

In collaboration with  
the Private Capital  
Research Institute



# The Evolution of the Private Equity Industry: Returns, Relationships and Responsibility

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# Foreword

Over the past decade, the private equity industry has undergone a series of dramatic shifts. In 2014, the World Economic Forum first examined one of these trends – the rise in direct investing by asset owners. Since then, the low-interest rate environment, strong growth in private equity returns and increasing focus on the materiality of environmental, societal and governance (ESG) issues have continued to shift the industry. The impact of these shifts has been evident in the **returns** from the asset class, the changing nature of **relationships** between industry players and considerations given to being a **responsible capital provider**.

On the one hand, these shifts have reflected a natural maturation of the sector; on the other, these have been a consequence of changing preferences of, and pressures on, limited partners (LPs). Whatever the origins, these shifts have and will continue to shift the industry.

This white paper presents an analysis of these shifts. It has resulted from a great collaboration between the Private Capital Research Institute (PCRI) and the World Economic Forum. It presents the findings for the three critical areas – returns, relationships and responsibility and closes with broader lessons and areas for further understanding best practice. Insights were drawn from a series of discussions and research presentations with global private equity firms and institutional investors.

We would also like to take this chance to thank all the firms and individuals who contributed to the discussions and this work. The intellectual stewardship and guidance of all those who participated have contributed to the rich insights presented in this white paper.

# Executive summary

This report presents the results and lessons learned from the research presentations and discussions at the Private Capital Research Institute (PCRI) meetings and the World Economic Forum, convening global private equity firms and institutional investors. It is also a prelude to the World Economic Forum's *Creating Value through Sustainability in Private Markets* initiative,<sup>1</sup> which will delve deeper into conditions necessary for industry-wide progress on environmental, social and governance (ESG) and sustainability in private markets, specifically private equity.

This report presents the findings for the three critical areas – **returns, relationships and responsibility**. These areas have attracted intense discussion when it comes to the private equity industry, but often with more heat than light:

1. The first of these is the changing nature of **returns**. Much controversy has surrounded the relative performance of private equity and the public markets, which has enormous implications for global pension funds searching for reliable investment strategies to generate returns to meet their massively unfunded obligations. While the results can be sensitive to the chosen time period and benchmark, the emerging academic consensus is that performance has been “good but not great”. Most recent studies suggest that private equity has outperformed public market benchmarks, consistent with the historical pattern, but the degree of outperformance has fallen over the decades. Moreover, the extent to which this is affected by adjustments for illiquidity and leverage remains controversial.
2. The second major shift has been the evolving **relationships** between limited partners (LPs) and general partners (GPs). The disputes over performance have masked a more fundamental change in the nature of GP performance: the apparent death of persistence in private equity. Historically, funds that outperformed their peers were likely to be followed by another. Beginning with the funds that matured during the global financial crisis (GFC), this pattern of persistence in later-stage funds disappeared: a winning fund is as likely to be followed by a loser. Interestingly, the same pattern is not seen in venture capital, where original high performers continue to do well in subsequent funds.

In recent years, LPs have been far more likely to emulate the major Canadian pensions and seek to supplement their fund investments with co-investments and commitments to special purpose vehicles raised alongside funds. These investments surged during the 2010s, motivated by a desire to avoid the hefty fees associated with partnership investments and by the greater control that such a strategy can give LPs.

The historical record, however, suggests that this approach may not be a panacea. In particular, the performance of these investments has been mixed. Despite the fee savings, these transactions have not outperformed those of funds for most of their history (the years after the GFC were a notable exception). The same disparities seen across LPs in fund returns, where established investors and endowments often outperform their peers, are manifested here. The alternative vehicles selected by top fund investors outperform the high benchmarks set by their funds, while those chosen by less successful fund selectors fail to clear even this low bar.

3. The final shift, and perhaps the most consequential due to the pandemic coupled with social unrest and disruption, has been the greatly intensified pressures on GPs regarding the measurement and nature of **responsibility** for their investments. The same ESG pressures long-familiar in public markets have manifested themselves increasingly in private markets. These questions reflect the pressures that endowments and public pensions – as well as other LPs – have been under themselves from stakeholders and politicians. It is also a consequence of a world where GP outperformance is no longer taken for granted and LPs increasingly invest directly, as delineated above.

The final part of each of the three sections highlights some broader lessons, although the conclusions will need to be tentative as in many cases, they reflect the recency of many of the phenomena discussed. These discussions also feature areas for further understanding of best practice, and large-sample patterns are needed.

1

# Returns: the changing dynamics of performance

There is still much to learn about private equity performance, despite substantial research in recent decades.

The first change has to do with the performance of private equity. Before discussing the results, however, it is helpful to talk about measurement issues in this context.

## Measurement challenges

Private equity (PE) performance is challenging to measure.<sup>2</sup> An initial consideration is the illiquidity of private equity holdings over long periods. This can result in difficulties identifying the market price due to a limited (albeit growing) market for secondary sales of PE funds, with large market spreads. Second, individual private equity investments are like works of art – each is different. For instance, fund managers may identify specific strategic opportunities for improving company operations – a company undergoing a turnaround is a good example of this as it may be difficult to value until the company or the portfolio has been exited.

Moreover, choosing a proper public market benchmark can be challenging. Advanced investors

use a “benchmarking” process by using data provided by an external vendor. In this process, they compare the returns of their private equity investors with other private equity opportunities derived from a peer group of PE funds.

Another alternative is to compare the performance relative to the public markets. This can be done by comparing returns over a given time period. An internal rate of return (IRR) is calculated based on compiled cash flows over a set time period in and out of the private equity industry, or a segment of the industry. Once the IRR is calculated, it is then compared to the returns of a public market index over the same periods.

## Performance results

Table 1 contains a comparison between the 10-, 15-, 20- and 25-year returns from Cambridge Associates with S&P 500 and MSCI World Index

over the same time period.<sup>3</sup> Over the periods chosen as a part of this analysis, private equity returns have exceeded public market returns.

TABLE 1 Pooled horizon returns to private equity versus public market indices, as of 31 December 2020<sup>4,5</sup>

Index	10-year	15-year	20-year	25-year
Private Equity Index	14.76%	12.94%	11.21%	14.98%
S&P 500 Index	13.16%	9.20%	6.83%	5.76%
MSCI World Index	9.86%	7.33%	6.02%	7.21%

Source: Refinitiv, 2021

It is important to note here that this comparison can be misleading because it gives equal weight to each year of public market performance. Yet, given the large influx of capital in the private equity industry, the private market returns put more emphasis on recent years. Therefore, to make an “apples to apples” comparison, it might make sense to weigh the public market returns in recent years more heavily.

A popular solution to mitigate the timing issues is using the “public market equivalent” (PME),<sup>6</sup> which allows for a more direct comparison of public and private equity. PMEs compare the proceeds generated by investing in a PE fund(s) with those achieved by investing the same funds in a public

index during the same period.<sup>7</sup> One of the most common PME measures is the Kaplan-Schoar approach. It computes the ratio of the returns from private equity investments to returns from the public market.<sup>8</sup> If the PME is greater than one, private equity has outperformed the public markets, whereas if the ratio is less than one, public markets outperformed private equity.<sup>9,10</sup>

Table 2 shows the Kaplan-Schoar PME for private equity funds from vintage years<sup>11</sup> 2000-2018 benchmarked with the S&P 500 and MSCI World Index.<sup>12</sup> The PE funds have consistently outperformed public markets over the same period for most of the years between 2000 and 2018.

TABLE 2 **Benchmark PME for all global PE funds, compared to the MSCI World Index and the S&P 500 Index, reported as of 31 December 2020<sup>13,14</sup>**

Vintage	MSCI World PME	S&P 500 PME
2018	1.05	1.02
2017	1.13	1.08
2016	1.16	1.09
2015	1.19	1.11
2014	1.46	1.32
2013	1.21	1.09
2012	1.27	1.12
2011	1.14	1.00
2010	1.35	1.15
2009	1.02	0.88
2008	1.17	1.01
2007	1.17	0.99
2006	1.42	1.22
2005	0.92	0.81
2004	2.13	1.96
2003	1.43	1.44
2002	0.72	0.73
2001	1.05	1.06
2000	0.63	0.65

Source: Preqin, *Private Equity Performance Analyst database, 2022*

“ 34.9% of managers believed they would perform much better than public markets, 41.9% thought they would perform somewhat better and only 1.7% believed they would perform slightly worse.

## Performance in times of crisis

It is interesting to note that the conclusions about the relative performance are more optimistic than those made as recently as eighteen months ago. This reflects the generally strong performance of private equity funds during downturns. Between July and August 2020, Gompers and co-authors conducted a study during which the authors surveyed over 200 PE managers with \$1.9 trillion of assets under management (AUM).<sup>15</sup> The survey found that PE managers believed 50.9% of their portfolio companies would not be affected by the COVID-19 crisis, 39.9% would be moderately affected, and 9.6% would be significantly affected.

Respondents of the survey were also asked how the pandemic has altered their expectations of PE returns. The average change in expected internal rate-of-return (IRR) was -4.4%, while the average change in expected multiple on invested capital (MOIC) was a modest -0.24.<sup>16</sup> Notably, the pandemic does not appear to have had a large

impact on exit expectations thus far, a crucial consideration, as exits are the mechanism by which PE fund managers sell companies and make cash distributions to investors. According to Gompers et al., despite the downturn, over 55% of PE managers surveyed are still actively seeking exit opportunities for companies in their portfolios instead of waiting for more favourable economic conditions.<sup>17</sup>

Finally, despite the COVID-19 pandemic, PE managers generally displayed optimism about the state of PE. According to the survey, 34.9% of managers believed they would perform much better than public markets, 41.9% thought they would perform somewhat better and only 1.7% believed they would perform slightly worse.<sup>18</sup> This optimism should support PE investment activity.

The optimism of PE managers is likely due in part to their willingness to engage with portfolio companies and work with them in various ways.

TABLE 3 PE managers' operational changes in portfolio companies severely affected by the COVID-19 crisis<sup>19</sup>

Operational change	Percentage of PE managers who made each change
Reducing headcount	87.1%
Reducing other costs	91.0%
Providing operational guidance	82.4%
Providing strategic guidance	89.8%
Connecting with customers, suppliers or strategic partners	61.9%

Source: Gompers et al, 2020

To this end, the survey found that PE managers were more engaged in the operations of portfolio companies that have been more severely affected by the pandemic. As shown in Table 3, these operational changes included reducing headcount and costs, providing operational and strategic guidance and connecting companies with customers, suppliers or partners.

These self-reported responses might be dismissed were it not for the fact that they are consistent with evidence from the past: the ability of PE fund managers to support portfolio companies during difficult periods and exit them profitably has been examined previously. A study of British firms during the global financial crisis (GFC) showed that all firms

experienced hardship during downturns, with a greatly reduced ability to access credit and raise equity financing. Yet, the effects of the financing difficulty were mitigated for firms backed by PE groups. As a result of these companies' ability to continue to access financing (albeit on a reduced level), investment levels for PE-backed companies fell less than those of non PE-backed companies. Consequently, the PE-backed companies gained market share. Figure 1 shows the relative changes in investment between the PE-backed and non PE-backed companies over time, with PE-backed companies showing substantially higher investment than their non PE-backed counterparts during the GFC.

FIGURE 1 | Change in investment for PE-backed and non-PE-backed firms<sup>20, 21</sup>



Source: Bernstein, Lerner and Mezzanotti, 2019

The greater investments that PE-backed companies were able to garner during the GFC came from a variety of sources. The buyout groups were not only willing to provide equity to their firms when other sources of financing were cut off, but the firms were

also able to access more bank debt. In particular, the academic literature suggests that larger PE firms often have strong relationships with banks that allow them to achieve better loan terms and provide more flexibility in refinancing agreements.<sup>22</sup>

## Unresolved questions

At the same time, several caveats are needed to highlight knowledge limitations and the need for future research. One concern is that the calculations above do not adjust for differences in liquidity and risk between private and public equities. These may end up affecting the conclusions regarding outperformance.

Fully addressing this question would require a long and academically dense discussion. In particular, Arthur Korteweg<sup>23</sup> summarizes the academic literature and highlights how seemingly benign assumptions about how private market valuations reflect news can have dramatic implications for the estimated correlation between public and private markets and, consequently the extent (or absence) of excess performance. In addition, assessing the

impact of liquidity on the fair rate of return also poses extremely subtle and contentious issues, but numerous works<sup>24</sup> suggest investors should demand a substantial illiquidity premium to make up for the difficulty of liquidating private equity stakes.

A final caveat is that while much of the discussion of private equity performance relates to the aggregate performance of the industry, another critical issue in PE is the dispersion of returns, i.e. the difference between the performance of funds in the top quartile versus those in the bottom quartile. This implies that private equity as an asset class offers a greater opportunity for more sophisticated and knowledgeable investors to earn higher returns than other asset classes.

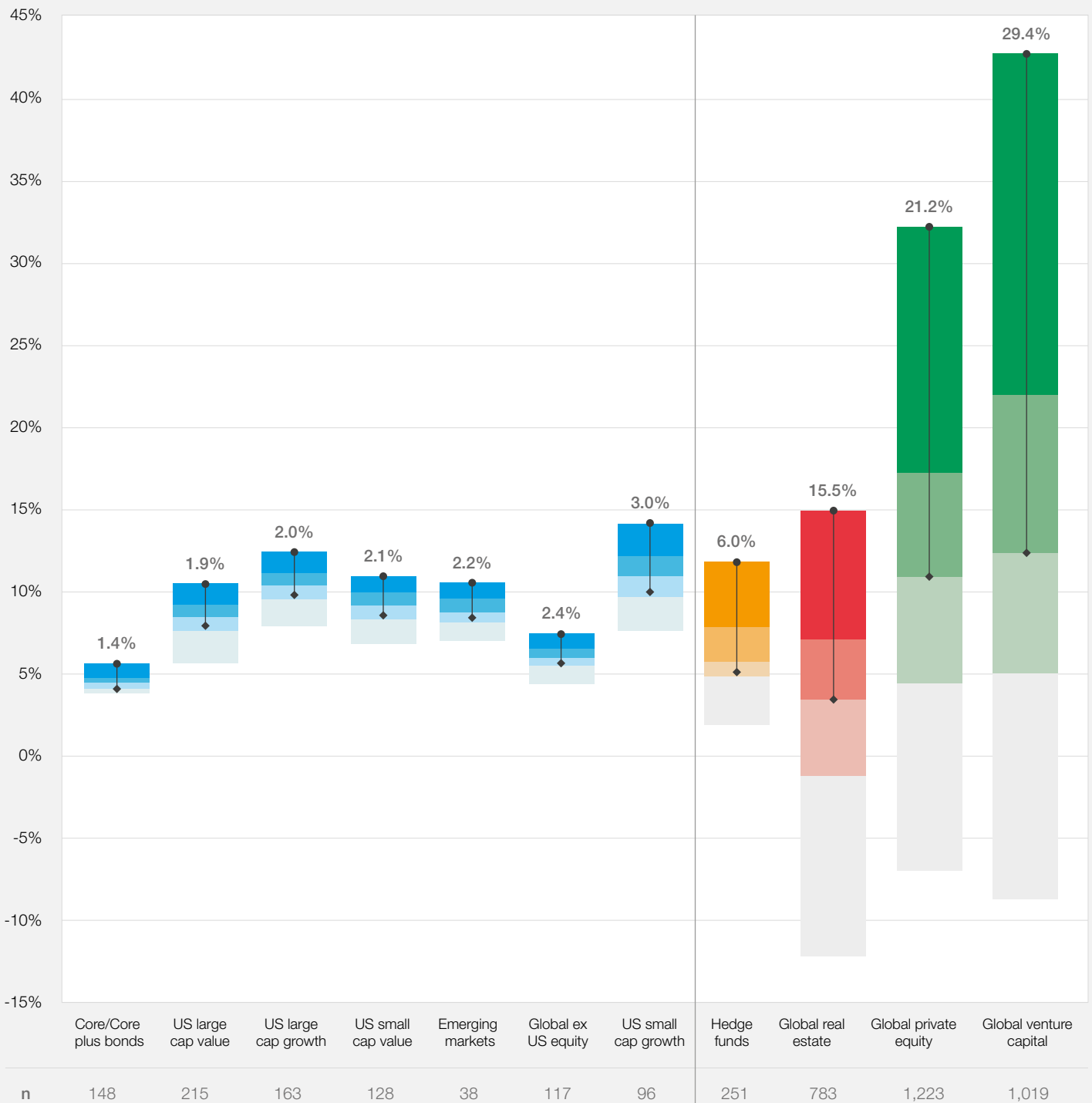


This point can be illustrated more effectively (see Figure 2) by examining the 15-year returns to global private equity over the period ending on 31 December 2019. The differential between a fund in the 50th percentile and a fund in the 95th percentile was 21.2% annually. Comparing this differential to that of US large-capitalization growth stock (2.0%), US small-capitalization growth stock (3.0%), or actively managed fixed income asset (1.4%) managers,<sup>25</sup> it can be seen that the performance

disparity in private equity is significantly higher. Only the PE fund managers in the top quartile consistently outperform the public markets.

These cautions suggest that, despite the voluminous work on private equity performance in the past two decades, much is unknown. Given the importance of increasing private capital in portfolios of investors of all types, this is an important area for future work.

FIGURE 2 Average annual manager returns by asset class, 1 January 2005-31 December 2019<sup>26</sup>



Source: Cambridge Associates Data, 2020



## BOX 1 | Subscription lines of credit and performance measurement

To illustrate the kinds of challenges that the measurement of performance faces, a look at subscription lines of credit (SLCs) is helpful. A recent study has shown that at least 47% of PE funds<sup>27</sup> use these vehicles, and one estimate suggests that US-based mid-market PE funds have access to \$300 billion in SLCs.<sup>28</sup> It is reasonable to wonder what effect SLCs might have on the industry.

Before going further, it is helpful to understand the role SLCs play in PE. In theory, they serve as a bridge loan. Typically, limited partners (LPs) will commit capital to a fund managed by a general partner (GP), but they do not write a check for the full amount. When GPs wish to invest in an asset, they must “call down” the capital from the LPs by sending a request that is generally fulfilled within ten days. Upon receiving the funds from the LPs, the GP can close the deal. SLCs streamline this process significantly. As the name suggests, they are lines of credit issued by a bank or a credit fund and secured by the LPs’ capital commitments. Upon finding a deal, GPs can use SLCs to close the transaction. LPs contribute their capital later, perhaps quarterly or even annually. Both parties benefit: the GPs can be more agile in response to fast-moving deals, and LPs can better forecast their capital infusions to the funds.

Both observers and academics, however, have pointed out some challenges stemming from the use of SLCs. A primary issue, they note, is the impact of deferred capital draw-downs on the

timing of fund cash flows. Delaying the arrival of LP capital reduces the time it is deployed, increasing the internal rate of return (IRR) and public market equivalent (PME) in a way that may give a misleading view of fund performance.

The two recent academic studies<sup>29</sup> took different approaches but arrived at similar conclusions: SLCs do have an impact on net IRR. The extent varies with the characteristics of the vehicle, particularly the length of its term, but predominantly serves to inflate PE fund performance. SLCs with relatively short terms (less than six months) increased the average net IRR of a fund by a meagre 0.4 percentage points, but the impact could be as high as 4.3 percentage points for SLCs with longer lives and funds less than five years old. In an extreme example, an investment fund could show nearly infinite IRR by calling on committed capital from its LPs a day before exiting a transaction. Almost half (44.4%) of the funds using SLCs moved up by at least one decile in their performance rankings.

The findings of these analyses are troubling. The literature shows that LPs base their investment decisions substantially upon the net IRR of a previous fund.<sup>30</sup> In addition, new funds tend to be raised when the current fund is between three and five years old – exactly when SLCs increase net IRRs most dramatically. It is possible, then, that fund investment decisions may be made with distorted information and that the performance benchmarks are increasingly distorted.

2

# Relationships: the shifting limited partner-general partner relationship

Direct investments by limited partners have changed the relationship between LPs and GPs significantly.

For much of the history of private equity, the relationship between limited and general partners was simple. Fund managers raised funds, asset owners invested in them, held them until they were liquidated, and the process repeated itself. Over the 21st century, however, there has been much more evolution. For example, it has been commonplace for LPs to sell their fund holdings in the secondary market, for GPs to sell stakes in their management companies and for fund managers to purchase insurers to serve as permanent capital. While each of these phenomena is important in its own

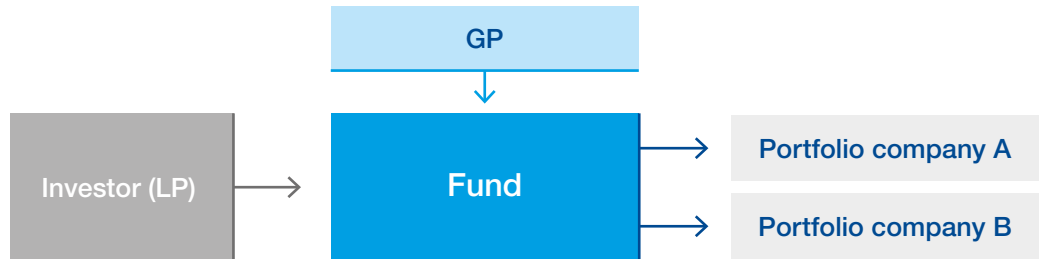
right, the focus of this section will be set on what is arguably the most profound shift in the LP-GP relationship: the rise of direct investments by LPs.

Direct investment has garnered significant interest in recent years. Sovereign wealth funds, pension funds, family offices and other asset owners are now choosing to make either<sup>31</sup> co-investments alongside their GPs or “solo” investments instead of only investing in their GP’s fund structures. Figure 3 below illustrates these different forms of private equity investing.

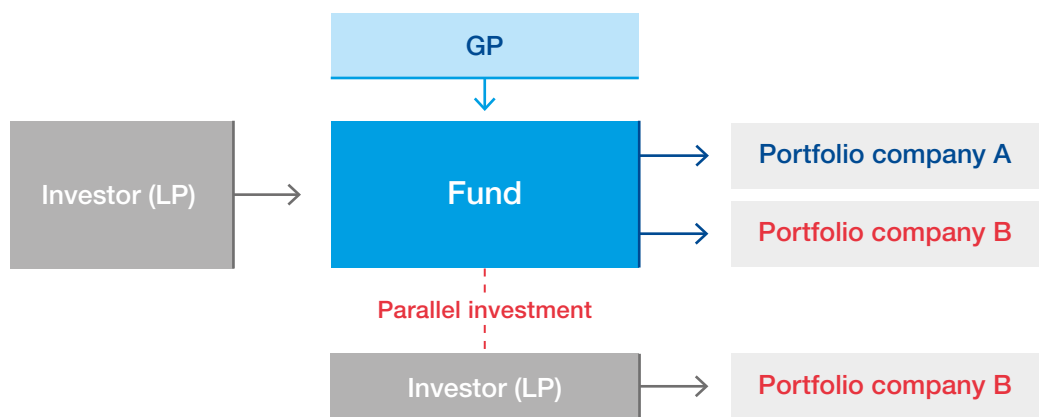
FIGURE 3 Different forms of private equity investing



**Traditional fund investing**



**Co-investing**



**Solo investing**



“As LPs seek co-investment opportunities, including smaller investors such as family offices, it becomes increasingly difficult for GPs to meet and manage the demand and expectations around co-investments.

Estimates of the growth of direct investing are astounding. Triago estimates that between 2009 and 2015, the amount of “shadow capital” – including solo or direct investments, co-investments and separately managed accounts (SMAs) – grew by 155%. In comparison, traditional fund investments grew by only 57%.<sup>32</sup> This trend of increased direct investments can also be seen in the public reports of asset owners with clear disclosure policies, such as the Canadian Pension Plan Investment Board (CPPIB). Their direct investments portfolio grew from CAD 1.5 billion in 2006 to CAD 38 billion in 2021.<sup>33</sup>

This increased interest in direct investment is to be expected. Table 2 shows the disappointing returns in several recent vintage years from private equity investing compared to public markets.<sup>34</sup> This lack of outperformance has stemmed from the substantial wedge between gross and net returns because of the fund managers’ fees and carried interest.<sup>35</sup> In theory, LPs can get all the benefits of traditional private equity without the “fee drag” through direct investments.

Moreover, despite the continued interest in this strategy expressed in Forum roundtables, it appears empirically that the approach of cultivating long-term relationships with a modest number of high-quality buyout funds is no longer as likely to be successful as in the past. Historically, this seems to have been a viable strategy. Kaplan and Schoar demonstrate the historical tendency of superior buyout and venture funds to repeat their outperformance. A similar pattern has been documented at the deal-by-deal level.<sup>36</sup> This was unlike mutual funds or hedge funds,<sup>37</sup> where the bulk of the evidence suggests that superior-performing funds quickly revert to the mean.

Since 2000, however, the extent of persistence in private equity returns appears to have sharply diminished, as Harris and co-authors demonstrate.<sup>38</sup> Various suggestions have been offered, from the decline in persistence, ranging from the impact of growth in fund sizes to the rapid changes in strategies needed for success (e.g. the commoditization of financial engineering).<sup>39</sup> Interestingly, in venture capital, persistence remains very strong.<sup>40</sup> Whatever the source of the decline in

persistence in private equity, it has triggered a rethink of investment strategy on the part of many limited partners.

Yet, direct investment efforts come with their own challenges. First, not all LPs can assess and execute direct transactions. Some sophisticated LPs, such as major Canadian pension funds, have hired professionals to assess transactions and build strong teams. This is not the case for many other LPs, whose capabilities are limited. Second, those LPs who successfully develop strong teams may struggle to retain their star employees, both deal-doers and those who intervene in case any investments encounter issues. This is primarily because of the inability of asset owners to offer compensation structures similar to private equity firms, given that they are often public, non-profit or regulated entities. Third, LPs who co-invest often have to make these decisions in a few weeks as opposed to the months or years that a GP has to assess a deal.

Finally, there is the issue of the “zero-sum” nature of these investments. As more and more LPs seek co-investment opportunities, including smaller investors such as family offices, it becomes increasingly difficult for GPs to meet and manage the demand and expectations around co-investments. Further, regulators’ increased scrutiny of co-investment allocation, such as the US Securities and Exchange Commission,<sup>41</sup> makes the task even more daunting for GPs.

A common question concerns the effectiveness of co-investments in generating superior returns for LPs. As seen in Table 4, which compares the PME performance of direct investments to an equivalently timed public market index investment, the performance has been disappointing.<sup>42</sup> While co-investments did particularly well in the 1990s, the entry of more LPs into co-investment programs has deteriorated performance. This can be attributed to two factors: an overconcentration of co-investments at the peak of the market cycle. Second, these investments are often concentrated as a part of the largest deals of any fund, which have historically done poorly compared to typical-sized deals.

TABLE 4 Direct investment (co-investment and solo) performance, 1991-2009<sup>43,44</sup>

	Direct investments	Fund benchmark	Difference
Mean PME, venture capital	0.98	1.45	-0.47*
Mean PME buyouts	1.40	1.29	0.11**

Notes: \*Statistically significant from PME fund benchmark at 1% level  
 \*\*Not statistically different from PME fund benchmark

Source: Table 3 in Fang, Ivashina and Lerner, 2015



Braun et al. provide an alternative and more optimistic view.<sup>45</sup> They find that asset owners benefit from co-investments as fees are more substantial for fund investments. When comparing returns completely invested in by traditional funds and co-investments, using investment data from the S&P Capital IQ, they find the distribution of gross returns before fees between these are similar. Table 5 provides a summary of the performance results. The average gross PME is 1.76 for buyout co-investments, compared to a PME of 1.70 for buyout fund investments. For venture capital, the pattern was reversed with a 1.25 for co-investments versus 1.37 for traditional funds.

A caveat to this conclusion is that several LPs have reported challenges with Capital IQ data. The database entries seem to have been taken from summaries circulated to bankers and PE groups of co-investment success. These cases tend to omit lower performance entries due to the self-reporting nature. Although some high-profile co-investment failures (such as TXU Energy) are depicted in the database, other lower-profile, unsuccessful co-investment deals may not be included.

TABLE 5 **Co-investment private equity performance**

	Traditional PE investments	Co-investments	All
<b>Mean buyout PME</b>	1.70	1.76*	1.70
<b>Mean venture capital PME</b>	1.37	1.25*	1.36

**Notes:** \*Not statistically different from PME of traditional PE investments

**Source:** Braun, Jenkinson and Schemmerl, 2017

Finally, using novel and very high-quality data from State Street Corporation, very recent research<sup>46</sup> documents for the first time several key facts about the growth of co-investments and other alternative vehicles over the last four decades. These questions are examined using a data set of investment vehicles organized by private capital funds but invested in by 108 asset owners, for whom State Street Corporation acts as a custodian. This includes private capital funds that specialize in buyouts, growth capital, venture capital and private debt. Together, they represent half a trillion dollars of commitments and 20,000 investments. The following findings stand out.

First, the analysis shows how pervasive such vehicles have been. Growing from a tiny share of investment dollars in the 1980s and 1990s, co-investments and other alternative vehicles reached almost 40% of all capital raised in private equity by 2017. This was particularly the case for buyout firms, which raised more capital in alternative vehicles relative to other groups.

The paper also finds that performance across all LPs in alternative vehicle investments varies. LPs with better past performance of portfolios across all prior PE investments had above-average market performance, often even when outperforming the main fund of the GP sponsoring them. Alternative vehicles with lower performance were associated with those LPs with worse past performance.

This pattern, in part, is due to differences in access: investing with transactions associated with top-tier GPs is twice as common for top-tier LPs than those associated with lower-performing GPs. Contrastingly, transactions by lower-tier LPs were more balanced than those of lower-tier and top-tier GPs. Nevertheless, alternative vehicles still perform better than the bulk of funds in the low-tier LPs PE portfolios. It makes sense for these LPs to continue to invest in alternative vehicles of the top GPs when they get a chance, even if they underperform the main funds.<sup>47</sup>

With all of these studies considered, it raises the question of why GPs use co-investments and other such vehicles instead of negotiating a different fee and carrying arrangements with LPs with whom they wish to cultivate a deep relationship. Due to several unique structural features of the private equity industry, the use of alternative vehicles is desirable for GPs:

- First and foremost, the consequences of underperformance in alternative vehicles for GPs are much lower than the typical approach of assessing performance on main funds. Minor performance differentials in the main fund influence the ability to raise future funds. There is much less visibility about the performance of alternative vehicles, as the major data vendors such as Burgiss and Preqin do not gather systematic data.

- LPs in the main fund may also prefer private equity groups to offer different products to different investors rather than increasing the size of the main fund.
- LPs may prefer having a consistent set of peer LPs to invest with rather than opening up the main fund to less experienced, lower-tier investors who, in an economic downturn, may be more likely to experience liquidity shocks.
- There is a prevailing tradition of LPs not treating major investors differently, referred to as the “most favoured nation” clause. This dictates that economic and other treatment must be equal for all LPs who make similar-sized commitments in the main fund. Disturbing this equilibrium might be prohibitively difficult for GPs, especially in the main funds.

## BOX 2 **Lessons for limited partners**

While there is still much to learn about co-investments, lessons for LPs so far include:

- Avoid concentration of co-investments at market peaks. Use analytical tools to make co-investments steadily as they can help monitor the “market temperature”.
- Avoid the transactions where private equity funds might be “punching above their weight”, for instance, investing in larger transactions than they might typically invest in.

- Knowledge of the markets and geographics in which an LP invests is associated with improved performance for LP co-investments.
- Consider using additional ways, such as separate accounts, to reduce the fees being paid to GPs.

# Responsibility: the new paradigm for value creation

There is increasing demand for sustainability to be incorporated into investment processes.

As sustainability considerations move from the strategic periphery to the centre, businesses worldwide are shifting. Private equity is not immune to this, and recent years have seen considerable pressures on GPs regarding the consequences of their investments. This has translated to demands for more comprehensive reporting on investments' environmental and social impact and efforts to incorporate these goals into investing. These trends reflect pressures that endowments and public pensions, as well as other LPs, have been under themselves.

Away from the spotlight of public markets, however, how adept are private markets at responding to the sustainability agenda? Some argue that private markets are a natural home for such strategies. The governance agility afforded to private equity means GPs (and, in some cases, LPs) can directly execute strategies that investors believe could help create value over the long term. With a genuine push from LPs and other stakeholders towards this, it seems the time is right for progress.

Despite this, there remains significant variation in where GPs and LPs are starting and where they aspire to get to when it comes to sustainability and responsible investment. As this topic has been a focus of the industry, set out below are two areas of further exploration to build out the topic:

## 1. How does sustainability create value in private equity?

Sustainability and ESG have historically been considered part of a private market investor's risk management strategy. Increasingly, it is being considered a fundamental driver of value creation. Although it remains challenging to measure the realized premiums in private markets (considering sectoral dimensions), this is worthy of further consideration.<sup>48</sup>

Further exploration could also be undertaken to understand the variation in strategies and approaches employed by GPs in embedding sustainability into investment processes and how this corresponds to profit and loss and valuation premiums at exit.

## 2. How important is measurement comparability regarding ESG and sustainability?

To date, much of the focus on ESG in private markets has centred on standardization of measurement, mirroring the debate in the public markets. It is the most frequently cited obstacle to progress on the sustainability agenda. There are undoubtedly efficiency gains to be made within the reporting framework between GPs and LPs. For example, standardizing a set of metrics would improve comparability for both GPs and LPs as they assess ESG progress across portfolios. Standardization would also streamline the reporting process for GPs, as they work to respond to the many requests of LPs.

Industry efforts to work on this have focused on this problem statement, with the establishment of a collaborative ESG data reporting system. There have been important innovations in the academic literature, measuring aggregate impacts relative to peers in the same sector and of the same type,<sup>49</sup> as well as in industry studies,<sup>50</sup> which the industry could benefit from emulating.

Focusing on data alone will not solve the responsibility equation for private markets. For that, further analysis is needed holistically at the full investment process.

# Conclusion

This discourse has highlighted several areas that are the subject of intense academic and practical interest. As discussed in the report, many open issues for future exploration remain. These include many questions related to returns, such as the best approaches to risk- and illiquidity-adjusting returns. What are the reasons for the decline in the persistence of performance? The changing relationships between LPs and GPs pose many issues, particularly in the case of secondary transactions and the sale of GP interests.

Most questions surround responsibility. Some of these relate to the consequences of traditional buyouts. Others relate to adopting ESG principles in the industry. For example, does ESG create value in

private equity? And how is the relationship between ESG performance and financial performance expected to evolve?

Much is also currently unknown about the varying strategies that are being employed by GPs and LPs when it comes to fully integrating ESG considerations into their investment processes and businesses. This includes, for example, changes in investment strategies and organizational shifts for both LPs and GPs regarding their culture, incentive structures and other processes. There remains a lot that can be learnt from industry peer-learning on the conditions needed to progress and the results. This remains an area for future exploration that the World Economic Forum will delve deeper into in the coming months.



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# Endnotes

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