What the future holds for pension funds moving into private equity

Pension funds are increasing their exposure to private equity. ***Daniel Engel*** *explains the reasons for this shift, the challenges faced by pension funds on the way and the different approaches they are taking.*

PRIVATE EQUITY OPPORTUNITIES

Private equity is enjoying significant growth. PwC estimates that it could increase its assets from USD 3.6 trillion in 2013 up to USD 7.4 trillion by 2020. Pension funds, which traditionally invested into bonds and equities, are increasing their exposure to private equity and alternatives. eVestment predicts that pension funds will increase their alternative allocations from 15% of their portfolios to 19% in the next three years.

This is being driven by the performance of private equity relative to other asset classes. Sixty-four per-cent of investors said in 2015 that their private equity portfolios had met expectations while 30% acknowledged expectations had been exceeded, according to Preqin. **The mood remains bullish with 95% of investors telling Preqin they anticipated their private equity portfolios would exceed public market returns over the coming year.** Furthermore, a study by the S&P Dow Jones Indices found the majority of traditional European equity fund managers failed to beat their respective benchmarks over the preceding decade.

The priority for pension funds in this zero and negative interest rate environment is to deliver alpha if they are to meet their growing liabilities. The shift by pension funds towards private equity is also driven by their desire to have less correlation to the markets and to attain risk diversification. The long lock-ins typical of private equity are also better tolerated by pension funds who take a long-term view on their portfolio investments.

THE DATA CHALLENGES

Investors and regulators have both increasingly been pushing for enhanced transparency requirements. Dodd-Frank in the US requires private equity managers to supply Form PFs to the Securities and Exchange Commission (SEC) while the EU's Alternative Investment Fund Managers Directive (AIFMD) obliges them to submit Annex IVs to national regulators.

US and EU regulatory reports are detailed and contain significant swathes of data about private equity managers' businesses. Meanwhile, Solvency II requires alternative asset managers to disclose in-depth information about their portfolio exposures to insurance clients who in turn must then report to regulators. Enhanced transparency in this example helps insurance clients manage their Solvency II capital charges against underlying investments. Although these reports have posed challenges for managers, they have facilitated greater transparency, and this has been welcomed by investors.

However, the amount of data required to fill these reports should not be underestimated. Collecting the information and then tailoring it to individual investors and regulators is time-consuming. These reports have subtle differences, of which managers must be cognisant. The sheer volume of data could also overwhelm regulators and investors. Pension funds have

Daniel Engel leads the global product and solutions for private equity and debt at BNP Paribas Securities Services.

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KEY POINTS FOR PRIVATE EQUITY MANAGERS

- ESG is gaining traction among clients
- Co-investing and direct investing is a growing trend
- Valuation must be independent and reported succinctly
- Collecting data is difficult. Simplifying and harmonising the data for clients is even harder
- The industry is moving towards standardisation of reporting, both in terms of content and format
- Working with an established service provider to manage these changes will help private equity attract investors

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Industry groups are pushing for greater standardisation. Altexchange is gaining traction around its data standard format which can facilitate information sharing between managers and investors. The standard incorporates a number of areas including portfolio company financials, fund information, cash flows and capital accounts. The Institutional Limited Partners Association (ILPA) has created a standardised report for fee and expense disclosure to investors amid criticism of some of the practices at managers.

It is important private equity managers and their service providers work towards a method of standardising this data to ensure it can be supplied to investors in a concise format. The data should include a complete look-through on private equity portfolios and holdings. It is crucial pension funds and managers work with experienced service providers who can assist them with the operational complexity of managing this data.

Service providers with a global presence enable this reporting to investors to be undertaken seamlessly. Pension funds and insurers are global investors and need reports from managers themselves operating across diverse geographies to be supplied in a consistent format by service providers, whether it be depositary or administrator. Demonstrating flexibility and offering specialised solutions is a core strength of quality service providers and it is something institutional investors look for.

Valuation of illiquid, Level 3 assets is a complicated process. Its importance has been elevated under AIFMD which requires private equity to ensure assets are valued independently from the deal teams and portfolio managers – either internally or externally – to mitigate the risk of conflicts of interest.

It is essential that managers' valuation processes are in line with market practices, and that the infrastructure exists to challenge and review valuations. Working with an administrator who has wide expertise of valuing complex assets is essential for private equity if they are to ensure compliance with rules and industry standards.

ESG AND CO-INVESTMENT

Private equity managers and service providers need to be mindful of the changes that are occurring in investor sentiment, not least Environmental, Social and Governance (ESG) issues. Research compiled by the London Business School's Coller Institute of Private Equity and Adveq, a private equity investor, found **85% of private equity firms managing in excess of USD 10 billion said ESG integration into the investment process was being encouraged by allocators.**

ESG data and transparency is critical for pension funds. Custodians are already data consolidators for pension funds, providing a range of valuation services and risk reporting, and are therefore well placed to extend their services to incorporate ESG into a broader investment and risk reporting framework.

Another trend is the growing number of large investors such as pension funds which co-invest alongside managers on deals. This is the preserve of investors with experienced in-house private equity teams. **Managers may allow co-investment as it can make fundraising easier and enable greater capital to be deployed in deals.** Investors enjoy lower management fees and no carried interest. Furthermore, Preqin data found 85% of Limited Partners had higher returns through co-investment deals than traditional private equity portfolios.

There are disadvantages to co-investing. Managers complain that executing deals can take longer, while investors expose themselves potentially to more risk concentration. Other investors are going further, electing to go directly into private equity deals. This can occasionally result in investors and their private equity managers competing for the same investments. Again, private equity managers need to be mindful of client trends and cater accordingly.

Private equity is an attractive asset class for pension funds. Institutional investors often require enhanced reporting and transparency, and this should be noted by managers. Working with service providers, who can help provide clients with digestible and coherent data reports, is critical for private equity managers. It is equally important that private equity managers evolve with their investors' changing demands.