Australian investors and emerging markets: a bridge too far?

21 Sep 2010. Source: Dennis Mothoneos

Australian and New Zealand institutional investors have been strong supporters of domestic private equity. In some cases, this has resulted in an under-allocation to GPs focused on North America, Europe; and especially, the rapidly growing Asian and developing markets. Whilst LPs and developing markets GPs are looking eagerly at the opportunity, a number of factors have discouraged significant commitments so far.

Australian and New Zealand institutional investors have a strong interest in Asian and developing market GPs because of growth rates largely unavailable in developed markets and diversification benefits - there is a higher concentration in industries underrepresented in Australia - such as healthcare and IT in India and consumer products in China. However, many investors lack confidence in their understanding of the different business practices, corporate governance - especially in regions with a high preponderance of family-owned firms - and language, or they are simply unfamiliar with the country and region.

This is even true for some of the well-resourced mega institutional investors. Additionally, many of the global generalist consultants, as well as domestic consultants lacking global networks, readily admit they require greater depth of knowledge and resources to confidently recommend stand alone allocations to GPs outside Australia; and particularly, to developing countries.

A few institutional investors have invested with well known global or regional funds of funds with exposure to developing markets; believing risks were reduced across these diversified portfolios, by manager selection and portfolio construction. However, there is growing skepticism whether these products deliver meaningful developing markets exposure due to their size and relatively small allocation to developing markets. Also, most regional funds of funds have an exposure to Australian GPs - exacerbating LPs' relative undercommitment to international private equity.

At the GP level, investors prefer a manager with a local base of operations; “fly-in-fly outs” are not of interest. Also, investors remain cautious as few developing market GPs have vintages prior to 2004. Consequently, only a small number of realisations exist which investors can rely upon to assess the transactional and operational skills of a team - making deal attribution critical. Relatively small fund sizes, usually less than $1bn, present another problem - large LP commitments may comprise a disproportionate amount of the capital raised. Alternatively, reducing typical commitment sizes may make investments less meaningful given the due diligence and monitoring costs.

Beyond GP issues, investors need to be convinced that developing markets can provide viable exit strategies for portfolio companies and protection of shareholder rights. However, investors are more comfortable with minority positions when accompanied by experienced majority investors.

From the GPs perspective, Asian and developing market managers must overcome a number of obstacles if they are to raise capital in this region. They will need to sell their market as much as their offering, requiring deep knowledge of the regional macroeconomic situation, financial market developments and applicable regulations – a key concern in China.

For many developing market managers – outside of Asian high net worth/family offices - their first fund-raising destinations are the Gulf, Europe and North America (often GPs studied and began their careers in the latter). As fund sizes tend to be small they have raised sufficient capital from these regions; which are often less intermediated, without approaching Australia. However, developing market GPs will continue to grow and expand their LP base - obliging them to visit this region. The recent preference for non-domestic GPs in Australia and the end of commitment periods from pre-GFC vintages may make this is an opportune time to visit.

Regarding their fund offerings, Asian and developing market GPs have to better communicate certain features their offerings can provide to regional investors, one being to differentiate their offering from global/regional Fund of funds. GPs will have to work harder to allay concerns over due diligence and post-commitment disputes, eg corruption. Additionally, the alignment of GP and LP interests by an appropriate carry distribution, meaningful co-investment levels and quarantining corporate interests will be important given the prevalence of developed market sponsors. Furthermore, tighter key man provisions will be critical given the high level of turnover at a number of GPs.

Liquidity is a key concern for investors; however, secondary opportunities in developing markets are scarce. Nevertheless, introducing flexibility to invest in secondaries when available will make them more marketable.

Most of these obstacles will dissipate as the lines of communication strengthen and as time passes. Fortunately, very few are intractable suggesting Asian and developing market GPs, and regional institutional investors, will not remain apart for long.

Dennis Mothoneos *is the joint managing director and principal of advisory and research firm, Clearway Capital Solutions. For information on the firm, go to www.clearwaycapital.com.au*

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