A FAST-EVOLVING LANDSCAPE

- Moose Guen, **MVision**

What do you think have been the most notable characteristics of private equity in 2016?

I think 2016 seems to have gone quite quickly. A lot of money was committed and there is definitely a support globally for larger funds which you can see from some of the record fundraisings that have taken place. Regulation is becoming very prominent; it used to be that it was driven quite strongly by the US, and now it is driven by everybody. The environment in which we are operating, whether it is on the investor side or the general partner side, is changing very quickly.

Investors have also become extremely focused on their net performance; anything that impacts that performance, whether it is hidden costs or slow deployment, has come to the forefront of review. As a result, it has become quite important to investors where the capital that is being invested is denominated.

The other thing that has been an important development in 2016 that I think the market has not really picked up on as much is that private equity firms, especially in new markets, are looking to build best-practice businesses. In China, there are general partners that have grown in AUM quite dramatically, and they want to do the best they can do; they want to run excellent businesses, deploy capital, have robust reporting and governance, have proper investor relations, and they want to work with ESG, which is an important part of today's mindset for the private equity community. So they are bringing in top-notch consultants to 360 their businesses, and to help them build these best-practice firms.

You mention that domiciliation has become more important to investors. Why is this?

Say, I am a US investor, investing in US dollars, and I am investing with fewer general partners and putting more dollars to work. My general partners are buying excellent companies, they are running very good businesses, but then Brexit happens, and you have a huge amount of volatility, and the UK pound falls to a 30-year low. Now, when I look at the performance of my general partners, and compare them to their US domestic peers, there is a big gap. But the general partners have not done anything wrong – they are working hard, but as an LP, how do I deal with this? I am pleased to make long-term commitments and long-term investments, but I am assessed quarterly. My performance is impacted, so how do I explain this, and what do I tell my Board what I would like to do with the remaining capital?

Should GPs be buying now because it is at a low, or should they just stay and put the rest of the money to work domestically, and eliminate the variables that have created disruption? Brexit is still an unknown. The currency is at a low but it could go even lower, and if you are an investor, these are very difficult times to start running a globally diversified portfolio. If you are a general partner, it is a fantastic opportunity – you could be buying well-run domestic companies for pittance, if you are a US-dollar-denominated group.

Do you think that the trend of more LPs making larger commitments and looking to establish relationships with existing managers, rather than emerging managers, is a direct correlation with the record distributions and the fact LPs are simply trying to put their money back to work?

Yes, and that is why what we are seeing is strong brands developing their business into multi-products. In Europe and the US, for example, we have seen large firms launch mid-sized funds or funds oriented towards smaller companies, and they have had a fantastic reception, because these larger firms have a very good investor relations program, and they can leverage that across different products. Working with a brand that performs, and, that you know works with best practice and has best governance, ticks all the boxes and has a lot of benefit.

With greater levels of competition in the market, have LPs changed their due diligence practices? Are they now more demanding of information from their GPs?

Investors have very detailed review processes, and not only does it take quite a long time, but they pre-identify almost a year ahead and pre-select who they will be working with. There was a time when private equity firms had a bit of a break, because you would have 3-5 years before you needed to fundraise, and your portfolio and your track record could have a bit of flexibility of movement within that period, as long as you start approaching the fundraise, you are starting to see the proper direction in terms of performance. But because the selection is done earlier, the pressure on the general partner to be able to perform consistently and at all times is very high. The only way to do that is to drop your returns a bit, because if you stay targeting much higher returns, you will have more volatility, which makes pre-selection more complex, and so you are almost better off building a portfolio with safer bets, and that will impact performance.

How do you see high entry prices for assets impacting performance?

To me, performance is not a problem, because private equity firms are very sophisticated, well-run businesses, and those that are not will not exist tomorrow – there is a natural attrition that occurs, and those strong firms will deploy the capital. So that is not what is driving down returns, and buying at higher valuations does not really make a difference because some of the private equity firms have been buying expensive companies their whole lives, and generating 2x net returns, and so what you are looking at is the skill of the general partner to be able to develop these companies. I am not openly bothered with what mark-to-market valuation methodologies say.

If your funding base has a particular target return in mind, the general partner will adjust to those return numbers. As a result, it can be lower than it was before, but what is important is that the deployment is regular, that the return is consistent, and that the volatility of the principle is realized, so there are very few losses.

The other thing you have to remember when doing the diligence, when presenting to your investment committee or to the Board, is that they will focus on loss-making investments. We have spoken to general partners that have done unbelievably well and then all of a sudden they did a big deal that went completely wrong. Ten to 15 years ago, investors would be lenient, but what is happening now is the investors are not re-upping, and they will skip a fund.

How has the emergence of co-investments affected the private equity market?

To co-invest is direct investing. We live in an environment of growth and change, a living characteristic reflected in our industry; like all creatures in life, we mature and we grow, and so 30, 40, 50 years later, the investors also have the know-how to make investments – they do not need to necessarily put all their capital in third-party structures. It is interesting because there seems to be a bit of a reticence from the general partners in accepting that their investors are now grown-ups; as with your children, they are now adults, so your relationship with them has to change.
I think that one of the things in 2016 is that this is coming to prominence, and I am seeing large investors working very closely with a general partner, who might decide to walk away from a deal, but the deal will still be executed by the investor. That change is going to permeate across the market and that is a big change in the relationship between the LP and GP. So now the path is: an investor makes fund commitments, then co-investments, and then directs. Now the argument by some general partners is that the investors do not have all the expertise, and maybe not, but they certainly have enough general partners to choose from nowadays to bring in the expertise.

When you look at private equity in Australia and you look at private equity in Canada, the Canadians are a fraction of the Australians in headcount: where did they all go? What happened was, a lot of the private equity professionals that were captive in financial institutions moved into the pension community. These are general partners that are in these pensions – we are going to see more of that.

Where do placement agents fit in with this new structure?

It all depends what you do. Whether we are working with a pension plan, whether we are working with a private equity firm, we are here within the private equity industry to identify opportunities and provide solutions for the needs of their portfolios or the needs of their businesses; I can raise a fund, but I can also identify a very good opportunity that could be a private equity commitment made by a substantial investor to a platform. You see this being very prominent in the renewables space, because the traditional fund structures have too short a horizon relative to the underlying assets: the long-term investors have a horizon that is more suited at 15-20 years. That completely changes the dynamic, and that is why when you look at some of these larger investors, you will see that they seek shopping malls, parking lots and airports.

What are your predictions for the private equity industry over 2017?

I do think that the economic tailwinds we have experienced in the last few years will not be as strong. I do think that tailwinds are not alpha, and the industry needs to realize that. Alpha is skillset. I am seeing the private equity firms really acknowledging this and improving their businesses and their practices, and I am seeing the investor community being more selective and more robust in what it is that they need, but we have to be respectful and understand that different pools of capital have different needs, which means that we will have a number of trends in the marketplace. Therefore, the US will continue to be prominent and eminent because of the high degree of skills that market has. Europe will be a fantastic opportunity – it is priced right. Asia has a dynamic that is stunning – whether you look at internet usage, mobile telephony, app usage, the growth of the middle class, there are systematic changes on the horizon. But the common element across the dynamics of these regions – and of course you have got the other markets, Africa, Latin America etc. – is the professionalism of the industry; the regulators are heading in the right direction with their focus on transparency and their visibility, and the investors know what they need.

Fundraising will still be exciting, and, if anything, we are going to have a lot more participants coming into the asset class. If you look at the Asian institutions that will be quintupling or more in AUM, there is a very strong drive to find returns in the marketplace, and so I see more participants coming into the asset class, and that will be reflected in 2017 when the Asian institutions become quite prominent in terms of their presence in investing in the asset class.

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