Private enterprise

Why Australia is getting interested in private equity fund investing

The potential returns from private equity investments are attracting increasing attention from investment professionals. In the US, private equity funds have been available for half a century, but the Australian experience has been limited to only a few years. PETER O'REILLY and JENNY DIGGLE outline the key concepts and issues in private equity.

PETER O'REILLY is manager, treasury risk management services, ANZ Banking Group Ltd. **JENNY DIGGLE** is director, industry research, at RMIT Business. This article is a summary of a paper presented in the School of Economics and Finance, RMIT Business.

Superannuation administrators and fund managers are always searching for cost-effective investments that have low risk and a high return, but which also fall within the investment guidelines under which they operate. Bernstein (2000) comments that "the trendy accumulation of so-called alternative assets such as private equity, venture capital, and real estate by pension and endowment funds makes good sense". While these assets provide funds with greater diversification, they also create a demand for new investment products that have the potential to offer the same characteristics. As a result, new international investment asset classes have emerged, being categorised as "alternative investment assets".

Four distinct types of investment fall into the category of alternative assets:

- hedge funds;
- managed futures;
- infrastructure investing; and
- private equity (also known as venture capital).

Hedge funds, managed funds and infrastructure investing have been available to fund managers in Australia in one form or another since the deregulation of the financial markets. However, private equity investing using a pooled investment structure is relatively new.

What is private equity?

Private equity can be defined as equity in unlisted companies. There are four main subsets in the private equity asset class, identified by the probable investment life cycle (Professional Firms 2000).

- ***Venture capital***

Companies requiring venture capital are usually at the early stages of developing a product or process. They have unpredictable cashflows and are usually operating at a loss, requiring capital to ascertain whether their product has a viable market.

- ***Development capital***

Companies requiring development capital have established and proven technologies but wish to generate earnings growth by producing and developing additional products.

- ***Greenfield finance***

A greenfield project is typically a joint venture, which intends to introduce an existing technology or service to a new market. Finance is provided to the partners to facilitate the project, which may be quite large.

- ***Buyouts/spin-offs***

These are typically investments made in self-contained divisions of larger businesses, with an established management structure and proven technologies. Capital is sought when the existing management wishes to purchase the division from the parent business.

A common denominator in private equity investing is that the investor has an active interest in guiding, leading and growing the companies in which they or their agents have invested. They seek to add value to the company by using their experience.

The investor has an active interest in guiding, leading and growing the companies in which they or their agents have invested. They seek to add value to the company by using their experience.

As with listed equities, the main institutional investors include corporations, insurance companies, superannuation funds and foreign investors. Many choose to invest through managed vehicles because of the intensive nature of the investment process. Some may invest as part of a syndicate led by an investment management group. From the needs of this specialist investor group has emerged the managed fund group known as "private equity funds". These funds are defined by a broadly diversified investment structure generated by investing in companies in industry sectors as diverse as semiconductors, software, retailing and restaurants, while other funds may specialise in only one field or technology (Macquarie Investment Management 1999).

Characteristics of private equity fund investing

There are distinct characteristics associated with private equity investing that take on terms associated with most investment assets, in particular when investing through a managed fund. These terms require some clarification.

Commitments and fund-raising

Fund raisings are the commitments of capital from the investors raised during the formation of the fund. A private equity fund will set out prospecting for investors with a target fund size or cap. It will distribute an information memorandum or prospectus to potential investors and may take weeks, months or even years to raise the requisite capital (Macquarie Investment Management 1999). The fund-raising is generally focused on institutional investors as the capital-intensive nature of the commitment, the risks, length of investment and the lack of liquidity generally make this asset class unappealing to individual investors.

Institutional investors typically gain their exposure to private equity investing by investing in a pooled vehicle rather than directly in individual ventures. The pooled investment helps spread the ownership risk and provides diversification across managers and sectors.

Capital calls

Putting money into companies in its portfolio requires the private equity fund manager to start "calling" its investors' commitments. The fund collects or "calls" the needed investment capital from the investor in a series of tranches commonly known as "capital calls". These capital calls from the investors to the private equity fund are also known as "takedowns" or "paid-in capital" (Asset Alternatives Inc. 2000).

Disbursements/distributions

The investment by private equity funds into their portfolio companies is called "disbursements" or distributions, from the fund into the private equity business. A private equity fund may make these disbursements by itself or in some cases will co-invest in a company with other private equity firms. This is known as "co-investment" or "syndication" (Asset Alternatives Inc. 2000).

Lack of liquidity

It may be several years before the first investments generate either income or capital return; in many cases the invested capital may be tied up in an investment for seven to ten years (Asset Alternatives Inc. 2000). Since private equity funds in Australia are trusts, there is usually no way to exit before the trust is wound up. In the US, a new form of private equity fund has evolved: so-called "secondary" funds that specialise in purchasing the investments of an existing private equity fund manager. This type of fund provides some liquidity for original investors. Secondary funds, expecting a large return, invest in what they consider to be undervalued companies that the private equity funds may have to sell at distressed values for liquidity reasons (Harbourvest Partners 2000).

Exits

Exits are subject to the investment focus and strategy of the private equity fund. Generally, they will seek to exit the investment in a single company in the portfolio within three to five years of the initial investment. While an initial public offering (IPO) may be the type of exit favoured by the private equity capitalist and owner of the company, most successful exits occur through a merger or acquisition of the company (Professional Firms 2000).

Initial public offering

The IPO is the most talked-about form of exit for a private equity investment. Bernstein (2000) comments: "The lure appears to be in the sugarplums of goodies in the IPO exit strategies, or the expectation that fixed assets are always convertible into paper assets." Technology companies have been in the limelight during the IPO boom of recent years. According to the US National Venture Capital Association, over the past 25 years almost 3,000 companies financed by private equity funds have gone public (NVCA 2000). If the company is strong enough to meet listing requirements, it is considered to be strong enough to afford a capital withdrawal by the initial private equity investors. Once the capital is raised on the open market, the private equity investors are bought out by the newly listed firm, or their capital is converted to equity ownership.

Mergers and acquisitions

Mergers and acquisitions are the most common type of successful exit for private equity investments. In this case, the private equity firm will receive stock or cash from the acquiring company and distribute the proceeds to its investors.

Valuations

The net asset value of a private equity fund, or the value of an investor's holdings in the fund, is determined not through public market transactions but through a valuation of the underlying portfolio.

Private equity funds value their investments using guidelines or standard industry practices and by terms outlined in the prospectus or information memorandum. Usually, the value of each company is agreed by the private equity fund when making the initial investment. In subsequent quarters or years, the private equity fund will usually keep this valuation intact until a material event occurs to change the value.

Management fees

The private equity fund will usually have an investment manager which charges a fee to cover the costs of managing the fund. The management fee may be paid quarterly for the life of the fund, or it may be tapered or curtailed in the later stages. Some funds charge fees relating to the undrawn component of the fund and fees relating to the performance of the fund can be a significant expense (Macquarie Investment Management 1999). The management and administration fees typically range between 175 and 250 basis points per annum, and performance based fees may be about 20% of the over-performance returns (Australian Mezzanine Investments 2000).

Other types of private equity funds

Advisers' funds

Potential investors may have neither the resources nor expertise to manage private equity investments and may delegate decisions to an investment adviser or "gatekeeper". This adviser pools the assets of its clients (similar to a property syndicate) and invests these proceeds in a private equity fund (Macquarie Investment Management 1999).

Fund of funds

An investor may invest in a "fund of funds", which is a fund organised to invest in other private equity funds. This approach has these advantages:

- Access to specialist expertise through a single fund.
- The fund-of-funds personnel identify investment strategies and select the individual funds to match them. They also undertake due diligence and analysis of the underlying managers.
- Easier access to the better individual fund managers.
- Administrative ease, with single reporting from one fund.
- Greater diversification geographically and through industry sectors.

A disadvantage is additional cost, as the investor effectively pays a margin over the fees applying to the underlying investments (Asset Alternatives Inc. 2000) — although the advantages may compensate sufficiently for the fees charged.

Typical time horizons for private equity investing

Access to investing in private equity in Australia is generally through an unlisted, fixed-term, wholesale unit trust. The term of private equity funds is normally fixed at about 10 years or the date at which all underlying assets are sold. The proceeds are returned to investors if the assets are sold before the end of the fixed period. This is distinct from the term of investment in the underlying assets, although the two are linked. An early-stage investment may take seven to ten years to mature, while a later-stage investment may take only a few years, so the chosen term of the fund must correlate with the investor's requirements for liquidity or early exit.

An early-stage investment may take seven to ten years to mature, while a later-stage investment may take only a few years, so the chosen term of the fund must correlate with the investor's requirements for liquidity or early exit.

There is usually no obligation for the manager to redeem units in the fund during the fixed term. Hence, these funds are highly illiquid and, once committed to a fund, it is not always possible for an investor to withdraw until the end of the fixed term. Further, if investors exit before the end of the period, they may not receive the benefit of realisation profits, which tend to occur late in the period.

Expected returns from private equity funds

Strong equity markets are favourable for private equity managers, as listing is a common exit strategy. However, private equity portfolios are typically valued on an appraisal basis (similar to direct property) and so returns will not move in line with shorter-term trends in financial markets. Private equity investments are riskier than direct listed share investments because:

- the private equity market is less informationally efficient and pricing of the underlying assets is based on valuation rather than supply-and-demand. As there are fewer reporting requirements than for listed securities, information about the risks and other company-specific issues is less transparent;
- the private equity market is still relatively underdeveloped, especially in Australia. Hence the level of competition is still restricted, reducing liquidity and therefore the ability to exit from the fund before maturity.

Private equity in Australia

Managers of private equity vehicles in Australia typically maintain portfolios of 10-12 investee companies. Over the life of the vehicles, a common experience is that two or three investments will be spectacular successes, a number will perform reasonably well and some will be total failures (Ferris 2000). It is difficult to predict the outcome for any individual investment with any certainty and the risks are many (failure to identify markets, production difficulties, management upheavals etc.) especially at the venture-capital end of the sector.

The major risks associated with investment in private equity remain:

- risk associated with investing in small companies;
- lack of marketability and liquidity of many assets;
- cost of investment and market risk; and
- the level of experience required from the investor or agent.

In Australia, private equity funds are relatively immature and it is too early to make a firm judgment about returns. Most of the funds' managers focus on a segment of the private equity market with a few willing to spread themselves across the whole market. Some find themselves investing in the same projects, thereby limiting the underlying level of diversification achieved for investors. In addition, a number of US private equity funds have begun to target the Australian market, with some forming strategic alliances to gain access to the local market. This trend effectively reduces the opportunities for private equity funds to analyse and select for their own investors.

More recently, a small number of overseas managers have begun raising funds from Australian investors for fund-of-fund vehicles. These managers have the advantage of operating in the more developed private equity markets of the Northern Hemisphere, especially the United States. In addition, they have a longer history in this market and records of success in the US and UK. Choosing to invest with these managers raises issues such as currency risk, future income flow, reporting and client servicing.

REFERENCES

Asset Alternatives Inc., 2000, "Private Equity Primer", http://www.assetnews.com/ped/primer.htm, 26 October.

Australian Mezzanine Investments Pty Ltd, 2000, "Partners in Success", information memorandum, Sydney, 10 February.

Bernstein, P.L., 2000, "In Search of the Meaning of Risk", *Journal of Portfolio Management*, Spring, 26, 3, pp. 2-4.

Ferris, B., 2000, private equity presentation, Castle Harlan Australian Mezzanine Partners Pty Ltd, Melbourne, 10 February.

Harbour Vest Partners, 2000, "Secondary Investments Overview", www.harbourvest.com/secondary/overview.html, 26 October.

Macquarie Investment Management Ltd, 1999, *The Macquarie Alternative Investment Trust Quarterly Update*, March, Sydney.

National Venture Capital Association (NVCA), 2000, "What is Venture Capital?" www.nvca.com, 17 May.

Professional Firms, 2000, "Private Equity/VC Industry Structure and Future Thoughts", www.professionalfirms.com, 17 May. J

Nothing ventured, 165% not gained

Risk is what provides the thrills in venture-capital investing. Whether the thrill leaves you rich or sleepless, however, can depend on which side of the investment you inhabit.

In the United States, the heartland of venture capital, gung-ho investors in 1999 reaped an average return of 165% on initial public offerings (IPOs) of Internet-based companies. The euphoria persisted into 2000, when venture-capital funds sucked in $US70 billion of investment money, a ten-fold increase since the mid-1990s. High-tech glamour seems to have passed its peak, of course, but those golden years explain the allure of taking a chance on e-commerce entrants: high risk, high return.

The stumbling of the "new economy" showed up the fact that unpredictability is a characteristic of risk; otherwise it would not be risk at all. This year, investors have pulled in their horns. A PricewaterhouseCoopers report showed that financing of US start-ups in the first quarter fell by 40% compared with the previous three months.

And while venture capitalists are grimacing at the disappearance of three-digit percentage profits, they are not going to let the leakage go unchecked. In the not-so-cheerful environment of 2001, they are backing away from the least successful of their protégés and reserving their support for those who are — wait for it — lower risk.

Not that there is any shortage of investment cash. Surprisingly, investors are still reportedly pouring money into venture capital funds. Throughout the world, pension funds and other institutional investors are recognising private equity as deserving a place in their portfolios and setting aside a percentage for venture capital funds — but, in the US at least, those funds are being more circumspect in dishing it out.

Where they do agree to back a high-tech start-up their terms are sometimes draconian, with continued financial support depending on high performance hurdles and requiring returns that are difficult for the growing company to sustain.

In the not-so-cheerful environment of 2001, they are backing away from the least successful of their protégés and reserving their support for those who are — wait for it — lower risk.

That is the other side of venture-capital risk: these days a start-up or early-stage company needing financial support does not have much glamour at all — if it does not have a convincing business plan and real prospects of success, it can quickly become the victim of a violently pulled plug.

Some venture capitalists, putting on a brave face, say that a bit of pain is good for the industry. Entrepreneurs who have to work harder for their funding may finish up building stronger companies in which quick profits take a back seat to long-term health. That may seem to take the excitement out of venture capital investment but the sector has a robust tendency to cling to its beliefs, especially the one about the next roll of the dice.

Not everyone believes the Internet frenzy of 1999 will be repeated, but cycles are hard to resist and a new flurry of IPOs is always possible. Venture capitalists will be waiting with money to burn. It's the nature of risk-takers. J