Themes and Trends – June 2011

The following comments are based on our discussions with investors and investment managers, as well as our review of investment publications, over the last quarter. We have referred to investors in the comments below but in most instances investors will be working closely with their consultants and you can infer that a reference to one is a reference to the other also.

At the time of writing investors globally are focused on the ongoing debt crisis afflicting Europe and the US. Equity and bond markets are reflecting these concerns. In Australia, the headlines are all about the negotiated agreement of the cross-party climate change committee regarding legislative proposals to price carbon emissions (ahead of transition to an Emissions Trading Scheme).

Many Australian super and non-super funds and their advisors have given much thought to the risks and opportunities associated with climate change, and responding to climate change. In fact, recently a number of funds have brought dedicated resources in-house by hiring individuals with broad ESG expertise who can apply their skills at a whole of portfolio level. Our observation is that some institutional investors have already sought to hedge some of the risks of climate change and create exposures to new opportunities. However, while it appears climate change legislation will pass through both Houses, until such time as it does, uncertainty remains and as the Coalition is promising to retract the legislation if they are elected, it is still difficult for investors (and businesses for that matter) to know how to best respond specifically to the current plan.

Other Themes and Trends we have identified since our previous update are as follows:

- The financial crisis and ongoing uncertainty have continued to focus investors' attention on investment strategies providing some reasonable reliability of stable income streams and/or providing some downside protection in bear markets. Floating rate and/or CPI-linked strategies of one kind or another are seen as attractive relative to fixed coupon investments and valuable as an inflation/interest rate hedge;

- Curtailed bank lending to private equity firms, in particular, has created an opportunity for institutional investors to fill the funding void by investing into corporate and/or infrastructure mezzanine debt at attractive yields. Investors have accessed these domestic opportunities directly or via funds, whilst overseas opportunities are accessed primarily via Limited Partnership structures. Notwithstanding the illiquidity of Limited Partnership fund structures, underlying floating rate interest exposures (more common in Europe than the US), with regular cash distributions and strong protections in their contractual terms are being considered by investors in order to reduce their J-curves and because the targeted IRRs are only slightly below those of private equity buyout but with the underlying investments positioned higher in the capital structure;

- Infrastructure investing, particularly for income, continues to be a strong focus for investors. Long-term stable cash flows from secure projects, in theory, are well suited for investors with very long-term liabilities. Investors are attempting to find ways to bridge the disconnect between these liabilities – which in many cases will be 25 years or longer – and the typical term structure (and management team incentive) for an infrastructure fund vehicle of 5 years to invest and a further 5 years to return capital. In our previous Themes and Trends we mentioned that several institutional investors had appointed hedge fund advisors/fund of funds to assist them with building their own in-house multi-manager structures. An interesting paper – The New Era of Infrastructure Investing, co-authored by QIC – posits that investors could pursue a similar approach with infrastructure investing, relying upon 3rd party fund managers to assist with building in-house direct infrastructure project exposures that can be more closely aligned with liability objectives. This has been happening in private equity for a little while, with a number of fund of fund managers now involved in advisory work, assisting super and non-super funds to build private equity direct and fund programs. However, determining the level of compensation and structuring of incentives is more difficult for managers and the LPs. We will watch with interest;

- Still on the topic of infrastructure, some events in Europe have highlighted that the risks inherent in the asset class can be quite complex. Or, perhaps they have been previously underestimated. Just recently in the UK the awarding of a train contract to a German engineering firm has generated some controversy. An unsuccessful bidder has since indicated they will shed jobs in the UK and the question has arisen as to whether the determination of the tender was made with a view primarily to the least direct cost to the public purse but with insufficient consideration of the economic impact of the outcome. The decision may be challenged in the courts. We also note that with bailouts, and changes of Government, of various European countries, most notably Spain, some scrutiny is being directed towards the structure of past infrastructure transactions. Arguably, some administrations may have worked rather too hard to attract infrastructure investment for their projects. It may be difficult for Governments or agencies to retrospectively change the terms of a PPP but it may not be for want of trying. Consortiums who have taken advantage of obviously generous subsidies may find their success rate with future opportunities is somewhat reduced;

- At risk of being repetitive, fund mergers continue apace and obviously result in a smaller number of larger funds. In most, not all, instances outcomes will likely include a rationalisation of the fund manager line-up and a reduction in the number of generalist consulting mandates. Conversely, as we have noted previously, larger investors are increasingly appointing specialist asset class advisers. Generalist consultants have increased the breadth and depth of their expertise in these areas in response. In order to remain viable and to grow their businesses, they are also increasingly looking to broaden their client bases beyond their own traditional institutional super segments (e.g. looking beyond the superannuation segment/s they have historically targeted and even beyond superannuation to endowments, insurance, private banks, platforms etc., if those areas have not been targeted previously);

- An interesting development in private equity markets is that as bank lending for risky ventures has declined and private companies have rebuilt cash reserves, private equity GPs are finding themselves competing with strategic investors looking to invest to grow their own businesses. In fact, determined corporations with capital may well have greater capacity to chase targets at higher earnings multiples than GPs relying upon bank lending. Although it may be harder for GPs to find bargains, LPs may actually be quite pleased that one of the outcomes will be less selling of assets between private equity firms (given some cynicism regarding the ability of multiple private equity firms to continue to add value sequentially); and

- Still on private markets, some LPs surprised by the level of correlation between private and listed markets over the period of the financial crisis, are showing significant reluctance to re-up with existing managers. However, indications are that those who have performed well in what was a tough market are likely to attract attention. Additionally, comparatively niche segments such as energy and power, emerging markets, distressed debt and mezzanine will find an audience.