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Australian fundraisers feel the strain

Are changes in superannuation laws the cause or the scapegoat? Either way, Australia's fundraising landscape is undergoing substantial change. Local GPs must choose between going offshore or going out of business

WHEN ARCHER CAPITAL – THEN KNOWN as GS Private Equity – raised its first two funds more than a decade ago, every single LP was Australian. Funds III and IV came along in 2004 and 2007 respectively, and at that stage 15% and 55% of investors hailed from abroad. Archer Capital Fund V closed at the end of 2011 on A$1.5 billion, with two-thirds of the capital coming from overseas.

The changing composition of Archer's LP base might be seen as a proxy for the Australian private equity industry as a whole. Tough fundraising conditions over the past four years in particular have caused even the best-of-breed fund managers to look offshore to raise capital. Few – Quadrant and CHAMP Private Equity being the obvious exceptions – have matched Archer's success in doing so, however.

Fundraising cycles for even the top performing funds have been extended, while GPs without long-standing track records have had to abandon planned raises altogether. Examples include Propel Investments and Crescent Capital, which recently put their fundraising efforts on hold, and Sydney-based Shearwater Capital, whose co-founder Gary Stead admits that operations have been scaled back, leaving the partnership's future uncertain.

"We decided not to pursue a second fund because we didn't feel we could raise the scale of fund that we wanted in order to be competitive. This was due to the very challenging fundraising environment and notwithstanding the fact that our investing performance was strong," says Stead, who is now the Australia country head for pan-Asian investor Olympus Capital Asia.

The scapegoat for the difficulties for a number of GPs has been the pressure placed on superannuation funds in the wake of the 2010 Cooper Review. The initiative, officially termed the Super System Review, caused Australian supers to start heavily reducing the management expense ratio of the funds they manage. As a result, some are no longer prepared to pay the heftier fees charged by PE managers compared to those of other asset classes, leading to an understandable degree of ire within the industry.

"A simplistic focus on low fees, as it relates to an asset class that is highly active, is frankly quite ludicrous," Andrew Thompson, head of private equity for KPMG Australia, tells *AVCJ*. "To benchmark the costs of a high-caliber 30-person PE operation with that of a boutique listed equity manager comprising two people and a computer screen in a serviced office is like trying to compare apples and oranges."

Largest funds raised in Australia, 2006-2011

Fund	Launch date	Total raised (US$million)	Fund manager
Pacific Equity Partners Fund IV & Pacific Equity Partners Supplementary Fund IV	Feb-07	3,564	Pacific Equity Partners
Archer Capital Fund 5	Sep-11	1,496	Archer Capital
CHAMP Buyout III Fund	Aug-09	1,340	CHAMP Private Equity
Archer Capital Fund 4	Jan-07	1,127	Archer Capital
Pacific Equity Partners Fund III & Pacific Equity Partners Supplementary Fund III	Nov-05	946	Pacific Equity Partners
Ironbridge Fund II	May-06	805	Ironbridge Capital
Quadrant Private Equity No.3	Dec-10	739	Quadrant Private Equity
Australasian Mezzanine Fund 2	Jan-07	605	Goldman Sachs
IFM Australian Private Equity Fund IV	Jan-06	537	Industry Funds Management
Catalyst Buyout Fund 2	Nov-07	513	Catalyst Investment Managers

Source: AVCJ Research

Multiple causes

While the Cooper Review, and the MySuper product which it inspired, do go some way towards explaining the current environment, industry participants see the current fixation on management expense ratio is no new phenomenon. The majority of these funds have always been focused on keeping costs down, suggesting that all MySuper has done is bring the fee issue to the forefront of everyone's minds.

A more pertinent issue is the denominator effect caused by the increasing number of mergers amongst Australian LPs over the past year, believes Ken Licence, managing director at Australasian placement agent Principle Advisory Services. Consolidation began in earnest in November 2010 when First State Super merged with Health Super to form one of the Australia's top five supers by assets under management, while earlier this month the country's largest super, AustralianSuper, merged with the $3.4 billion WestScheme fund.

"There's fewer LPs in the marketplace than two years ago," says Licence. "A number of LPs are bigger but due to having gone through mergers, some have inherited portfolios which they're assessing. There has been a review process of their underlying asset allocation and this stalls new investment or capital raising activity from some of those LPs."

Another development causing problems for PE fundraisers is the greater breadth of choice as to where LPs can invest their cash. Where previously private equity constituted buyout and venture investors, fringe products such as distressed debt and mezzanine, and real estate funds are now taking some of the allocation away from more traditional investment options.

Additionally, a report published last

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September by mutual fund manager Vanguard revealed that total cash and cash products held by self-managed super funds – under which end users take direct control of how their pension savings are allocated – have grown by $40 billion since May 2009 to $113 billion. Cash-rich investors are thought to be waiting for the current market volatility to fade before reallocating funds to growth assets.

"Members of some of the bigger industry superannuation funds have elected to stay in cash versus being invested in more traditional asset classes such as equities or bonds, so have less of an allocation to play with," says Ben Sebel, managing director at CHAMP Private Equity, whose third fund closed at the end of 2010 on A$1.5 billion.

Some international LPs have attributed this cautiousness to a lack of understanding of the private equity J-Curve, due to the relative newness of the asset class in Australia. Going back before you go forwards, they argue, is a difficult thing for local LPs to sign up to.

Overseas exodus

Many Australian LPs have opted to remain invested in private equity however – albeit in offshore-based GPs. Indeed, in what one GP describes as the most important trend in the superannuation funds' approach to PE for the last 10 years, domestic managers are increasingly attempting to weight their portfolios to a more global benchmark. Big Australian LPs, which might typically have 50-75 GPs in their program, are cutting down their local managers to around four or five, thus freeing up funds to invest in regional or global fund-of-funds.

What they seek is diversification, and this may take them anywhere from high-growth China to floundering Europe. The mid-market buyout space, co-investment, distressed debt and real estate are areas of particular interest.

A further factor that appears to be driving this exodus is the prevalence of defined benefit sponsors overseas. According to John Brakey, head of private equity at Australia-based asset manager MLC, defined benefit money has actuarially determined hurdle rates of return offshore, allowing LPs to focus purely on the asset class that's going to deliver the highest returns.

"Here in Australia, you're not trying to hit those hurdle rates of return – people aren't held responsible if you fall short," says Brakey. "Because it's a defined contribution system, the members wear the risk at the end of the day, so that has certain implications for how you go about constructing your asset allocation."

As local LPs boost their allocations to foreign managers, where does this mean for Australian GPs? "If you don't have an offshore LP program, get one quick," is the response of Archer Capital Managing Director Peter Wiggs, while CHAMP Private Equity's Sebel admits that the firm's proportion of offshore LPs has increased with every fund. The bulk of the money coming into Australia now appears to be from large offshore-based fund-of-funds and pension funds, which are looking for more Asian exposure.

For an overseas fund-of-funds, Australia – like Japan – represents a lower-risk way of participating in Asia's growth potential, by investing in a Western economy which is closely linked to China, India and Japan. They will typically seek to back two to three local GPs.

While many view going overseas as the only option for those with even the faintest hope of raising another fund, this route can present significant challenges to firms at the smaller end of the spectrum. First, there's the issue of scale. While a A$2 billion local superannuation fund with a A$300-400 million private equity program might be happy to write checks for A$10-20 million into a local GP, it's much harder for GPs to go offshore and ask overseas investors for checks of the same amount.

"Australia is a long way away from most places and LPs who make a commitment to an Australian fund manager are going to write a check of A$50 million," says Archer's Wiggs. "You have to raise at least A$500 million before you even talk to these guys."

The second issue for smaller firms is the expense and time that fundraising overseas entails. Many have a much lower ability to absorb these new overheads and will struggle to keep their heads above the water at a time when LPs are trying to reduce their volume of GP relationships. "The result of this is likely to be a significant consolidation in the Australian GP market", predicts Michael Lukin, managing

Superannuation: Australia's revolution explained

Home to around A$1.4 trillion of Australians citizens' retirement savings, last year Australia's compulsory superannuation system underwent some of the most fundamental changes to its regulatory framework since its inception in 1992. At the heart of the changes was the introduction of legislation last November which paved the way for a simplified, low-cost superannuation product known as 'MySuper.'

From July 2013, MySuper is set to become the default choice of fund for the 80% of people who don't currently choose where their money is held. There will be a transitional period ending in July 2017 for all account balances to be migrated to MySuper. In order to reduce the costs paid by fund members on their retirement savings, trustees of the products will be encouraged to focus on reducing the fees associated with their investments – bad news for alternative asset classes like private equity and hedge funds that charge relatively substantial fees.

The investment stipulations put on MySuper products include:

- An obligation to take into account the expected costs in implementing investment strategies
- The introduction of 'comply-or-explain' guidelines on the structure of any performance fee payable to third party managers
- An obligation to 'clearly articulate' target rates of return over a rolling 10-year period
- The introduction of an ability to automatically move members into different investment mixes based on their age

Predictably, this increased focus on fees has seen many superannuation funds – until now an important source of LP capital for domestic private equity – reduce their exposure to the asset class in favor of less costly alternatives, such as listed equities. But while many expected fee levels to fall as GPs rush to appease prospective investors, there is limited evidence of this happening, except in the case of newly-created GPs.

None of the established players with strong track records have capitulated, but instead decided to go offshore to scout for commitments. "Australia is not going to drive the change in fee terms for globally competitive quality fund managers," says Ken Licence, managing director at Principle Advisory Services. "They'll go to where they can achieve the higher returns for their business."

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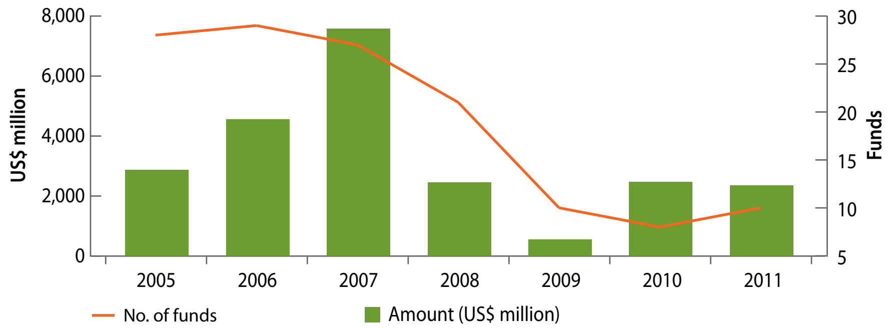
Australia private equity fundraising



Source: AVCJ Research

director of fund-of-funds at Macquarie Funds Group.

Back to the knitting

Outcomes such as this reflect how the fundraising difficulties of late have undoubtedly spelt doom and gloom for the majority of Australian GPs. For some, however, the situation has conferred certain advantages, such as LPs with a focus on Australia. Where previously they had to compete with superannuation funds, the latter's reduced investment into the sector has provided other LP categories with opportunities to participate in funds which five or six years ago may have been closed to them. And due to the predicted scaling back of a number of funds unable to reach their targets, smaller funds will be benefitting from greater resources and operating teams – a throwback from the days when vehicles were larger.

It's also felt that the competition for LPs is making GPs think harder than ever about the way they implement their private equity strategy. As a result, more thoughtful, targeted programs that generate better returns are expected going forward. Funds like MLC are already seeing GPs returning to operate in their core areas – "it's back to the knitting", as Brakey says.

Whatever the outcome for individual GPs, the challenges of the last few years are not without precedent in Australian private equity. A similar situation occurred in 2001-2003, when many of the early investors in the country pulled out of the asset class as a result of the poor returns generated by the 1999-2000 vintages.

Groups such as GS Private Equity, Archer's predecessor, and Ironbridge Capital, struggled to garner support from LPs during this time, but then went on to become some of the strongest performing PE funds in the nation's history. Back then, the attraction of strong returns resulted in renewed interest to private equity, suggesting that the current predicament is only a phase. Quality GPs who broaden their LP bases will continue to survive and thrive.

"It's common sense," says KPMG's Thompson. "If domestic LPs are sitting on the sidelines or running very limited programs, then in time that will change as long as the returns relative to the other investment classes ultimately prove to be superior."

The problem is that most LPs may choose to return when the markets heat up again and the opportunities for good quality investment are less.