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PRIVCAP REPORT/

PLUS:

- Endowment Investing Mandates
- PE’s Emerging Markets Growth Story
- Risks of Re-upping With a Manager
- A Resurgence in Co-investments

Voice of the LP, Vol. 2

In depth-interviews with influential
private equity limited partners

With Expert Insights from:

Towers Watson
Rockefeller University Office of Investments
Offit Capital
StepStone

The Risks of Buoyancy

I hope you enjoy this new collection of in-depth LP interviews, part of the "Voice of the LP" series that Privcap has done in conjunction with Thomas Franco of Clayton, Dubilier & Rice and Dan Feder, managing director at Washington University Investment Management Company.

While each investment professional has his or her own unique goals and portfolio characteristics, you'll note that a recurring theme throughout the conversations presented here is the challenge of investing in a market that is very robust.

The investment market is not starved for capital—far from it. Nearly every subsector, including ventures, buyouts, and secondaries, is awash in dollars seeking opportunities. As our featured LPs explain, the opportunities to invest do exist— witness the startup and M&A booms.

According to Sanjay Mansukhani, a partner at Towers Watson, many managers are responding by moderating investor expectations about future returns.

A lot of private equity managers are being very upfront about this. As Thomas Carrier, a partner at Offit Capital, puts it: "This is no longer a 20 percent [return] business."

If private equity wants to remain the belle of the portfolio ball, it needs realistic LPs, like the ones featured in this report, that are willing to invest with the cold calculus of diminished absolute expectations.

Enjoy the report,

David Snow
CEO & Co-founder
Privcap
@SnowsNotes

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The Rockefeller Way

Thomas Lenehan of the Rockefeller University Office of Investments talks about the mandate of his organization, as well as its approach to venture capital and private equity allocations

Thomas Lenehan
Rockefeller University Office of Investments

→ BIO

Lenehan joined the Rockefeller University Office of Investments in September 2011 as deputy chief investment officer, helping to manage all aspects of the $2.0B endowment. He has a B.S. in business administration from Georgetown University and an MBA. from Stanford.

Privcap: Can you tell us about the Rockefeller University Endowment Fund?

Lenehan: We are America's very first medical research institute, founded in 1901 by John D. Rockefeller himself, and our motto is "Science for the Benefit of Humanity." We've had 24 Nobel Prize winners in our history, and we manage an endowment of about $2B that supports about a third of the operating budget of the university.

With competition and multiples being so high in today's PE and VC landscape, how do you think about where we are in the cycle, and how are you adapting in building your own portfolio?

Lenehan: Every cycle is different, but just looking over the last several years, venture [capital] has come back in a big way. Funds are being raised quicker than average, and they seem to be raising larger dollar amounts than average. And valuations, or the headline numbers, are back, whether it be Uber or any of the other flavors of the month. To us, at least, it feels like a resurgence, which is very welcome. But I would say we're toppy right now.

Is there a disconnect there? Sure, you have Uber, but broadly, is the innovation really delivering?

Lenehan: If we've learned anything-from the prior cycles, it's that funding

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> **“Venture really is a different animal from generic private equity. In private equity, if you invest in bad businesses that end up losing money—especially if you have any amount of leverage on it at all—that usually does not bode well for returns.”**
>
> –Thomas Lenehan, Rockefeller University

innovation—just the fact that you have capital to put to work—doesn’t create innovation. Innovation is really created by fantastic ideas being executed by fantastic management teams. You need the capital to get there, but if you have an abundance of capital, it doesn’t mean you can force the issue and create more innovation. So that’s where we get a little bit concerned, that currently there appears to be an oversupply of capital.

The managers that we tend to back have been around for a long time. They’ve been through cycles. All of those managers wvill say that prices are crazy—not necessarily in the press, but behind closed doors—and how concerned they are about the well being poisoned by a lot of new entrants, whether they be some of the micro VC managers or angel investors. There is [such] a flood of capital that when an idea seems to gain any traction at all, there is a land-grab mentality. That’s where the disconnect for me comes, when people have been touting capital efficiency forever, but when they have something that seems to be getting some traction, they want to plow as much capital into it so they can grow as quickly as they can and build the moat around the competition.

Venture really is a different animal from generic private equity. In private equity, if you invest in bad businesses that end up losing money—especially if you have any amount of leverage on it at all—that usually does not bode well for returns. The weak get culled from the herd, if you will. Within venture, a lot of the companies are supposed to lose money, and they do for a very long period of time. Then they might be bought by Google the next day for 20x original cost. So it is not even a home run game; it’s more of a grand slam game.

Where do you see opportunities at this point in the cycle?

Lenehan: Since we feel like we have a pretty developed program domestically, we’re trying to find opportunities outside of the United States. We are believers that on average, the U.S. is as developed a country as you can get, where growth will just be harder to come by. The U.S. seems to be along at the top right now, but that’s with a 2 percent annual growth rate. So China will ultimately get back online, as will a lot of other emerging market economies, so it’s important for us, as we continue to develop our program, to become more diversified by expanding outside the U.S. to capture that growth that will be ever more elusive here.

Asia and Latin America are two geographic areas where the private markets are developed enough to generate attractive returns. There are enough management teams that have completed round-trips with invested capital, by successfully executing business strategies, so that’s where we’re spending the balance of our time and attention. We do use a fund-to-funds partner in Asia to help educate us and have feet on the ground. It’s extremely helpful to have eyes and ears on the ground with people who speak the language, who have been in those geographies for their entire careers, to make sure we don’t step on a land mine. ■

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No Bucket to Fill With PE Investments

Offit Capital first advises its clients to target an investment theme with the cheapest, most liquid alternative. However, partner Thomas Carrier says that for areas like the emerging markets, Offit finds that private equity best captures the growth story.

Thomas Carrier
Offit Capital

→ BIO

Carrier leads the investment strategy committee at Offit Capital and is a member of the firm's investment committee. He is responsible for the firm's investments in private equity and real assets, including LBO and venture firms as well as real estate and other real assets.

Privcap: What does Offit Capital do?

Carrier: We're an investment advisory firm headquartered in New York, with an office in Los Angeles. Today we are advising on $9.2B, and we have approximately 140 clients. We invest in everything from hedge funds and private equity to municipal bonds, cash management, managed accounts for equities, commodities, real estate, etc.

One thing that makes us unique is the way we think of our private equity. We don't have a bucket that we fill up with private equity investments in any given year—we sort of end up there. We are focused on an asset class, geography, industry, or a particular type of transaction, and we will typically start with the most liquid, cheap alternative to access that. We're always looking for an interesting opportunity.

So we end up with a private equity allocation for clients in the upper single digits to low double digits, which is typical. But we don't start out looking for that. In some years, we do hardly any private equity. And in other years, we do a lot. The way we access that with our clients is through a feeder platform that we have created. So for every transaction we do, we will have an on-shore and, if needed, an offshore platform. And if the deal or if the fund will allow it and if our client's large enough, we'll just access it directly.

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> "It's an interesting time for emerging [markets] and private equity, but you have to have a strong stomach and live through some volatility in the listed markets and in the currency, which has become more and more important."
>
> –Thomas Carrier, Offit Capital

What are some interesting opportunities in emerging markets?

Carrier: When you look at Asia and, let's say, emerging markets in general, you look at the process of whether there's a liquid way to get exposure. Your first thought might be whether you can invest in public equities in emerging markets so you have exposure to the growth story. And in almost every emerging market, the listed equity market doesn't give you exposure to the underlying consumer-demand story. Those companies are typically private, and so private equity is really the optimal way to get exposure to that story.

Are emerging markets making a comeback in private equity investments?

Carrier: It's an interesting time for emerging [markets] and private equity, but you have to have a strong stomach and live through some volatility in the listed markets and in the currency, which has become more and more important. You have to have a long outlook, a long investment horizon, because the issue with emerging markets private equity—although I think it's quite attractive from a contrarian perspective and a value perspective—is you can buy businesses today for four to five times cash flow in many of these markets. The exit can be more difficult. And even in less volatile markets than we've seen recently, the equity capital markets are not nearly as well-developed as in the U.S. or Europe. And they can be closed for long periods of time.

The M&A markets are not nearly as robust as what we're used to seeing in the U.S. and Europe. And in the U.S., to the degree that you have a private equity or an IPO market that's not open or a weak M&A market, at the very least you can typically sell to another private equity firm. In Brazil or China or Nigeria, that's not an option. You have to wait for those markets to be open.

What is your current outlook for private equity?

Carrier: The next couple of years feel like a somewhat challenging environment. Prices are high, and financing is intermittent and certainly volatile. And also you're dealing with more issues where regulators are managing the amount of leverage that you can put on an asset. So it's becoming harder to engineer an upper-double-digit return in this marketplace. And a lot of private equity managers are being very upfront about this. This is no longer a 20 percent [return] business, and some people say it's 15 percent, 16 percent. Is it 12 percent or 13 percent? And at some point you might say, "Hey, that sounds pretty good to me relative to this equity environment." But once you layer on the fees and illiquidity involved, is it worth it? There's a lot of capital still out there, and the world generally is awash in liquidity. And so many alternative strategies are set up to address dislocation, volatility, off-market transactions, and I feel like the market for private assets is just becoming more and more efficient. ■

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Avoiding Mediocrity in Private Equity

Sanjay Mansukhani
Towers Watson

→ BIO

Mansukhani is a senior manager research consultant for Towers Watson. He leads the firm's research on private equity and real assets in the U.S. and assists clients in structuring and implementing private market programs. He received a bachelor's degree from the University of Calcutta and an MBA from Pittsburg State University.

> Sanjay Mansukhani, a senior investment professional at Towers Watson, talks about the risks of re-upping amid a "frenzy of fundraising"—backing a manager before fully understanding what's in the portfolio

Privcap: Life has been pretty good in private equity for the last couple of years. But is it sustainable? And is the environment benign going forward, or should we be more defensive?

Mansukhani: It's certainly going to be anything but benign. It's been a very frothy market, very hard to deploy capital. A number of the investment managers that we're speaking with are smart and are beginning to recognize that the party's not going to last in terms of fundraising, and some of the forward-thinking managers are trying to figure out alternative solutions to meet client-specific expectations of risk-adjusted rates of return to match their specific portfolio's goals.

Overall industry returns will most likely moderate from a combination of higher financing costs—when they come—and high entry multiples that are generally paid. Business models are slowly adapting to figure out where an investment manager best fits in the ecosystem of alternative investments.

For example, some traditional private equity managers are beginning to pay attention, hence the talk of hybrid strategies.

Do you think the GPs have learned the lessons of the "frothy" market?

Mansukhani: I think they have. In many cases, I feel like they're fighting yesterday's battles. Some of the managers are reaching the end of the investment period, and what I'm afraid of is that extreme caution is suddenly going to turn into less caution because that money needs to be deployed. Suddenly a deal that didn't sound as investable from a target return perspective begins to look justifiable.

It used to be if you delivered the goods, you could count on a re-up if you're a GP. Do you subscribe to that?

Mansukhani: Persistence is declining as the industry becomes more efficient. Increasingly LPs are using tools or seeking out advice on dissecting returns in a way to identify true skill—which is hard to find, but is the sustainable component of the equation if a GP enjoys barriers to their model and core competencies. Private equity, after all, is equity and having these tools allows LPs to sort out true excess performance, pay for it, and reduce costs for beta exposure. Sophisticated LPs ought to put even their best-performing managers through this test. Try to consider your options for other assets in your portfolio and the broader options available in private equity and private markets overall to avoid settling for mediocrity from your investments. ■

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Co-investments Back in Vogue

While there is once again interest in doing co-investments, Darren Friedman of StepStone lays out differences in the practice between now and before the financial crisis. He also weighs in on LPs looking to reduce their fee burden.

Darren Friedman
StepStone

➜ BIO

Friedman is a partner at StepStone, focusing on co-investments, mezzanine investments, and managers, both domestically and abroad. He was previously a managing partner at Citi Private Equity and worked in the investment banking division of Salomon Smith Barney. He received a B.S. from the University of Illinois and an MBA from the Wharton School of the University of Pennsylvania.

Privcap: I understand that you and StepStone are very active around co-investments and direct investments. As you look at the market now, is there a lot of enthusiasm for these types of investments?

Darren Friedman: I have not seen this much interest in co-investments since probably 2006-2007. And we all know what happened then. We're in part of the cycle right now where most people think you can't lose money in co-investments. But co-investing is just investing. You have to decide what investments to make. You have to be careful. You have to be judicious about how you go about your process.

Some of the demand is very different than it was in 2006-2007. You don't have any hedge funds with their illiquid side pocket, in which some of them moved very aggressively into private equity structures. Those are essentially out of the market 100 percent. Banks were putting transactions on their balance sheet to earn extra returns. They're out of the market as well. And if you look at the people wanting to co-invest, it's a much broader subset of the market overall then you had in 2006-2007.

How do you make a GP comfortable about letting you in on seeing the sausage being made? That could be an ugly process, right?

Friedman: It could be a very ugly process. I like to say one of the nice things about our business model is that you learn the most about your partners during that [co-investment] process—how they really tackle due diligence and what their issues are. When you ask them questions, how do they answer it? What are their due dili-

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> **"If you look at the people wanting to co-invest, it's a much broader subset of the market overall then you had in 2006, 2007."**
>
> –Darren Friedman, StepStone

gence angles that they could bring to the table, whether it's internal, operating partners, or what external resources they could bring. You learn a lot.

But really, it's also a much more difficult part of the market for a GP, because they really have to work with people who they trust. Not that they're always going to get to the same answer that they will, but that the communication will be very clear. So if we are working on a transaction and we have a different viewpoint than the general partner who's leading it, we have to be very clear in saying, "These are our issues."

And the interesting thing about a lot of the club transactions done before the financial crisis is that when things are going great, everyone is a friend. You're working collaboratively. But when you have to make some tough decisions, it's how you make those when you have four or five people around the table. I've talked to CEOs of companies in club transactions where they've said, "I'm not sure who my boss is. It takes me three days to schedule a conference call, because I have to get five people's schedules to sync up." So it's just less efficient.

There's a trend that will continue in the future where GPs will look to strategic investors to be their partner in those club transactions.

So there is a category of LPs that would be good partners around co-invests. What are the types of LPs that really should not be active around co-invests, or where you think, in general, it wouldn't be a good strategy for enhancing returns or building a portfolio?

Friedman: When I think about co-investment, investors typically have two goals. The first one is: Can I lower the overall cost—the fee burden—of my private equity portfolio? If all you're trying to do is just lower the fee burden, you should do almost every co-investment you see. Because if you're getting it on an unpromoted basis alongside a GP that you've invested with and you've backed already, you should do that. The second thing you should get is, can you be selective on assets to add some outperformance—some more alpha—to your private equity portfolio? There you have to be selective.

I'm curious how you'd react to LPs who are predominantly looking to reduce the fee burden on their programs.

Friedman: My view is, there are many GPs who are saying, "I'll give you fee breaks. We're cheaper." And in private equity, let's face it, the fees are a loan. They're like the greatest loan ever. If I earn 8 percent, I pay your loan back with interest of 8 percent. And if not, let's just forget it ever happened. So it's very attractive for the GP. But for most LPAs, it essentially is a loan.

But the basis point savings—when you take that into consideration, why would you ever invest in a manager that you don't think is top quality, just to save 25 bps on fees? Because if you're going to lose 500 or 600 bps on returns, it just doesn't make a difference. Trying to get people into the first close is a different argument. But to invest in a fund that you wouldn't otherwise invest in for a fee break, I would never do that.

What are the challenges in the next 12 to 24 months for private equity?

Friedman: The biggest challenge is that we're in a period where there's a lot of liquidity in the world. Fundraising is much easier than it has been—maybe even easier than in the '06 to '07 time frame. There's a saying in the industry: When the best get funded, so will the rest. And unfortunately, you have a lot of people who are going to have a lot of capital. The big struggle is going to be staying disciplined. Meaning not feeling the weight of money at the GPs—that you have to constantly put capital into transactions.

Also, there are elements around currency and commodity volatility that people really haven't put a lot of thought into. There are a lot of dollar-based funds or euro-based funds investing in other currency. We've had some pretty volatile moves there, and people need to think a little more about currencies. ■

From the Archives

ESG

Impact and ESG: Measuring Social Impact

Gene Wolfson of Catalyst Investors discusses investor requests for employment impact reporting.

Inside Endowment Investing

Daniel Feder of Washington University Investment Management discusses endowment investing, the impact of margin decisions, and why he finds his job rewarding.

Secondaries & Liquidity

The Seven Biggest Challenges Facing PE

Altius Partners' Eric Warner talks about the major issues facing the PE sector, as identified by Altius' Dr Richard Charlton, in a new research report.

Secondaries Success: Not Dependent on Paying Discounts

Many secondaries investors are focused on acquiring PE partnership interests at a discount to NAV, but Pantheon's John Greenwood says discounts aren't performance predictors.

Real Assets

Deal Stories: Emerging Markets Infrastructure

Experts from Pembani Remgro, IFC Global Infrastructure Fund and NSG Capital talk about investments they've made in the infrastructure of emerging markets.

First Reserve's Latest Infrastructure Mandate

Privcap spoke with the firm's head of infrastructure, Mark Florian, about its $2.5B fund targeting infrastructure in the energy sector.