to compensate for their illiquidity. On the one hand, you have the publicly traded instruments offering liquidity, so it can affect when the insurance company needs to rebalance its portfolio. On the other hand, you have illiquid instruments that don't allow rebound financing, but they generate alpha. It's always good if we can demonstrate a clear difference between public equity and private equity.

Let's talk about the fun part of the job: selecting managers. How do you assess a group's operating capabilities?

Seibert: The words "operating executive" cover a variety of skill sets and levels of involvement in companies, and commitment and time to that endeavor. One has to go beyond the mere title of "operating partner."

Many executives with operating capabilities come with prestigious titles that may be helpful to start with, but one has to look beyond this to understand what they've done. What have they accomplished? What were situations of adversity they had to overcome? Do they have the credibility to speak with CEOs of portfolio companies? Are they able to share insights gained from working on difficult situations with the management teams of portfolio companies?

"Hedge funds, private equity, and private debt take a backseat to these fixed instruments. They're in favor because they're expected to generate alpha to compensate for their illiquidity."

–Ferdinand Seibert, Zurich Alternative

What do you see as primary benefits of a co-investment program?

Seibert: Co-investments have a lot of benefits. The most measureable types are the financial ones in which it's the mitigation of the J-curve and performance improvement due to less fee drag. The less tangible aspects are the ability to better understand a GP and satisfaction of the private equity staff, who often enjoy working on co-investments. ■

LPs in Focus/

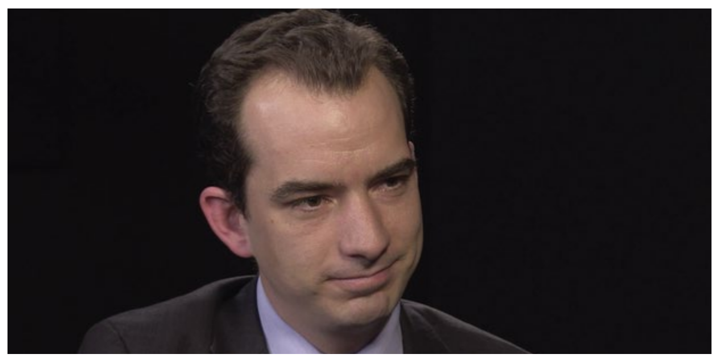
We hope you've enjoyed this compilation of views on how investors are becoming increasingly sophisticated in PE investing. For the full interviews of all of the participants, click the video links below, or visit **Privcap.com**

Changing Dynamics of LP-GP Contact

Former KIC Exec on Sovereign Wealth Fund Investing

Inside Endowment Investing

Ardian's Independence Day



Breaking Down GP Selection

A Global Insurance Group's Bet on PE

MVISION

To us,
performance is everything

The sight of geese flying in a 'V' formation is familiar around the world. They do so to increase their flight efficiency; in fact, their performance is 71% better than that of an individual bird flying alone. The birds also encourage each other while in formation to maintain their speed.

At MVision, we command streamlined execution tactics evolved over a decade of resourcefulness, investor relationships and knowledge to achieve our clients' goals.

Learn more at
www.mvision.com