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THE BIGGEST END OF TOWN

Public markets are shrinking and institutional investors are snapping up private companies, property and infrastructure. What really goes into these huge deals? And can an individual get in on the action? **Elizabeth McArthur** writes.

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Private markets had a turbulent start to the decade, just like most of the world. There was a 2020 correction in private markets that is comparable to what was experienced in public markets, according to a McKinsey report from April 2021. McKinsey observed a K-shaped recovery from the pandemic in private markets - with private equity quickly bouncing back along with private credit, while real estate was slower to pick up and headwinds were also seen in natural resources and infrastructure.

The report also observed that private equity investors have a stronger risk appetite now than they did a decade ago. Similar to price-to-earnings multiples in the public market, private equity purchase multiples have kept climbing during the pandemic and at April 2021 were higher than pre-GFC levels.

Funds held in dry powder reached another new high during the pandemic, McKinsey said, while debt grew cheaper, and leverage increased. All these factors have created a perfect storm for private equity to flourish.

BlackRock research in 2021 observed that private equity delivered significant outperformance compared to other asset classes, and as one of the more mature and established components of the private market, BlackRock concluded that it is now a core component of institutional investor portfolios.

Shrinking public markets

Brian Parker[01], chief economist at Sunsuper, explains that large institutional investors need to take advantage of private opportunities to get the best returns possible because alongside the boom in private markets, public markets have shrunk significantly around the world.

As the number of public companies in the US has almost halved, private equity has boomed.

"If I think about the number of American firms that have 500 or more employees, over 85% of them are private," Parker says.

"In 2000, there were 7887 companies listed on the US stock market, and in 2020 that had fallen to 4891."

Parker cautions that the growth of private equity ownership over the same period - from 1698 companies to 8892 companies (Figure 1) - may not be able to continue at such speed. However, the outperformance of unlisted assets compared to public markets in the recovery from COVID-19 is a positive indicator.

This trend could have a curious reversal, Parker says, as the outperformance will create increasing temptation for private equity to exit its investments - and one of the ways to exit is through an initial public offering (IPO).

"It may be that the number of companies listed on stock markets actually gets added to by private equity," he explains.

Liberty Street chief investment officer and portfolio manager Christian Munafo[02] argues that in the meantime, this trend of shrinking public markets and booming private equity means that the average investor is at a fairly significant disadvantage compared to the big end of town.

"The typical investor, who does not have access to all these private market strategies, may lose out on alpha generation opportunities because the universe of listed public companies on US exchanges has essentially been cut in half," Munafo says.

"We've seen massive amounts of capital flowing to private markets over the past couple of decades. The US venture capital market just last year alone saw more than US $300 billion coming in. Over the past decade it's been well over a trillion flowing into that market."

Naturally, with opportunities for alpha generation in public markets shrinking, alternative assets have gained more of an allure - and not just for the typical institutional investor. Munafo says he has increasingly seen family offices and individuals looking to find the right private opportunities for their portfolios.

The demand for this kind of access in Australia has led GAM to partner with Liberty Street on a new fund for the local market.

The power of super

In Australia, as the superannuation industry consolidates through regulator-encouraged mergers, the $3.5 trillion and growing pool of super money is becoming more concentrated among the largest "mega funds" like AustralianSuper, Aware Super and the soon to be merged Sunsuper and QSuper (which will become Australian Retirement Trust).

This concentration of capital influences public and private market dynamics locally, especially given super funds' penchant for keeping a significant portion of their investments close to home.

"The reason we invest in private assets is because over time you get a premium return for giving up liquidity, and you also tend to reduce the overall volatility of the fund," Parker says of why Sunsuper looks to alternatives.

"We don't want our members to be as exposed to share market volatility, as they might be in other funds. That's why I think a lot of the profit-to-member funds have been doing this for a number of years. And, if you look at the big pension funds in the US, Canada, and parts of Europe and at the big sovereign wealth funds, this is how they invest as well."

However, while alternative assets have been a priority for many of the largest super funds, Edison Partners head of private equity Michael Thompson[03] points out that isn't the full story.

According to Rainmaker Information, as at 31 March 2021 Australia's super funds owned about 37% of the ASX. Of this, the average not-for-profit fund's Aussie equities holdings sits at 13%, retails funds at 9% and smaller funds and self-managed super funds at 15%

"Amazingly, local super funds invest almost the same amount in the ASX as they do in all the other listed markets combined ($500 billion in the ASX vs $600 billion in international listed equities). And it has also left them woefully underweight alternative assets," Thompson says.

"There is nothing inherently wrong about Australian workers investing their retirement savings into Australian businesses – it is a powerful source of capital for local listed businesses, which in turn supports domestic employment and economic growth. But from an investment perspective, it ignores 30 years of global best practice on asset allocation."

By that, he means it leaves funds too exposed to the performance of the ASX (as Parker also pointed out) and it limits their ability to generate alpha.

Thompson suggests that for some of the leading thinking on allocations to private markets and alternative assets, Australian super funds should look to US endowment funds.

"The legendary David Swensen of the Yale Endowment, for example, transitioned the Yale portfolio from 60% listed equities in 1990 to less than 15% at the end of his tenure in 2021," he explains.

"Their exposure to private equity and venture capital increased from 5% of the portfolio to 40% over the same period. By comparison, Australian super funds today collectively hold 51% of their assets in listed equities and only 4% in private equity and venture capital."

David Grose[04], head of alternatives for Australia at State Street points to the recent acquisition of the ASX-listed Sydney Airport by a consortium including IFM Investors, AustralianSuper and QSuper as an example of how the might of super funds is being felt in the local public markets.

"As has been seen recently with AustralianSuper's unsuccessful bid for Infratil and the successful acquisition of Sydney Airport by a consortium comprising a number of super funds, even very large public companies are not too big to be acquired by private capital," Grose argues.

"In addition to listed infrastructure, it is likely that super funds will increasingly look to acquire underpriced REITs and other listed companies with strong asset backing and predictable cashflows."

Allens partner Christopher Blane[05] worked on the Sydney Airport deal, which was the largest cash takeover to ever happen in Australia. He explains public takeovers have a different set of challenges compared to buying an asset in the private market.

"Many of the large scale acquisitions that super funds would undertake in a private setting would involve a formal sales process, often a privatisation process run by government," Blane says.

"Those situations are competitive, but super funds are accustomed to the process. Yes, parties can allocate a lot of energy and resources to

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> **Brian Parker**

04:
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05:
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06:
Claire Smith
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Schroders

a process only to be outbid, but that would usually occur in a private setting, because these processes are typically highly confidential.

"But in the context of a public takeover, a process will unfold in full view of the market."

As super funds grow, the deals they participate in are going to be bigger than ever and there will be hot competition for assets that represent good returns, Blane says.

The role managers will play in this though is unclear.

"In the past, it was common practice for super funds to acquire a minority investment in an infrastructure asset alongside or through a manager. Then funds' practices evolved and we saw a greater willingness to take more than a minority stake, and to do that without necessarily involving a third-party manager," he says.

"And now we see super funds form and run their own consortia or participate alone in large scale transactions."

Competition for assets

Grose also has a warning for fund managers, saying he thinks as super funds become more and more sophisticated in direct investing in private markets, fund managers are going to have a harder time justifying their fees.

"More recently, the trend towards direct investment and increasing fee sensitivity of super funds (due in part to very rigorous fee disclosure rules) places additional pressure on managers of core private markets assets who risk being disintermediated," he argues.

"In order to avoid this, it will be crucial that they can differentiate themselves from their competitors (and the in-house investment capabilities of their investors) either by demonstrably and consistently generating alpha for their investors or via some other highly compelling narrative."

While others have observed demand from high-net-worth and family office investors for private opportunities, Grose cautions that it is also in fund managers' interests to promote funds to the wholesale market that might have traditionally been the domain of the institutional investor.

Claire Smith[06], alternatives director, private assets at Schroders, also refers to the Sydney Airport deal when thinking about the impact super funds are having on the market.

"As we've seen with several listed companies going private - such as Sydney Airport, Citadel, and BINGO - there are good companies on the ASX being taken private, which by nature precludes them from the investment portfolios of individual investors (or other institutional investors for that matter)," she says. "However, by global standards, Australian listed companies are still on a growth trajectory, which is different to other mature markets around the world."

While public markets in the US and UK have seen their universe of companies shrink over the past decade, the same isn't true for Australia.

And, even globally, Smith says there is room for fund managers to add serious value.

She points out that the largest private equity transactions represent 50% of the deal volume but less than 5% of the number of transactions. It follows that the long tail of private equity - often referred to as the smaller and mid-sized part of the market - represents about 95% of transactions, but the entire other half of deal volume.

"Given its high number of transactions, the long tail of private assets provides investors with a wider array of opportunities to capture the complexity premium and to manage the diversification of their portfolio more actively along different dimensions," Smith says.

> *But in the context of a public takeover, a process will unfold in full view of the market.*
> **Chris Blane**

"We think it will be difficult for very large direct investors to have teams of adequate size, scale, and diversity of backgrounds to adequately address this long tail of opportunities. This is where asset managers can add significant value."

Democratisation

As Munafo mentions, the democratisation of private markets is a hot topic.

Traditionally, private investment opportunities have only been accessible to institutional investors like pension funds and sovereign wealth funds. Not even a high-net-worth advised client is likely to have the appetite for illiquidity and the cash to make a significant private equity play unless they are a multi-billionaire.

"Quite frankly, globally, these types of strategies are often only available to highly qualified, highly accredited wealthy investors, which essentially carves out a significant amount of the potential investor population," Munafo says.

Naturally, an idea has emerged that the advised investor should also have a way to access the returns and diversification that private opportunities can add to a portfolio.

Koda Capital adviser and partner Sabil Chowdhury[07] has seen immense demand for private investments among his ultra-high-net-worth and family office clients.

"At Koda, we specialise in niche private investments that include sustainable fisheries, life sciences and private debt opportunities to name a few. We have observed that there is more interest from our sophisticated clients to invest in these type of private investments opportunities as they tend to better understand the genuine diversification benefits they bring to portfolios," he explains.

Chowdhury has observed an uptick in the number of clients becoming aware of private opportunities. He puts this down to recent volatility in public markets and government bonds generating negative real return rates.

He cautions that not every adviser is going to be able to guide clients into the right private opportunity, as it is an area that requires some specialisation.

"At Koda, we have built long-term relationships with specialist managers, which offer exposure to private assets through direct investments. Often, these direct investments are capacity constrained and specialist managers do not necessarily lower fees to attract new capital," Chowdhury explains.

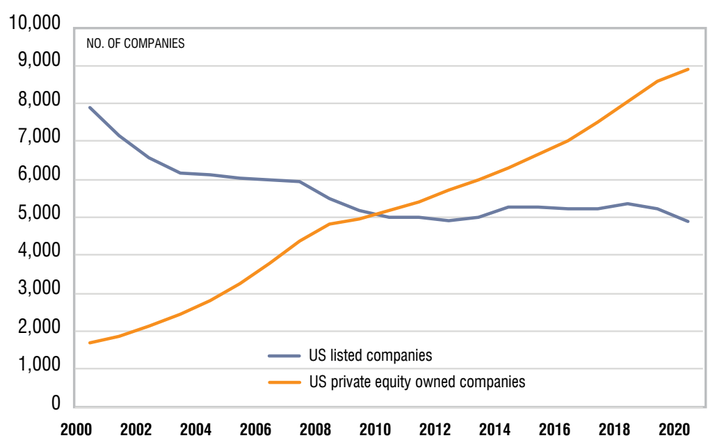
"However, we can offer clients attractive terms given Koda's scale and the long-term relationships we have built with these specialist managers over time."

Schroders is also invested in bringing alternatives to investors who usually wouldn't be able to access this asset class.

"We have surveyed the market to identify why investors have been reluctant to invest in private assets, with high minimums, low liquidity, lack of transparency and expensive and complex fee structures being the main impediments," Smith explains.

"We've structured our funds to overcome these points and are finding this wholesale/HNW client base very receptive to private assets, particularly in the current environment of low interest rates and arguably elevated equity prices."

Figure 1. The rise and rise of private equity ownership



Source: Neuberger Berman, PitchBook, Sunsuper and World Federation of Exchanges. Data as of December 2020, the most current available data from the World Federation of Exchanges.

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In full view

The growth of private markets and the increasing investor appetite for private opportunities have not gone unnoticed by regulators. The US Securities and Exchange Commission (SEC) voted on February 9 to propose new regulations for private fund advisers aimed at increasing transparency, competition, and efficiency in what it says is a US$18 trillion marketplace.

"Private fund advisers, through the funds they manage, touch so much of our economy. Thus, it's worth asking whether we can promote more efficiency, competition, and transparency in this field," SEC chair Gary Gensler noted.

The proposed new rules would prohibit private fund advisers, including those that are not registered with the SEC, from providing certain types of preferential treatment to investors and create new audit rules.

It's a move that Munafo supports, as he says using more transparent fund structures in private markets can level the playing field.

"These types of fund structures can democratise access to private markets and broaden access to a much larger universe of investors," he explains.

"However, there is a massive amount of information asymmetry in private markets, because unlike in the public markets, private companies are often not required to file and report all of their financials, dealings and inner workings. As a result, groups who can access the information may have an advantage. We often have to sign non-disclosure agreements to gain access to this information."

Networks mean everything in private markets, experience and a well-connected team is how fund managers in the private space make themselves indispensable.

QIC general manager, capital solutions Katrina King[08] agrees with Munafo that this is where an experienced team adds value - even for the institutional investor that may be able to directly purchase private assets.

Asked why a super fund would turn to QIC rather than relying on its in-house investment capability, King says: "Firstly, the experience and a long-term team in that specialty. If I think about our team, they've been together for some time, and they know the market well and the assets well and have networks in the market."

While the new SEC guidelines are likely to improve transparency on some level for investors accessing private markets through funds in the US, institutional investors all over the world have already demanded - and received - higher levels of transparency to meet their ESG commitments.

Chris Newton[09], executive director of responsible investment at IFM Investors, explains that publicly listed companies have increased their ESG reporting in large part due to continuous disclosure regimes and demands from large investors, like IFM, who use the data and insights to make investment decisions.

And there's no slackening of that approach when it comes to private markets.

"Privately held assets - like those in our infrastructure portfolio - also report a great deal of ESG data to investors. This reporting underpins how we engage with asset teams to drive ESG strategy that creates sustainable value," Newton says.

"Although there are ongoing challenges around assured, consistent ESG data across sectors and geographies, this is improving all the time, particularly with the emergence of "green taxonomies" and regulatory requirements that define metrics, like the European SFDR, and the establishment of the International Sustainability Standards Board."

Grose says while investors might have the same standards for private assets, there are some unique challenges in the ESG space.

"What we're hearing from our clients is that they don't currently have a great solution for sourcing private markets data," Grose says.

"Effective monitoring and reporting of ESG involves sourcing, ingesting, and standardising thousands of data points from multiple providers and extracting meaningful information from that data is a complex task."

> *We often have to sign non-disclosure agreements and things like that to gain access to this information.*
> **Christian Munafo**

While this remains an issue, Grose has observed that the large incumbent data providers are increasingly focussed on providing data on private markets.

QIC is pulling no punches in integrating ESG into its work to keep institutional investors happy, committing to net zero in its $5 billion Global Infrastructure Fund by 2040.

It has also implemented an ESG-linked debt feature which incentivises borrowers to meet agreed goals.

"When forming the funding relationship with a borrower, we are able to agree on set goals tied to ESG-related outcomes," King explains.

"Depending on whether or not periodic targets are met, the coupon paid by the borrower will rise or fall. If they are not meeting them, then the coupon would step up (as a penalty) but if they are meeting them, the coupon would step down."

King adds that QIC is also working in the natural capital space, finding that investors are interested in assets that "provide both an economic return, but also a biodiversity return and potentially a climate transition, base return or carbon credit units as well," she says.

For Munafo, venture capital is a space that naturally lends itself to ESG as these companies look to solve problems they see in the world.

Liberty Street has also worked to structure its funds with more transparency than the typical private equity fund, recognising that investors want to be able to monitor ESG metrics and have some oversight themselves.

"In addition to how these more retail-friendly fund structures can help democratise access, they may also provide enhanced transparency for investors compared to traditional private market funds," he says.

Just as Blane has observed in public takeovers, it's likely the next iteration of private market investing will be a little more public than it has been in the past - driven by contemporary investor ethics along with the sheer size of deal.

This new transparency will likely also be driven by shrinking public markets, as private investments become more integral to alpha generation in portfolios, we will all want more of a glimpse at the private opportunities that are out there. **FS**