Private equity: Assessing its role in a nonprofit portfolio

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Executive summary

- Private equity (PE) continues to be an alluring asset class for nonprofits attracted to its promise of higher returns and low correlations to traditional assets. While it can potentially have a place in the portfolio, PE imposes a very long time horizon and considerably higher costs and complexity.
- Given the sizable up-front investment and long periods of zero or negative returns, investment committee members and stakeholders are advised to undertake exceptional due diligence to find a trustworthy partner who is fully aligned with them philosophically. A tolerance for volatility, realistic expectations, and a solid understanding of the investment and its cash commitments are key to successful PE investing.

Introduction

Nonprofit endowments and foundations were early adopters of private equity (PE). While the earliest investors were large university endowments such as Yale, PE has cemented its place in the nonprofit investing landscape broadly to include other institutions, large and small.

As adoption has risen, so have allocations to PE in portfolios. According to a Cogent survey (below), more nonprofits wanted to increase their allocations to PE than to any other asset class. About 48% of nonprofits with $100 million or more in assets under management (AUM) cite their intention to increase their allocation to PE over the next three years. An even more impressive 74% of endowments said the same.

Figure 1.

		AUM				Category		
	Total	$100M–<$250M	$250M–<$500M	$500M–<$1B	$1B+	Endowment	Foundation	Tax-exempt organizations
U.S. equities–Active	17%	14%	13%	38%	13%	18%	17%	16%
U.S. equities–Passive	18%	13%	21%	24%	28%	19%	21%	15%
International equities–Active	23%	19%	13%	37%	45%	14%	17%	36%
International equities–Passive	21%	23%	29%	10%	5%	18%	12%	30%
U.S. fixed income–Active	25%	18%	34%	35%	29%	6%	29%	38%
U.S. fixed income–Passive	14%	8%	23%	16%	21%	7%	7%	26%
International fixed income–Active	13%	13%	12%	18%	11%	1%	20%	18%
International fixed income–Passive	10%	7%	12%	13%	11%	2%	7%	18%
Alternatives	29%	29%	34%	20%	27%	17%	17%	49%
Private equity	48%	41%	53%	50%	65%	74%	42%	31%
Real estate/REITS	16%	13%	19%	17%	21%	14%	21%	12%
Real assets/Commodities	20%	13%	24%	29%	29%	8%	28%	23%
Cash/Cash equivalents	4%	1%	3%	17%	4%	1%	10%	2%
Other asset categories	7%	7%	2%	10%	14%	13%	7%	3%

Source: Cogent, *US Institutional Investor Brandscape*, 2019.

LOW — HIGH

KEY: ≤15% | 16% to 30% | 31% to 45% | 46% to 50% | ≥60%

But PE has its challenges, including limited access for most nonprofits and risks, complexity, and time horizons that require a different kind of mind-set for committee members.

PE requires more than just a willingness to take on risk. It requires the ability to truly think long-term, a willingness to embrace illiquidity and less transparency, the discipline to remain committed to a strategy, and the understanding that performance outcomes will vary considerably.

Given the added complexities of PE, how do nonprofit committees decide if this asset class has a place in their portfolio?

This paper provides context and considerations for nonprofit committees that are exploring if PE is right for their organization. And, if the committee does decide to move forward, the paper provides guidelines for successful PE investing.

Components of successful PE investing

The components of successful PE investing are similar to those of active investing in general, though PE has unique attributes that require special attention.

Philosophical alignment

For investors considering PE as a strategic and long-term investment, it's important that you invest with or be advised by organizations and individuals strongly aligned in interests and values with you, your stakeholders, and your organization.

Ensure that your committee is aligned philosophically with your PE asset manager and/or outsourced chief investment officer (OCIO). You should share a set of beliefs and principles that guide your investment decision-making process.

In the case of PE investing, alignment includes shared views on the potential of PE investing, its role in your portfolio, and how you view the risks, volatility, and extended time horizon that come with PE. In addition, ensure that you and your asset manager/OCIO/consultant share similar views when it comes to handling performance uncertainty, less transparency into your assets, and long-term illiquidity.

Ensure that your partner is qualified and has your organization's best interests in mind when recommending PE. Do they have the experience and expertise to evaluate PE? Can they clearly articulate their strategies and the true risk/return characteristics of PE in the context of the total portfolio?

Do your partners stand to gain more in fees when recommending PE? It's sensible to charge higher fees, but it may also present a potential conflict of interest. Another potential conflict of interest is the time horizon for PE and "locking in" a client for the long run by recommending an investment with a time horizon of ten years or more.

Top-tier talent

Finding talented investment managers is hard, and perhaps even more difficult when scouting PE managers. Best-in-class PE general partners (GPs) tend to seek investors with deep pockets who can commit to funding their strategies over the long run, which can limit access for the vast majority of investors. GPs often seek investors with connections and a vast network that can aid in raising even more capital.

Success breeds success, but that has its downside. When a manager achieves superior performance, they attract more assets, which may hamper their ability to deploy capital effectively, possibly dampening returns. When evaluating talent, it is important to determine if the manager is raising too much capital given their strategies.

On a similar note, the same successful manager who attracts more assets may choose to limit investments and only partner with select investors. Limiting investments shows discipline, but it also restricts access to most investors, as these top-tier managers can well afford to be very selective in their partners.

Furthermore, with estimated and subjective asset valuations, the lack of objective robust benchmarks, less transparency, and extended time horizons, evaluating performance is a more taxing and less precise exercise.

When evaluating a GP, be sure to include a deep-dive analysis into the people (partners and staff), process (how they expect to add value, etc.), philosophy (investment beliefs, organization's values, etc.), and performance (incentives appropriately aligned with investors). Culture and communications should also be scrutinized. Are they open and willing to talk and answer questions? Are they willing to be transparent about successes and failures? This is especially important in the PE space, where there is a great deal of "good faith" built into the equation. You will depend on partners who are open and honest in their communication style. Your auditors will demand the same.

Liquidity constraints/Time horizon

PE requires a heavy initial and ongoing capital commitment. Investing in PE can be lumpy, with committed capital being called with irregular frequency.

Before committing to PE investing, nonprofits need to perform extensive due diligence with their committee and partners in the finance office. Not all committees and organizations can withstand the illiquidity and time horizon inherent to PE investing. Your organization must be comfortable with PE, from an investment perspective and operationally, as well as over extended time periods, including potentially during periods of market stress. As a result, your portfolio's liquid assets will be accessed to meet your organization's spending needs, which may require further asset allocation changes.

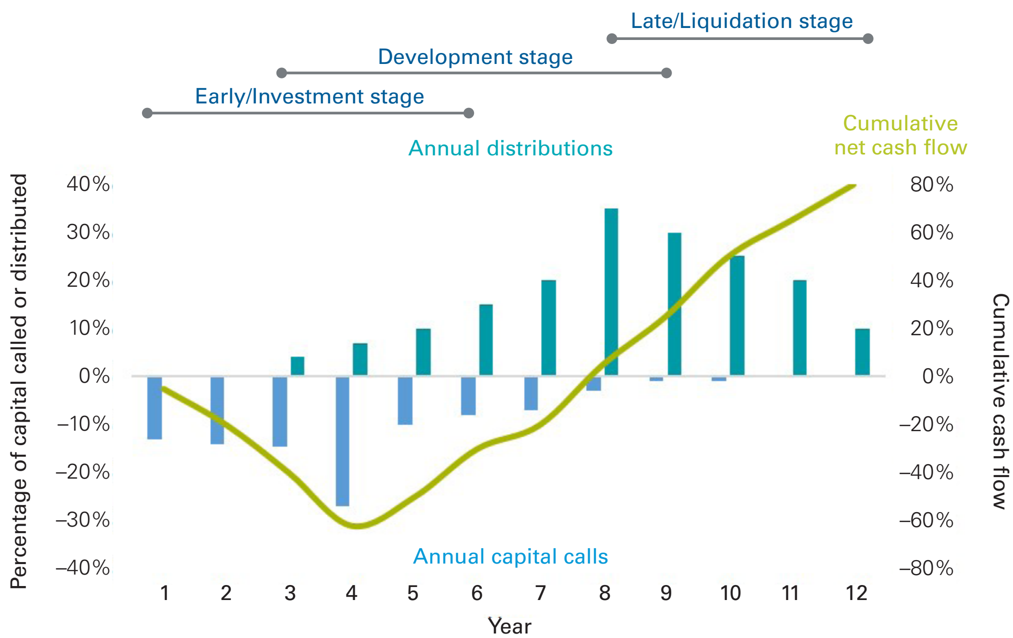
Though you can exit PE investments in the secondary market, this should not be viewed as optimal or as a fail-safe. All decision-makers—committee members, board members, and others—should be comfortable with the investment and in agreement before making the commitment. Unwinding a PE position can be a lengthy and costly process.

A clear understanding of the investment

PE involves a variety of strategies, each with its own risk/reward profile. Committees should be well versed on the types of strategies their GP is deploying and mindful of future obligations. GPs tend to seek out those who view themselves as a long-term investor in the program and can commit to future funding, or capital calls.

Figure 2. Illustration of PE cash flows

Single PE partnership



Early/Investment stage (years 1–6)

- Capital commitments are called from limited partner at partnership's closing.
- Investments are made in portfolio companies and generally are made through year 6.
- Capital is called to fund investments as needed.
- Investment fees are collected up-front.

Development stage (years 3–9)

- Manager aims to add value to portfolio companies.
- Additional investments are made.
- Initial investments start to mature.
- Mature investments are exited.
- Cash distributions are paid to investors.

Late/Liquidation stage (years 8–12)

- Many investments have been exited.
- Several investments are left to wind down.
- Some provisions may be made to extend, usually in one- to two-year increments up to a maximum of four years.

Source: Vanguard.

Comfort with less transparency, estimated asset valuations, and a prolonged road to rewards

PE generally comes with volatility, less transparency, and a prolonged road to realizing returns and rewards. This is not a negative, per se, but does require a different mind-set than investing in a diverse portfolio of publicly traded equities.

As seen in Figure 2, the "J curve" represents the prolonged period of losses or flat returns upon initial investment and then a turnaround, in this illustration, late in year 6. While cash flows will certainly vary from investment to investment, it is not unusual for investments to start paying back or turning a profit in year 5 or 6, or even later (and, in some cases, never). In an analysis performed by Cambridge Associates in 2016, the average breakeven point for global PE funds of vintage years 1986–2013 was at around the 8-year mark.[1] Not only are there likely to be negative returns in the early years of the fund, but early capital calls result in cash leaving securities that report a return daily and moving to investments that may not show a return for years down the line.

Figure 3.

The upside and downside of PE investing

Upside

- Potential for outsized returns relative to public equities.
- Possible diversification benefits when added to a portfolio of traditional asset classes.
- Large potential market—ratio of private to public is increasing over time in terms of market capitalization.
- Private companies staying private longer, potentially extending the life and return potential of the investment.

Downside

- High, complicated fees.
- Illiquid.
- Higher volatility than conventional broad-based investments.
- Limited access to top talent.
- Lack of objective, robust benchmarks.
- Lack of transparency—blind pools and lack of control leads to reliance on general partners.
- Subjective valuations.
- Demand for PE driving up current valuations, extending the time horizon needed to achieve desired returns for new investors.

[1] Compiled using cash-flow data from Cambridge Associates' database as of June 30, 2016. Funds formed after 2013 are too young to be analyzed and were excluded.

Is it right for your organization?

Given all of these factors, how do you know when—and if—PE is right for your organization?

There are eight questions for you and your committee and stakeholders to consider. These questions go hand in hand with the keys to successful PE investing:

1 Does your organization have a performance requirement that can't be achieved with a traditional portfolio?

Given the risk, uncertainty, and illiquidity, it is reasonable to exclude PE from portfolios that can achieve desired results with a portfolio of traditional asset classes.

If your performance requirement is not achievable with a traditional portfolio, it may be reasonable to consider allocating a portion of your portfolio to PE.

2 Do you, your committee, and all stakeholders have a strong preference for PE investing? And, if yes, will this collective group be intact over the long run?

Successful PE investing generally involves a very long time horizon and sustained periods of zero or negative performance. As such, PE investing is best suited for nonprofits with low turnover in their committees, boards, and stakeholders. They are more likely to maintain perspective and reflect back on the rationale to invest in PE. New stakeholders may not share that same commitment to PE, forcing an organization to unwind its PE position—which takes time and comes with a high price tag.

3 Are you, your committee, and stakeholders prepared for the J-curve effect—having negative returns over multiple years before ever seeing a profit?

Not only will your assets be "locked up," your PE assets will likely report negative returns in the early years of the commitment—five or six years, perhaps even longer. Adding PE to a portfolio of traditional assets will change how you and your committee evaluate your portfolio's performance and the timeline by which you evaluate the overall effectiveness of your asset allocation and performance.

Even well-diversified programs investing in a range of vintage-year opportunities may see negative returns year over year.

It's not a bad thing per se—it's the natural life cycle of PE-type investments. Committees and stakeholders must be ready to commit to a lengthy timeline before realizing the performance expectation going into the arrangement. And there's the possibility that those expected returns may never be realized.

4 Do you, your committee, and stakeholders have the tolerance for illiquidity over the long run? Ten or more years? During periods of market stress?

Of course, stakeholders who invest in PE initially feel the asset class will have a positive impact on the portfolio and the mission. However, it is hard to tell what anyone will do or feel in a situation in which they've never been. This is complicated further when considering the dynamics within a group instead of a single individual.

To pressure-test decision-makers and stakeholders, consider "what-if" exercises that test the resolve of your stakeholders. A scenario much like late 2008 into 2009 may be a reasonable starting point.

5 Are you and your stakeholders comfortable and prepared for the relatively costly and complicated due diligence that comes with PE?

With the complexity, lack of transparency, fuzzy valuations and timelines, and high and complicated costs, due diligence will require considerably more time and resources—including auditing and other fees that will inevitably rise with the addition of alternative asset classes such as PE.

Ensure your committee and stakeholders are aware of the time and the soft and hard dollars that will be required to choose, assess, and validate an investment in PE.

6 Can your organization manage the operational complexity and its impact on other functions?

With PE comes operational and reporting complexity not seen with traditional asset classes. Two such examples are unaffiliated business income taxes (UBITs) and K-1 (Form 1065) filings; both add to the operational burden and will likely delay your tax filings and financial reporting to your constituents. The delay in reporting, in turn, may further add to your operational burden, as stakeholders may demand additional preliminary reporting.

Ensure that your committee, constituents, and stakeholders are aware of these operational demands of PE investing and that they are committed to engaging the resources necessary to follow through on these additional requirements.

7 Are you and your stakeholders comfortable with the nature and magnitude of fees?

There are two things that ring true about the costs of investing in PE: The fees are difficult to understand . . . and they are high. However, given the complexity of the asset class, the broad range of strategies and deals, the need for top talent, and exceptionally long time horizon, it's not especially surprising.

Typical fees are shown below in Figure 4 but will vary.

Figure 4.

Fees	Direct funds
Management fees These fees are based on committed capital (i.e., not employed capital).	Approximately 1.5%–2.0.%.
Performance fees Also known as "carried interest," these fees are assessed once a predetermined return (or "hurdle rate") is achieved for investors.	Approximately 20% of profits once the hurdle rate is achieved.

Source: Vanguard.

Despite this, it is important that you and your stakeholders are comfortable with:

- The vague nature of the fees and how they are broken down—or not, in some cases.
- High fees demanded by GPs, especially those with strong track records.
- High fees up-front and over long periods of time without a return on your investment—or even sustaining steep losses during that period.

In many cases, fees are taken at the inception of the investment—before the assets are deployed/invested and long before any investment returns are realized. Fees, deployment of capital, and lengthy time horizons all contribute to the J-curve effect of PE investing. It's important that committees and stakeholders have a solid understanding of the magnitude and timing of fees and how they impact performance returns, especially in the early years of the investment. They also need the tolerance and perspective to sustain the ongoing investment over the long run, despite flat or negative returns.

8 Do you and your stakeholders have a partner you trust and with whom you are aligned philosophically?

It is absolutely crucial that you are philosophically aligned with your partner and have full confidence in their ability to guide you through the long journey that is PE investing. This is important for any investment and any partner. When it comes to PE investing, however, it is even more important, given the uncertainty and lack of transparency. Unlike the public markets, PE is nontransparent, valuations are fuzzy at times, there are long periods of zero or negative returns, and limited partners like you may pay high fees without a good understanding of how they are derived.

Having full alignment with your partner, knowing you share the same investment beliefs, and viewing risk-return trade-offs through the same lens will help you navigate the PE investing landscape with confidence.

Conclusion

PE investing continues to cement and grow its place in nonprofit portfolios. Given the challenges and complexities of the asset class, investment committee members and stakeholders are advised to undertake exceptional due diligence to find a partner they can trust and who is fully aligned with them philosophically. Successful PE investing has shown its ability to deliver performance above and beyond what can reasonably be achieved with a portfolio of traditional asset classes. That performance, however, comes with extreme volatility at times, prolonged time horizons, illiquidity, lack of transparency, high fees, and added layers of due diligence and operational complexity.

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