Middle ground blurs as private equity moves to a new level

Private equity investing has been around for a long time and will continue to be around notwithstanding short-term gyrations of over-pricing, over-leveraging and credit shortages. But that doesn't mean it won't change. GREG BRIGHT spoke with two of the world's most influential private equity middlemen, who happened to be in Australia at the same time last month.

As institutional investors continue to search for new opportunities in unlisted markets, notwithstanding recent concerns about liquidity, the influence of packagers and advisers is growing.

Lines between the various types of intermediaries are becoming blurred as the diversity of offerings increases.

The major traditional asset consulting firms are building their research capabilities in private equity and other alternatives, at a time when placement agencies are also offering a clear alternative to the funds-of-funds which have tended to dominate international private equity for the institutional market.

Placement agents research alternative investments, negotiate capacity limits for various markets or segments, and then package them typically as closed-end funds, which offer a brief window for investors to get set.

One of the oldest placement agencies in Europe, UK-based Helix Associates, is expanding its private equity relationships into emerging markets.

Visiting Australia last month was the chairman, Lord Charles Cecil, and managing director, Clive Norton.

Helix has an affiliation with Australia's Principal Advisory Services, which operates as an adviser, third-party marketer and placement agent in its own right.

Coincidentally, also visiting Australia was Ed Francis, the London-based head of private equity for Watson Wyatt.

Despite their different approaches, the message from both was similar: the demand for good private equity managers and investment vehicles is intense and unlikely to abate much, even in the current climate. The challenge for super funds is to choose the intermediary – be it consultant, placement agent or funds – with whom they are most comfortable in terms of quality of research and negotiation skills.

Les Fallick and Lord Cecil …
research and due diligence the key

Lord Cecil says Helix has one of the largest teams of researchers – 15 in Europe and 15 in North America – but still limits the number of deals it offers to clients to 30-40 a year.

"We establish a level of trust, both with the investors and our clients. Helix is unique in letting investors access the due diligence we do on funds," he says.

There is no doubt that the Helix clients are the providers of the investment opportunities and not the pension and other funds that invest.

But what makes them different from third-party marketers is placement agents such as Helix want the power to decide whether they wish to participate in an offering and the power to decide how it is presented to investors.

"We make sure that the case is properly made and we have added value," he says. "There are lots of issues such as how you allocate when a fund is over-subscribed."

Norton, who oversaw about $US20 billion in private equity funds-of-funds for Goldman Sachs between 2002-2007, says very few funds-of-funds have the capacity to analyse and evaluate opportunities in the fashion that placement agents do.

Helix formed a relationship in Australia with Les Fallick, who founded Principal Advisory, in 2003.

The new areas for the firm are emerging markets, infrastructure and, in the near future, distressed debt.

Principal has a separate arrangement, with its own fund, for international opportunistic property.

Lord Cecil says that emerging markets such as India are in a similar position for private equity as Europe was 10-15 years ago.

"There have been only 14 major management buyouts in India, ever," he says. "But it is encouraging that you can execute a buyout there… Money flows in private equity to economies which are not only experiencing high growth but also structural change. In India, people are now seeing this as irreversible."

In private equity terms, some developed markets are also seen as 'emerging', such as Germany and Japan.

The search for good distressed debt managers is difficult at the moment, because the established players already have dedicated followers, with a new-found appetite, and don't need anyone's help in raising money.

Watson Wyatt's Ed Francis says the firm has a long history in private equity and in the past three years pension funds have been looking to adopt more complexity.

"Most big UK funds have been through the fund-of-funds phase. Funds-of-funds are efficient but they're expensive," he says. "So we can have the same or better level of underlying performance with more cost efficiency."

Watson Wyatt has about 100 client funds in the UK in private equity, out of 350 clients overall in that country, but only a dozen are doing direct private equity with individual mangers. The ratio is probably a little higher in Australia, according to Sandi Orleow, the head of private market research in Australia. This is because the Australian institutional market tends to be dominated by very large funds.

Nevertheless, Watson Wyatt will focus on funds-of-funds in certain areas, such as venture capital.

"Venture capital takes up a huge amount of time," Francis says. "It is very difficult for direct investment because of the time and effort involved."

Watson Wyatt has 14 specialist researchers in private equity, four of whom are in Australia, and separate teams handling infrastructure and opportunistic property.

The main investor nervousness remains around the "weight of money" argument, Francis says, with too much money chasing too few opportunities.

Echoing Helix's move into emerging markets, Francis says that an emerging theme for Watson Wyatt is about benefiting from growing economies for years to come.

"The key question with private equity will always be 'are you with the smart money?" he says.

Between 2002 and 2006, the debt/EBITDA multiples of private equity deals rose from 4.0 to 6.2. Prices, as expressed by EBITDA purchase multiples rose from 7.0 to 8.6 in the same period.

"This trend persisted into the first half of 2007 and is an issue for the industry," Francis says. "We focus our research on the firms which show they are disciplined in debt and pricing. We still believe there are some high quality managers in private equity."

Over the longer term, winners in private equity will be those with genuine expertise in driving operational change.

"There is some evidence that public markets are starting to 'get it'," Francis says. "Investors want an efficient balance sheet. So, private equity's historic advantage in optimising capital structure should be arbitrage away."

In the 1980s most value-add in private equity came from the leverage in the deals. This was replaced in the 1990s with multiple expansion, as the stock markets ran. Operational improvements started to overtake leverage as the most important source of value-add this decade and this trend should continue for the next few years at least, according to Watson Wyatt.

The consultant believes that private equity may be about to take a further public relations hammering, with the possibility of material leveraged buyout defaults.

But Orleow says that private equity returns are likely to normalise at about 4-5 per cent above the listed markets. ■