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Investment decision challenges in private markets

Private market insights

Introduction

It is generally accepted that meaningful feedback can improve the outcome of many activities. Edutopia.org lists five research-based tips on delivering meaningful feedback: 1) be as specific as possible, 2) the sooner the better, 3) address the learner's advancement towards a goal, 4) present feedback carefully, and 5) involve learners in the process.[1] However, the nature and structure of private markets are inconsistent with several of these concepts and this, in turn, presents challenges for learning from both the Limited Partners' (LPs) and the General Partners' (GPs) perspective. For LPs, a robust learning function is important to improve their manager selection and to develop insights into how GPs create value. For GPs, better learning could enhance their pattern recognition and improve their portfolio company selection, as well as the development and operation of their portfolio companies. This paper will discuss how the characteristics of private market investments attenuate meaningful feedback, and examine some of the ramifications of these limitations for both LPs and GPs.

Four characteristics of private markets

Some of the characteristics of private markets that impede meaningful feedback include long holding periods; the small size of most individual private market fund portfolios; the 'noisiness' in returns, and information constraints. Not only do these characteristics act singularly, but they often act in concert with each other, constraining the ability to develop a beneficial feedback loop.

- **Long holding periods:** Most private market portfolio companies are held by GPs for several years, typically three to five. Moreover, it is very uncommon for a GP to exit a portfolio company in less than a year. As we discuss in our paper *The Value Add Premium*, GPs often have extensive Value Creation Plans (VCPs) that they implement after purchasing a company. A long holding period is necessary for GPs to implement what are often complex changes as well as to see the corresponding improvement in financial results from the changes. As we flag in the paper, the success of the transformation is a major factor in a GP's ability to generate returns that are superior to public markets.

  At the fund level, an additional characteristic that compounds the long holding period is that a fund's capital is not deployed immediately. Rather it is invested over the fund's investment period which is usually the first five years. Thus, there is a cascading series of long holding periods with companies at various stages of transformation in most private market fund portfolios.

- **Small portfolios:** The size of a private market portfolio is often very dependent on the strategy and resources of the specific GP but, typically, there are 10 to 30 companies in an individual fund.[2] A major limiting factor in the number of companies in a fund portfolio is the capacity of each individual partner to manage the extensive changes in their portfolio companies. Private market GPs tend to have only a handful of partners which thereby limits the manageable size of a fund's

[1] *Source: https://www.edutopia.org/blog/tips-providing-students-meaningful-feedback-marianne-stenger*

[2] *Note that a GP may have several funds open at any point in time, so the number of active portfolio companies can be larger than the individual fund portfolio.*

portfolio. Due to the small number of portfolio companies, the success (or failure) of just a few companies can therefore have a profound impact on the returns of the overall fund.

To apply a sports analogy, in the 2016-2017 NBA season Stephen Curry (Golden State) made 89.9% of his 476 free throw attempts while Fred VanVleet (Toronto) made 81.8% of his 22 attempts.[3] With Curry's large sample size it is easy to conclude that he is a superior free throw shooter (Curry ranked 4th in the NBA for free throws). However, the jury was still out on VanVleet as a few shots in either direction could substantially alter any conclusion. Interestingly, in the 2020-2021 season VanVleet made 88.5% of his 191 attempts. Thus, with a significantly larger dataset, it is reasonable to draw the conclusion that VanVleet is actually a very good free throw shooter as well (Curry made 91.7% of 410 attempts, earning him a 6th ranking).

- **Noisiness in returns**: After holding most companies for several years, a GP will exit them by either taking a company public, selling it to a strategic acquirer, or selling it to another financial sponsor. As mentioned above, GPs are often rewarded for the changes they make to a company, but the return also depends on the market conditions both at the time of purchase as well as at the time of the exit. Market conditions can either help or hinder the return, but GPs can choose the timing of the exit within the limits of the fund life.[4] Thus, GPs will often extend their holding period in a poor market and continue to implement changes in the hopes of exiting the company under more favourable market conditions. However, a GP may have exhausted their ability to add value to the portfolio company and extending the holding period can still impair returns even if market conditions improve. The noisiness in returns in combination with the small portfolio size can make it challenging for LPs to accurately assess a GPs' "true" value add.

- **Information limitations:** One of the aspects of private markets that frustrates many observers and participants is that generally only LPs receive detailed portfolio company information from their GPs on a regular basis. GPs may share performance information with outside investors when they are fund-raising but they do not regularly or publically release detailed portfolio company performance information.[5] There are subscription data services that use a variety of means to obtain information on some funds, but no single service provider has coverage of the entire private market and, furthermore, relevant information is often communicated verbally to LPs rather than through written quarterly reports. Also, determining the appropriate peer set for comparison is more art than science and often requires detailed knowledge of the GP's strategy being benchmarked as well as that of the potential peer set.

[3] *Sources: https://www.teamrankings.com/nba/player/stephen-curry and https://www.teamrankings.com/nba/player/fred-vanvleet*

[4] *See our recent paper on Continuation Funds for an interesting and recently popular alternative path for exits.*

[5] *Several years ago when Freedom of Information Act (FOIA) requests were used to force some U.S. pension plans to release detailed fund performance information, several GPs responded by refusing to accept any additional investment from U.S. pension plans.*

What does this imply?

The characteristics of private markets described above have important implications for both LPs and GPs, although they are notably different in nature. Due to the cascading series of long holding periods, an LP that makes a new investment in a GP is unlikely to have a good idea of the GP's performance until several years into the fund's lifecycle. If this is a new private markets program for the LP or if the LP's staff is new to private markets, the LP may not know if the criteria they applied in making the investment decision was appropriate. And, without that feedback, the LP may continue to apply suboptimal criteria to other investment decisions before identifying any problematic issue which may result in portfolio underperformance over a number of years.

Similarly for the GP, the long holding periods may allow them to continue to apply transformational approaches that are less than ideal and do not generate the desired results. However, GPs usually have very detailed information on the performance of their portfolio companies and can make interim adjustments if they recognize the issues in time. On the other hand, small portfolio size can be a factor as GPs can also choose to discount any problems and lay the blame for them on "unique" circumstances facing an individual company (underperforming CEO, deteriorating end market conditions, etc.). This can lead to a GP not admitting that the deficiencies could also be due to their development of the VCP or their general oversight of the company (after all, who found/hired/evaluated the underperforming CEO?).

A classic question when assessing investment performance across asset classes is: Are the returns generated down to a manager's skill or luck (market)? Small portfolio size, noisiness of returns, and long holding periods combine to make this a very difficult question to answer when evaluating most private markets funds. And, as GPs are usually raising their next fund prior to fully realizing their current fund, LPs must often make the next fund investment decision under a great deal of uncertainty. Thus, it might take an extended period of time for an LP to gain sufficient experience to be able to effectively develop appropriate criteria and processes.

From a GP's perspective, the issue often comes down to how honest they are with themselves about the contributions they have made to the success (or failure) of their portfolio companies. In most cases, returns will depend on both market conditions as well as the changes implemented by the GP. The real challenge, therefore, is determining the "true" attribution of each.

The implications of the information limitations center primarily on benchmarking, both externally and internally. While LPs have detailed information on their own GPs, the lack of public information on other GPs makes it difficult to develop an accurate picture of an individual GP's performance relative to other, similar GPs. The lack of such information again constrains an LP's ability to assess their investment decision criteria and processes. A subtle point here is that as LPs cannot directly observe the GPs that they declined, they may continue to apply criteria that is preventing them from investing in GPs that are potentially generating better performance than those in their portfolio.

GPs usually have a general idea of their fund-level performance relative to their peers but may not know portfolio company-specific information of other GPs. Having access to that information would allow a GP to make a more accurate assessment of their own performance (e.g. How did your retail pet company do relative to ours?).

Conclusion

For both LPs and GPs, the nature and structure of private markets create a situation in which learning is difficult and requires several years' experience, if not longer. This is especially relevant to LPs starting new private markets programs, bringing new staff into their existing programs, or making substantial changes to an existing program (such as adding co-investments).

Generally, LPs should be cautious as to how they implement any changes and be sufficiently judicious about the speed of their capital deployment until they are confident that they have developed robust experience, criteria, and processes. Many LPs employ the services of external consultants to provide continuity in their private markets programs which can help mitigate some of the issues discussed. The long-term success of GPs may be directly correlated with the accuracy and honesty that they apply to their assessment of their contributions to their portfolio companies. This can be enhanced significantly if the GP develops a systematic, rigorous, and objective post-investment review process which would also be viewed positively in the due diligence evaluation of LPs.

While some characteristics of private markets are evolving, it is likely that many of those discussed here will not change, which will continue to make learning in the space challenging for both LPs and GPs.

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