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LF7 Capital Idea Lab

Private equity for the private investor

In partnership with

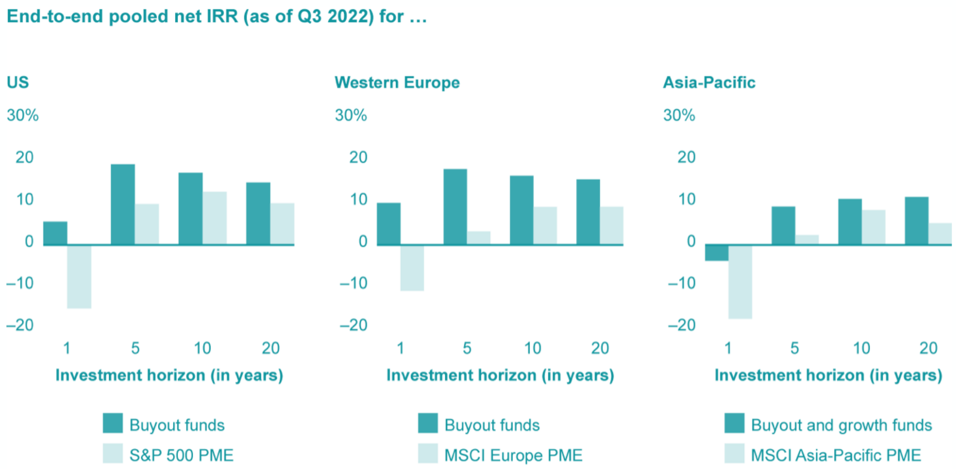
Provalinvest

In our first edition of LF7 Capital Ideal Lab, we presented ideas to help wealth managers create performance in inflationary times through financial and technological innovation. In particular we outlined a way to beat the equity downturn with innovative private equity solutions.

Beating the equity downturn in 2022

We showed a chart to highlight that except in very bullish markets, private equity offers significant upside to listed markets. Below are other illustrations of our statement.

Buyout funds generate higher returns than listed equities

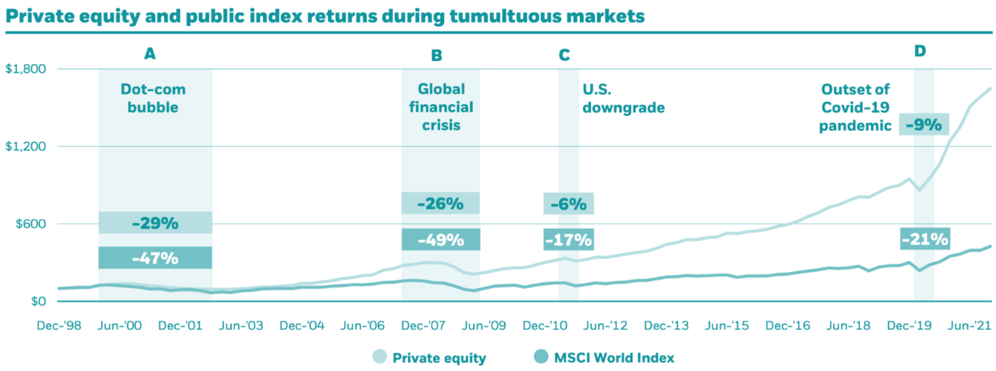


Source: Burgiss; Bain & Company

If we look at it a little deeper through the prism of 2022, the S&P and MSCI Europe took a significant beating, whilst PE valuations held rather well in comparison, using the latest industry-wide data available (as of November 2022).

This held true in previous downturns too.

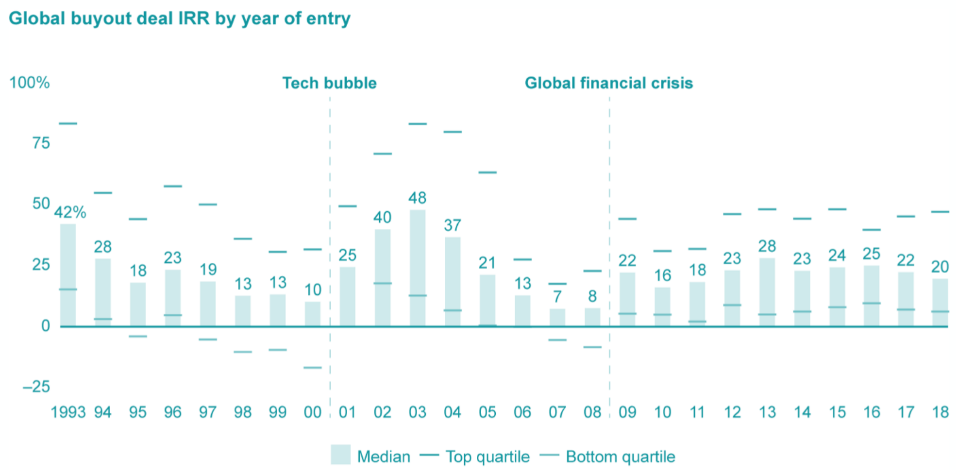
In a downturn such as 2022, private equity outperforms



Source: Blackstone; Burgiss, and MSCI World total return index for public equities. Private Equity data sourced from Burgiss covers vintages 1999-2019 as of 31 December 2021. Private equity strategies include Buyout, VC (Late), VC (Generalist), and Expansion Capital.

But what happens after a drawdown ? How about timing ? Is now the time to invest ? The common theme with the last major downturns (tech bubble in 2000 and GFC in 2008) is that years prior to an equity drawdown underperform whereas investing in the years after the drawdown generate superior returns over time.

Vintages after a downturn for the best returns



Source : DealEdge; Bain analysis as of December 2022

A market for institutional investors?

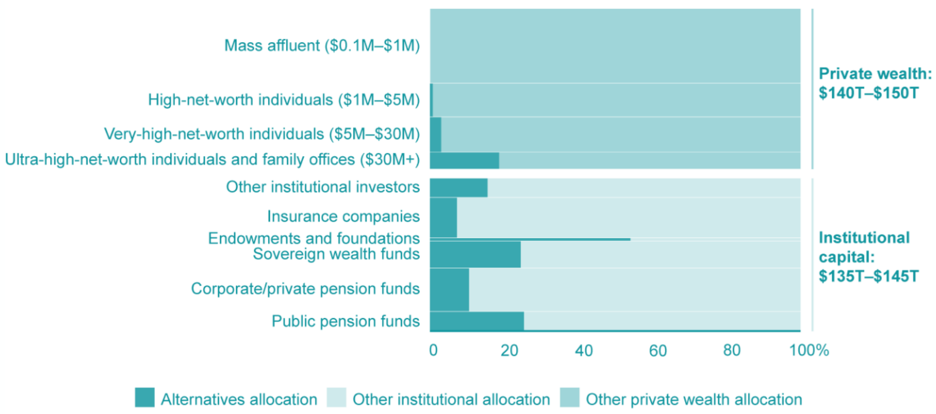
We just highlighted the performance benefits of private equity markets. Yet, individual investors hold a relatively small share of the $11.7 trillion market. Individual investors, including Ultra High Net Worth and Family Offices account for about half of all global AUM. However their share of private markets AUM is significantly smaller.

The goal of our Ideal Lab #3 at LF7 Capital is to understand why.

Private wealth is as large as institutional capital

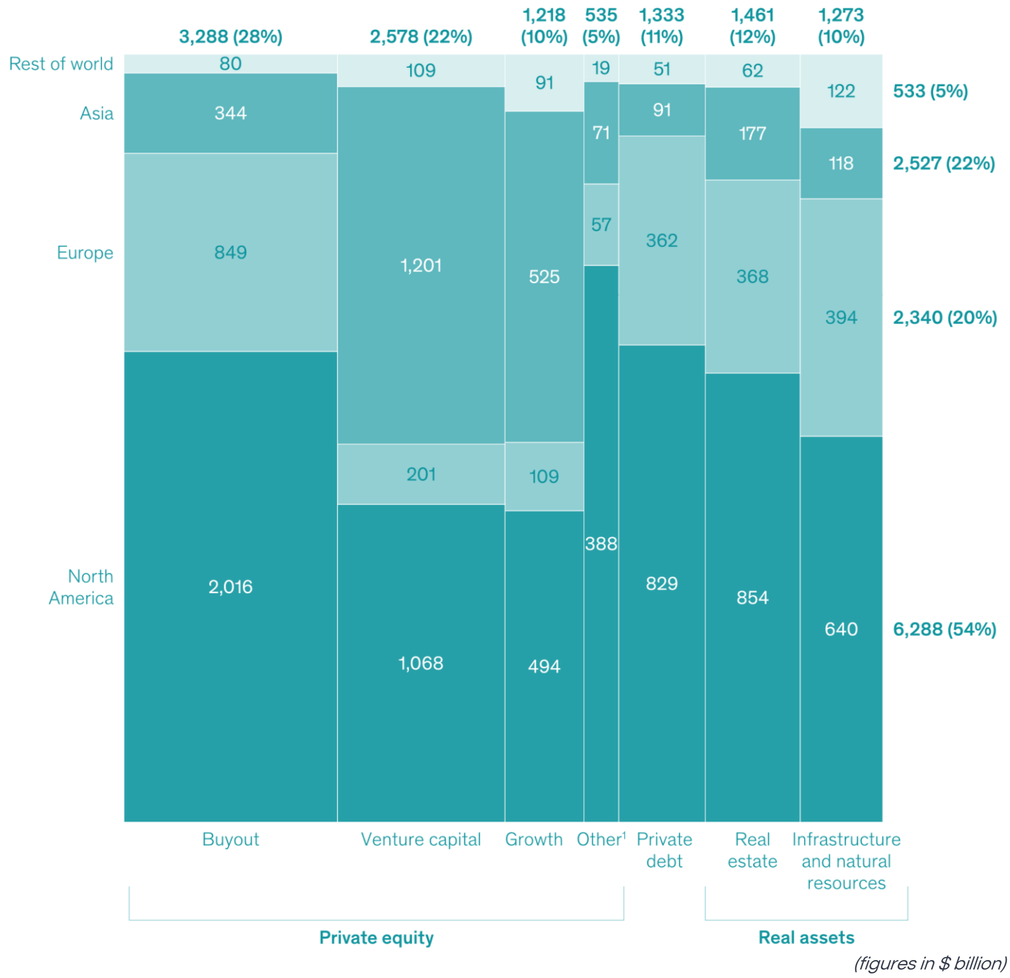
Just not in private markets

Global wealth by investor type, 2022



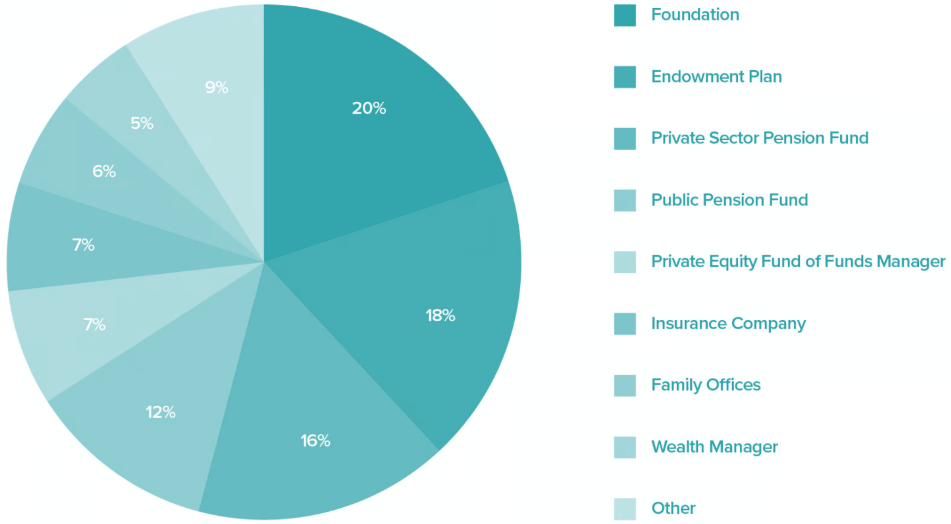
Source: Preqin; GlobalData; Bain analysis

Private markets AUM totaled $11.7 trillion in H1 2022



Source: Preqin; Mc Kinsey & Company

Breakdown of Investors in Buyout Funds by Firm Type



Source: Preqin Investor Intelligence ; Toptal.com

Private wealth clients are becoming a key target for private markets

Achieving Diversification

As we can see in the charts above, private investors allocate a small portion of their wealth to alternatives and private equity. The smaller their net worth, the smaller their allocation. One of the most important factors for this low allocation is the difficulty of achieving a reasonable level of diversification.

It is nearly impossible for clients up to "Very High Net Worth", i.e., with assets of up to $30 million, to invest in large primary funds. Why?

For large primary funds, the traditional ticket size is $ 5 to 10 million.

So even if a $30 million private client were to allocate 20% of his assets into PE (which, as we see in the charts, is far from being the case), it would equate at most to $6 million. At best 1 investment into 1 large primary fund.

Zero diversification. And that is where the problem lies. What are the options to achieve the required diversification?

Diversification is a key challenge for private investors

- Building a team of analysts who will conduct due diligence and select the best managers. Using the same numbers as above, that means allocating a minimum of $ 30 to 50 million to PE every year. Which we believe is at least $ 200 million over a period of 6 to 10 years and therefore is reserved to large family offices or External Asset Mangers / private banks.

- Outsourcing the work to a dedicated entity such as a large private bank or digital platforms such as Moonfare or Titan Bay in Europe, iCapital in the US. They offer access to large funds in smaller sizes. But this comes at a significant cost. More on that later.

- Invest in a secondaries fund. Secondaries offer an attractive risk return balance for investors looking to invest in the PE sector.

Diversification through a secondaries fund

Secondaries are an easy way to diversify your PE portfolio

Diversification of the portfolio is critical to mitigate the risk of external events potentially affecting the fund's global performance. The diversification is built along several dimensions:

- Industries
- Geographies
- Fund managers
- Funds
- Funds' vintages

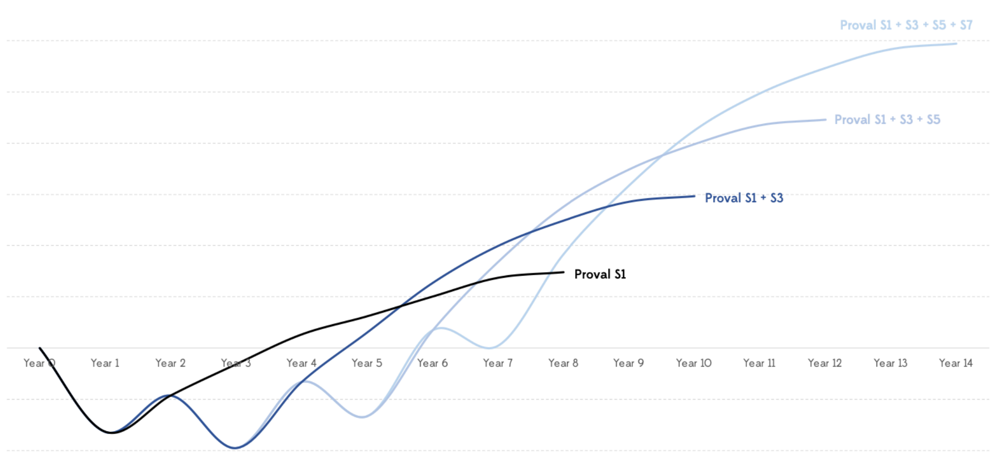
A secondaries fund such as Proval*invest* has formal restrictions that ensure minimum diversification:

- *No more than 40% of commitments to be invested in funds managed by a single manager*
- *No more than 20% of commitments to be invested in any single fund*

It is envisioned that at the end of its 1 year investment period, the € 75 million fund should have investments in **50 to 80 underlying companies**, located in 6 to 10 funds, themselves managed by 4 to 7 independent managers. The underlying companies should be operating in more than 10 independent industries across Europe.

The graph below illustrates the J-curve of a Proval fund (actual cash flows of the portfolio previously invested by Proval*invest* partners) as well as the compounded curves illustrating respectively a commitment in Proval S1 whose distributions are recycled to finance a commitment of the same size in Proval S3 (Proval S1+S3) and a commitment in Proval S1 whose distributions are recycled to finance a commitment of the same size in Proval S3 and then in Proval S5 (Proval S1+S3+S5), etc. Proval*invest* raises and invests a new fund every year.

Proval funds – compounded return



	Proval Funds			
	S1	S1 + S3	S1 + S3 + S5	S1 + S3 + S5 + S7
ROI	1.83x	n/a	n/a	n/a
Peak ROI	**1.91x**	**2.52x**	**3.28x**	**4.04x**
IRR	21%	21%	21%	21%
Breakeven	Year 4	Year 5	Year 6	Year 6
Duration	7 years	10 years	12 years	14 years

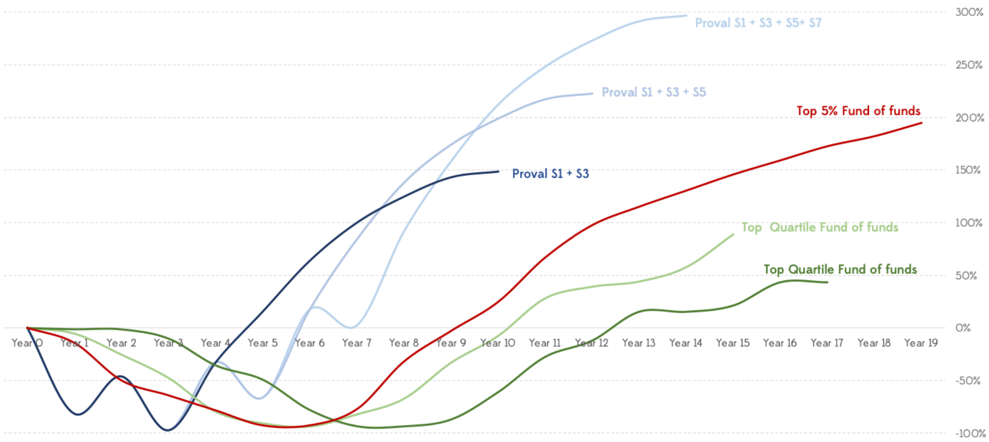
Access to the best managers through a fund of funds

Apart from investing in secondaries, smaller investors are left with one other choice: investing in a fund of funds.

This is often the solution offered by private banks. Some of the key advantages is that they allow private bank clients to access prestigious primary funds, showcase the bank's ability to construct products and select best in class solutions.
We will come back later to the topic of fees because fees are also relevant to secondaries.

Whilst a fund of funds gives access to best in class in managers and achieves diversification, the main drawback is that it increases duration as illustrated in the chart below. We have chosen some of the best fund of funds in the industry and compared their performance to that of our partner Proval*invest*. Peak ROIs can be very similar to Proval*invest*, but IRR is different due to mostly one factor: the shape of the J curve. For a similar risk / reward, it simply takes much longer for a fund of funds to return cash.

Proval vs Fund of Funds



Fund of funds have the longest J-curve

	Proval funds			Top Quartile Fund of funds	Top Quartile Fund of funds	Top 5% Fund of funds
	S1 + S3	S1 + S3 + S5	S1 + S3 + S5 + S7			
ROI	n/a	n/a	n/a	1.65x	1.31x	3.10x
Peak ROI	**2.52x**	**3.28x**	**4.04x**	**1.95x**	**1.46x**	**3.10x**
IRR	21%	21%	21%	9.4%	5.6%	14.5%
Breakeven	Year 5	Year 6	Year 6	Year 11	Year 13	Year 10
Duration	10 years	12 years	14 years	15 years	16 years	19 years

Fees and their impact on performance

	Proval*invest*	Secondaries	LBO funds	Fund of Funds
Management fees & Carry				
Overlying GP	1.25% & 12.5%	1.25% & 12.5%	2.0% & 20%	0.8% & up to 5%
Underlying funds	n/a (*)	n/a (*)	n/a	2% & 20%
Cumulative management fees (**)	7%	app. 12%	app. 18%	app. 30%

The shorter the better. Even more so for fees

It is always difficult to make a short comparison of fees as they vary considerably between managers and over time. They even vary depending on the size of the investment within the same fund.

But there is one very clear takeaway: fees have a lot more impact when capital is not called. The longer it takes to invest and return cash, the higher the fees will be. The impact on IRR even more so.

Reducing J curves and fund duration

In the traditional PE fund model (blind pool commitments, 5-year investment period, 10-year term), primary and secondaries funds present similar limitations:

- Slow capital deployment, blind pool commitment
- Undrawn capital locked in during the investment period and beyond, with LPs not able to reallocate it to other investments

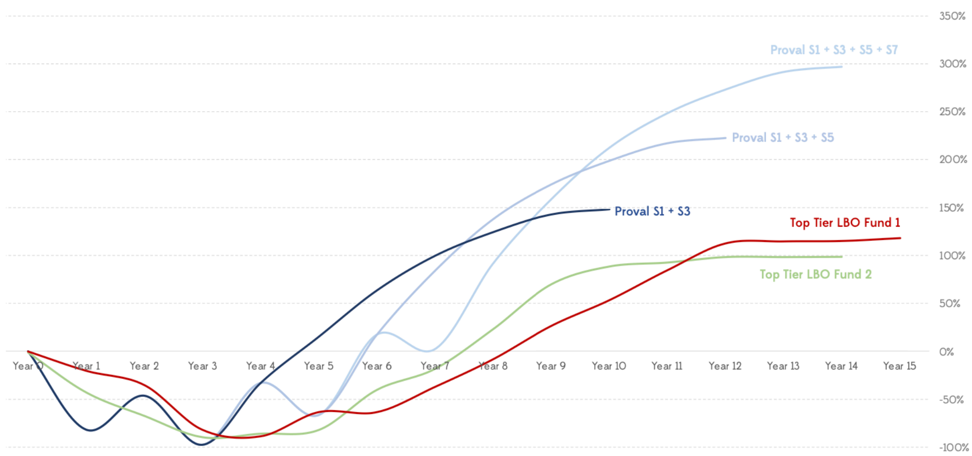
Financial innovation is necessary to shorten the J curve and deploy capital as quickly as possible:

- Investing within one year
- Efficient deployment of committed capital
- Overall amount of fees paid throughout lifetime of fund significantly reduced
- Undrawn capital unlikely to be called can be identified at the end of the short investment period and reallocated by LPs

This is very well illustrated in comparing best-in-class primary funds with Proval*invest*

Putting capital at work within a year

Proval vs LBO Funds



	Proval funds				Top Tier LBO Fund 2	Top Tier LBO Fund 1
	S1	S1 + S3	S1 + S3 + S5	S1 + S3 + S5 + S7		
ROI	1.83x	n/a	n/a	n/a	2.03x	1.95x
Peak ROI	**1.91x**	**2.52x**	**3.28x**	**4.04x**	**2.13x**	**2.32x**
IRR	21%	21%	21%	21%	13%	14%
Breakeven	Year 4	Year 5	Year 6	Year 6	Year 7	Year 8
Duration	7 years	10 years	12 years	14 years	14 years	15 years

Because size matters

As the secondaries market evolved from a few billion in 2001 to 140 billion in 2022, the duration and J curves of the large funds have become very similar to those of primary funds. Just look at the terms offered: they are identical in most cases. The main cause is simple: it takes time to deploy large amounts of capital, regardless of the strategy. Hence the need to keep the funds small.

Not something the larger secondaries (or primary funds) are keen to do because size matters to their bottom line. Unfortunately, the opposite is true for the investor.

There is another very important consequence of keeping a fund small: it allows for a "Cherry picking" strategy based on multiple considerations such as fund's strategy, vintage, performance, geography, and GP quality.

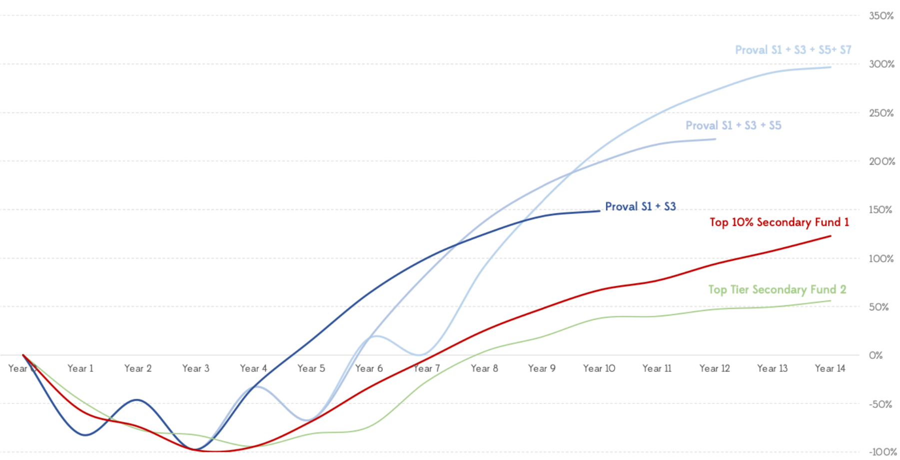
The large secondaries funds conduct statistical and probability-based analysis at portfolio level but not at company level. It is sufficient and an optimized use of resources. But investing in a fund that conducts due diligence and runs financial models at company level is unique. And an amazing source of co-invest opportunities.

Think of it as Ferrari compared to BMW or Patek Philippe vs Rolex in terms of production numbers. Both great brands in their industry. Just a different business model.

We can illustrate this with a performance comparison between (excellent) large secondaries funds and the smaller Proval*invest*

J curves of secondaries have become like primary funds

Proval vs Secondary Funds



	Proval funds				Top 10% Secondary Fund 1	Top Tier Secondary Fund 2
	S1	S1 + S3	S1 + S3 + S5	S1 + S3 + S5 + S7		
ROI	1.83x	n/a	n/a	n/a	1.57x	1.38x
Peak ROI	**1.91x**	**2.52x**	**3.28x**	**4.04x**	**2.25x**	**1.59x**
IRR	21%	21%	21%	21%	13.3%	8.0%
Breakeven	Year 4	Year 5	Year 6	Year 6	Year 7	Year 8
Duration	7 years	10 years	12 years	14 years	14 years	14 years

In summary

With financial innovation, our partner Proval*invest* designed the best solution for private wealth investors:

- Top tier returns
- Shortest possible investment period @ 12 months
- Resulting in the shortest J curve
- Reducing the impact of fees to the minimum
- With optimal diversification
- And a very low level of risk for the asset class
- Offering co-invest opportunities

In the next edition of the Idea Lab, we will look at opportunities in the real estate sector.

In the meantime, get in touch to know more about the investment solutions mentioned in Idea Lab #3.

LF7 Capital

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