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## PE Hot Topics

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# Can the direct investment model be replicated in the US and Europe?

Limited partnerships (LPs) continue to seek ways to minimize the costs of their alternative programs. Anecdotal evidence suggests that some are exploring direct investments as a potential solution. Can the direct investment model work for investors in the US and Europe?

## The impetus is real, and increasingly urgent

The last decade has seen tremendous growth in private equity (PE). Once a niche asset class, the importance of PE and other private market investments in institutional portfolios has grown dramatically in recent years. Investors are attracted to PE's broad investible universe, the ability of managers to directly influence the outcome of an investment and the increased incremental returns that PE firms generate – over the last 10 years, PE has returned a median 3.2% above public indices on a net basis.

However, this performance comes at a cost. Despite recent pressure on pricing, the standard 2 and 20 model has remained remarkably resilient. While many LPs receive breaks via co-investment, separate accounts and breakpoints for large commitments, fees for large programs can be staggering. CalPERS, for example, the US' largest PE investor, made headlines when it disclosed in late 2015 that it has paid more than US\$3.4b to PE fund managers in performance and management fees since 1990.

The result is increasing discussion around the direct investment model. For large LPs that see the value of private market investments but are looking to control costs, introducing a measure of disintermediation into the process by engaging in-house staff to source, manage and harvest their own deals is surely tempting. And while the cost benefits are one of the clearest and most compelling reasons to invest in the development of a direct program, there are other benefits as well, such as the ability to more effectively match assets with long-term liabilities. Direct investment models can free investors from the typical 10-year fund life cycle, instead allowing them to put large amounts of assets to work in attractive investments, including potentially in perpetuity.

With today's bull market, the second-longest on record, investors are bracing for compressed returns across all asset classes in the coming years. As such, the need for high risk-adjusted returns delivered in a cost-effective manner is perhaps more urgent than ever.

## The evolution of the direct investment model

There are, of course, a number of investors that are successfully employing the direct investment model. Beginning 25 years ago, pension funds in Canada began making direct investments, driven by the need to better match liabilities with future obligations. As the model evolved, Canadian pensions, sovereign wealth funds (SWFs) in the Middle East and elsewhere, and a handful of others have built sophisticated teams of sector and region specialists dedicated to investing assets across a range of opportunities, in some cases with full complements of operational expertise to help drive returns.



## It can work in the US and Europe, but with some important caveats

With the benefits clear, and the imperatives increasing, many are wondering whether a similar model could work for investors in the US and Europe. Indeed it can, but there are a number of considerations that investors need to consider.

### The development of a successful direct investment program takes time

Investors currently active in direct investment programs didn't establish their programs overnight – they built teams over significant periods, learning as they went and evolving the model along the way. Many began with commingled funds, increased their involvement with co-investments and eventually built out direct investment capabilities complete with sourcing, deal teams and operational/value creation professionals.

For LPs considering direct investment programs, co-investments in particular can be an opportunity to stretch their wings and learn from the best. To that end, some LPs are now seconding investment staff with GPs as they conduct diligence in order to better enable knowledge sharing and train their staff in the nuances of the business. And many LPs are thinking more strategically about the funds in which they invest, looking at investments not only through the traditional lenses of risk/return and diversification, but also the opportunities they offer in terms of learning about specific markets, sectors and competencies.

**“I don't think there's a secret sauce to their success. People look at these funds doing direct investments and think it's an overnight success. But it's not something they've turned on overnight, they've grown it steadily over a long period of time.”**

*– Tim Piggott, Partner  
Transaction Advisory Services, Ernst & Young LLP*

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## Key considerations

In November 2016, Ted Eliopoulos, Chief Investment Officer, CalPERS asked staff to explore the viability of developing a direct investment program. CalPERS stressed that no decisions are imminent and that it expects the review to take several years. Nonetheless, the announcement is significant – the fund is seen as a bellwether in the world of institutional investors and one can be reasonably assured that the boards of other large LPs are watching closely to see what actions they take. For CalPERS and others mulling direct investment programs, there are a number of key learnings they can take from those that have forged the path:

### It will require cultural changes in the way investors view risk ...

One of the biggest barriers to adoption of the model in the US and Europe is cultural. Many LPs in the US and Europe have remained culturally conservative relative to Canada's pensions and other investors with established direct programs. However, lower expected investment returns, and for pension investors in particular, longer life spans that will require increased payouts, is making the need for cultural conversion more pronounced.

Having the right governance structures in place is a key enabler. Boards need the ability to provide effective oversight without overly constraining investment capabilities; effectively segregating the day-to-day investment decisions from fund-level matters such as establishing payout levels can be a powerful tool. Such segregation allows management teams the latitude to buy, sell and manage deals without the second-guessing, political influences and micromanagement that can be endemic to many boards. Perhaps most importantly, having the right governance model in place will be especially important when the inevitable setbacks occur.

### ... and the way they recruit and compensate talent

Perhaps the most commonly cited challenge to starting and maintaining a direct investment program is attracting the right talent. Clearly, compensation for senior rainmakers at large PE funds can be extraordinarily high. However, the gap might not be as large as many think, especially beyond PE's "bulge bracket" firms – according to a survey conducted by Preqin in 2016. Managing GPs at buyout shops averaged roughly US\$800k in total compensation last year.

When you factor in the additional benefits – freedom from fundraising pressures, the potential for greater alignment with colleagues and a strong sense of civic contribution – it's easy to see why there exists a cadre of top-level dealmakers attracted to the opportunities. Indeed, the Canadian pensions and other investors have been very successful in recruiting top talent. As the model continues to develop, some investors are even moving away from their historical salary-based compensation structure to include a carried interest component for their staff in an effort to make themselves even more competitive.

And while the compensation required to attract top talent might come as a shock to the sponsors and beneficiaries of US and European pensions, foundations and endowments, increased transparency and publicizing the value-add and cost savings relative to existing practices should go a long way toward building trust with constituents and making clear the case for a direct investment program.

### The opportunity is substantial

Overall, there are no insurmountable structural impediments that are preventing investors in the US and Europe from implementing a direct investment model; indeed, there are a number of models that could be viable for LPs with the desire to go direct. Large LPs could obtain the skills they need by acquiring an existing alternatives manager. They could also partner with firms to invest more assets in "master" separate accounts wherein they would retain greater control over their investments. In addition, smaller investors with similar time horizons and investment objectives could even pool resources in order to create dedicated investment offices to manage plan assets "in-house."

Macroeconomic and geopolitical developments could provide additional tailwinds. Potential policy changes – specifically around carried interest – could narrow the gap between market rate compensation and what pensions are able to pay. Furthermore, given the length of the current economic expansion, some are wondering if an economic downturn might present opportunities to obtain high-quality staff at a time of market dislocation.

Clearly, investors need a sizeable base of assets for a direct investment model to be viable. According to Willis Towers Watson, Canada's pensions, for example, collectively manage more than US\$1.5t, allowing them to fully punch their weight with respect to their structure and operating leverage. However, the US and Europe also have a significant population of LPs for whom a direct investment model could make sense. If just one or two of these funds were to make the commitment, it's not hard to imagine this might embolden other boards to someday do the same.

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