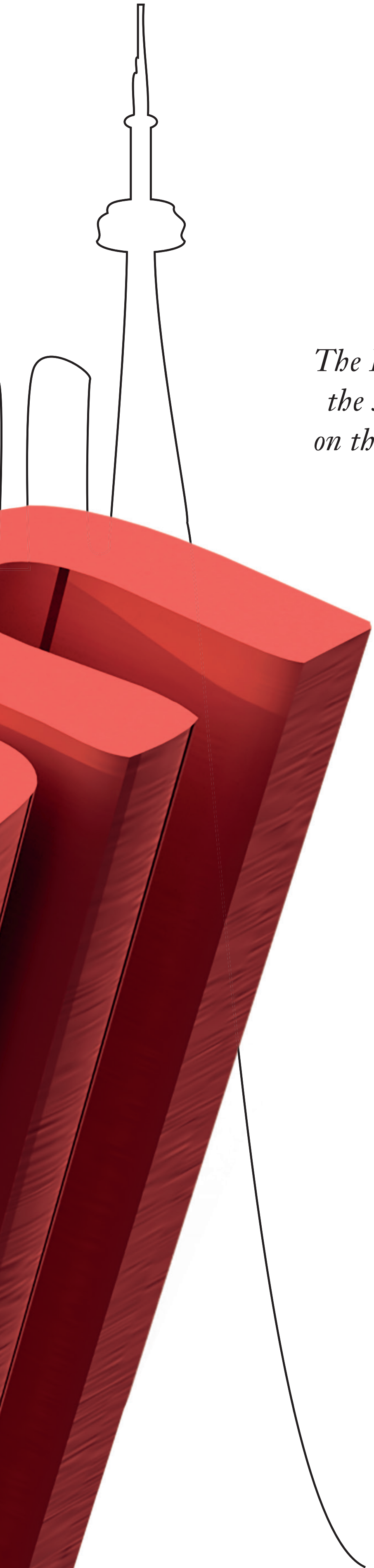

the race to



Cover story

The Investment Management Corporation of Ontario wants to triple the size of its private equity portfolio by 2025. How can GPs get in on the windfall? Craig Ferguson, who is leading the PE effort for the C$70bn pension manager, explains. By Rod James

Clairvest Group and GM Investment Management Company were the recipients of the first two private equity cheques ever written by Canada Pension Plan Investment Board some 20 years ago. In a press release at the time, the pension assured that it was only investing capital "not needed" to pay current pensions, a sop to members sceptical about this novel, illiquid asset class.

Today CPPIB has the equivalent of $361 billion in assets under management and is the world's largest private equity investor, with more than $80 billion of exposure, nearly double second-place GIC, according to *Private Equity International's* Global Investor 100 ranking of the biggest PE investors. It is one of three Canadian pension funds in the top three and six in the top 30, with only the US better represented on the list.

Canada's large pension funds have been hugely influential. They were among the first to invest in the asset class (CDPQ had a private portfolio as early as 1976) and among the first to build up in-house investing capabilities and to see the value of direct and co-investing in bringing down fees.

Their approach has paid off. A 2017 study by CEM Benchmarking found the "Canada model" of pension fund management produced 0.6 percent more in returns than a diversified passive index. "Our cost of running the business is less than two and 20," Mark Redman, then global head of private equity at the Ontario Municipal Employees Retirement System, said at the time, adding that the performance of OMERS' co-investments had been "materially ahead" of its funds.

In 2019, the C$70.3 billion ($55.2 billion; €45.5 billion) Investment Management Corporation of Ontario embarked on a similar journey. In its annual report, it outlined plans to build a global private equity programme that would leverage direct and co-investments to drive returns. In addition to forming strategic partnerships with GPs, it would build in-house investment capabilities. In January 2020 it brought in Craig Ferguson, a managing director from the equity and debt investment team of Manulife Capital, to lead the charge.

IMCO wants to act quickly, Ferguson tells *PEI*. It aims to grow its private equity AUM to C$6 billion or more by 2025 from around C$2 billion today, in line with what he described as a "fairly conservative" increase in the allocations of its underlying clients – Ontario-based public pension funds.

"We are starting these partnerships in earnest with fairly large cheques and looking to drive co-investment and direct investment, while building our capabilities behind the scenes to keep up with it."

A lot has changed since the early days of the Canadian giants, when private equity was something of a Wild West. How does a large pension grow its private equity operations and AUM – at speed – in a competitive market? How does it become a co-investor of choice? And, how does it build the infrastructure and attract the people to put the plan into action?

> *"We know we are not going to just elbow our way to the front of the line at McDonald's and order everything we want"*
>
> **CRAIG FERGUSON**
> **IMCO**

IMCO is born

The idea of IMCO came into being in 2012, when the government of Ontario concluded that pooling provincial pension funds would lower costs and allow pensioners to access a broader range of investments. It was formally created in 2016 and in July 2017 took on its first clients, Ontario Pension Board and the Workplace Safety and Insurance Board. Today it manages C$70.3 billion for four public pension funds.

IMCO gives its clients the opportunity to invest in public equities, bonds, real estate, liquid alternatives, infrastructure, private credit and private equity. The clients manage their liabilities – choosing a percentage exposure to the different asset classes – and IMCO invests the money. Private credit and private equity each accounted for 3 percent of total exposure as of 31 December 2019, making them the smallest sub-portfolios on IMCO's books.

In 2020, OPB said that it was to reallocate away from listed stocks towards private equity and infrastructure to improve portfolio diversification, reduce the volatility of its portfolio and hopefully benefit from an illiquidity premium. In response to changing client needs, IMCO began looking at ways to grow its PE business.

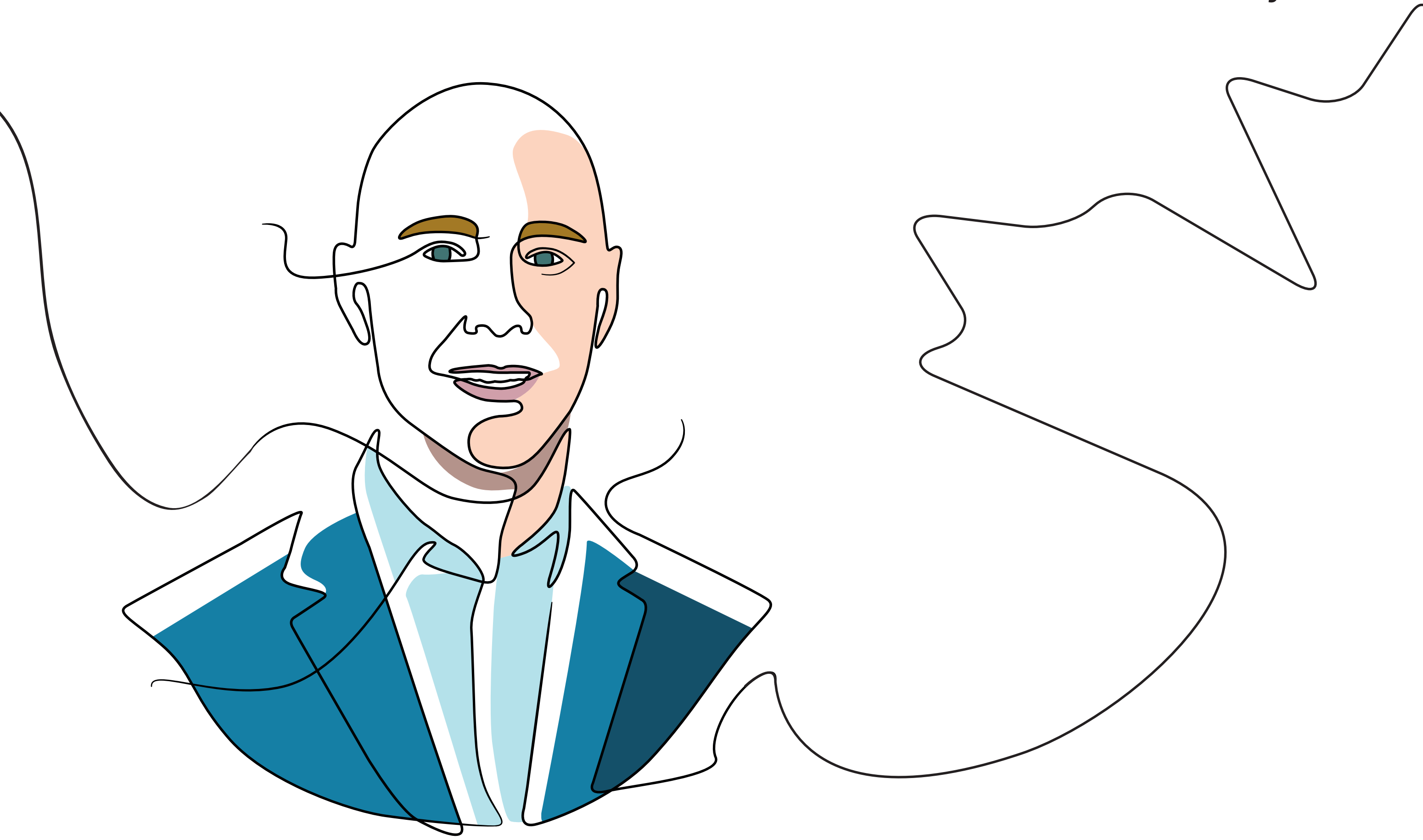
There are a few ways that large pension funds can quickly grow private equity exposure, each with their own benefits and drawbacks, says John Haggerty, managing principal and director of private market investments at investment consultant Meketa Investment Group.

They could simply write big cheques for big funds or work to set themselves up as a go-to co-investment partner. They could form a customised account to build exposure, a low-fee way of learning how to manage a GP relationship. They could acquire mature stakes on the secondaries market, allowing them to mitigate the J-curve while getting a foot in the door with sought-after GPs.

IMCO's strategy combines several approaches, Ferguson says. Initially the pension manager is looking to make commitments to mid-sized buyouts funds – of between C$1 billion and C$8 billion – focused on North America and Europe. It backed three funds in October, committing C$1 billion across Nordic Capital's Fund X, Kohlberg & Co's Fund IX and Morgan Stanley Capital Partners' North Haven Capital Partners VII.

These GPs tick a number of boxes. They have all raised multiple funds and replicated the same strategy with minimal style drift. They all espouse the importance of value creation through operational improvement and focus on sectors where Ferguson's team sees upside, such as industrial, consumer, technology and healthcare. Also, none of the GPs has had big issues with succession, another "red flag", Ferguson says.

Most important, these funds are the right size for IMCO to be able to count among their "top five most prominent" LPs. Ultimately, IMCO wants to leverage its ability to write large cheques to drive the best economics with GPs and gain co-investment opportunities to further minimise the drag of fees.



In return, it will be able to source and diligence co-investment opportunities alongside its GPs and share the break-up costs of failed processes.

"At the initial stages, we are leaning on them to some degree to get our programme off the ground," Ferguson says. "We are building our reputation with these folks, showing them we are a good partner."

Around 25-35 percent represents a "great ratio" of co-investments to fund commitments, he adds.

IMCO also wants to build sufficient in-house research capabilities to be seen as a sector expert in certain markets. It is especially interested in payments, an area where partner Nordic Capital has invested heavily, and in the potential of the under-consolidated business and non-bank financial services markets in Europe. Despite the double whammy of covid-19 and the UK's withdrawal from the EU, Ferguson sees long-term potential in the UK, which will account for up to a third of its PE exposure.

"Diversification is the only free ticket in the business," he says. "The UK and Europe are such a large part of the global economy and we want to make sure we are exposed appropriately."

Secondaries are likely to play a role in helping IMCO build quick, diversified exposure and mitigate the J-curve of its young portfolio, he adds: "Because [secondaries funds] buy mature assets, you tend to get higher IRRs and maybe slightly lower MOICs. That's OK because it's an effective way to deploy capital."

Benefits and pitfalls

IMCO's belief in direct investing mirrors that of its Canadian counterparts and makes sense, says Meketa's Haggerty. He posits that co-investing can save as much as 500 basis points of return versus making the same investment via a fund, provided the deal meets a typical buyout return target of 2x multiple and 20 percent internal rate of return.

Research by Swiss asset manager Capital Dynamics bears this out. It found that co-investment funds of vintage 1998-2016 made an average net IRR of 15.8 percent versus 13.5 percent for commingled PE funds of the same vintage. For funds of 2009-16 vintage the spread was even greater, with co-investment funds averaging returns of 18.9 percent versus 14.6 percent for commingled funds.

Growing a private equity portfolio is hard, however, never mind at speed. The market for top-performing GPs is fiercely competitive, with even large, established investors sometimes losing out. Few are as candid as Gary Bruebaker, the former chief investment officer at Washington State Investment Board, who in 2017 said the pension's allocations to groups such as Blackstone, Cinven and Silver Lake had been cut due to the pension's inability to approve commitments and co-investments as quickly as its rivals.

The pressure to put money to

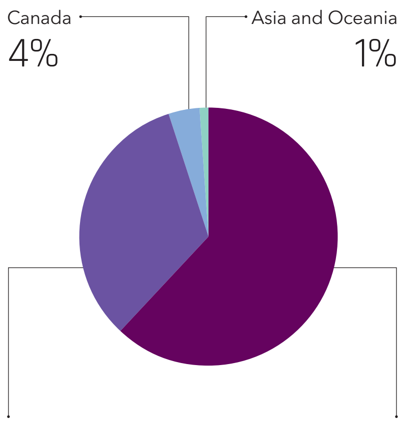
work requires an LP to generate more high-quality leads. There is always a risk that it will end up cutting corners on due diligence or just making poor investment decisions if it can't increase its resources in line with that growth.

"You have to do more work to identify actionable opportunities so there's no diminishment of quality," Haggerty says. "You don't want to be going to your third- or fourth-best ideas for deploying capital."

The quality of the co-investment and the favourability of the terms are closely linked to the calibre of the GP, says Sean Gill, a partner with investment consultant NEPC. Some GPs have a habit of offering a lower proportion of co-investment on their best deals and keeping more for themselves or keeping the deals with the highest potential for multiple expansion.

"If you are a GP with a $100 million opportunity and you like it, you might keep most of it for the fund," Gill says. "You get a pretty good total return and a high amount of carry for yourself. With a $700 million opportunity, you put $200 million in the fund and allocate $500 million for co-investors. The $100 million opportunity is a potential

As of December 2019 IMCO's portfolio was C$1.9bn. It is targeting C$6bn by 2025



Source: IMCO 2019 annual report

IMCO's private equity team

Craig Ferguson
Managing director
Ferguson joined in January 2020 to oversee the development of IMCO's private equity business. He was a managing director at Manulife Capital, the investment arm of the insurance giant, where he spent nine years leading deal teams in private equity and credit. He made the move to IMCO because he "was attracted by the challenge of building a new global PE business from the combination of existing client assets and team. IMCO's culture and values strongly align with my personal views".

Mary Chang
Senior principal
Chang joined IMCO in 2017 with a focus on infrastructure assets. She transferred to the private equity team last year to focus on funds, directs and co-investments. Previously, she held numerous roles across private equity, including an eight-year stint as a director at OMERS Capital.

David Lee
Senior principal
Lee joined IMCO in September 2020 after nearly nine years with Manulife Capital. He was a director in private equity and credit teams responsible for making minority equity and junior capital investments in the North American mid-market.

Christian Hensley
Senior managing director, equities and credit
Hensley oversees IMCO's private equity, public equities and global credit programmes. He was formerly managing director and head of relationship investments with CPPIB, before joining IMCO in April 2019.

four bag, [while] the $700 million [is only] a two bag."

Even when the resources are in place, it can take time to get into the rhythm required to give a quick yes or no on co-investments, particularly if you've hired lots of new team members from places with contrasting working styles, Gill notes.

Size could help

Ferguson acknowledges that the "art of scaling" is not without challenges but believes IMCO has certain advantages. Its size – significant but outside the top division – means it doesn't naturally get pushed towards the largest funds, where competition (against the likes of WSIB) is fierce. Unlike many of its Canadian counterparts it is in growth, rather than maintenance, mode, so it is not restricted to a relatively narrow band of lower-risk, steady-return opportunities.

"As a large LP, you have a certain amount of resources to do due diligence, create relationships and monitor funds," says Meketa's Haggerty. "If a GP is not offering you a meaningful commitment, you may not want to spend the time. It can lead to a large-market, large-fund bias, which can be good or bad for the portfolio, depending on how the market goes."

> *"You have to do more work to identify actionable opportunities so there's no diminishment of quality [when making direct investments]"*
>
> **JOHN HAGGERTY**
> **Meketa**

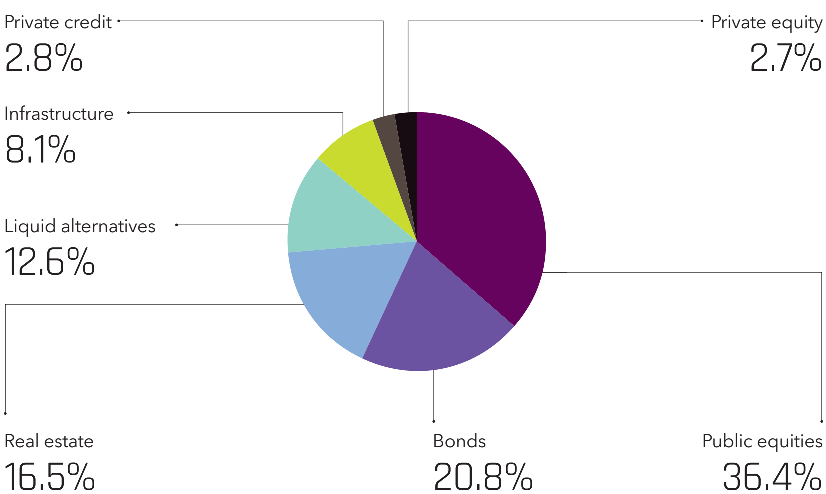
To secure good co-investment opportunities, Ferguson is mindful of the need for IMCO to be a well-resourced partner without becoming a competitor to its GPs. Co-investing may be cheaper, but the more direct capabilities you have, the more a threat you represent, and the less likely it is that GPs will give you their best co-investment opportunities. If you are not getting good co-investments, it makes the overall fee burden less palatable.

"A lot of pensions have ended up crossing that line," Ferguson says. "You have a book of C$6 billion [in NAV], half or more of it in funds. As soon as you start becoming your own buyout firm, you lose leverage on that C$3 billion to C$4 billion of scale and are paying fairly meaty fees on it. It's a balance."

Ferguson is hopeful that the disruption caused by covid-19 will fuel IMCO's growth strategy rather than hinder it. Some larger, established managers will take longer to raise funds because of the crisis, which is no bad thing for a new player trying to work its way into the top echelon. Still, he is not getting ahead of himself.

"Our current C$2 billion is comprised of a book of managers and directs that gives us a foundation to build off… We know we are not going to just elbow our way to the front of the line at McDonald's and order everything we want."

As of 31 December 2019 private equity was IMCO's joint-smallest sub-portfolio



Source: IMCO 2019 annual report

The right personnel

The success of these plans is highly dependent on having the right people and processes in place. IMCO's private equity team went from four members at the start of 2020 to eight by the end, with a target of at least 20 professionals by the time it reaches its growth target in 2025.

Since starting in January 2020, Ferguson has been joined by two senior principals: David Lee, another Manulife Capital alumnus, and Mary Chang, who moved across from IMCO's infrastructure investment team. Ferguson's familiarity with the culture of Manulife and IMCO should help reduce the friction that comes with assembling a new team.

IMCO is aiming to build a team with a mix of experience in direct investments, fund investing, investment banking, M&A advisory and consulting. The core of its strategy is to build "a

Canadian pensions by PE exposure

Pension fund	PE AUM ($bn)	As a % of total AUM	Notable direct holdings
CPPIB	80.75	24.9	Axel Springer, Immarsat, Refinitiv
CDPQ	38.57	14.7	AlixPartners, Sanfer
OTPP	30.32	19.3	Camelot Group, Flynn Restaurant Group, Flexera Software
PSP Investments	18.16	14.0	Galderma, AltaGas Canada, Alliant Insurance Services
OMERS	11.78	14.0	Vue International, CBI Health Group

group of talented people that have some relevant experience… into becoming a more direct-oriented investment programme through apprenticeship and internal development".

Among IMCO's selling points, according to Ferguson, is that it has a small, flat team in which new hires can gain experience of both fund and direct investing. It is also growing rapidly in terms of AUM, headcount and its network of GP relationships, an environment that should prove particularly exciting to junior and mid-level hires. The team is Toronto-based for now, but Ferguson does not rule out future expansion.

While IMCO did not share salary specifics, in a job ad for the position of public markets and alternatives analyst, it says that "in addition to offering a competitive salary and comprehensive benefit package, we pride ourselves on helping you reach your potential [and] making a difference in our communities".

This again brings to mind the words of Mark Redman, who told *PEI* that "ultimately, there's a clear line of sight between what we [OMERS] do in terms of investing and who we actually work for" – something he considers part of the Canadian model of PE investing.

Long term

For the time being, IMCO will focus on its strategy of leveraging co-investment opportunities from relationships with well-established, mid-sized funds. Down the line, the pension manager would like to be able to back new funds and provide cornerstone investments for newly spun-out teams – "groups with more of a story", in Ferguson's words.

The pension manager may also look to bring on more clients. Given the potential pool among Ontario's public pension funds, Ferguson thinks C$100 billion is "not an unreasonable size" to aim for: "Some of these funds are half a billion dollars in size… They would have to invest in a fund of funds, maybe two or three of them, and they are stuck with full-bore management fee and full-bore carry with no direct exposure. We can cut that notionally in half."

"If you have a public pension fund that is looking to increase its pace and willing to put $100 million into your next fund, with the potential for them to be a solid co-investment partner…" mused one London-headquartered buyout GP that *PEI* asked about the pension manager's prospects.

"GPs like working with institutions that have a good reputation – and ambition." ■

IMCO's investments so far

Manager	Fund	Target	Strategy	Launch date	Other LPs
Nordic Capital	Nordic X	€5bn	Focuses on healthcare, technology, financial services, and industrial and business services sectors of Europe	May 2020 (closed September 2020)	Massachusetts Pension Reserves Investment Management Board, Minnesota State Board of Investment
Kohlberg & Company	Kohlberg Investors IX	$3bn	Takes $100m to $500m positions in the manufacturing, services, consumer product, financial services and healthcare sectors of North America	2019	School Employees' Retirement System of Ohio, State of Wisconsin Investment Board
Morgan Stanley Capital Partners	North Haven Capital Partners VII	$1.25bn	Makes control investments in North American mid-market companies in the business services, consumer, industrials, healthcare and education sectors	December 2019	–

Source: PEI

"GPs like working with institutions that have a good reputation – and ambition"

LONDON-BASED BUYOUT GP