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Birth of a golden age

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CFO | 01 Dec 2006

Institutional money has barnstormed into private equity, swelling its coffers to a record high. It's this wall of capital that is changing the dynamics of Australia's mergers and acquisitions scene.

A simple example suffices. When Gresham Private Equity raised its first fund in 2000, it raised \$200 million - and half of that came from Wesfarmers. When a team of Gresham managers left to form Ironbridge Capital in 2003, the fund raised \$450 million. Fast forward to 2006 and Ironbridge is in the process of raising a \$1 billion fund.

"Institutional investors have 10 times the appetite that they used to," says Les Fallick, managing director of alternative assets specialist Principle Advisory. "This is a golden period for Australian private equity."

The backdrop to that is the run of funds - such as Gresham Partners, Quadrant and PEP - that raised money in 1999-2000 and have delivered superb returns. Suddenly super funds that had derided private equity as too risky could no longer afford to ignore it. This is clear among the industry funds that have taken to alternative assets like ducks to water.

Leading the charge is Industry Funds Management, which manages close to \$11 billion for several industry funds. It has close to \$3.4 billion in four private equity fund-of-funds (which invest in underlying managers, rather than directly in companies). Two of them, worth a combined \$1.7 billion, focus on the international market while the other two, also worth about \$1.7 billion, focus on the domestic market (IFM is in fund-raising mode for the fourth fund, which will close at \$700 million). Private equity investment has been a big success for IFM and yearly returns have averaged about 15 per cent.

"We have always been a specialist in alternative investment classes that we categorise into private equity and infrastructure," Gary Weaven, chairman of IFM, says.

DIVERSIFICATION IS KEY

Super funds chase the returns that private equity offers, but it is attractive for portfolio theory reasons as well. It is not correlated with most other asset classes and so gives valuable diversification. "Our client funds are very large and growing rapidly," Weaven says. "The key to their success is

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diversification and that they are in every part of the market, including those that are not strongly correlated to the listed equities market."

Paul Watson - deputy executive director of \$4 billion fund MTAA - puts 7 per cent of the fund into private equity. Most of it is done through very direct participation although it does have exposure to some funds. The direct participation comes when Macquarie Bank finds a potential investment and then comes to Watson to ask if MTAA wants to be a part of the consortium.

"Our involvement in private equity comes from looking to devise an investment strategy that's tailor-made for a patient investor," Watson says. "We took inspiration from some of the great endowment funds at Harvard and Yale that had a long history of private equity and alternative investments that spanned decades."

That strategy is to have two portfolios - a market one with listed assets, fixed interest and cash and a target one made up of unlisted assets. "It most demonstrated itself between 2000 and 2003 when we had a bear market," Watson says.

"The target return portfolio was highly uncorrelated with the yin and the yang of the markets, and when you combined the two, we went through that period without a negative crediting rate because of the outperformance of the target return stable," Watson says. Part of the MTAA strategy is to take the chase for alpha out of the market portfolio. Its managers aim for an enhanced index return, while the majority of risk and alpha is in the target return portfolio.

Despite the noise that private equity makes over returns, it is still considered a high-risk investment by funds, which is why exposure in most funds is generally less than 7 per cent.

The asset class is yet to attract the attention of small retail investors and its illiquid nature means that that won't change soon.

"There are two factors holding it back for retail investors," John Brakey, divisional director at Macquarie, says. "One is the newness of the asset class. It's only now getting the publicity that means that they understand it more, and retail investors don't like the long lock-up periods - which means it can't be priced on a daily basis, and so it won't sit on wraps or platforms."

But while retail money is rarely attracted to private equity, there is still more capital to come. The weighting that Australian super funds give to private equity in their portfolios is still lower than that given by offshore pension funds. Expect super fund exposure to grow - and then watch private equity funds wonder where to put all the cash.

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READER ROI

- * Institutional investors have become big supporters of private equity.
- * The asset class provides worthwhile portfolio diversification.
- * Overseas pension funds allocate more to private equity than do Australian superannuation funds.

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