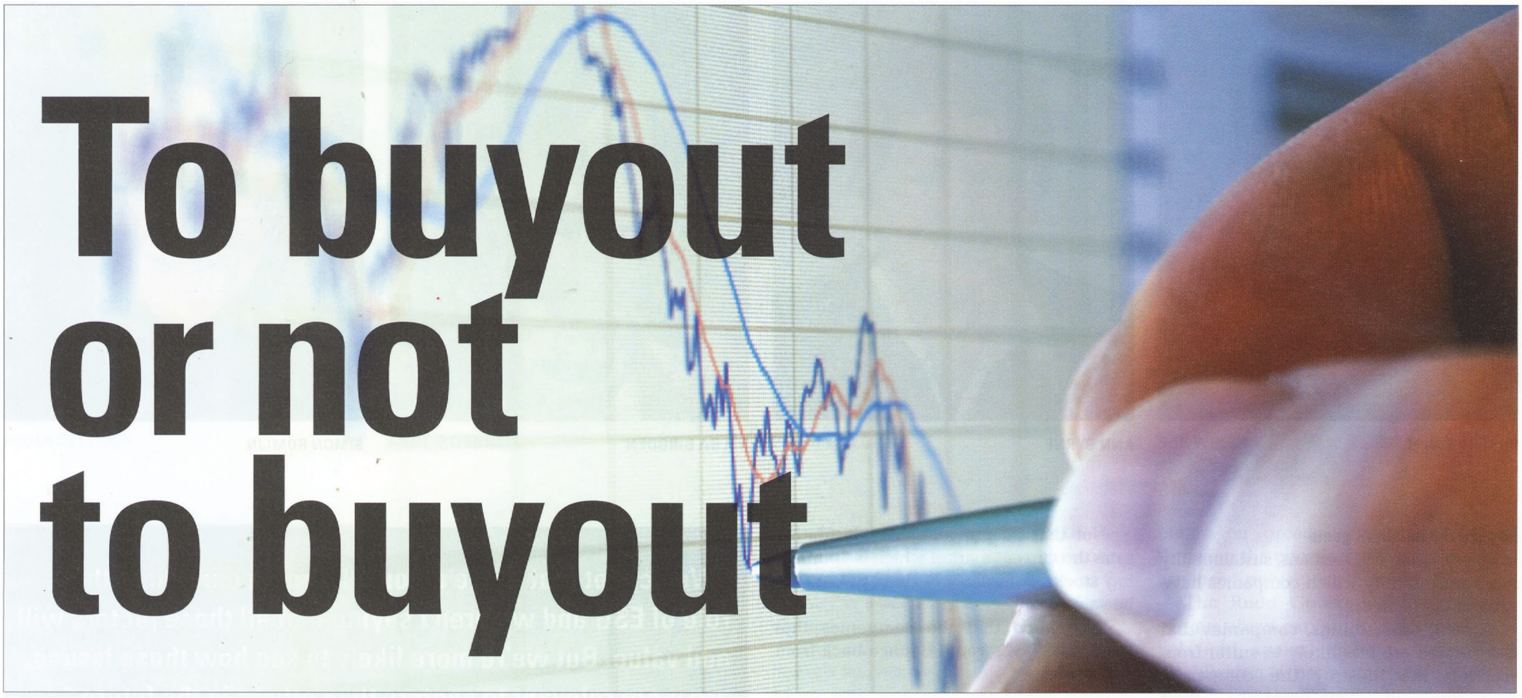

To buyout or not to buyout

Super funds are finding it difficult to commit more to private equity investments, at ironically the time when they should be pouring more into the asset class, writes DENNIS MOTHONEOS.

When it comes to private equity, Australian superannuation funds face a conundrum due to the impact of the credit crisis, the subsequent decline of listed markets and the deterioration of the real economy.

Despite private equity – particularly middle and small buyouts – becoming increasingly attractive, several factors have discouraged new commitments – leading to a challenging capital raising environment for managers.

Superannuation funds that made significant commitments to buyout funds in 2006 and 2007 vintages (particularly mega and large) are for several reasons finding it difficult to commit in the short term.

Firstly, actual private equity allocations may have become significantly higher than strategic targets – as the steep decline in public equity prices has not been matched by similar devaluations of private market holdings. Consequently, this may lead to a potential breach of investment parameters.

Secondly, some risk-averse superannuants have switched from growth and balanced options to cash. This exacerbates the asset allocation problem, given the obvious place to fund redemptions is from listed assets. This is further exaggerated by the introduction of the Government guarantee on bank deposits.

Thirdly, declines of around 30 per cent in the Australian dollar require a significant amount of cash to fund currency losses realised in relation to hedging programs and increased the dollar value of calls on international private equity commitments.

Finally, distributions from portfolio companies have fallen steeply following the worsening real economy.

While mandated employer contributions under the superannuation guarantee scheme direct some cashflow to superannuation funds, these have not been sufficient in some cases to offset the factors described above. Therefore, many funds are constrained in terms of making further commitments to private equity.

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Some funds have been prompted to review their strategic asset allocations with a view to increasing ranges for private equity. This has enabled them to consider new commitments. However, this is only possible for those funds that have sufficient levels of liquidity to make available. Others have taken the rather more significant step of selling down their undrawn commitments or investments in the secondary market – often at significantly lower multiples.

Nonetheless, several of the factors cited above may unwind in the not too distant future, helping to mitigate the fund raising problems for managers.

Firstly, an increase in public equity prices will help – but without a sustained improvement in credit markets this is unlikely to occur. Secondly, and more encouragingly, an appreciation or stabilisation of the Australian dollar is unlikely to require further significant amounts of cash to meet forward contract settlements. And the rolling of forward currency contracts may be more likely to realise profits than losses in the immediate future.

Thirdly, investors are likely to begin transferring out of cash and into less defensive assets once the worst of this latest crisis is over. Fourthly, and very significantly, relatively new accounting rules (such as FASB 157 in the US) will apply more broadly across the investment management industry and will require private equity firms to regularly mark to market their portfolio companies.

For the December 2008 quarter, this is likely to result in significant write-downs, which will help bring into line the relative valuations between public and private equity actual allocations.

Finally, private equity allocations have been on an upward trend for a number of years. Once the latest problems dissipate this is likely to endure going forward.

Nevertheless, the next 12 months are likely to present significant investment opportunities for superannuation funds that are brave enough, and positioned, to go against the tide. Historically, returns from buyout funds for vintage years during and shortly after a recession have significantly outperformed the vintage years prior – due to lower purchase price multiples and increasingly attractive company valuations.

More specifically, the middle markets in developed economies such as the US are generally considered to be the most attractive places to invest during these difficult times. Unlike mega and large private equity buyout managers, who typically buy apparently undervalued publicly traded companies with the aim of selling them at higher prices, middle market buyout managers aim to buy growing private businesses they believe will benefit from their operational and management expertise.

Additionally, these transactions require only moderate levels of debt finance. This is beneficial because for existing deals, less debt means less likelihood of defaults; and future deals are more likely to be completed considering the credit rationing by lenders.

However, superannuation funds face additional challenges accessing the middle market as there are an extraordinarily large number of managers who are often specialised by deal stage, industry and/or geography. This creates additional challenges for funds trying to identify managers with quality investment teams, focus on the middle market, reputation for adding value to portfolio companies, ability to source deals (but avoid auctions) and a track record of success.

For some investors the absence of substantial in-house research capabilities means that a fund of fund or co-investment manager with access to quality middle-market funds may be the most appropriate way to access the middle market. ●

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