WORKING SMART IN A GROWING INDUSTRY

MOUNIR GUEN

CEO, MVision

What is your view on the growth of the private equity industry?
I think that the industry has seen steady growth – and that is really driven by the low interest rate environment and the fiduciary structures of the pension, life insurance and government programs. Investors are looking for strategies that have an ability to generate returns consistent with performance versus certain benchmarks and generate yields that help attain their target portfolio return. Private equity, and alternatives in general, are critical components to attain this return profile.

The interesting thing is that if you actually look at the investment opportunity sets, at the penetration of private equity in markets versus the investor demand for those types of yielding assets, it is a real mismatch. Around the world there is a great set of opportunity, but private equity penetration is generally very low – so that means there is still more growth as a percent of corporate activity. The investors' high demand for funds currently outstrips the supply available.

So how are investors looking to effectively put capital to work in private equity?
If you look at the mega-investors, and you look at their average ticket sizes of around $350-500mn plus, most have a guideline that they cannot be more than 10% of a fund. Their capital is driving them to look for long-term, consistent funds with decent returns, but more importantly, it pushes them to focuses on larger funds given their deployment needs.

Access is a big issue for investors in top-quartile funds; this takes them to the next level where the largest will make direct investments to maintain their portfolio and deployment needs.

We are seeing more and more of the investor community able to integrate members of the GP community at the same time. They are not looking to replace the GP community: there is a nice new type of partnership that has formed between the two, especially at the larger end of the market. We are seeing more managed accounts and targeted deals, and we are seeing more and more of this at the very large end of the market.

Note, many GPs offer low or no economics around co-investment which can boost the return profile and improve the J-curve for an investor. All investors now are looking for an increasing share of it in their portfolios – as well as doing secondaries.

What activity do you expect to see in the secondary market in the future? How do you think a market correction could impact activity?
It is not necessarily related to a market correction – at the end of the day investors can always experience a tightness or a denominator effect or a change in their views which leads to secondaries.

Recently I visited a country which had experienced a close to 20% drop in its local equity markets, and this particular investor – who was also close to their limits on their allocation to private equity – had their allocation impacted because they were already tight on their limit at a time when many great funds were in the market. So, one of the things that investors can consider in this situation is to use the secondary market to release some capital.

Speaking more geographically, where have you seen, and where do you expect to see, growth in private equity?
In the 2000s, the private equity world was a bit more balanced globally. Following their recovery post-2008, the US and Western Europe markets looked

very strong and attracted vast inflows of capital, especially the US. There is not enough capital that is currently going into new and emerging markets; they are very underpenetrated at this time and will remain so for a while.

I look at new or significant economies that I think are absolutely terrific, like Japan, and see an incredible under-penetration. There are over 6,000 GPs across all strategies in the US (economy number one), 3,000 GPs in China (economy number two), and then we get to economy number three in the world and there are just 250 fund managers. You can fit the whole known Japanese private equity community into a couple of buses.

Are fund managers looking to expand internationally and move into these underpenetrated markets?
Yes and no. I agree that it helps fund managers to have local expertise and networks, and they need to be able to generate the local deal flow. It cannot happen from day one – there must be an evolution. It will probably be stimulated by economic growth and government policy support like we have seen in Spain, and a build-up of resources.

If one looks today at Latin America: it is so difficult to raise capital there, and that makes no sense whatsoever. Africa is also not easy to raise capital for. In these countries you have a special type of investor which is the development funds, development finance institutions (DFIs), for smaller GPs in these emerging countries; they are a great funding base, but these GPs will struggle to scale in fund size and in number.

The larger global managers have huge teams of people. They are able to really get a laser-focus view on where to deploy capital, what they want to do and how they are going to generate returns. They have a wealth of internal talent and access to capital to be able to lead new deal flow and build up their businesses into new markets.

How can fund managers look to overcome challenges in deploying capital in 2019?
The private equity community is dependent on very clear governance and understanding how to operate through cycles, i.e. if the market presents fantastic opportunities, GPs deploy aggressively; if the market has concerns, the GP needs to continue to deploy, but deploy selectively and more smartly. The market continues to grow to get larger and deeper.

The industry has to continue to deploy and work the capital, and that means it is not only down to the talent of the individual in harder cycles. The firms with more data, which have deeper pockets of information, will be better positioned for the cycle challenges and the complexity of the industry as they will have deeper insight. If I have better information than you, I might pay a price that looks high to the market, but I will have a very good idea on where that company can exit, so the investment was worth making. I think the industry itself is going to need to figure out how to access better data and better information, as well as exercising discipline and maintaining governance.

Some of our survey respondents expect a market correction; what is your view?
Everyone is waiting for it, but you cannot stop investing, and you cannot try to guess the market. I think that if we are looking at private equity in and of itself over the next 12 months, I do not see dramatic changes. We all have to put our heads down, keep working smart and generate returns. The bigger firms will get much bigger.

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