An industry comes of age

The recent growing pains felt by Australian private equity managers may be easing. *Martin Lawrence* gets the prognosis.

After growing rapidly in the three years leading up to June 30, 2001, when Australia's super funds started to pour money into the sector, private equity fundraising came to a shuddering halt.

But now, after a long period where most managers described raising funds as difficult, verging on the impossible, signs of optimism and maturity are encouraging investors and managers alike.

Good early indications of performance from the funds raised three or more years ago, coupled with improving investor confidence generally and increased interest in alternative investment after two years of pain from traditional markets are all combining to make private equity managers more confident about the future.

Joint managing director of fund-of-funds firm, Quay Partners, Sam Armstrong, says "there are some really good signs emerging" in terms of investors being willing to allocate to private equity, as well as some good indicators of performance.

Armstrong, and his co-managing director, Stephen White, emphasise there are still black spots in terms of performance and fundraising - early stage private equity is still "very ugly" according to Armstrong - and certainly, internationally there is still a lot of gloom among private equity managers.

Cynicism among some investors is alive and well, too. Private equity has no place in any of GMO's absolute return portfolios, senior fund manager Forest Berkley said on a recent Sydney visit, because the "massive divergence" of performance meant manager selection was a minefield, and the higher fees made the asset class "look a lot like plain equities", most of which the manager believes are overvalued anyway.

Charles Cecil, director of UK-based private equity placement agents, Helix Associates, says it is still a "very difficult market" internationally for raising money, especially in the venture capital technology sector that attracted so much 'hot money' in the late 1990s.

But in Australia at least, managers and advisers are universal in their confidence things are turning around at last, and, alongside this returning confidence, point to signs of an industry that is rapidly maturing.

Principle Advisory Services, for example, the private equity consultancy founded by former AMP and Gresham executive, Les Fallick, has set itself up as Australia's first known placement agent: A specialist external fundraiser for private equity firms which does everything from advising on fundraising and preparing offer documents to the actual raising, leaving investment teams free to focus on their portfolios.

John Brakey...
skills are increasing

Principle has teamed up with Helix Associates, which will enable the firm to do offshore fundraising for Australian firms and allow it to bring Helix clients to Australian investors.

Cecil, one of the founders of Helix, says placement agents can only really exist in a market of a certain size and maturity.

"It does predicate a reasonably sophisticated market ... you really do need a certain amount of investors to justify using placement agents," he says.

Fallick says the reaction from gatekeepers and managers to placement agents has been generally positive, and he says there is a "good pipeline of business" ahead.

He says these clients are sourced from two groups: Those managers who have previously raised funds from institutions and have existing portfolios occupying their time, and those firms getting ready to go to external investors for the first time.

Legislative reform at last

Of course, selling Australian private equity to offshore investors has only really become viable in the past year, with the long-awaited announcement by the Federal Government that it would pass legislation allowing the use of the limited partnership (LP) model, used for private equity funds in the US and Europe, ending the long running tax barrier to offshore private equity investors.

This new legislation, the product of a concerted lobbying effort by the private equity industry, has contributed to the rising optimism in private equity.

Executive director of Wilshire Australia, Ovidio Iglesias, whose clients include some of Australia's largest super fund private equity investors, says the long wait for the venture capital LP model may also have contributed to the recent slowdown in private equity fundraising by keeping some of the better-known firms out of the market.

"I'm sure there are a couple of managers that postponed their raising until those reforms were passed,' he says.

When assessing the maturity of the market, Iglesias also points to the kind of deals now being done by private equity managers.

He says deals like Tasman Building Products - recently sold to Fletcher Building for a substantial profit for private equity investors GS Private Equity and Gresham - are important milestones for the local industry.

"It's the first time that a secondary buyout has been done (Gresham and GS bought out AMP Henderson, which led the initial buyout syndicate) and both buyouts were very successful for clients," he says.

Macquarie Funds Management associate director, John Brakey, who oversees the firm's fund-of-funds program, says some recent deals - like CHAMP's investment in Austar - are "incredibly complex transactions to put together" and reflect a growing level of skills among the more established firms.

Similarly, portfolio manager on MLC's $900 million private equity program, Stephen Whatmore, says "you're starting to see the emergence of some quite sophisticated M&A skills" among Australian managers.

These transactions, like the existence of placement agents, also require an industry with a reasonable number of players and the Australian industry has grown steadily over the past decade.

As the chief executive of industry fund-owned private equity fund-of-funds, DAF, Ian Court says: "When I first started going to AVCAL conferences in 1994, there were 25 people there and now there are four, five hundred."

The growth in numbers, and the passing of the years, has also seen

Ovidio Iglesias...
LP dam set to break

the older private equity firms become more established.

Court, and Macquarie's Brakey, put the universe of potential private equity firms in which to invest at between 35 and 40, while Igelsias says the fact some firms, like CHAMP Ventures, are now raising their fifth fund, is an obvious sign of a maturing industry.

The hard times experienced by the local private equity industry of late have also contributed to its growing up.

"We're probably having some consolidation at the moment - there were some managers funded up in the last cycle who may find it harder going forward," says Iglesias.

The long, hard drought breaks

Expressions of optimism are now near universal in the local industry, with the success of DAF in raising, at last count, $355 million from super funds the first tangible indications of renewed investor interest.

It came after Australia's big super funds, which still dominate private equity investment in this country, had closed their purses to new investment in local managers.

One reason given by most industry participants and observers is the slump in listed markets saw most super funds turn their attention to their equities and bond portfolios.

The managing director of Frontier Investment Consulting, Fiona Trafford-Walker, says many investors pulled back from private equity because "they were worried about their listed portfolios and after all, you've got to remember, most private equity allocations are still pretty small".

Another reason for the fundraising freeze is those small allocations suddenly became a lot larger as equity markets fell.

Funds which had marked out a modest 5 per cent allocation to private equity across their portfolio, to be reached by slowly funding a number of managers over a number of years, suddenly found themselves with a portfolio already approaching their strategic asset allocation.

Court, who oversees three domestic fund-of-private equity funds and a $1 billion international private equity fund-of-funds, says the general bad news coming from markets around the world meant investors became much more risk averse across the board - even in sectors which had not in fact cost them money.

"People became much more risk averse, and they started looking very closely at Australian private equity and issues like is the market big enough, can you make money?" Court says.

Sam Armstrong...
good signs emerging

Adding to the problems faced by private equity managers trying to raise funds, the relative youth of the Australian market meant until recently, it was hard to prove Australian private equity did produce returns.

The past six months have seen a string of profitable deals realised by Australian private equity firms, with the listing of Atlas Steels, the trade sale of Tasman Building Products and the forthcoming sale or initial public offering of private equity-backed firms Repco, Just Jeans and Pacific Brands all predicted to make strong returns for investors.

Because of the long term nature of private equity, investments made in 1998, 1999 and 2000 are only just now beginning to be realised, so as Trafford-Walker says, Australian super funds had made a "leap of faith" in investing in the sector. ❇

The untapped market: Retail private equity

Australia's retail investors have to date not had much opportunity to invest in private equity.

While there are a small group of listed private equity funds, and groups such as JBWere, and Colonial First State have all raised retail money, for most of Australia's planners, private equity remains too hard.

Part of the problem is a lack of product, and it is significant the only firms to raise retail money have been established players.

As Macquarie Funds Management's John Brakey says: "You need to have a distribution network to do it."

Macquarie's fund-of-private equity funds, the Macquarie Diversified Private Equity Fund, which has been modified to make it suitable for platforms, has been listed on a string of major wraps and master trusts and Brakey says this has resulted in $5 million in "actual flows and probably $10 million in soft commitments".

Private equity's illiquidity also makes it hard for retail investors but this illiquidity does have a return payoff.

"It's no coincidence that the higher returning industry funds have allocations to alternative assets," says Brakey.

Some retail investors have already benefited from private equity in a balanced portfolio, with MLC having a $900 million commitment to the sector.

The manager of this private equity program, Charl Pienaar, says even though it is still, after being founded in 1996/97, in its infancy in terms of private equity, it has already benefited investors.

"We made quite a lot of money in the tech venture capital sector before it started to come off," he says, adding the portfolio to date is returning well in excess of listed markets over its life.