



**RICK SPENCER**  
HEAD OF FUNDS & CO-INVESTMENTS

## CONSTRUCTING AND MANAGING A PRIVATE EQUITY ALLOCATION

IN THIS Q&A, RICK SPENCER DISCUSSES THE POTENTIAL BENEFITS OF AN ALTERNATIVE INVESTMENT STRATEGY FOCUSED ON FUNDS AND CO-INVESTMENTS. IN PARTICULAR, RICK TOUCHES ON SOME OF THE CHALLENGES FACING INVESTORS IN THIS SPACE AND IDENTIFIES THE AREAS WHERE HIS TEAM IS SEEING OPPORTUNITIES.

### Can you tell us about the funds & co-investments group and how it fits into the Barings Alternative Investments platform?

Barings Alternative Investments manages over \$54 billion of client assets and consists of more than 450 professionals. The group seeks to find differentiated sources of return in global real estate, private equity and real assets through:

- A *Real Estate* group that offers a diverse range of investment opportunities across public and private debt and equity strategies
- A *Private Equity and Real Assets* group focused on actively managed and thematically driven control oriented asset-based equity investments that produce both current income and capital appreciation for investors
- A *Funds & Co-Investments* group that operates as a strategic partner to investors, addressing all private equity and real assets requirements through a solutions oriented platform focused on investments in third-party primary funds, secondary opportunities and equity co-investments

Barings' Funds & Co-Investments (FCI) business serves as a professional limited partner, investing across all major investment strategies of the private equity market—buyouts, growth, venture capital, infrastructure, natural resources and real estate. The FCI platform is focused on the construction and management of customized portfolio solutions that meet the diverse private equity goals and objectives of a range of investors including institutions, public and private pensions, foundations, endowments, family offices and high net worth individuals. Employing a high-touch, consultative approach to investor services and investment management, FCI works with investors to solve for a range of portfolio requirements and to provide targeted results, whether those investors are seeking assistance in building a portfolio from the ground up, adjusting or repositioning existing exposure or looking to target a specific area of the market where Barings offers access and expertise.

**AI** **BARINGS ALTERNATIVE INVESTMENTS**

**\$54+ BILLION**  
ASSETS UNDER MANAGEMENT  
**450+**  
PROFESSIONALS

#### REAL ESTATE

One of the largest global real estate managers, providing our clients with a diverse set of investment opportunities enhanced by local market insights and a cycle-tested perspective

#### PRIVATE EQUITY / REAL ASSETS

Concentrated, control ownership of actively-managed, thematically-driven asset-based investments that generate both current income and capital appreciation

#### FUNDS & CO-INVESTMENTS

Efficient, highly diversified delivery of the full spectrum of private equity and real asset risk premia with alpha generation through proprietary manager selection and sector and vintage rotation strategies

AS OF MARCH 31, 2018.

Since 1991, FCI has built a successful track record meeting the evolving goals and objectives of our clients through a global network of sponsor relationships and a comprehensive database of investment information. The private equity and real assets universe is large and growing, and navigating the landscape of sponsors, strategies, styles and geographies across fundraising cycles requires dedication and experience. Through our 27 years investing in these markets, FCI has built the capabilities to identify, source and underwrite sponsors capable of delivering superior performance in a market where investors are increasingly looking to private assets to meet their portfolio objectives.

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*“One aspect of private market investing that cannot be overlooked, regardless of an investor’s size and level of experience, is the importance of maintaining a consistent and disciplined approach to making new commitments.”*

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### **What are some of the overarching issues and challenges investors are facing in these markets today?**

Most investors participate in the private equity market for its potential to offer both absolute and relative long-term performance benefits versus the public equity markets, with most recognizing the limitations on liquidity and transparency.

At a high level, the current market environment for private assets is characterized by high valuations, easy access to credit and increasing investor demand for higher return alternatives. The universe of managers and investment strategies is also proliferating to the extent that, for an investor, identifying the nuances of various managers’ investment strategies and differentiating capabilities often requires a significant dedication of time and resources.

Additionally, as investors have looked to enhance overall returns and mitigate fees and expenses associated with their portfolios, demand for co-investments has grown, resulting in increased competition for access to highly coveted deal flow. In this environment, with demand outpacing supply, there is arguably an increased risk of adverse selection as investors stretch for incremental co-investment exposure.

From the manager perspective, there is a requirement for professional co-investors who are capable of underwriting and executing opportunities in abbreviated timeframes. Investors, in response to execution pressures, can experience a strain on resources and internal processes, impacting their overall ability to make sound investment decisions. Additionally, as investor allocations to co-investments grow, so does the risk profile of their portfolios as positions in individual companies become increasingly concentrated. As this occurs, proper portfolio management and risk mitigation techniques are required to avoid unintended consequences such as over-allocation to one sector, geography or macroeconomic factor.

## As you think about the different types of investors in this space, what are some of the more specific, or less understood, challenges materializing today?

When considering some of the less understood challenges in this space, investors generally fall into *one of two broad categories* based on sophistication, risk tolerance and the goals and objectives they are seeking to achieve:

- 1 Large institutions with ample experience investing in the private markets and established PE programs that represent a diverse range of holdings. These investors are typically looking for differentiated opportunities—often in the form of co-investments—or access to particular “niche” segments of the private equity market to which they may not have exposure, such as real assets, the lower middle market or emerging managers. In many of these niche areas, the funds and target assets are small, and the manager universe can vary widely in quality and experience.
- 2 Smaller institutions or investors that may not have an established private equity allocation or may have very narrow market exposure. In either case, whether looking to construct a portfolio from the ground up or develop more diversification, successful execution requires time and resources. Investors are faced with navigating an increasingly complex market in which numerous sponsors and strategies are looking to raise capital. While venture capital and buyouts still dominate the fundraising landscape, specialists have emerged across strategies, sectors and geographies.

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*“...manager selection is arguably the most significant contributor to investors’ ability to achieve their expected returns and long-term objectives.”*

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For smaller institutions, the challenge lies in understanding the broader market in order to determine the best investment opportunity for their particular risk and return requirements. The traditional fund-of-funds model was originally constructed to help institutions or investors gain access to private equity and provide manager selection expertise. Larger institutions, on the other hand, are facing the challenge of allocating large sums of capital in each opportunity while still trying to find attractive differentiated returns. Today, access and manager selection are only part of the service offerings required of investment managers as investors, large or small, are demanding better performance, thoughtful portfolio construction, greater customization and increased transparency in support of growing exposure to the asset class.

One aspect of private market investing that cannot be overlooked, regardless of an investor’s size and level of experience, is the importance of maintaining a consistent and disciplined approach to making new commitments. Given the structure of most fund opportunities—10-year terms with five-year investment periods—it can be difficult for investors to time market inflection points. Lock-up structures and multi-year investment periods require sponsors to potentially source, transact and operate companies through multiple economic cycles. To that end, manager selection is arguably the most significant contributor to investors’ ability to achieve their expected returns and long-term objectives.

Investors, as allocators of capital, must be willing to maintain consistent commitment levels to avoid adverse selection. In fact, during periods of economic weakness, disciplined adherence to commitment programs and prudent manager selection can be highly effective, as demonstrated by the strong vintage performances of 2008-2010.

## Where are you currently seeing opportunities in the funds and co-investments space?

At Barings, we have the advantage of investing across a broad spectrum of investment opportunities including primary funds, co-investments and secondaries across traditional private equity (buyouts, growth, venture capital) and real assets (infrastructure, natural resources). There are three areas of the market where we are seeing compelling investment opportunities for our clients: real assets, the lower middle market and emerging managers.

### THE OPPORTUNITY IN REAL ASSETS INVESTMENT SECTORS



OIL & GAS



METALS & MINING



ENERGY MIDSTREAM



POWER GENERATION



TELECOMMUNICATIONS  
INFRASTRUCTURE



TRANSPORTATION  
INFRASTRUCTURE



AGRICULTURE



TIMBER

### REAL ASSETS

In today's environment, uncovering value in traditional private equity can be difficult. At the same time, demand for commodities—oil, gas and certain base metals—and infrastructure—power generation, energy midstream and transportation—is strengthening. The market environment for investing in real assets is characterized by the combination of long-term, structural demand trends and near-term technological disruption that we believe is creating compelling opportunities for private capital. Urbanization, global growth and emerging middle class wealth across developing markets provide tailwinds for commodity and infrastructure demand over extended investment horizons. At the same time, innovation is altering how companies compete within various real assets sectors.

For instance, the shale energy revolution, driven by technological advancements in horizontal drilling and hydraulic fracturing, has redefined traditional oil & gas supply networks and led to billions of dollars of new investment across the energy value chain. Within power generation, once-dominant coal-fired plants are increasingly displaced by highly efficient natural gas-fired and renewable generation units that have, in some instances, achieved grid-parity with conventional power sources.

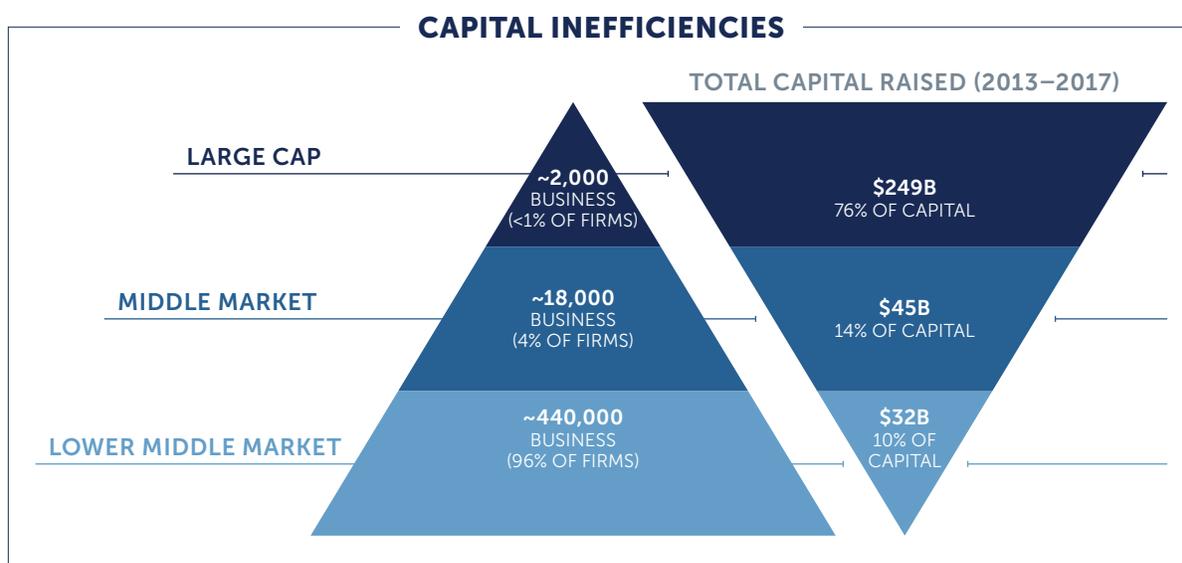
Of particular interest in the real assets space are co-investments and secondaries. There are fewer limited partners with the technical underwriting capabilities to execute real assets co-investments and as a result, we see less competition for co-investments that are being offered by real assets managers. Secondaries also offer an intriguing opportunity. The real assets segment of the secondary market is less developed and expertise in the space is not as broad-based as we see across traditional private equity secondaries. This results in less competition for attractive real assets interests. Today, Barings is generating a strong pipeline of secondary opportunities with interesting value propositions for our investors.

## LOWER MIDDLE MARKET

Competition for attractive deals across traditional private equity is challenging as the level of dry powder remains high and fund sizes continue to grow, increasing pressure to put capital to work and pushing valuations higher in many parts of the market. Against this backdrop, we tend to focus on segments of the private equity market that we believe offer the most value for our clients, such as the lower middle market, or the lower end of the North American buyout market, which represents over 90% of businesses in the U.S.

We believe the lower middle market, broadly, has the potential to offer attractive value across market cycles. This highly diverse universe is composed of companies that specialize in niche areas spanning a wide variety of sectors and industries. Often, a general partner with market expertise and sound business execution principles can capitalize on these companies' niche strengths to create significant value for investors.

At the same time, managers typically have more value creation levers with smaller companies, including lower valuation multiples at purchase, being the first institutional capital to professionalize an organization, and the ability to drive both top-line and bottom-line growth. Barings has a strong reputation as a professional limited partner in the lower middle market and has developed very strong manager relationships that drive investment opportunities for our clients.



SOURCE: NATIONAL CENTER FOR MIDDLE MARKETS. AS OF 2013. BASED ON BARINGS MARKET OBSERVATIONS. AS OF FEBRUARY 2018. LOWER MIDDLE MARKET (<\$500M); MIDDLE MARKET (\$500M-\$1B); LARGE CAP MARKET (>\$1B).

## EMERGING MANAGERS

Another area of differentiation is in the emerging manager subset. Emerging managers are generally closely aligned with their investors, as value creation within their first, second or third funds can build long-term enterprise value for their business. The potential benefits of emerging manager opportunities in an investor's portfolio include:

- Stronger general partner alignment
- Fewer distractions from legacy portfolio companies
- More targeted sector strategies
- Specialized operational or value-creation capabilities that can potentially drive asymmetric returns

It is once again worth noting that opportunities can present themselves even in those areas facing more challenging macroeconomic or cyclical conditions. In any given market segment, we believe with discipline and consistency it is possible to find top-tier managers that are capable of generating attractive returns. An emerging manager investment strategy, like all areas of the private markets where we invest, requires our investment team to spend considerable time meeting with managers, identifying capabilities, mapping the markets and understanding what investment strategies offer the highest probability of driving returns in the current market environment for our investors.

## THE BARINGS TEAM

Barings' experience investing in the private equity and real assets markets dates back to 1991; during this time, we have developed a number of capabilities that we believe truly differentiate us from our peers:



### LONG, ESTABLISHED TRACK RECORD

During our 27 years investing in these markets, we have partnered with some of the world's most sophisticated institutional investors in our Funds & Co-Investments business. Today, we have a vast network of partners and industry relationships that we rely on to source and originate deal flow. As the needs of our clients have evolved, we have been able to offer customized solutions to meet their private market goals and objectives.



### BROAD CAPABILITIES

In addition to our broad capabilities across the private equity and real assets markets, we are a truly global manager capable of originating, structuring and managing diversified portfolios on behalf of a wide variety of institutional investors across North America, Europe and Asia Pacific.



### EXPERTISE IN THE ATTRACTIVE SEGMENTS OF REAL ASSETS, LOWER MIDDLE MARKET, EMERGING MANAGERS

Barings has developed unique expertise in areas targeted as attractive segments of the private equity market including real assets, lower middle market and emerging managers. Based on our long track record of investing in these segments and experience investing through multiple economic cycles, we believe we are in a good position to deliver differentiated and customized solutions to help investors achieve their risk and return objectives.



### PORTFOLIO CONSTRUCTION AND MONITORING

We view ourselves as highly selective investment managers (rather than deal makers) and believe we spend much more time than typical managers thinking about portfolio construction and building a diversified set of return streams to help deliver our clients' desired outcomes. Through our selective approach, we aim to add incremental alpha by rotating and tilting to the vintages that we believe offer the best value at any given point in time. This approach has contributed to our strong track record in the co-investment space.



### RISK MANAGEMENT

As part of a \$304+ billion global asset management firm serving a wide variety of institutional investors, we understand the importance of transparency and have developed proprietary, sophisticated systems for managing risk, reporting and regulatory requirements, enabling us to provide a world-class client experience.

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