HYMANS ROBERTSON

Embracing the opportunities

Unlocking growth potential from private companies

Welcome to the third publication in our *Embracing the opportunities* series, focusing on why and how DC schemes should access private equity

The UK government's "Patient Capital" review back in 2017, a plan to encourage long-term investment in the UK economy, aimed to breakdown some of the barriers to investing in illiquid asset classes. Following previous publications focusing on illiquid assets generally and infrastructure, we explore the potential uses of private equity as an asset class for DC schemes, including the role the asset class could play, impact on member outcomes, and the practicalities of including it in DC default strategies.

In the first publication of this series, we established why those responsible for DC schemes should explore opportunities in illiquid investments to improve retirement outcomes for members. We also dispelled some of the myths associated with investing in less liquid assets. In our second publication we focused on infrastructure and its potential role in DC schemes.

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What is private equity?

Private equity (PE) investment involves seeking out privately owned companies with high potential for growth and/or revenue generation. Investment managers will typically take a controlling stake in the acquired company and then seek to add value by making operational or financial improvements to help the company grow, with a view to selling the business after a few years.

Different types of private equity investments have different risk and return characteristics, as summarised in the table below. We would typically expect investors to build a diversified portfolio covering all three types to help reduce unsystematic risk.

Type of PE Investment	Definition	Typical Return %pa
Growth Capital	Purchasing a stake in a mature company to allow it to expand or restructure, usually under the existing management team. It is also known as expansion capital.	10 - 15%
Buyouts	An outside investor (a leveraged buyout) or the existing management team (a management buyout) purchasing the controlling interest of a private or public company.	
Venture Capital	Purchasing a stake in a new or fast-growing private company, usually with very little track record. This type of private equity investing is considered higher risk than buyout, but it also offers the potential to earn higher returns.	

Why invest in private equity?

Return potential

Exceptional net return potential is one of the main drivers for holding private equity investments, as the asset class is generally considered to be one of the highest risk and highest potential return asset classes available. Returns are typically higher than public equity due to the illiquidity premium commanded and the high growth potential of the investee companies that private equity managers seek. However, the variability of returns is wide, and therefore getting manager selection right is crucial to long term success as the manager will play a key role in managing the investee companies. As DC savers are long term investors, they can typically afford to take on extra volatility in exchange for greater returns over the long run.

Potential Impact

Private equity managers take large stakes in their investee companies in order to influence change within that company. This therefore gives the asset class the potential to have a strong and positive impact on society by either investing in companies that make a positive difference, or by improving the integration of ESG considerations within that company's management team. Impact will be very much dependent on the philosophy and investment strategy of the private equity manager, again outlining the importance of selecting the right manager.

Government support

The UK government has been exploring ways to mobilize pension scheme capital to drive growth in the UK economy, through initiatives such as the Patient Capital review and the “Leveling Up” agenda. A key aspect of this is to encourage investment in young, innovative companies. We therefore expect to see further regulatory changes in the future to make it easier for DC schemes to access private equity.

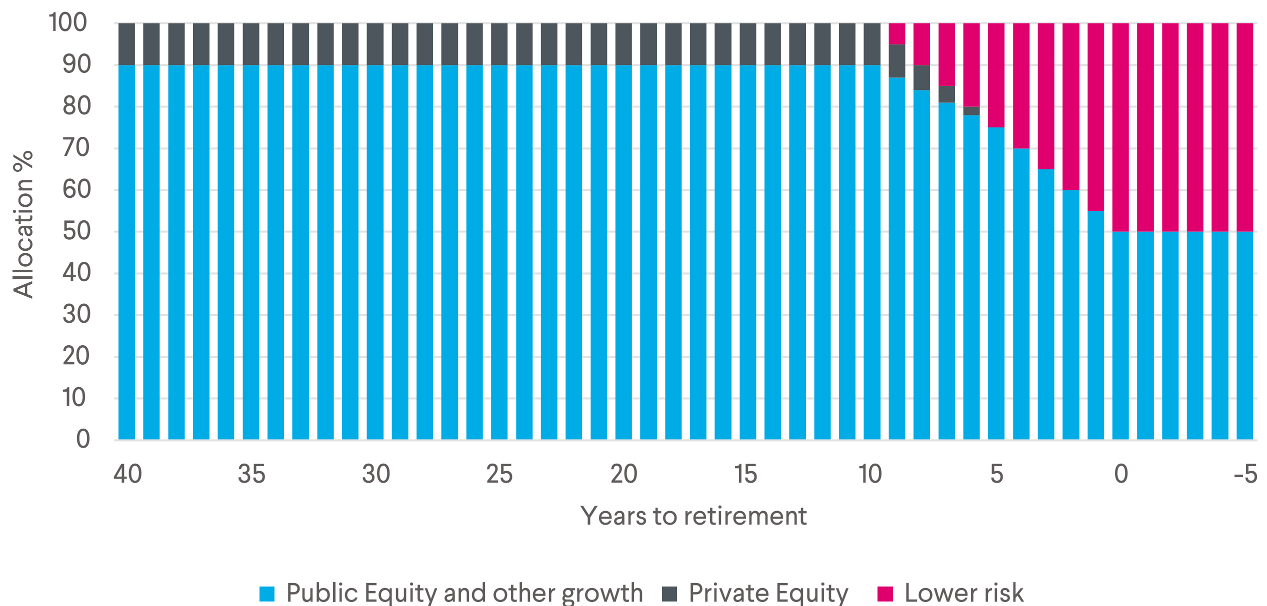
We think there is potential for up to £250bn of DC assets to be committed to private equity investments by the end of this decade, reflecting growth in the size of DC schemes. This will require a shift in emphasis on cost to overall value, which we’re driving with a longer-term member outcome focus in mind.

What is the potential role in DC strategies?

In our previous publication we set out some high-level views on how different illiquid investments could be used to improve retirement outcomes for DC savers.

We concluded that the average DC schemes could target an allocation of up to 20% to illiquid investments during the growth phase, with higher conviction schemes able to go further before compromising the resilience of their portfolios. Within this, we see a significant role for private equity assets in the earlier stages of a savings journey, reducing substantially before reaching retirement.

DC savers can afford to take more risk in the earlier stages of their savings journey, provided this risk is expected to be rewarded over the longer-term. Given the high risk and long-term nature of private equity, we think the asset class can play a role in the early stages of DC glidepaths to boost potential returns. However, we’d suggest reducing the allocation to zero before reaching the target retirement date, given the volatility and liquidity constraints of members at this point in their savings journey. An example glidepath is shown below:



Based on a 10% allocation in the earlier stages of the savings journey, private equity has the potential to improve retirement outcomes for DC savers well in excess of 10% based on the consensus views of returns. Even in the lower-than-average performance years, assuming an expected return of 6-10% per annum, a 10% allocation to private equity would improve retirement outcomes by more than 10%. With allocations to some of the higher risk opportunities as potential satellite investments in future, there’s further potential to enhance long-term returns and retirement outcomes.

How can private equity be implemented in DC schemes?

We think blended or target date funds are now an essential feature for future proofing your DC scheme's investment strategy. This means you can make changes to the underlying asset allocation, without creating onerous consultation and reporting requirements each time a change is made. It also means liquidity management and rebalancing can be structured efficiently. This will be increasingly important as the ability for DC schemes to access more sophisticated asset classes and fund structures improves.

Managing liquidity

As with other illiquid assets, managing liquidity is a key consideration for private equity investments. After an investor commits their capital to a private equity fund, there will be a period of time (usually around 3 years) for the manager to seek and execute deals for investee companies, known as the "drawdown" period. The nature of private equity investments also means there will be a period of several years during which the private equity investor will look to enhance the way the investee company is run, in order to improve profitability over the long run. The investors won't get their money back until the manager decides to sell their stake in an investee company, typically through an Initial Public Offering (IPO) or a secondary market sale. Investor capital can therefore be tied into private equity investments for upwards of 10 years.

The long-term capital commitment should not be an immediate concern for DC schemes given savers' very long time-horizons. As discussed in our previous piece on infrastructure investing, incorporating illiquid assets into a blended fund and fulfilling cashflows using liquid assets is a workable method for managing liquidity, providing the platform provider has the capabilities to do so.

Liquidity management can be implemented efficiently provided the platform provider has capabilities to adopt smarter rebalancing protocols. In practice, we would anticipate illiquid assets being left untouched within an asset mix, with cashflows facilitated through other liquid components held in the portfolio. We cover liquidity management in more detail in our first publication in the "Embracing the opportunities" series.

Examples of Private equity in DC schemes

Below are some examples of how DC schemes have successfully offered investment in private equity and other illiquid assets for DC savers. We expect the range of funds offering access to private equity and other illiquid assets to expand substantially in 2023 and beyond, with the first LTAFs likely to launch for investment in the first half of 2023.

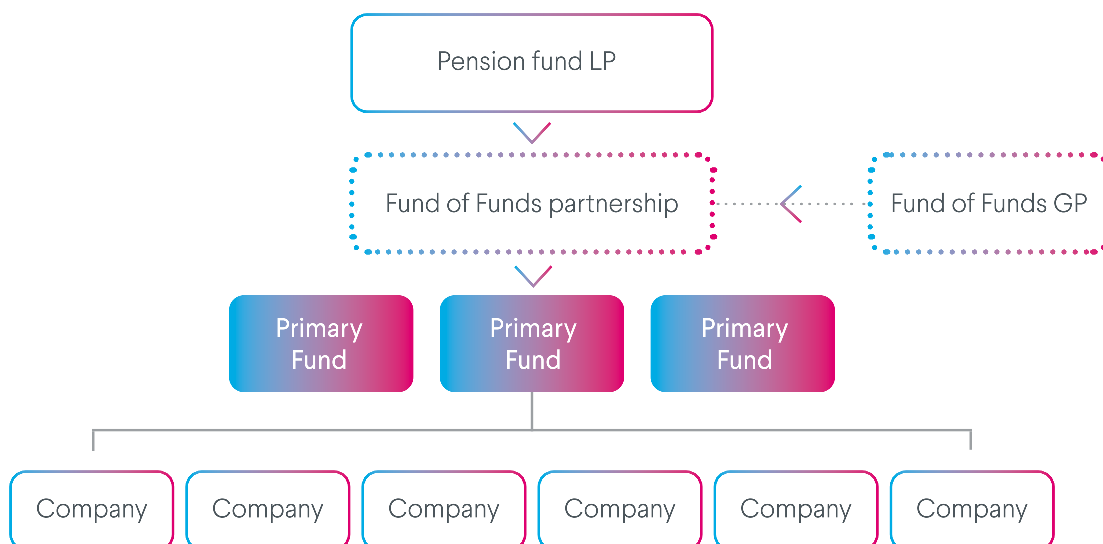
University Superannuation Scheme (USS)

USS use an in-house team ("Private Markets Group") to manage investments in Private Equity through both direct investments and co-investments with other private equity managers. Allocations to private equity are incorporated into the USS Growth Fund, used in the growth phase of the USS default strategy.

NEST

Nest announced earlier this year that they would be partnering with Schroders Capital to incorporate an allocation to private equity into its default investment strategy.

We see DC schemes most likely to access private equity through a **fund-of-funds** structure, where several private equity managers and investment strategies are wrapped together into one blended fund. This structure allows for diversification across managers and fund-types, which should lead to lower downside risk for investors.



Fees and the charge cap

The UK government announced in January that certain performance fees may be excluded from the charge cap calculations for in-scope schemes. We believe this is potentially helpful for easing barriers to meaningful allocations to less liquid assets, however, in our view a wider cost to value shift in approach is required to drive change more materially.

Although fees charged by private equity managers are higher than most other asset classes due to the high level of manger involvement in the investment process, we don't think this should put off DC investors. We would expect private equity to achieve higher returns net of investment fees in the long run compared to public equity, and so the focus should be on the impact to member outcomes rather than the level of fees paid.

Based on the average fee for a DC scheme of broadly 0.3%, there's headroom within the 0.75% charge cap to support investment of more than 20% of assets based on a "2 + 20" structure. In practice, we expect the fees for access to private equity to be lower than the headline rate, eg when accessed within a fund of funds and/or diversified private markets structures.

How do performance fees traditionally work?

Traditional private equity investing is synonymous with performance fees. In short, a performance fee is one where the fund manager participates in the profits generated through private equity investments alongside a management fee based on a proportion of capital invested. This means there's alignment and incentivisation for fund managers in terms of performance (consistent with regulations introduced to Statements of Investment Principles in recent years). However, the level of performance fee can be significant depending on the profits generated by the fund manager. Depending on the terms of the fee agreement, this performance fee may also be crystalised before the performance is realized, in terms of profits returned to the investor. This could lead to an issue in terms of fairness for members, where some may participate disproportionately in the fees but not experience the full performance depending on their entry and exit points in terms of investment.

Overall, performance fees mean alignment and incentivisation for the fund manager, but how they are structured is a key consideration.

The following table illustrates the impact of performance fees and the net performance outcome for a traditional "2 + 20" structure, assuming a uniform 10-year investment term for simplicity:

Profit % over 10 year period	Gross performance	Overall manager fee (management fee and performance fee)	Net return (annualised) %p.a.
0%	0.0%	2.0%	-2.0%
100%	7.2%	3.1%	4.0%
200%	11.6%	3.5%	7.9%
300%	14.9%	3.7%	10.8%
400%	17.5%	3.8%	13.2%
500%	19.6%	3.9%	15.2%

As shown above, while private equity management fees have the potential to grow to significant levels, this is largely when exceptionally strong performance is provided; this means the net experience to investors is a positive story.

How do we expect performance fees to work in a Defined Contribution context?

The above example relates to a single hypothetical investment. In practice, we anticipate investment in well diversified portfolios, with fund-of-funds structures likely to be attractive for investors looking to get access to diversification until increased scale in future years supports more direct and co-investing opportunities. This means that performance, and performance fee experience, would also be diversified (partly due to vintage diversification) and benefit from a degree of smoothing, significantly reducing concerns which could arise from the scenario described earlier. Indeed, we are already seeing evidence of managers of fund-of-funds approaches agreeing to absorb the variable performance fee experience from underlying assets by offering a flat fee structure for the overall fund.

Performance fees are unlikely to pose an issue in terms of fairness for investors for funds well-structured for the DC market. Investors should check that performance fees for underlying components vest alongside profits from capital invested.

Be careful what you wish for

Overcoming the likely higher level of fees is one of the main challenges for Defined Contribution schemes making meaningful investments in private equity opportunities. Historically, the range of outcomes from private equity investing is heavily (and positively) correlated with the fee meaning investors were likely to get stronger performance for higher fees. This is due to the quality of underlying investments and management approach. From a global investor universe perspective, demand for higher fee private equity managers is very strong indeed, meaning there is no material incentive for them to cut their cloth to appeal to a growing DC market.

So, what are the main take-aways?

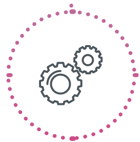
As demonstrated in this publication, there are significant opportunities in private equity investments which could lead to improved outcomes for members.

There is also the opportunity for pension schemes to integrate their climate and wider sustainability goals in line with the broader portfolio. Here are some initial steps you can take:

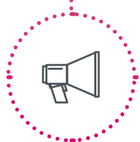
Educate
When receiving training on illiquid investing more generally, seek specific guidance on private equity investment. This should cover risk and return characteristics as well as social and environmental impacts.

Engage
Engage with your pension provider and advisors to understand how you may be able to access private equity investment opportunities. Platform capabilities will be key – is your platform provider up to scratch? This is a key engagement area to drive support for DC schemes well into the future.

Review
As part of your next review of your investment strategy, explore how private equity and other illiquid assets can be used to improve outcomes for your members. As part of your next provider review, attribute a weighting to platform capability, given lack of functionality could stifle your ability to deliver good outcomes for your members over the long-term.



Implement
If you identify opportunities to improve outcomes, you should take action to capture these for the benefit of your members. Work with your provider and advisors to develop plans to introduce allocations to private equity and illiquid assets over a reasonable time period.



Communicate
Share positive stories about the action you are taking to improve outcomes with your members. Private equity investments have strong potential to create engaging stories about how your members' money is being used to build a more sustainable future.

Illiquid investments: embracing the opportunities

Look out for further publications in our illiquid investments for DC schemes series, which will be published on our newly launched Illiquid Investments Hub. If you have any questions on the subject in the meantime, please get in touch:

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