Cases to accompany *Mastering Private Equity*

PRIVATE EQUITY

IN ACTION

Case Studies from Developed and Emerging Markets

Claudia Zeisberger Michael Prahl Bowen White

INSEAD

WILEY

Private Equity in Action

Case Studies from Developed and Emerging Markets

Claudia Zeisberger
Michael Prahl
Bowen White

INSEAD
The Business School for the World®

WILEY

This edition first published 2017

Registered office
John Wiley & Sons Ltd, The Atrium, Southern Gate, Chichester, West Sussex, PO19 8SQ, United Kingdom

For details of our global editorial offices, for customer services and for information about how to apply for permission to reuse the copyright material in this book please see our website at www.wiley.com.

Library of Congress Cataloging-in-Publication Data

Names: Zeisberger, Claudia, author. | Prahl, Michael, author. | White, Bowen, author.
Title: Private equity in action : case studies from developed and emerging markets / Claudia Zeisberger, Michael Prahl, Bowen White.
Description: Hoboken : Wiley, 2017. | Includes bibliographical references and index. |
Identifiers: LCCN 2017013990 (print) | LCCN 2017029759 (ebook) | ISBN 9781119328001 (pdf) | ISBN 9781119327998 (epub) | ISBN 9781119328025 (paperback) | ISBN 9781119328001 (ebk) | ISBN 9781119327998 (ebk)
Subjects: LCSH: Venture capital–Case studies. | BISAC: BUSINESS & ECONOMICS / Finance.
Classification: LCC HG4751 (ebook) | LCC HG4751 .Z425 2017 (print) | DDC 332/.04154–dc23
LC record available at https://lccn.loc.gov/2017013990

A catalogue record for this book is available from the British Library.

ISBN 978-1-119-32802-5 (hardback) ISBN 978-1-119-32800-1 (ebk)
ISBN 978-1-119-32799-8 (ebk)

10 9 8 7 6 5 4 3 2 1

Cover design: Wiley
Cover image: Skyline image: © Leontura/iStockphoto; World Map image: © pop_jop/iStockphoto

Set in 10/12pt Helvetica LT Std by Aptara, New Delhi, India
Printed in Great Britain by TJ International Ltd, Padstow, Cornwall, UK

CONTENTS

PREFACE

Private equity (PE) certainly has no shortage of critics, having been referred to as "capitalism on steroids," its general partners (GPs) or fund managers called "locusts" and their preferred deal cycle as a "quick-flip." Attention is generated when the media portray PE as a fast way to multiply invested capital by reducing jobs and overleveraging companies. It is time to clear the air, remove soundbite biases and set perceptions straight by showing how the industry frequently removes inefficiencies and turns underperforming companies into healthier, more dynamic ones or supports fast-growing enterprises with capital and expertise, while taking measured risks other financial players are ill-equipped to pursue.

The sheer complexity of PE deal making often obscures the mechanisms of success from casual observers and the theoretical concepts alone rarely do justice to the reality of investing in private companies. A clear understanding of the PE model is long overdue and this book provides detailed case studies to give senior executives and professionals a ringside seat to the day-to-day challenges tackled by partners in PE and venture funds, in both developed and emerging markets.

Private Equity in Action is the practical companion to *Mastering Private Equity—Transformation via Venture Capital, Minority Investments & Buyouts*, a rigorous textbook providing the theoretical foundations that the case studies bring to life. While this case book can very well be read on a standalone basis, newcomers to the world of PE will certainly benefit from working with both books in parallel and taking advantage of their synergies.

This case book offers a selection of rich, real-life case studies that demonstrate the application of core PE concepts by providing a unique behind-the-scenes look into the investment practices of PE and VC funds. It helps students and executives comprehend the complex processes associated with investing in private companies, from start-ups to mature businesses, and understand the inner workings of the PE model. While academic concepts build the necessary foundation, practical application and execution of these concepts are the critical link that leads to a successful learning outcome.

This book provides a wealth of opportunities for the reader to put oneself into the shoes of leading PE investors and face a range of actual managerial challenges. With a focus on the all-important executional element that is at the core of successful PE investing, it helps to explain how theoretical concepts translate into investment success. After all, the competitive advantage of PE investors arises from the diligent application of global best practices in their portfolio companies—and a lot of hard work.

All case studies have been written in conjunction with leading PE and VC firms, their senior partners, or with advisors who work closely with the industry; they provide insights into real issues faced and tell real war stories about actual (yet at times anonymized) investments. Each case explains how the actions taken by the PE investors contributed to the transformation of companies in practice with examples covering investment situations not only in the established US and European markets, but also in the emerging (or already emerged) growth markets of Asia, Africa and Central Europe.

Section Overview

The first section of the book focuses on the classic "GP–LP" fund model and shows how the relationship between institutional investors and PE fund managers is changing. The cases then move on to share examples from venture capital, growth equity (or minority) investments and leveraged buyouts in various settings (Sections II–IV).

Turnaround situations and distressed investments certainly test the mettle of PE investors—be they majority or minority owners. Dealing with short-term cash constraints, allegations of fraud and disgruntled creditors or (at times public) stakeholders certainly shows whether the operational partners in a PE fund can live up to expectations (Section V).

Given their positive demographic profiles and access to new customers, emerging markets are becoming attractive target destinations for PE. However, investing in these economies comes with additional risks related to the lack of legal certainty, governance frameworks and consistently applied best practices in deal making and execution (Section VI).

INSEAD Context

All cases in this book have been subject to the rigors of classroom debate and continue to be taught in INSEAD's MBA, EMBA and executive education programs, as well as in other top business schools; some have won prestigious case awards. They add color to the theoretical foundations laid in the text book, provide context, clarify theoretical concepts and give the reader a chance to step into the shoes of PE and VC professionals, as they deal with issues from fundraising to deal execution and effecting operational change to exiting their investments.

The selection of cases in this first volume leverages INSEAD and its faculty's international reach, network and connections, especially with professionals in the up-and-coming emerging markets. The settings of the case studies cover PE investing in:

- Early-stage companies and VC in India
- SMEs in the Middle East
- Buyouts in the US and Europe
- Turnaround situations in both Europe and emerging markets
- Food and beverage in Vietnam
- Real estate in Australia
- Agriculture in Africa
- Optimizing a European pension fund's PE portfolio
- Setting up a new sovereign wealth fund in eastern Europe

SECTION I
GP–LP Relationships

One of the competitive advantages we have is we have a large balance sheet, and economies of scale allow us to build big internal teams. We also have very long term time periods, so we never have to sell an asset unless it's at our choosing. We don't need the liquidity. Why aren't we looking for opportunities to invest higher up the capital stack and take advantage of that?

—Gordon J. Fyfe, CEO and Chief Investment Officer,
British Columbia Investment Management Corp. (bcIMC)
and INSEAD Alumnus

CASE

1 BERONI GROUP

MANAGING GP–LP RELATIONSHIPS

SYNOPSIS

This case follows Jack Draper, Managing Director of the Beroni Group, a private equity family of funds, as he manages his growing business and tries to satisfy his investor base. It deals with the issues arising in private equity firms once multiple funds have been raised from various limited partners and are being managed by a related set of general partners. Beroni has just closed its third fund successfully and has started to explore investment opportunities as the financial crisis of 2008–2009 reaches its apex and changes some of the fundamental assumptions for its investor base.

The case is set in a difficult economic environment, which raises some very interesting investment possibilities as well as problems. Jack strives to manage two competing groups of investors seeking exposure to these possibilities, as well as the cash flow problem at one of his leading investors.

The case highlights the different motivations of existing investors: some of them invested in both Funds II and III, others in only one or the other. As Jack starts to address the issue of the composition of the advisory committee (AC), queries regarding overlapping staff resources for both funds and pressure for a reduction in management fees, he is faced with a potentially critical issue: one of his investors is in serious financial distress and has asked to be given preferential treatment to avoid default.

PEDAGOGICAL OBJECTIVE OF THE CASE

The case explains the importance of a professional relationship between investors and managers in a private equity fund and discusses possible solutions that managers can offer to investors facing financial difficulties.

It sets the scene to critically debate investor demands and expectations with regard to the time managers allocate to individual funds and their overall commitment to managing a family of funds.

SUGGESTED ASSIGNMENT QUESTIONS

1. How should Jack handle the allocation of deal flow between the different funds that have overlapping mandates, and/or between one of his current funds and an eventual successor fund? Should allocations be fixed or discretionary? In addition, regarding the impending deal, which AC should he approach first, and with what sort of proposal, to minimize potential tension among the various investors.
2. How should he deal with downward pressure on his management fees as more assets come under management, since some costs (e.g., rental costs, back office

staff) are fairly steady regardless of how much capital is under management? How could he rebut investor demands to lower management fees?
3. Since the senior Beroni principals serve on the deal teams and investment committees of more than one fund, how could he help his investors feel comfortable that the principals (and staff) would allocate their time appropriately between the respective funds?
4. How could he help his investors be comfortable with the prospect of *de facto* cross-liability—that is, if one of his funds were to run into difficulty, how could he "ring fence" other unrelated funds to ensure there were no negative financial or time effects on the managers?
5. How could Jack balance the needs and requests of EUBank, one of his oldest and largest investors, with the legitimate expectation of other investors in BAF II and BAF III that EUBank not be shown any favoritism, and that a portion of EUBank's interest be forfeited and distributed to them? Would he be faced with a flood of defaults and withdrawal requests if he were to treat EUBank gently? What fiduciary duty did he have to the nondefaulting investors in BAF II and BAF III that have managed their finances more prudently than EUBank? Would the managers risk breaching the investment fund agreements to implement EUBank's proposal?

ADDITIONAL RESOURCES

To make the most of this case study, we suggest the following additional sources to provide context and background information:

- In particular, we recommend the following chapters from *Mastering Private Equity—Transformation via Venture Capital, Minority Investments & Buyouts*
  - Chapter 1 Private Equity Essentials
  - Chapter 16 Fund Formation
  - Chapter 17 Fundraising
  - Chapter 19 Performance Reporting
- You may also refer to the book website for further material:
  www.masteringprivateequity.com.

Beroni Group:

Managing GP-LP Relationships

03/2015-5594

This case was written by Greg Blackwood, Senior Research Associate, in close co-operation with Andrew M. Ostrognai, Partner at Debevoise & Plimpton LLP in Hong Kong, and under the supervision of Claudia Zeisberger, Senior Affiliate Professor of Decision Sciences and Entrepreneurship and Family Enterprise at INSEAD, with revisions by Rob Johnson, Visiting Professor at IESE Business School. It is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Additional material about INSEAD case studies (e.g., videos, spreadsheets, links) can be accessed at cases.insead.edu.

Introduction

Jack Draper had just completed the initial close of his third private equity fund for the Beroni Group, a family of funds based in Hong Kong and investing across Asia. As Managing Director, Jack had been with the group for nine years since its founding in 2000, and with his two partners had successfully steered the Beroni Asia Fund (BAF I) to a successful conclusion, creating the opportunity to establish follow-on funds in the same mould. BAF II was approaching the end of its investment period, after which remaining capital could only be invested in follow-on investments. BAF III had received US$500 million in commitments from its limited partners (LPs) by late summer 2008, before the fundraising environment for private equity funds became difficult. Notwithstanding these difficult conditions, Jack was able to get to a first closing, and expected to raise an additional US$300 million by the final close. He took pride in their ability to hit fundraising targets despite the difficult fundraising environment. It was typical of what he and the other principals who managed the fund on a day-to-day basis had achieved over the years.

With success, however, had come some unexpected issues. While managing each fund in isolation required essentially the same skills and processes, he was discovering that managing a group of funds required careful strategic (and sometimes political) manoeuvring. Just the day before, he had received final information about a proposed deal that he planned to present to the investment committee the following week. BAF II still had US$135 million in remaining capital that could be deployed (and another year left on the investment period), and BAF III's funds were now available. The seller in the proposed deal was in deep distress and the investment committee felt that the pricing on the deal was exceptionally attractive – it was likely to be one of the most successful deals ever sourced by the Beroni Group. But there were a number of other complications:

- Some LPs had invested in both BAF II and BAF III, while others had invested in one but not the other. LPs sometimes co-invested directly in companies with the fund in which they had invested.
- Each fund had its own advisory committee (AC), and the make-up of each AC was a reflection of LP participation. Hence there was not identical membership across the ACs.
- General partner (GP) resources were sometimes thinly spread across multiple funds since the same team managed all three funds.
- LPs participating in multiple funds were making noises about a reduction in management fees for the latest fund, since many of the costs associated with managing it were essentially fixed (rent, salaries, etc.). In difficult economic times, LPs were looking for any way to cut their costs.
- Finally, in any co-investment situation, the approval of the relevant ACs would be necessary in order to execute.

Jack knew he would end up doing the deal one way or another – he just needed to resolve some of these issues first in order to avoid creating future problems with the LPs.

Another problem facing Jack was that EUBank, one of the Beroni Group's earliest and largest investors, was (as with many financial institutions) having cash flow problems of its own, and was unable to fund its capital commitments to BAF II and BAF III.

As is common in the private equity industry, the limited partnership agreements for BAF II and BAF III had extremely severe penalties for a defaulting limited partner, including forfeiture of half of its interest in the fund. EUBank had proposed to the Beroni Group that it be allowed to suspend making any further capital contributions to BAF II, that its capital commitment to BAF III be reduced from US$120 million to US$60 million, and that none of its interest in either BAF II or BAF III be forfeited. The GP of BAF II had some discretion over enforcement of the forfeiture provision, but there was no mechanism in the limited partnership agreement for BAF III to reduce capital commitments in this way. Nonetheless, in light of the long and otherwise happy history of EUBank and the Beroni Group (and in the hope that EUBank would recover and be a large investor in BAF IV when it was raised), Beroni Group wanted to be as accommodating as possible.

Group History

Jack and his partners had founded Beroni in 2000, closing BAF I with US$250 million contributed by three LPs (see Appendix A). Over the following four years, Beroni successfully deployed all of the capital and went on to exit all portfolio companies in a relatively short six-year timeframe from closing, achieving a remarkable 42% IRR over the period. Shortly after fully investing BAF I's assets, and with a few credible exits under their belts, the Beroni GPs successfully closed BAF II in 2004 at US$350 million. All of the original LPs participated to some extent, and a further two LPs came on board (see Appendix B).

The firm had been less able to deploy BAF II's capital due to a dearth of quality deals, with only approximately US$215 million invested as of the initial close of BAF III. The deals in which the company had invested, however, had again generated spectacular returns, estimated to be around 30% IRR (including unrealised gains) – which in turn had further attracted LPs to BAF III. Prior to the meltdown of the financial industry in late 2008, LPs committed US$500 million to BAF III at the first closing. Even though the fundraising environment had become exceptionally difficult, Jack and his partners believed they could secure an additional US$300 million in further commitments by the final close of the fund (see Appendix C), largely because a number of liquid and savvy LPs believed that there were historically good buying opportunities in the market.

Key Issues

Jack now found himself with two active funds and several issues to manage:

- Disparate LPs

  Because one of the LPs participating in BAF II had elected not to participate in BAF III, and because a number of first-time LPs had subscribed to BAF III, the LP structures of the two funds were significantly different. Jack knew the LP that had opted out of BAF III (Gulf Developments, a sovereign wealth fund with considerable assets and influence which he could not afford to upset) wanted BAF II to fully invest its remaining assets before BAF III began to deploy its capital (particularly because they believed that asset values were now at an all-time low), and would therefore vehemently oppose any investment by BAF III before that time. On the other hand, the BAF III LPs were eagerly looking forward to their first deal in this attractively repriced market, so if a very attractive opportunity went to BAF II in preference to BAF III, Jack risked upsetting his new partners.

- Differing AC compositions

  Because the investor that had not subscribed to BAF III was on the advisory committee of BAF II but not on the AC of BAF III, and because some of the first-time LPs were on the AC of BAF III but not BAF II, Jack had different ACs to manage. Complicating matters was the fact that for the upcoming deal, Jack would have to engineer approval from both committees in order to receive the go-ahead on a co-investment – and this would generate tension depending on which LPs participated in each AC.

- Overlapping human capital

  Like many families of funds, Beroni employed the same staff across all three funds. The same senior staff, investment managers and associates that had executed deals for BAF I and who were currently working on BAF II would also manage BAF III; the synergies of information and experience were obvious, and utilising his staff in this way allowed Jack to generate higher management fees per headcount. Of course, each fund's LPs preferred staff to be 100% focused on their fund to the exclusion of the other, whether it was BAF II or BAF III.

- Reduction in management fees

  Because some of the LPs had invested in all three funds, they felt that Jack should reduce Beroni's management fees in some way to reflect the fact that the group as a whole was able to utilise the same staff to manage each successive fund. In addition, because each successive fund required neither additional office space nor additional administrative staff, the LPs felt certain that costs could be cut – providing additional justification for a reduction in management fees. Moreover, because of the difficult economic context, a number of LPs felt that the Beroni Group should "tighten its belt" and pass some of the cost savings along to LPs.

- EUBank default

  Beroni was faced with an imminent default by one of its largest and oldest investors, which would not only create cash flow problems for BAF II and BAF III (and might even jeopardise the ability of these funds to consummate the investment they were currently considering), but would also create some embarrassment for EUBank and for the Beroni Group. EUBank had put a proposal on the table that would mitigate some of these problems (and yet not leave EUBank in a good position), but accepting the proposal would not only anger other non-defaulting LPs (since they would not receive the forfeited interest to which they had a legitimate claim), but also create a moral hazard should other LPs try to extract a similar deal from the fund GPs. Also, it was not clear whether granting EUBank's requests would violate the GPs' fiduciary duty or even breach the limited partner agreements themselves.

Appendix A
Table of LPs (BAF I)

LP Entity	Amount Invested (US$ million)	Advisory Committee Seat (Yes/No)
Gulf Developments	100	Yes
EUBank	80	Yes
La Famiglia Inc.	70	Yes

Appendix B
Table of LPs (BAF II)

LP Entity	Amount Invested (US$ million)	Advisory Committee Seat (Yes/No)
Gulf Developments	120	Yes
EUBank	70	Yes
La Famiglia Inc.	40	Yes
Pensions-R-Us	70	No
StateFund	50	Yes

Appendix C
Table of LPs (BAF III)

LP Entity	Amount Invested (US$ million)	Advisory Committee Seat (Yes/No)
EUBank	120	Yes
La Famiglia Inc.	30	Yes
Pensions-R-Us	100	No
StateFund	80	Yes
New LP 1	90	No
New LP 2	80	Yes
*New LP 3	75	No
*New LP 4	75	Yes
*New LP 5	75	No
*New LP 6	75	No

*Denotes anticipated funding as of the final close of the fund.

Source: Fictitious data

CASE

2 GOING DIRECT
THE CASE OF TEACHERS' PRIVATE CAPITAL

SYNOPSIS

This case traces the evolution of the private equity investment platform at the Ontario Teachers' Pension Plan ("Teachers"), the largest single-profession pension plan in Canada. Unlike the typical pension fund at the time, Teachers forged a pioneering approach to investing by making a concerted push towards direct investing in private equity, well before disintermediation became popular among limited partners (LPs). The case follows Jim Leech, CEO of Teachers and formerly head of Teachers Private Capital (TPC), the private equity arm of the pension plan. It traces the multiyear journey during which Teachers' worked to develop in house the competence and culture required to move beyond fund investments into direct deals. The case discusses the advantages and limitations of the direct investing model, contrasts it with other approaches to investing in private equity, and raises important issues for institutional investors pursuing strong risk-adjusted returns.

PEDAGOGICAL OBJECTIVE OF THE CASE

The case requires readers to have a basic understanding of the private equity investment model and familiarity with the typical relationship between general partners and LPs. The purpose of the case is to introduce readers to the different avenues available to LPs when deploying capital into private equity, from investing purely in funds and co-investing in deals alongside funds with varying degrees of influence to investing directly in deals, be it for a minority or controlling stake.

In particular, the case delves into the attractiveness of the direct investing model for LPs, offering insights into the internal capability, governance framework and organizational culture that LPs need to build to implement such a model successfully and benefit from its inherent cost savings. The case also discusses the challenges of sustaining and scaling up any direct investment capability, and, more broadly, the challenges that arise when managing a comprehensive private equity program.

SUGGESTED ASSIGNMENT QUESTIONS

1. Discuss the attractions and challenges of the direct investing model for LPs. What characteristics of the Ontario Teachers' Pension Plan have enabled it to build its private equity platform?
2. Why did Teachers' Private Capital pursue the buyout of Bell Canada Enterprises? What lessons were learned in the process?
3. How would you assess the success of Teachers' Private Capital? To support your arguments, calculate Teachers' Private Capital's information ratio and comment on its contribution to the pension plan's overall risk-adjusted returns during different periods. What lessons can other large investors take away from the development of Teachers' program?

ADDITIONAL RESOURCES

To make the most of this case study, we suggest the following additional sources to provide context and background information:

- In particular, we recommend the following chapters from *Mastering Private Equity—Transformation via Venture Capital, Minority Investments & Buyouts*
  - Chapter 1 Private Equity Essentials
  - Chapter 6 Deal Sourcing & Due Diligence
  - Chapter 18 LP Portfolio Management
  - Chapter 21 LP Direct Investment
- Case website for faculty and lecturers: http://cases.insead.edu/going-direct
- You may also refer to the book website for further material:
  www.masteringprivateequity.com

INSEAD

The Business School for the World®

Going Direct

The Case of Teachers' Private Capital

03/2015-5993

This case was written by Deepa Ramanathan, INSEAD MBA class of December 2012, under the supervision of Michael Prahl, Executive Director, INSEAD Global Private Equity Initiative, and Claudia Zeisberger, Senior Affiliate Professor of Decision Sciences and Entrepreneurship and Family Enterprise at INSEAD. It is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Funding for this case study was provided by INSEAD's Global Private Equity Initiative (GPEI). The research was partially funded by the INSEAD Alumni Fund (IAF).

Additional material about INSEAD case studies (e.g., videos, spreadsheets, links) can be accessed at cases.insead.edu.

Introduction

As the first snow fell outside his twelfth floor office in the north end of Toronto, Jim Leech, CEO of Ontario Teachers' Pension Plan, contemplated the recent settlement that Teachers' (as the pension plan was known) had reached with Bell Canada Enterprises (BCE). The year was 2012 and the settlement pertained to the leveraged buyout (LBO) of BCE, a transaction that would have been the largest LBO in history. Recalling the transaction that had catapulted Teachers' into the limelight, he marvelled at how Teachers', which belonged to a class of investors known to be very conservative, ended up leading a consortium of investors in the C$52 billion buyout of the telecom giant. Jim mulled over the long and eventful path that Teachers' had traced from first venturing into direct investing in private equity, subsequently emerging as a respected partner and a formidable rival to established private equity funds.

Background

With C$129.5 billion in assets at the end of 2012, the Ontario Teachers' Pension Plan is the largest single-profession pension plan in Canada, investing and administering the pensions of 303,000 active and retired teachers in the province of Ontario. An independent authority on pension fund benchmarking, CEM Benchmarking Inc., ranked Teachers' number one in terms of 10-year returns and 'value add' above benchmark among all peer pension funds in the world for the 10-year period to the end of 2011. The fund had recorded a 10% average annualised rate of return (Exhibit 2.1) and C$60.5 billion in cumulative value added (with compounding) above benchmarks since 1990.

The pension plan for Ontario teachers was originally created in 1917. For the next 73 years it was run by the Ontario government and funds were invested in the debt of government agencies. In 1990, the government privatised the plan by creating an independent, jointly-sponsored pension plan, the Ontario Teachers' Pension Plan Board, with the authority to invest all assets, administer the pension plan, and pay members (or surviving relatives) the benefits promised. The privatised plan was co-sponsored by the Government of Ontario and the Ontario Teachers' Federation (OTF), an umbrella organisation for four teachers' unions. The two co-sponsors appointed four independent members each to the board of directors and an independent chair was chosen jointly. The board members oversaw the pension fund's management team, which carried out the actual work of investing and administering plan assets and paying out benefits. By law, board members were bound to act in the best interests of plan members and their beneficiaries. Teachers' also advised the plan sponsors about its funding status, which was determined annually by an independent actuary hired by the plan.

Teachers' is a defined benefit pension plan, that is, the sponsors are responsible for paying out a pre-defined level of retirement benefits based on factors such as length of employment, salary history, projected lifespan of retirees, etc. What this means in practice is that if the net assets of the pension plan are not sufficient to meet the present value of the liabilities (i.e., the benefits promised to retirees), the sponsors are required to make extra contributions and/or reduce future benefits to bridge the funding deficit. On the flipside, plan sponsors can also make use of funding surpluses, i.e., the excess of net assets over liabilities to reduce the contribution rate of active teachers or increase members' benefits (See Exhibit 2.2, pension fund terminology).

As sole plan sponsor from 1917 until privatisation in 1990, the Ontario government was responsible for all funding deficits and entitled to all funding surpluses. Under the jointly-sponsored framework, the Ontario Teachers' Federation became a co-sponsor, making it responsible for half of any surplus or deficit. Strong investment returns in the early 1990s gradually transformed Teachers' funding status from a deficit of C$3.6 billion in 1990 to consistent funding surpluses in the late 1990s. As a result, teachers in the plan enjoyed low contribution rates and improved benefits during the second half of the 1990s. However, by the 2000s, falling interest rates, a declining ratio of working teachers to retirees (from 10:1 in 1970 to 1.4:1 in 2012) and longer life expectancy leading to an increase in the expected number of years on pension from 20 to 31 years, combined to turn the surplus into a persistent funding deficit. This led to an increase in the contribution rate required from teachers and the government and reductions in the future benefits to be paid to retirees. With these changes the pension fund was able to meet its regulatory obligation of showing a fully-funded plan at least once every three years.

Investment Objectives and Asset Policy Mix

Teachers' 2011 Annual Report stated:

> *"Our investment strategies are designed to earn strong returns that support stable contribution rates and pension sustainability and help meet the plan's long-term funding needs. Our approach is to manage funding and investment risk together. Taking plan demographics and future pension obligations into account, we aim to earn the best return possible at an appropriate level of risk. The need for investment returns must be balanced with strong risk management practices."*

In practice this translated to a target real rate of return of 4.5% per annum for the fund over the long term, an objective which had remained unchanged since the creation of the fund as an independent entity. However, the gradual change in the demographics of the plan had resulted in lower risk tolerance and restrictions on illiquidity, accompanied by an increased emphasis on the cost of implementing investment programmes. At the same time, the changing economic landscape – from the high interest rate environment of the 1980s to the moderation of the 1990s to the asset bubbles of the 2000s and the post-global financial crisis world of today – meant that the means of achieving the targeted rate of return had to be regularly reviewed and revised accordingly. This was reflected in the fund's strategic asset allocation or 'asset policy mix', as Teachers' refers to it.

The plan's investment managers performed an ongoing balancing act between the need to fund promised benefits and the need to control the risk of a loss that would have to be covered by increasing contribution rates and/or reducing benefits for future service. This focus on the ultimate risk facing the plan – funding risk – meant that Teachers' took a holistic view of risk, including market risk, credit risk and liquidity risk facing its assets and liabilities, to determine its asset mix. Teachers' used a proprietary asset-liability model that incorporated long-term historical data and the current economic outlook along with decisions to be made by the plan sponsors on contribution and benefits levels. Using this model, together with management experience and judgment, Teachers' established a weighting for each asset class that reflects its long-term risk and return trade-offs in relation to those of other asset classes. The fund used risk budgeting to allocate risk rather than capital, across asset classes, with the risk budget reviewed by board members annually.

Until 1990, the pension plan invested solely in non-marketable Government of Ontario debentures. Following the creation of Teachers', the asset policy mix of the plan (Exhibit 2.3) changed to allow investment into equities, both public and private, Canadian and foreign as well as income-producing real estate. Teachers' also began investing in absolute return strategies, hedge funds, money market securities and a wider range of bonds, all of which it classified as fixed income. To achieve its investment objectives, Teachers' decided on a strategic asset allocation of two-thirds equities and one-third fixed income in 1990. Initially Teachers' used derivatives to gain exposure to equities, a highly unconventional move for a pension fund. Over five years the fund gradually reduced its holdings of Ontario government securities, increased investment in equities, and reached its target allocation. To allow the investment team to take advantage of tactical opportunities, actual asset allocation was allowed to vary in a 5% band around the strategic asset allocation targets.

Over the years, Teachers' expanded its universe of investments to include commodities, real estate, infrastructure and timber. Along with real return bonds, these assets were then grouped together in a category that Teachers' labelled 'Inflation-sensitive investments'. Starting at 7% in 1996, the target allocation to Inflation-sensitive investments climbed steadily to nearly a third of the portfolio by the early 2000s, and almost half (45%) in 2009. In parallel, in view of the increasing volatility in equity markets and the diminishing risk tolerance of the pension plan given its maturing profile, the target allocation to equities was cut back from two thirds of the portfolio to 40%.

Phase 1: The Origins of Teachers' Private Capital

As a division within the Equities Investment team, Teachers' Private Capital invested in private companies; directly, either on its own or co-investing with partners, and indirectly through private equity and venture capital funds managed by third parties. At the end of 2011, TPC's portfolio of direct investments, co-investments and private equity funds totalled C$12.2 billion. Since inception, this had generated a net-of-fees internal rate of return (IRR) of 19.3%, validating the conviction of Teachers' initial management team which had envisioned investments in private companies and alternative assets to be part of its portfolio from the start.

The original executive team was led by Claude Lamoureux, who joined the fund as President and CEO in 1990, after a 25-year career in financial services in Canada and the United States. Robert Bertram, a former Treasurer of Alberta Government Telephones, was hired as Senior Vice President of the newly established Investments division the same year. Under their combined leadership, Teachers' aimed to build up a C$2 billion private equity portfolio within ten years. Investing in private companies was deemed attractive as the plan had long-term liabilities and could therefore afford to earn the illiquidity premium associated with private equity. However there were few private equity firms in Canada in the early 1990s, so the plan took the unusual step of investing directly in Canadian companies, often in partnership with third-party investors. The first private placements were made in 1991: C$100 million of growth capital was committed to seven privately-owned Canadian companies. Three of these were direct investments: Commcorp Financial Services Inc., a leading national equipment financing and leasing company; Strong Equipment Corporation, a national distributor of construction and related equipment; and White Rose Crafts and Nursery Sales Limited, a retailer of lawn, garden and craft supplies across Ontario. The remaining four investments were made through limited partnerships (LPs) and merchant bankers specialised in the media industry.

Teachers' decision to pursue both direct and indirect investments was driven by the desire to accelerate the pace and efficiency of building up a private equity platform for the fund. Teachers' targeted mature operating companies with a proven track record, strong management and significant management ownership for direct investments, providing them with either development capital or recapitalisation funds to reduce debt. At the same time, it formed alliances with established merchant banks, brokerage houses and a limited number of established private equity funds to invest in their funds and also co-invest alongside them in larger transactions. This channel allowed Teachers' to cast its net wider into markets it was not yet prepared to tackle independently (e.g. the United States and Europe), to tap into specialist expertise (e.g. Providence Equity Partners for telecom sector investments, another fund focused on oil and gas investments in the Canadian province of Alberta), or to access segments of the private equity market that TPC could not invest in cost-effectively on its own (e.g. investments less than C$50 million in Canadian private companies). However, the path Teachers' had chosen was not easy – while it tried to establish itself as an equal to private equity fund managers, often it was not taken seriously by investment banks and established general partners of private equity funds.

Teachers' approach to investing was in marked contrast to that of other large institutional investors (Exhibit 2.4). For instance, the Canada Pension Plan Investment Board (CPPIB) had all its assets invested in government bonds as recently as 1998.[1] CPPIB began a private equity investing programme in 2001, choosing to rely solely on external fund managers. It was only in 2006 that it launched a multi-year transformation to build internal capabilities in making direct investments in private equity. Other large institutional investors, such as the endowment fund of Yale University, saw private equity as an integral part of their investment allocation, yet only performed fund manager selection internally while outsourcing the investment process entirely to the selected fund managers. At the other end of the spectrum, investors such as Norway's Government Pension Fund Global (GPFG) had strong convictions about transparency and performance assessment relative to a benchmark that led to a total avoidance of private equity. Instead it pursued a low-cost beta-only approach, with strict index-linked investments in market-traded equity and fixed income instruments and very limited active management.[2] Occupying the middle of the spectrum of institutional approaches to private equity were investors such as the Government of Singapore Investment Corporation (GIC) that made fund investments as well as direct investments in private equity, but typically limited to minority equity stakes.

By 2000, Teachers' had developed expertise in all facets of merchant banking and held over 100 investments in the consumer products, communications, industrial products, entertainment & media, financial services, retail, and energy industries. Teachers' invested directly in Canadian firms, which represented 40% of the merchant banking portfolio. In the United States and Europe it invested both directly and indirectly as a limited partner. The merchant banking portfolio included C$329 million of venture capital invested in Canada and the US, principally in life sciences and information technology.

Teachers' had become one of the largest sources of private capital in Canada and, with an annual rate of return of 23% from private capital investments since inception, one of the most respected. Typical equity cheques were C$25-500 million, with a sweet

1. Nicole Mordant, "Canada's big pension funds reach for the top", *Reuters* News, April 18, 2007 (Factiva).
2. David Chambers, Elroy Dimson and Antti Ilmanen, "The Norway Model", 19 September 2011, http://www.tilburguniversity.edu/about-tilburg-university/schools/economics-and-management/news/seminars/finance/2011/Dimson.pdf.

spot in the C$75-100 million range. In 2001, Teachers' total direct investment portfolio including co-investments stood at C$1.9 billion and fund investments at C$1.1 billion, with 18 investment professionals managing the overall TPC portfolio.

Jim Leech: Tasked with Taking Teachers' Global

With a nascent platform in place to make (minority) investments in private companies, Teachers' Private Capital was looking for someone with a solid track record in building businesses to expand its direct investing model further into controlling investments and into new markets. With an honours degree in Mathematics and Physics from the Royal Military College of Canada and an MBA from Queen's University, Jim Leech had built a career leading large public companies in the financial services, and real estate and energy industries, as well as smaller technology start-ups. Most notably, he had served as the President and CEO of Unicorp Canada Corporation, one of Canada's first merchant banks, and Union Energy Inc., then one of the largest integrated energy and pipeline companies in North America.

When Claude Lamoureux and Bob Bertram approached Jim in 2001 to head the Private Capital division, he had just completed the sale of a successful technology venture and was poised for a quiet retirement overseas with his wife. But the vision and the ambition they conveyed were compelling. Teachers' had long been known for the way it fearlessly embraced innovation and risk: it was the first pension plan to buy 100% of a real estate development company, the first to use derivatives to achieve its targeted asset mix, and the first to invest in commodities. This willingness to take well-considered risks appealed to Jim's way of thinking. He put his retirement on hold and accepted the opportunity. Soon he would be leading Teachers' to "venture into galaxies where pension funds feared to tread".[3]

Under his leadership, the total amount invested in direct and co-investments increased almost fourfold from C$3.3 billion in 1990–2001 to C$11.5 billion in 2001–2011. As a result, OTTP became one of the earliest pension funds anywhere in the world to make a concerted push into direct investment in private equity. It pioneered the disintermediation approach that gradually gained wider adoption among institutional investors.

Phase 2: Growing Ambition

Following Jim's arrival at Teachers', the minimum equity commitment for direct investments was gradually raised to C$100 and then C$200 million, with the ideal size being C$300-400 million. In 2004, the merchant banking division was renamed Teachers Private Capital (TPC). The rebranding was prompted by the desire to emphasise the association with Teachers', which had a good reputation in capital markets and derivatives, and at the same time downplay the association with pension funds, which Wall Street derided as "dumb money".

Jim reorganised the team, creating regionally focused teams, and also initiated exposure to Asia. He separated the Direct Investments team from a dedicated Fund and Co-Investments team to manage relationships with general partners (GPs). Unlike

3. Karen Mazurkewich, "Teachers' next test; Jim Leech has a big task dealing with the pension plan's $12.7B deficit", *Financial Post/National Post*, August 28, 2008 (Factiva).

many funds which bought a portion of a GP's investment in a company after the GP had already made the investment, Teachers' participated alongside GPs with its own direct investment team in all major steps of the investment process, conducting due diligence, negotiating on deal structure and valuation, and closing the transaction. For this reason, Teachers' preferred to refer to its Co-Investments as "Co-Sponsoring".

Jim re-engineered processes and approvals, brought in senior people and expanded the TPC team significantly. Although the team grew in scale and scope, he continued to remain involved in larger transactions. Based on the early success of TPC's private equity investing, Teachers' also started to invest directly in infrastructure and timber, marking yet another first in the industry. Investing in these assets which produced stable long-term cash flows linked to inflation involved many of the same investment processes required for direct investing that Teachers was by then well versed in. As these asset classes grew in size, they were eventually spun off into a separate division which managed C$10.8 billion in assets by 2011.

It was in 2005 that Teachers' Private Capital's US$450 million purchase of Alliance Laundry Holdings, North America's leading manufacturer of commercial laundry equipment, had first made Wall Street sit up and take notice of TPC as a serious private equity investor. The fact that TPC beat established American fund managers such as Kohlberg Kravis Roberts & Co. (KKR) to buy the asset from Bain Capital sent a clear message to those who until then did not believe in Teachers' commitment to or capability in the asset class. By 2005–07, TPC was looking at cheques of C$1 billion, and opportunistically considered transactions as large as C$4 billion in conjunction with other investors. Simultaneously, as the international diversification that Jim was tasked with bore fruit, the portion of Teachers' private equity portfolio invested in Canada fell from 40% a few years earlier to 32% by 2006.

A star performer during this period was the Yellow Pages telephone directories business. Acquired by Teachers' and KKR in November 2002, Yellow Pages sold units to the public through an income trust less than a year later, netting a 146% IRR for the two investors. On the surface it appeared to be at odds with Teachers' professed long-term investment horizon, but not when one considers that while KKR had exited its stake in Yellow Pages by 2004, Teachers' remained invested in the company for several years longer.[4] This illustrated a crucial point that differentiated Teachers' from the likes of KKR: unlike PE funds that were evaluated mainly on their past IRR track record when they attempted to raise a new fund, Teachers' needed to focus on generating cash rather than percentage returns. As Jim Leech put it, "You can't pay pensions with IRRs – you need cash."

Maple Leaf Sports and Entertainment (MLSE), owner of prominent professional sports teams, venues and television networks in Canada, was a case in point. Teachers' held its investment in MLSE for nearly 18 years before finally selling it. While the fivefold return implied a moderate IRR of about 16% p.a. due to the lengthy holding period (during which additional investments had taken place at various points), the sale proceeds of C$1.3 billion were substantial when compared with the C$4.7 billion in benefits the pension plan had paid out during the year it announced the sale.

---

4. Immediately after the Yellow Pages Group converted itself to a public income trust, Teachers' reduced its stake in Yellow Pages from 30% to 20.8% while KKR reduced its holding from 60% to 41.7% and BCE, the other remaining shareholder, reduced its share from 10% to 7%. In December 2003, KKR further reduced its stake to 19.4%, eventually exiting Yellow Pages entirely by June 2004.

Teachers' was an active and vocal shareholder in public equities, vigorously advocating good governance by speaking out, talking privately with management and directors of public companies, and voting against management proposals that it judged as being against the interest of shareholders. As a large investor with substantial share ownership in individual public companies, it was in a position to practice what it termed "relationship investing": encouraging company managers to increase shareholder value by practicing good corporate governance, setting strategic priorities, and meeting long-term performance criteria. Spurred on by superior results from in-house management rather than external fund managers, Teachers' increased the proportion of actively managed assets in-house in public and private equities. In 2002, it formed the Canadian Coalition for Good Governance in partnership with other institutional investors to promote good corporate governance practices in Canadian public companies.

Teachers' campaigns for better corporate governance extended to participating in shareholder class action suits in some cases. For example, at Nortel, once the second largest telecom equipment manufacturer in the world, alleged accounting wrongdoing cast suspicion on bonus payments made to the then CEO. To bring governance issues to the fore, Teachers' participated in a class action lawsuit with other shareholders in the U.S. courts, culminating in Nortel agreeing to settle the case for $2.4 billion. Nortel never recovered from the accounting scandal and eventually filed for bankruptcy. In a classic case of journalistic hyperbole, Teachers' activism was described as "a governance jihad that gutted the company".[5]

The fund's practice of active management also extended to its investment in private companies such as Maple Leaf Foods, one of the earliest instances where its investment (C$150 million) was accompanied by a change in the management team as well as the business plan of the company.

Annual returns from the TPC portfolio ranged from 27% to over 40% between 2003 and 2007, substantially surpassing benchmark returns. TPC's prominence as a source of private capital continued to grow. At the 2007 Private Equity International Awards it was named 'Best Buyout Firm in Canada', 'Best Limited Partner' and one of the top 20 private equity firms in the world in terms of total capital deployed over the past five years.

In parallel with the steady increase in in-house active management, Teachers' worked to educate its stakeholders on the need for competitive remuneration to ensure continued value creation through active management. While the lack of fundraising pressure at Teachers' certainly meant more job security for staff at TPC than at a private equity fund, attracting the right financial and operational expertise from the private sector and from private equity into Teachers' quasi-public sector environment required that compensation for investment professionals be competitive. Advised by an independent consultant, Teachers' developed an incentive system that linked compensation to long-term outperformance over benchmarks. The system, which applied to all investment staff, paid out bonuses only if managers did better than their benchmark over a four-year period, while also taking into account the overall performance of Teachers' investments. Payouts could still be substantial: in 2004, 2% of four-year value added over the benchmark, amounting to C$52million, was set aside for long-term incentive payments to staff.

5. Terence Corcoran, "Teachers' arrogant role at Nortel, BCE", *Financial Post/National Post*, December 12, 2008 (Factiva).

Although investment professionals at Teachers' and other Canadian pension funds were among the highest paid in the world,[6] their total investment management costs were among the lowest because they avoided significant fees (paid to external managers) by managing a large portion of assets in house. The typical PE fund charged 1.5-2% in annual management fees and retained 20% of profits in the form of performance fees (carried interest), sometimes even on a deal by deal basis. Given these fees, a 20% gross return achieved by an externally managed fund would (in a typical fee structure) result in a net-of-fees return around 6% lower for investors in the fund. Another advantage from having developed internal capabilities in PE was the flexibility it bestowed: while PE funds required investors to commit capital upfront and then make that capital available when required to fund investments, Teachers' could vary the pace of its direct investments if and when it made sense to do so.

One spectacular success for TPC was the sale in 2007 of Samsonite Corp. for a total of US$1.7 billion in cash, a fivefold increase on its investment. The world-famous luggage maker was on the brink of bankruptcy when Teachers', in partnership with Ares Corporate Opportunities Fund and Bain Capital, had acquired and recapitalised the company in 2003. Under the direction of a new management team, Samsonite was repositioned globally as a stylish, high-quality brand, enabling a headline exit for investors such as TPC.

Partly fuelled by confidence from the success of earlier investments and partly by the ample availability of financing from competing investment banks, TPC set its sights on increasingly large investments. As a Reuters article[7] put it, "Once largely shepherds of low-risk investments", pension funds such as Teachers' were now "invading the boardrooms of some of North America's biggest corporations and have become leading dealmakers in the public and private equity markets." Nothing could illustrate this better than the case of Bell Canada Enterprises (BCE) which, with a market capitalisation of C$25.3 billion, was the most widely held public company in Canada and the parent company of Bell Canada, the country's largest phone company.

Phase 3: The Peak – Leading the World's Largest LBO

Teachers' interest in BCE dated back to 1990 when it began investing in equities. The 1-2% stake it held in BCE (Exhibit 2.5) was one of its largest ever equity positions because BCE was a prominent constituent of the TSX index. BCE had originally been a leader in mobile, but hampered by a lack of focus, it lost ground to two newcomers. Shares in BCE returned 7.1%, including dividends on an annualised basis over a four-year period (2002–2006), while those of its domestic peers Rogers Communications and Telus Corp returned 48.1% and 35.5% respectively over the same period.[8]

6. Jody MacIntosh and Tom Scheibelhut, "How Large Pension Funds Organize Themselves: Findings from a Unique 19-Fund Survey", *Rotman International Journal of Pension Management*, Volume 5 Issue 1 Spring 2012 (http://www.cembenchmarking.com/Files/Documents/How_Large_Pension_Funds_Organize_Themselves.pdf).
7. *Reuters News*, April 18, 2007.
8. Bloomberg Data. Returns calculated assuming dividends are reinvested in the respective security, for the period from 31 Dec 2002 to 31 Dec 2006.

BCE appeared to be clearly undermanaged both by Canadian standards and compared to global benchmarks in the sector. Teachers' had been active in expressing its views to management and had increased its stake in the company to 5% by the end of 2006, steadily gaining influence on BCE's board, but not enough to drive change. Frustrated with BCE, the Public Equities team turned to TPC to see if it was interested in initiating a take-private or a conversion of BCE to an income trust in order to unlock value. Since the team at TPC knew BCE quite well from having purchased two of its divisions – Yellow Pages and CTV Bell Globe Media – in earlier transactions and a recent unsuccessful bid for its satellite business, TPC agreed. Responsibility for BCE was transferred to TPC in 2006, overseen by a team led by Glen Silvestri, who would later become head of investments in Telecom, Media and Technology (TMT) and Energy within TPC. As a response to growing shareholder discontent, the management of BCE began considering various options to breathe life into its lacklustre performance: a large share buyback, a debt repurchase, a blockbuster acquisition or converting itself into an income trust. It decided to convert itself to an income trust.

Income trusts had been growing in popularity with Canadian investors at that time due to the tax advantages they possessed. However, the spurt in income trust conversions led the Ministry of Finance to fear significant erosion in the country's corporate tax base. Shortly after BCE disclosed its intention to convert, government legislation was revised in a way that removed the advantages of conversion, as a result of which BCE was forced to cancel its plans. Exposed and rudderless, with no other value-creation strategy on hand, it went 'back to the drawing board' in late 2006 to consider all of its options, at the urging of external advisors and interested investors. Having recently sold a satellite communications subsidiary for C$3.25 billion, BCE was cash rich but bereft of imminent investment opportunities for that cash, and thus began to attract serious interest from private equity funds including KKR and Providence Equity Partners Inc. This prompted Teachers', which had long been contemplating options for its stake in the company, to throw its hat into the ring.

In early April 2007, a few days after Jim Leech and Jonathan Nelson, CEO of Providence Equity Partners, had met with BCE CEO Michael Sabia, Jim informed BCE that Teachers' planned to file a 13D notice with the U.S. SEC. The implication was loud and clear: the status of Teachers' investment in BCE was changing from passive to active. Realising that a buyout was becoming unavoidable, the board of BCE decided to embrace what it could no longer avoid and decided to extract the best possible deal for its shareholders. It created an official auction process and invited bids from interested buyers, with a June 26 deadline for the submission of bids.

The sheer size of a likely deal meant that Teachers' could not act alone. Teachers' had already decided to partner with Providence and Madison Dearborn Partners, LLC – funds that it knew and respected for their telecom sector expertise from earlier investments.[9] Meanwhile, KKR partnered with CPPIB, and Cerberus Capital Management LP headed another consortium of investors, who all put in competing bids for BCE.

9. OTPP invested in four different buyout funds managed by Providence Equity Partners (1999, 2001, 2005 and 2007). OTPP also made several investments in the Telecom, Media and Technology (TMT) sector alongside Providence Equity Partners such as the purchase of Kabel Deutschland, Germany's largest cable operator, and investments in Grupo Corporativo Ono, Spain's largest alternative provider of communications, broadband internet and pay TV and Idea Cellular, one of India's largest cellular companies.