

MyConsultant

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Since joining JANA, Matthew has advised clients on a number of transactions including a European gas distribution network and Australian Public Private Partnership investments. Matthew is also part of JANA's Private Equity and Infrastructure Research Team through which he has undertaken detailed due diligence on a number of managers, as well as contributed to various research pieces.

Prior to joining JANA in 2008, Matthew was a research analyst for MLC's ThreeSixty Research Solutions managed funds team. Matthew also completed the two-year MLC Graduate Program with rotations in Accounting and Finance.

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The benefits of investing in private equity

Institutional investors are continuing to look for lower cost investment solutions. That's why investments that require high levels of resources and have associated higher costs are being asked to justify their fees.

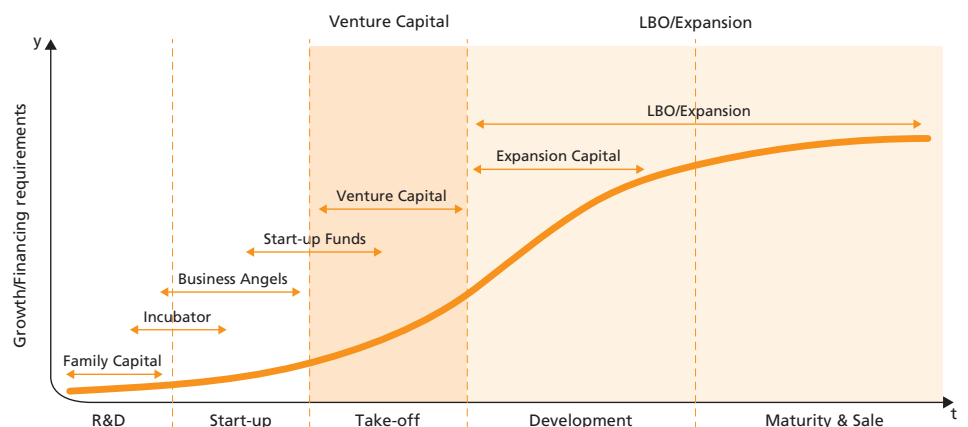
As a result, many investors have been questioning the viability of private equity as part of their diversified investment portfolios. In this article JANA goes back to basics to outline what private equity is, what role it can play within a diversified portfolio and then finally, why JANA still supports selective exposure in client portfolios.

What is private equity?

Private equity is much like owning a stock in a publicly listed company except it involves taking an ownership interest in an underlying set of private (or unlisted) businesses or assets. Private equity investing seeks to generate superior returns by pursuing an active role in monitoring and advising companies, and through operational and corporate governance improvements in order to sell the investment at a premium.

Private equity can be classified according to a company's growth lifecycle (as seen in Figure 1).

Figure 1: Private equity and the growth lifecycle of a company



Source: Credit Agricole Private Equity

Some of the most common private equity investment strategies include:

- **Venture capital** – finance provided by investors to smaller start-up firms, typically invested in an early stage company with negative cash flows that needs support until its product can be commercialised. Due to the nature of the investment, the outcome for venture capital tends to be a more binary outcome (home run or capital loss). This type of investment has considerable risk, although as demonstrated by Atlassian, Facebook and other companies, the payoff can be extremely large. Venture capital is more suitable for investors with a mature private equity program, who can withstand the potential for substantial capital losses and who have the patience to ride the long journey of venture capital.

- **Buyouts** – which includes Management Buyouts, Leveraged Buyouts (LBO) and Expansion Capital, occurs during all phases of growth for established companies where use of leverage, enhanced corporate governance and operational efficiency are used to improve the performance of the company.
- **Distressed/special situation** – an investment strategy that involves purchasing the discounted bonds of a financially distressed firm. Distressed debt investors frequently convert their holdings into equity and become actively involved with the management of the distressed firm.

What are the main characteristics of private equity?

Private equity has a number of unique characteristics that potential investors should consider in the context of their own investment circumstances. The main characteristics are:

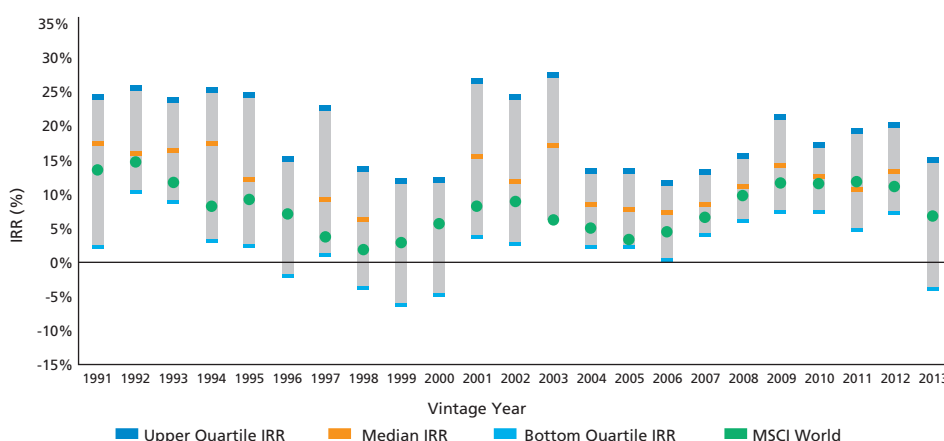
- **Illiquidity** – private equity is typically long term and illiquid due to the investment characteristics of the portfolio companies and the private equity fund structure (generally 10 years plus extensions). For investors with a longer time horizon and patient capital, this should not necessarily be a cause for concern. Conversely, for investors with a shorter time horizon (less than 10 years) and a need for liquidity, private equity investment should not be considered.
- **J-curve effect** – investors in private equity will typically experience a “J-curve” effect, where they will experience negative cumulative cashflows during the initial phase, as committed capital is drawn down for new investments and fees are paid on the committed capital. As investments mature and realisations are sought, the cumulative cashflows will start to turn positive as investors receive distributions from the sale or exit of its private equity investment. It can therefore take several years to have a clear assessment of performance.
- **Volatility** – private equity investments generally tend to have lower price volatility compared to the listed equities market due to the frequency of valuation, which tends to range from quarterly to annually. The lower price volatility does not always reflect lower company risk.
- **Active capital** – managers often take an active role in the portfolio company via board representation and other executive positions. In contrast, investors in public companies rarely have board seats or a controlling interest.

- **Alignment of interests** – private equity has the potential to improve the alignment of interests between investors and management through the use of incentive structures that may be unfeasible to implement for a listed equity manager. For example, management and the General Partner (GP) are often provided with the ability to invest their own money (“skin in the game”) alongside investors; and earn out provisions may be applied.
- **High fee structure** – private equity fee structures are significantly higher relative to other traditional asset classes, with management fees on committed capital typically 1.5% to 2.0% pa plus a performance fee of around 20%. If investors are investing through fund of funds structures, there will be an additional layer of fees. Although the private equity approach is more active and hands-on compared to listed equities, it is arguable whether the high fee structure can be justified. However, it is difficult to pressure managers to reduce their fee structure, especially those top-tier managers who tend to be oversubscribed by investors when fund raising. Private equity fee structures are a topical subject that warrants a separate piece and we’ll cover this subject in the future. However due to the high fees and the large discrepancy of returns between top and bottom ranking managers, choosing the very best opportunities is paramount.
- **Barriers to entry** – private equity funds generally require a relatively large minimum investment commitment amount (>\$5m-10m) and for investors to establish a diversified private equity program requires significantly larger commitment amounts. Hence, for smaller investors, private equity investments are generally harder to access, although there are means to access private equity in a diversified manner via fund of funds structures or secondary private equity markets; albeit at a higher fee level.

What is the role of private equity within a diversified portfolio?

While there are a number of roles that private equity can play within an investor’s diversified portfolio, depending on their preferences and situation, we believe its primary role is to access high returning investments that are not directly correlated to equity market returns.

Figure 2: Private Equity IRR Quartiles by Vintage Year. Performance of Private Equity since 1991.



Source: Hamilton Lane Fund Investment Database (November 2015) MSCI World, net reinvested Dividends. Benchmark calculated as PME (Public Market Equivalent) using all private equity pooled cash flows.

- **Potential to generate high returns (after fees)** – private equity investments have the potential to generate outsized returns – a key rationale for investing in the asset class. If private equity investments cannot generate high net returns relative to traditional asset classes to compensate for its illiquidity and heightened risk profile, there is little point in considering private equity. Figure 2 displays the performances of private equity funds by vintage year (otherwise known as the first year in which investment capital is deployed) and depicts a couple of interesting observations. Firstly, the dispersion between upper quartile, median and lower quartile private equity performances are quite significant throughout the vintage years going back to 1991. Interestingly, private equity tends to exhibit greater manager performance persistency than traditional asset classes. This means that upper quartile managers will tend to generate upper quartile performances for their successive funds. The second observation we can draw from Figure 2 is that upper quartile private equity performances have significantly outperformed the MSCI World Index since 1991. These observations demonstrate that private equity has the potential to generate high returns relative to the listed markets, especially if investors are selective and invest with the upper quartile managers.

At JANA, we have been emphasising the importance of manager selection, especially within the private equity asset class. Accessing upper quartile managers is essential to having a

successful private equity program. Investors need to spend time and effort in identifying and establishing relationships with these upper quartile managers.

- **Diversification** – private equity can provide diversification benefits when used as part of an investment strategy as the asset class provides exposure to an expanded opportunity set, including companies too small or unsuitable for listed markets; as well as early stage and growth capital businesses. There are also sectors and regions where private equity is able to provide better access relative to listed equity markets, especially in emerging markets. Industries such as Consumer, Healthcare and Information Technology are poorly represented in the listed markets for countries like China, Brazil and also MSCI Frontier Markets. These industries in the emerging markets are better represented in the private markets, where private equity managers can more easily access these industries compared to listed markets.

Why are we still supportive of private equity?

Despite the heightened risk profile, unique nature of private equity relative to traditional asset classes, and relatively high fee structure, we continue to be supportive of private equity investments on a selective basis, where the investment can provide an opportunity to generate a high post fee and tax return. The exposure should also improve the portfolio's overall diversification.

JANA takes an opportunistic/selective approach to investing in private equity. In practice this means we allocate to private equity when we can identify an opportunity that is more attractive relative to traditional asset classes, and with a high quality manager. Due to the long term illiquid commitment to the manager, we do not compromise on

manager quality. History shows that gaining access to upper quartile managers is essential to having a successful private equity program.

As much as the potential high returns generated from private equity investments are important, JANA continues to focus on finding solutions to reduce the overall fee levels for our investors, whilst maintaining the quality of the private equity portfolio. Strategies to reduce overall fee levels will depend on each investor's circumstances and may involve working closely with the managers to derive a suitable solution. These strategies include transitioning from a fund of funds model to a separate mandate account or a direct private equity program with a more favourable fee structure. Another strategy could include introducing private equity co-investment funds in the portfolio to help reduce the overall fee levels for investors.

Conclusion

Private equity by virtue of its unique characteristics is not a mainstream asset class. It's therefore important for investors to have a clear and unequivocal understanding of their investment objectives and risk tolerance before considering this asset class.

However, for longer term investors who can tolerate the unique characteristics of private equity, investment in this asset class can be very rewarding. Especially in the current market environment where long-term forecast returns from traditional asset classes are looking subdued, investing in private equity can provide an opportunity to generate a higher absolute return, while improving a portfolio's overall diversification.

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