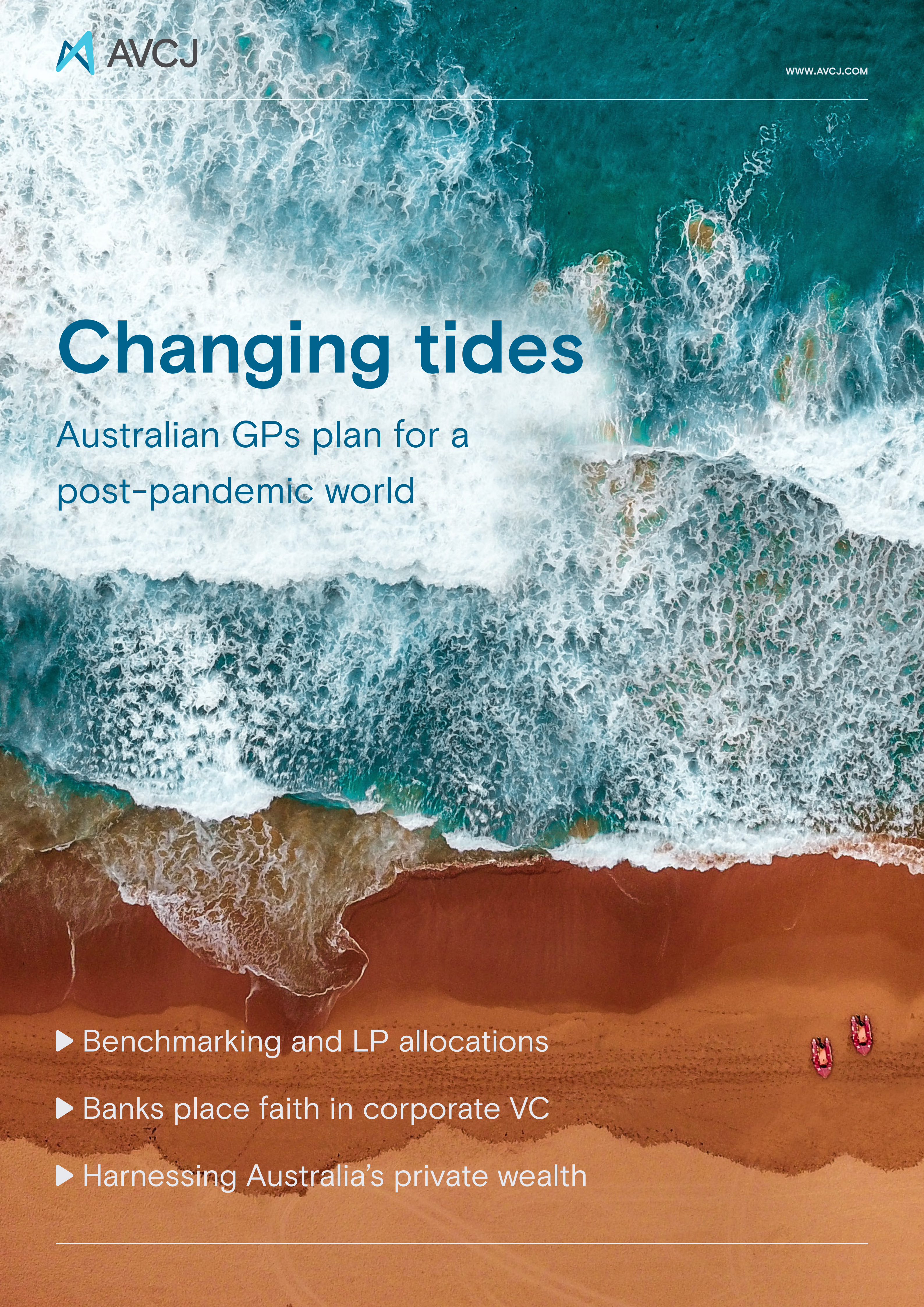

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Changing tides

Australian GPs plan for a post-pandemic world

- Benchmarking and LP allocations
- Banks place faith in corporate VC
- Harnessing Australia's private wealth

AVCJ Australia & New Zealand conference issue

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ISSN 1817-1648

Australia in six trends

1 Competition at the top-end

The large-cap buyout space in Australia and New Zealand has always been competitive, populated by a collection of global and pan-regional players with plenty of dry powder and ready access to debt financing. Private equity investment in the two countries stands at $16.8 billion year-to-date. The 12-month totals for 2020 and 2019 were $19.6 billion and $16.5 billion, respectively. Deployment is highly concentrated, with half a dozen buyouts of $500 million-plus accounting for 60-90% of investment across all strategies in any given year. CVC Capital Partners has joined the list of private equity firms chasing these deals, following its announcement of plans to open a Sydney office and the recruitment of Brett Sutton, formerly of Affinity Equity Partners, as country chair. Sutton was widely expected to go solo, adding competitive edge to the upper middle market, but he will oversee CVC's Australia rebuild instead. With EQT also staffing up in Australia and looking to pursue larger transactions across the region, there will be no shortage of dealmakers participating in auctions and tracking take-private opportunities.

2 Fundraising challenges

The HEC-Dow Jones Private Equity Performance Ranking has been an historical shut-out for US and European managers, with Genstar Capital Partners, Veritas Capital, Thoma Bravo, Waterland Private Equity, and Clayton, Dubilier & Rice regularly featuring in the top 10. In February, Quadrant Private Equity became the first Asia Pacific-based GP to join this exalted company. It capped a busy 2020, with exits from disability services provider APM (4x) and radiology business Qscan (3x) as well as a partial exit at IPO for online beauty retailer Adore Beauty. Quadrant ended the year with a quickfire final close on its 10th fund – and seventh as an independent – with A$1.24 billion ($938 million) in commitments. Activity has continued into 2021 with the firm achieving a final close of A$530 million, despite the departure of Justin Ryan, who previously led the strategy. The last couple of years have been understandably difficult for Australia and New Zealand fundraising, with Quadrant accounting for more than 40% of the $921 million running total for 2021. The firm's flagship fund contributed 34% of the $3.9 billion raised in 2020 – down from $5.2 billion in 2019 and $9.1 billion in 2018.

3 The rise of Canva

Australian design and workplace collaboration platform Canva closed a $200 million round in September at a valuation of $40 billion – up from $15 billion five months ago and $3.2 billion in 2019. Global names such as T Rowe Price, Dragoneer Investments, Franklin Templeton, and Greenoaks Capital are supporting this vertiginous rise, while early local backers like Blackbird Ventures and AirTree Ventures have weighed in with re-ups. Eight-year-old Canva is now being touted as one of the fastest-growing software providers in history. Revenue has more than doubled in the past year and is on track to surpass $1 billion in annualized terms by the end of 2021 amid positive free cash flow generation. The growth has been attributed to a shift toward enterprise-facing products at a time when organizations – from large corporates to micro-businesses and nonprofits – have been increasingly pressured to digitize their operations and manage decentralized teams. Corporate adoption has more than quadrupled in the past 12 months due to the shift to distributed working. Company presentations are the fastest-growing use-case, with some six million created every week.

4 B2B bonanza

Canva is not the only B2B software sucess story. Start-ups in Australia have leveraged "bottom-up" marketing techniques such as search engine optimization and viral features built into digital products. They also have global scaling advantages such as less domestic competition early on and familiarity with UK and US markets in terms of language and culture. In the past 12 months, workforce management software specialists Culture Amp, Go1 and Employment Hero have achieved valuations of $1.5 billion, $1 billion and $800 million, respectively, while training platform SafetyCulture has hit $1.7 billion. Given the nature of the investors in some of these deals, IPOs might be imminent. Indeed, SiteMinder, a software provider to the hotel industry, described its recent A$100 million ($73 million) raise as a pre-IPO round. The Australia software-as-a-service (SaaS) thesis has also been reinforced by a few trade sale exits. Ascender, another human resources specialist, was sold for around $500 million, Panviva was exited for a smaller sum, and New Zealand-based Seequent went for $1 billion. All three were bought by US-based strategics.

5 Place your bets

Reduced footfall at casinos and racetracks because of COVID-19 has created a PE special situations opportunity, with The Blackstone Group targeting casino operator Crown Resorts and Apollo Management pursuing a carve-out of Tabcorp Holdings' wagering and media and gaming services businesses. These situations have yet to unfold, with Crown rejecting Blackstone's latest A$8.3 billion ($6.5 billion) bid for Crown and Tabcorp seeking to list its assets rather than sell them Apollo for A$4 billion. Nevertheless, they have revealed the basic commercial appeal of gambling, as well as the accompanying legal and regulatory headaches, in all their glory. Crown is a mess. Profit slumped 80% last year due to government-mandated closures, while scandal swirls around anti-money laundering investigations, junkets with links to organized crime, and a withheld gambling license in one state. Tabcorp is a mixed bag. Its lotteries and keno business, which has a sizeable online presence, has largely withstood COVID-19, but retail closures have hit wagering and media and gaming services. It remains to be seen whether private equity can get in at a perceived discount, clean things up, and ride the upside.

6 Strong exits story

Despite a remoteness that might dissuade international buyers operating under travel restrictions, private equity exits in Australia and New Zealand have held up reasonably well. Transactions worth $6.4 billion have been announced so far this year, which means the 2020 total of $6.7 billion should be surpassed over the full 12 months. Both represent improvements on 2019's $4.2 billion, although the average for the preceding four years was $8.5 billion. Secondary sales to other financial sponsors accounted for the bulk of activity in 2020 by capital committed. Seven of the 10 largest announced deals fit this profile, including data center operator AirTrunk, disability employment services provider APM, and education resources supplier Modern Star. In 2021, the focus has returned to trade sales, which make up eight of the top 10 exits. Defensive sectors are being prioritized like software providers Message4u, Seequent, Ascender, and Sensis, and Affinity Education Group and Education Perfect. Meanwhile, the much-hoped-for glut of large-cap IPOs has failed to materialize. PE-backed offerings raised $2.5 billion in 2020 – a four-year high – thanks to a strong second half. The running total for 2021 is $1.5 billion..

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Macro: Brave new world

As Australia contemplates opening its tightly controlled borders and finding a way to live with COVID-19, private equity probes an opportunity set in transition yet surprisingly stable

Having rebounded strongly from severe lockdowns last year, Australia appeared on track to be the first market in Asia Pacific that could be truly described as a post-pandemic economy. The subsequent outbreak of the Delta variant of COVID-19, which has prompted a re-shuttering of much of the country, has tempered that bullish sentiment but not snuffed it out.

Private equity investors claim to have more visibility on business outlooks in the current environment, with vaccination rates expected to hit 80% within weeks. Meeting that threshold should result in an opening up of domestic and international borders – and therefore the broader economy – to a significant degree. Pipelines are therefore said to be full and deal flow steady.

Throughout the pandemic, this optimism has come with a sectorial caveat. B2B businesses are more insulated than B2C. Non-discretionary spending is generally safer than discretionary. Non-essential services where digitalization is unfeasible or impossible are to be avoided.

To some extent, this logic remains a valid guide as Australia moves into a more open style of virus management. But when the country relinquishes the comforts and predictability of being a pandemic hermit state, the relevant uncertainty variables might be harder to calculate.

Pacific Equity Partners (PEP), for example, counts itself lucky that its portfolio was largely in resilient categories such as non-discretionary consumer staples and medical services when COVID-19 hit. Fund VI is 30% deployed with deal flow tracking normally during recent lockdowns – but the mix of target areas is changing.

Three diligence questions have come to the fore: First, are inflated valuations justified for companies that have benefited from the pandemic to date? Second, will struggling companies hoping to tap pent-up consumer

"It looks very much as though the new normal is a great opportunity for the informed investor, but that has to be qualified with a fair degree of significant risk"

– Tim Sims

demand be able to realize those projections? Third, to what extent will recent changes in consumer behavior prove permanent in a post-pandemic Australia?

"It looks very much as though the new normal is a great opportunity for the informed investor, but that has to be qualified with a fair degree of significant risk," says Tim Sims, a co-founder and managing director at PEP.

"There is no doubt there will be a rush where people assert their right to do things they've been starved of, but a vast majority of them have also found some aspects of life in lockdown quite acceptable. The question is, how will that settle into a long-term sustainable mix. Will people do as much of activity A or activity B as they did before? Nobody knows."

Damage contained?

The persistent willingness to invest in this uncertainty is underpinned by the long-range picture and the idea that, even in the short term, the damage has been contained. On the bullish side, the Reserve Bank of Australia (RBA) expects GDP to grow 4.7% in 2021 and 5% in 2022. National Australia Bank (NAB) is more conservative, forecasting 3.3% and 2.9%.

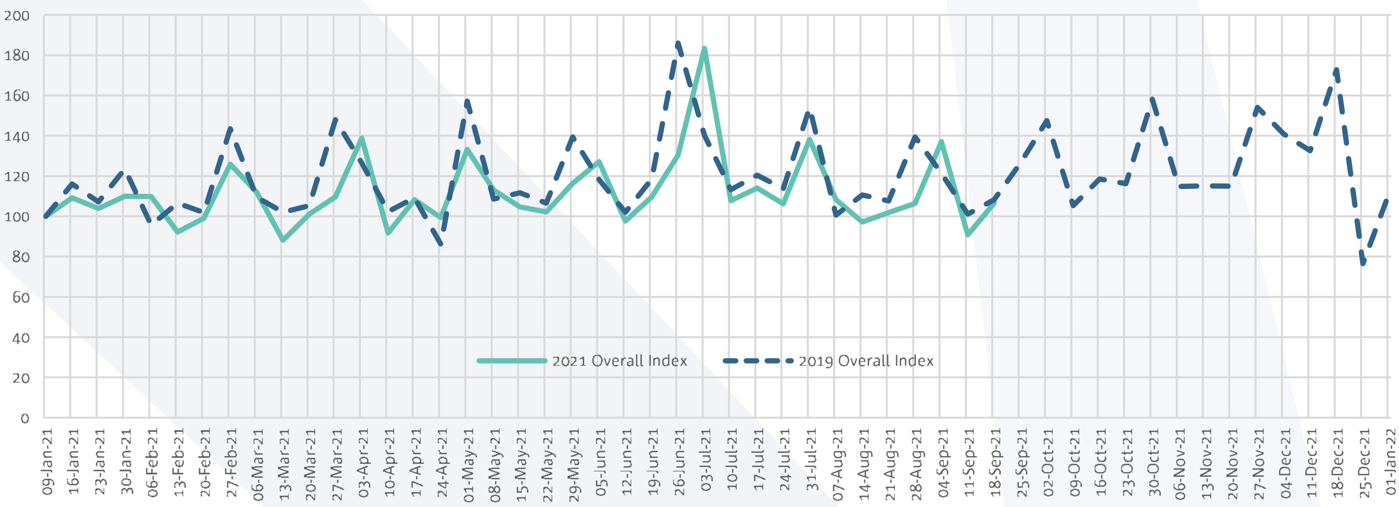
The worst fears were assuaged earlier this year when one of the government's key business-support stimulus programs, JobKeeper, was terminated and an expected wave of insolvencies failed to materialize. Government data indicates that the business closure rate has held steady around 12%, although a delayed effect is still possible.

Anil Hargovan, a professor at the University of New South Wales specializing in insolvency law, believes the country is yet to see the full result of any fallout, noting that "history shows us that you can expect at least a four-year gap between crisis and impact." However, this aftershock could simply be a matter of tallying up the so-called zombie businesses, which are no longer viable but still to be restructured or formally closed.

"We feel good about the investment environment over the next four years, but we are cautious about investments right now. While we must think about how a business will manage in the new world, we aren't trading on a month-by-month basis. As a 10-year fund, we are positive," says Mark Jago, a partner at Advent Partners.

"The Australian economy is in a good spot relative to the rest of the world, and we like the sectors we are investing in. It's just been a challenging 18 months, dealing with the on-off situation regarding JobKeeper and helping portfolio companies that have been impacted.

Relative payment inflows - overall



Source: NAB

But generally, we've been fortunate in the businesses we have backed."

Advent demonstrated long-term confidence in discretionary offline spending as recently as last month with the acquisition of Zero Latency VR, a Melbourne-based virtual gaming company that manages warehouse-sized venues where customers congregate in person. Still, the lower middle-market investor's overall activity has been conservative; it pulled out of two deals in 2020 because the outlook was uncertain, one in healthcare, one in consumer.

Advent's experience also helps explain industry confidence in a short-term recovery. For example, Frosty Boy, an ice cream company in the portfolio, saw revenue fall 80% in the second quarter last year, but this has since rebounded to record, higher-than-pre-pandemic levels.

NAB observes that GDP growth fell by eight percentage points year-on-year in the first half of 2020, but then staged a seven-percentage-point recovery in the second half. Still, the bank, which serves about 30% of the local retail sector, has tracked only a marginal decrease in the cashflows from its merchants when comparing 2019 and 2021, suggesting less scope for a rollercoaster swing this time around. It expects this year's post-lockdown bounce to be about half as big as that of 2020.

"We think activity will come back quite strongly but nowhere near as strongly as it did last year because it's nowhere near as negative as it was last year, and we don't think consumers have huge amounts of money they can spend," says Alan Oster, chief economist at NAB.

"Also, we're slightly nervous that, last year, everyone went out [after the lockdowns] and didn't even think about catching the virus. This time, they might not be as keen to go out. So, we aren't as confident as the RBA – we're still optimistic the economy will come back, but it won't be supercharged."

> "We're slightly nervous that, last year, everyone went out [after the lockdowns] and didn't even think about catching the virus. This time, they might not be as keen to go out" – *Alan Oster*

Deal roadblocks

For some investors, the end of lockdowns will mean more than a boost in consumerism – it will mean a chance to meet founders. Axle Equity Partners, a deal-by-deal private equity firm targeting the local small and medium-sized enterprise (SME) space, has not made any investments during the pandemic, citing due diligence challenges more than macro gloom.

One of Axle's key investments, Star Car Wash, has seen 110 of 170 nationwide locations forced to close by government order in the latest lockdowns, but a strong balance sheet and faith in an imminent reopening have kept morale high. The bigger problem is that interstate travel is once again at a virtual standstill and even within Axle's home base of Sydney, people are prohibited from getting together regardless of whether they're masked and vaccinated.

"A few businesses we've been looking at have been very positively impacted by the lockdowns and the pandemic. The challenge we're facing is meeting people face-to-face – that's not been possible with the opportunities coming to us," says Marcus Lim, a managing director at Axle. "There are plenty of investors who don't need to do that, but for me personally, I certainly find it very difficult to go 50% or 60% alongside the founders of a business without having gotten to know my partners."

For those comfortable with video-based relationships, several due diligence roadblocks remain, especially in terms of pricing assets based on expectations of a post-lockdown surge in business. As a result, big auctions are out (a $1 billion process for grocer Harris Farm Markets notwithstanding) and exhaustive debates about

theoretical operating metrics between small groups of buyers and sellers are in.

David Willis, head of private equity at KPMG Australia, observes that while triangulating future earnings inputs has become more art than science, a record level of dry powder in the market – including domestic, Asian, and notional allocations from global funds – has helped maintain deal flow. The hottest areas include defensive technologies, healthcare, and B2B services, as well as climate and sustainability thematics.

Exits have arguably lagged investment somewhat, although the relative stagnation is less directly attributable to the macro environment. PE-backed IPOs have run cold as the market has digested everything from reporting irregularities at cosmetics retailer Adore Beauty to murmurs about insider trading at software provider Nuix. But strategic M&A has continued to tick along, albeit with some diligence-related difficulty.

"We've certainly seen a couple of deals where they've gone a long way down the path and a trade buyer has been spooked somewhat by lockdowns and said, 'Let's put this on hold and come back when we get back to things being open again,'" Willis says.

"I would describe it as similar to 2011-2012, after the GFC [global financial crisis]. There weren't a lot of exits through IPOs, so you had to do a lot of work bilaterally. That's all part of the pricing challenge, but high-quality deals are pressing ahead."

What distress?

One of the most difficult wildcards in the idea of pent-up demand as a post-lockdown panacea is the China factor. Trade tensions between the two countries have made headlines in high-visibility categories such as wine, where political beefs have translated into tariffs of more than 200%. But by and large, Australian exports to China have continued to boom.

In terms of PE exposure, China tensions are mostly an indirect supply chain issue, but there could also be direct long-term impacts in sectors such education and tourism. Education in Australia is best analyzed as an export product, one which uniquely recycles money back into the selling country while benefiting from multiplier effects around accommodation and other services. Closed borders have hammered this space at the university level, which depends on overseas students, especially those from China.

Australia's expected reopening later this year will involve special dispensation for foreign students, but there is uncertainty about whether the program will recognize Chinese vaccines. BGH Capital is among the more exposed private equity investors in this area, having led an acquisition of higher education business Navitas for A$2.3 billion ($1.8 billion) in 2019.

"If you're in the right part of education and have the right response, it's a very positive story," says one investor with experience in the sector. "But if you're losing a significant portion of overseas students or if you're a university with huge fixed costs, you really have a hemorrhage on your hands – particularly if you have your own accommodation and you haven't put it into a different system."

Perhaps the most surprising aspect of the macro environment on Australia's deal market is the relative lack of distress opportunities. Credit and turnaround specialists contacted by AVCJ have described the current landscape as strangely yet understandably quiet, with sellers holding on for the promised rebound and traditional banks continuing to accommodate them.

For investors such as FC Capital, credit activities have therefore leaned disproportionately toward growth financing. This has been especially true in categories benefiting from government infrastructure spending such as mining and construction, as well as healthcare, renewables, and data centers.

In some cases, companies are experiencing some stress due to COVID-19, but they're seeking private credit to maximize their post-pandemic bump rather than to stay afloat. FC's transactions usually fall in a range of A$2-20 million, although there are plans to target a growing class of deals as big as $60 million via syndicates.

"There's no shortage of opportunities, and now we can see the end. Vaccination rates are fantastic. There's just an extra facet of the due diligence that you have to do – what are the likely timeframes of the economy opening up again," says Damian Speziali, an executive director at FC.

"We have a good view on when that's going to happen, so we can consider those opportunities. We have an additional lens of diligence around COVID-19 and the China trade situation, but we just continue to target businesses that are performing strongly."

Waiting to explode

Macro-influenced strategic pivots also dovetail into this area of deal flow. Corporates are less incentivized to generate cash through traditional carve-outs in Australia due to the ready availability of low-cost debt. However, pandemic and geopolitical conditions have created underperforming subsidiaries in attractive segments that cannot be separated from their parents without complex restructuring.

Turnaround investor Allegro Funds was a beneficiary of this theme in April, when it acquired the express delivery division of local logistics giant Toll Group. The private equity firm secured A$500 million in funding to complete the separation and drive a business transformation. The consolidated book value of the target company was A$820 million, even though operating revenue reached A$2.97 billion in the 12 months ended March 2020. The operating loss was A$100 million.

Underperformance was attributed to a general decline in Australia's economy and rising supply chain costs, offering a neat example of how the macro backdrop is creating both pain and promise in an apparently stable environment.

Chester Moynihan, a managing partner at Allegro, like many investors, is quick to point out the anecdotal signs that shocks to the system remain on the horizon. As such, while opportunities abound, the idea of a post-pandemic economy may still be premature.

"We're not seeing a lot of deep distress right now, but waves are brewing that are going to hit us. The knock-on effects of the pandemic as government stimulus starts tailing off will ripple through, and the whole geopolitical situation with China as a massive trading partner is not healthy. Also, there is a chronic labor shortage that has gotten worse with closed borders and created wage pressure on businesses," Moynihan says.

"All these stresses have not filtered through that much yet, but they will going forward." ■

LPs: Revert to the mean

Engagement, efficiency, and accountability are the driving forces behind reforms to Australia's superannuation system. But could private equity lose out in a race to the middle on returns?

Strong private equity returns are giving Australian superannuation funds some breathing room. "Trustees are saying, 'Maybe you're overallocated, maybe you have outflows, maybe the allocation isn't what we need for the long-term – but the numbers have been so great, let's not do anything to jeopardize that in the short-term until we figure out what we want to do,'" one portfolio manager explains. "We have a hall pass, at least for this year."

AustralianSuper, the local behemoth with A$225 billion ($170 billion) in assets, was unequivocal in linking a record single-year return for its balanced option to a long-term outlook and "a higher allocation to growth assets such as listed shares and private equity." Its PE portfolio has doubled in size to A$9.6 billion since 2018, and the 40% uptick in value for the 12 months ended June comfortably beat public equities. There's a desire to push the overall allocation from 4.2% to 10%.

AustralianSuper's approach to PE is no secret. For the most part, it runs a highly concentrated portfolio, making fund commitments of $300 million-plus to international managers. There is a strong appetite for co-investment and often in a co-sponsor role. The twin objectives are to access high-quality assets while reducing costs: zero-fee co-investment brings down the overall cost of the relationship.

Almost every superannuation with a meaningful private equity program is pursuing more co-investment as a means of fee mitigation. AustralianSuper, given its size, arguably offers a snapshot of behavior after the current wave of consolidation.

Various combinations are being mooted or actively discussed. First State Super and VicSuper have already joined forces to become Aware Super, the second-largest player with $126 billion in assets. SunSuper and QSuper

"This will likely push funds towards more passive investing and more fee-efficient and low tracking-error positions, which may cut out some really high-performing sources of returns for members"

– Kate Farrar

> "Any reforms to the superannuation system in Australia, modest of significant, tend to be controversial"
>
> *– Yasser El-Ansary*

will surpass that with A$200 billion.

But the journey will be far from smooth, and the destination is unclear. Rather than big beasts making their presence felt in global private equity – not an unrealistic ambition for the world's fourth-largest pension market – it might end with allocators rendered toothless by a fear of failure.

Conflicting objectives sit at the heart of the issue. For government, consolidation is the byproduct of a drive for greater efficiency and accountability within the superannuation system. While the latest reforms should deliver this, concerns are rife about collateral damage. On one hand, it is feared that performance benchmarking will deliver homogenous returns rather than the best risk-return outcomes. On the other, a potentially fraught disclosure regime may restrict access to top GPs.

Mapping the future

Even as robust returns grant portfolio managers temporary respite from the pressures of a fee-sensitive system that is allergic to high-cost asset classes like private equity, they are thinking about the implications of Australia's Your Future, Your Super legislation.

Some senior executives have already made their views clear. "This will likely push funds towards more passive investing and more fee-efficient and low tracking-error positions, which may cut out some really high-performing sources of returns for members," Kate Farrar, CEO of LGIAsuper, which will have A$20 billion in assets on merging with Energy Super, told Global Investment Institute.

Others prefer to keep their counsel, noting that performance benchmarking – which Farrar believes will encourage superfunds merely to track these marks – represents uncharted territory. The Australian Investment Council (AIC) is taking this approach, while putting Canberra on notice that a significant contraction in superfund appetite for private markets should prompt a reevaluation.

"If we see that eventuate, we will want to talk to government again and encourage it to look at recalibrating the reforms to deliver a better market outcome," says Yasser El-Ansary, the organization's CEO. With a nod to the highly charged atmosphere, he adds: "Any reforms to the superannuation system in Australia, modest or significant, tend to be controversial."

This reform has been a long time coming, even though some claim to have been blindsided by fine detail in the proposal issued last year. In early 2019, the country's Productivity Commission published its report on the efficiency and competitiveness of the superannuation system. Among other things, it found that members often ended up in subpar MySuper funds chosen by their employers because they didn't exercise the right to choose on starting a new job.

These observations contributed to legislation that has three key components: a stapling system, so a superannuation account follows an employee from job to job; a requirement that trustees act in the best financial interests of members at all times; and annual performance tests, with superannuation providers obliged to inform members if they fall short one year and then cease accepting new members if they fail the following year as well.

The Australian Prudential Regulatory Authority (APRA) serves as the authority on performance. It analyzes the strategic asset allocation (SAA) set by each superfund and calculates a return target over a rolling eight-year period based on benchmarks established for each asset class. Private equity will be benchmarked against global listed equities – not unlike what many superannuation funds do internally. Nevertheless, there are concerns about a reversion to benchmark tracking.

"Trustees will probably develop investment strategies aligned around these rules rather than what is directly in the best interests of members. The consequences of failing the performance tests are so catastrophic," says Nathan Hodge, a partner at King & Wood Mallesons (KWM). "But they must also justify that what they do is in the best interests of members. It will be interesting to see how this legislation influences behavior."

This is confirmed by the portfolio manager cited earlier, who flags the threat of portfolio volatility on single-year performance. While he doesn't expect PE allocations to fall materially, because the capacity for alpha generation is well-known, neither will they grow beyond the standard 3-6% range. Ultimately, the volatility risk is too great, and the notion of going into too many new funds – and the impact of the j-curve effect on near-term returns – is unpalatable.

"The best you can do is maneuver your portfolio, so it looks more like the index, and minimize exposure to things that don't match that public market profile, which means fewer funds every year, relative to the size of the program, and more secondaries and co-investment," the manager says.

"Exposure to alternatives will likely be limited. Superfunds must decide whether they want that benchmarking tracking error to be for private equity, private credit, infrastructure, or real estate. They will look at their internal capabilities for each asset class versus the benchmark and allocate more to the one with the best chance of outperformance. It is not objective portfolio construction."

The caveat is that it will take at least six months, plus some detailed modeling, to ascertain the impact of the legislation on asset allocations. Several other portfolio managers endorse this view. "We are not planning any changes right now. It is too soon to tell what action might be needed," says Serge Allaire, head of private equity at Cbus Super, which has more than A$54 billion in assets.

Agreeable benchmarks

This is one of three areas of general agreement. The other two are that, even in the medium term, larger players are unlikely to see sharp shifts in allocation because changing up a private equity portfolio is time-consuming and can be expensive; and the public market benchmark is eminently beatable, based on historical trends.

While property and infrastructure managers lobbied successfully for a dedicated unlisted benchmark, private equity held back. According to AIC's El-Ansary, this was because "there was no simple way to land on an alternative benchmark that would have broad-based support from both investors and managers and would be an appropriate bar to set." The conclusion was the industry shouldn't oppose a public market benchmark when it could offer nothing better.

Uppermost in the minds of investors in real estate and infrastructure was a belief that public market comparatives would be unfair. A portfolio largely comprising passive vehicles that own properties and collect rent represents a starkly different risk-reward scenario to listed real estate investment trusts (REITs) fed by residential real estate developers.

"A huge amount depends on the benchmark for your asset class and whether it accords with the reality of what you are investing in," says Geoff Sanders, a partner at law firm Allens. "Are you testing the same investment performance, the same cost base, and the same fee base?"

Moreover, an unlisted benchmark is acceptable to Australian investors in infrastructure, for example, because there is a relatively high degree of homogeneity in their portfolios. IFM Investors, which is owned by 26 superannuation fund shareholders and invests heavily on their behalf, is a common factor. A consensus is less likely to be reached on a private equity benchmark when programs can differ markedly in fundamental ways, such as domestic versus international exposure.

At the same time, there are readymade global private equity benchmarks, but superfunds might be reluctant to be held accountable against them. A second portfolio manager notes that Australian groups generally have less exposure to venture capital than the global norm, yet this area has outperformed in recent years. Therefore, they risk trailing a benchmark that is heavy on VC.

"If you do the math, it's easier to beat a listed benchmark than an unlisted benchmark," he adds. "I know of people within funds who were told by their strategy departments that if there were another benchmark for private equity, they would probably cut the allocation, because it's harder to beat."

Cost conundrum

The Productivity Commission report was regarded as a progression from the original MySuper reforms, which created a class of easily comparable mass-market pension products, because there was an emphasis on performance, rather than just cost. This has been carried forward into the benchmarking system, which focuses on net returns.

The enduring hope is that GPs visiting Australia with a view to fundraising will no longer find their discussions are challenged by an unfriendly policy and regulatory framework. "Introducing a test that incentivizes a focus on after-fee performance is good," says AIC's El-Ansary. "But it's about the detail and how it is implemented, not so much the concept and whether it is meritorious."

Initial feedback on the role of cost in benchmarking is muted. There is an assumed annual fee for each listed asset class, with infrastructure set at 26 basis points compared to five basis points for Australian equities. Other actively managed asset classes are likely to be treated much the same. There will also be an online YourSuper comparison tool for members, which will sit alongside APRA's existing heatmap that tracks changes in fees and costs.

At the provider level, if a fund opts for a fee structure that is higher than its peers, a best-

Disclosure: Not so indecent

Seven years ago, a well-intentioned transparency-oriented reform threatened to push relations between Australia's superannuation funds and VCs to breaking point. The much-maligned portfolio disclosure regime was repeatedly delayed and ultimately expired before passing into law. Now it is back, in modified form, and industry participants are gauging the potential impact.

"This has been a long journey and a complex one for regulators and government. It started off with a simple proposal – all superfunds should be required to disclose their investments so that mum and dad members know exactly where their hard-earned savings are being invested – that sounds very sensible and balanced," says Yasser El-Ansary, CEO of the Australian Investment Council (AIC).

"But execution is difficult. There is a lot of detail, and many areas of uncertainty that have yet to be resolved."

When the issue first emerged in 2013, the government wanted superfunds to publish full details on their portfolio holdings, including relevant valuations of each position, on a look-through basis – not only identifying the funds but also the assets that each fund is invested in. Superfund portfolio managers worried that they would be dropped by Silicon Valley venture capital firms much like various US LPs over a decade earlier.

A breakthrough in the ensuing to-and-fro came about three years ago when the government agreed that superfunds could isolate up to 5% of their portfolio by net asset value, enabling them to shield certain sensitive commercial information from public disclosure. The Your Future, Your Super legislation, which recently passed into law, removes the 5% disclosure exclusion.

"We continue to worry that forced disclosure of holdings and valuations will disadvantage the superfunds in accessing the best investments," says Rick Baker, co-founder of local VC firm Blackbird Ventures. "It seems crazy to require look-through disclosure with no materiality threshold."

However, the regime differs from previous iterations interest advisory opinion is required. The first portfolio manager notes that advisors are wary of stating that 3% outperformance is sustainable at 30 basis points in extra cost. They would endorse a 12% return over 15%, for a lower fee, reasoning that the outcome is still likely to be better than public equities.

"I don't think fee and cost pressure will ease because of the underperformance test," adds Sanders of Allens. "The reality is funds will still be judged in other contexts based on how expensive they look. And they will still compete to attract members based on fees and cost because those are easier for people to understand than net returns."

In situations where superfunds are falling short of their overall benchmarks, more aggressive strategies – higher risk, higher return, higher cost – might be adopted to make up lost ground. However, early anecdotal evidence points to volatile behavior, especially among the smaller providers. Some are defying their advisors and sticking with lower fee options because there is greater certainty as to the return or they are familiar with the framework.

At the same time, one Australia-based fundraising professional with a global private equity firm, suggests that superannuation providers are taking on additional risk in their tactical asset allocations (TAA). The SAA – used by APRA for benchmarking – is unchanged.

"Four years ago, you wouldn't have expected to hear these funds talk about PE. Now they are making allocations to managers in the US. When asked about the rationale, they say returns and their consultant has a view on the manager. But it doesn't form part of a strategic allocation," the fundraising professional says.

in that disclosure stops at the point where the superfund ceases to have full control over the investment. It would, for example, state that it has exposure to Blackbird's second fund, put a value on the holding, but the identities of the portfolio companies within the fund would remain outside of the public domain.

While fund-level disclosure isn't ideal in the eyes of many VC managers, the Australian approach isn't necessarily a deal-breaker. Many US public pension funds reveal the amount of capital they committed to a fund, how much has been deployed and distributed, as well as the multiple and IRR. Superfunds must disclose the value of their interest in a fund and the size of this interest in terms of the overall investment portfolio. The amount originally invested doesn't feature.

"You could only reverse engineer the valuation of the fund if you knew the starting cost and the share of the fund. GPs we've spoken to are not worried about the level of disclosure. The concern was with company-level information," says Geoff Sanders, a partner at law firm Allens. "I only see this being a problem for co-investments and fund-of-one arrangements."

Asked if he has informed GPs about the change, one portfolio manager explains that he is leaving it until the last possible moment because there may yet be changes in the implementation of the legislation. He makes two further observations. First, the watered-down disclosure regime might still be enough to warrant exclusion from some VC funds, but probably not all. Second, this is only a problem for the minority of superfunds that have international VC exposure.

Only three mainstream Australian institutional investors have built meaningful global venture capital programs – QIC, Future Fund, and MLC. Of those, MLC is the only superannuation provider.

"Some industry superannuation funds have established domestic VC exposure in the last few years, but they have done it with fee concessions," says Phil Cummins, a venture partner at Greenspring Associates, which advises institutional LPs on VC exposure and invests on their behalf. "The global standard for venture – 2/20 or 2.5/30 – is just too expensive for Australian superannuation funds."

As for co-investments, AIC is still seeking clarification from regulators and government. Much depends on transaction structure and where the superfund ceases to exercise control. When a co-investment is downstream syndication of a deal that has already been negotiated and multiple LPs contribute capital to a single holding vehicle, disclosure would stop there. Even when a superfund is the only co-investor, there is usually a holding vehicle, and most of the governance rights reside with the partner GP. ■

"They are tilting to play catch-up on performance, and if you have an 8% strategic allocation to private equity and a 7% tactical overweight on top of that, it will have a meaningful impact on the portfolio. But you can't build a program overnight. They could end up being hurt by the j-curve."

Big beasts

It is important to note that this phenomenon is confined to the smaller end of the market and, perhaps, to providers that the regulator expects to be victims of consolidation – because they fail the performance test and are closed to new members, or they agree to mergers before this happens. Larger players with established, diversified PE programs are better placed.

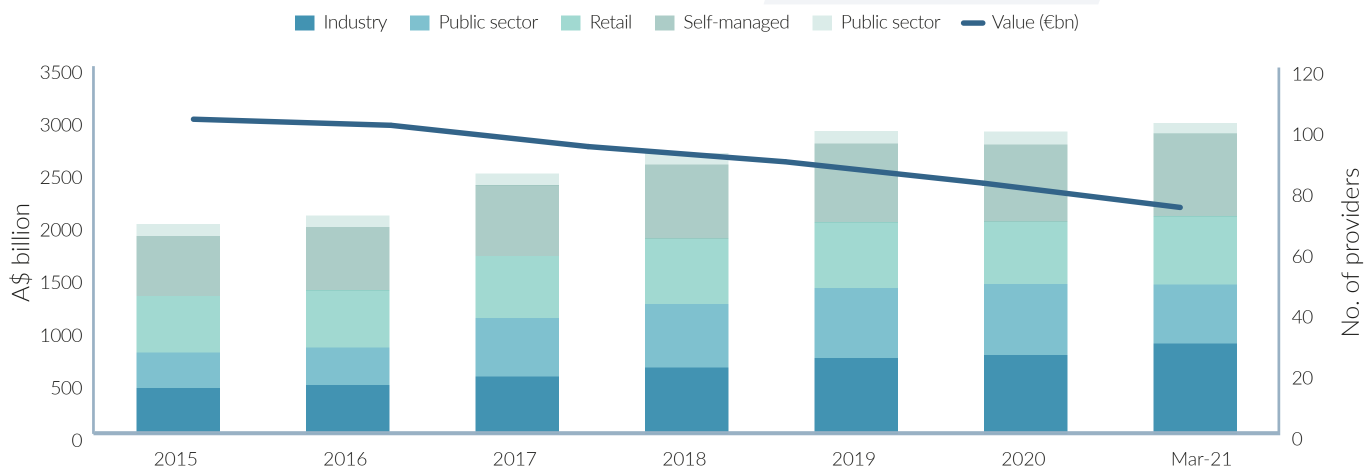
"The major private equity LPs are the larger funds. Smaller funds often don't have a traditional asset allocation. They might have gone for alpha in infrastructure or property," says the second portfolio manager. "In some cases, private equity has hurt them. And in every case, the fee burden to get into private equity is high. They don't have the scale to average down cost using co-investment."

Size is not necessarily a panacea. KWM's Hodge observes that some smaller superfunds have achieved strong performance. Similarly, there is no guarantee that larger players will be able to negotiate preferential terms in a global market where demand for access to quality managers exceeds supply, or that superfunds can build out successful co-investment programs.

But the Australian government's preferred scenario appears to be less variability in outcomes across the superannuation system; and facilitating the emergence of a core group of mega-funds that drive down the cost of implementation is a relatively straightforward means of achieving that goal. It is unclear whether private equity can play an expanded role in this vision of the future, or indeed whether it makes the bulk of members richer.

"I think it plays into the whole narrative of homogenized returns," says Michael Gallagher, head of Australia at the Alternative Investment Management Association (AIMA). "The conversation has forgotten that people can do better than the benchmark, but there is no incentivization to do more than just meet the benchmark. It's like just going out and buying market-tracking ETFs." ■

Australia's superannuation industry



* Includes corporate, industry, public sector, and retail funds
Note: Annual data is for 12 months ended June

Source: Australian Prudential Regulation Authority

Corporate VC: Appetite for disruption

Banks across Asia Pacific are leveraging their capital and domain expertise to stay ahead of the curve on financial technology. Each aspect of the corporate VC ecosystem engages with start-ups in different ways

Assembly Payments was an early mover in the payments space, launching its plug-in technology for online marketplaces in 2014. Reinventure – an Australia-based VC firm that is aligned with Westpac but operates independently of the bank – provided seed funding the same year. The opportunity set was so nascent that Westpac probably wouldn't have made the investment of its own volition.

"We thought the growth in e-commerce would lead to a need for payment capabilities like escrow services, which were not that common at the time," says Danny Gilligan, a managing partner at Reinventure. "The company then pivoted and changed over a number of years, and ultimately became two very discrete markets, neither of which was predictable when we made the investment."

Four years and three funding rounds later, the business case was proven, and the bank made a direct investment. Westpac even moved its own payments team into Assembly, tasking the start-up with integrating its point-of-sale (POS) software with the bank's merchant terminals.

Last year, the business was split in two, with Westpac retaining its interest in the core banking payments technology assets, which were rebranded as mx51. Now a white-label payment-as-a-service (PaaS) platform that integrates software with POS systems – much like Square – the company closed a $25 million funding round in May. Mastercard was among the participants.

Meanwhile, the online payments assets retained the Assembly name and received a substantial investment from SC Ventures, the VC unit of Standard Chartered. It is now positioned ▶

"If a start-up wants to do business with 10 insurance companies, it doesn't want to be seen as taking money from one of them because the other nine could sever ties" – *Udayan Goyal*

> “These are technologies built by communities, not leaders, and that is too foreign a notion for corporates with traditional control structures to get their heads around” – *Danny Gilligan*

as a digital platform that manages transactions across multiple payment types, and as of April, entered the cross-border payments space with the acquisition of CurrencyFair.

For Reinventure, the investment is a vindication of its model. In making its pitch to Westpac, the VC firm noted that banks, with their predilection for strong business case planning and short paybacks and their low tolerance of poor outcomes, were unsuited to building long-term portfolios characterized by emerging business models, high foul rates, and the possibility of a couple of home runs.

Yet Assembly’s subsequent journey offers a glimpse of the corporate venture capital ecosystem within financial services, where start-ups often have multiple touchpoints with strategic players – as vendors, portfolio companies, and acquisition targets. As technology disrupts the industry across front-end user engagement, back-end servicing, and the various layers that are getting peeled off in between, these relationships will only become more complex.

Modes of engagement

Reinventure was a pioneer in Australia, but now all four of the country’s major banks have investment programs of one kind of another. Their Hong Kong and Singapore-based peers are no different, while in recent years, there has been a burst of activity across Southeast Asia’s emerging markets involving banks, telecom providers, and platform technology companies. Fintech sits high on the agenda.

Captive investment, though still relatively nascent, has a mixed track record in Asia. Corporate parents have been known to shutter VC units if their core business comes under pressure or they don’t see tangible near-term results. At the same time, investment mandates and parental oversight can be restrictive, while compensation structures are not geared towards retaining talent.

Outsourcing is one solution. This could be a fund-of-one structure like Reinventure, where the manager raises standalone funds but Westpac supplies almost all the capital, a separate account that invests alongside a fund, or a completely outsourced program. Fintech specialist Apis Partners has experience with the latter two options, for a bank and an insurer, respectively. Udayan Goyal, a managing partner with the firm, adds that outsourcing also addresses adverse selection issues.

“Often, an underlying company is trying to disrupt the person who is putting the money in, so there are tensions, and maybe adverse selection,” he says. “If a start-up wants to do business with 10 insurance companies, it doesn’t want to be seen as taking money from one of them because the other nine could sever ties. If there is an intermediary like us, they are more comfortable.”

Even if there is some element of outsourcing, it may coexist with an array of internal programs that support companies at different stages of their development and work towards various corporate objectives. Accelerators, digital garages, and innovation hubs have proliferated in recent years on the seed investment side, often complemented by venture funds and strategic investment and partnership units targeting the growth phases. Meanwhile, venture building units develop technologies in-house.

“Telkom has a concept of build, buy, and borrow. There is a software house that does the building, and we do the buy and borrow,” says Donald Wihardja, CEO of MDI Ventures, the VC arm of state-controlled Telkom Indonesia. “We look at start-ups, preferably those we have seen from the inside, and we escort them through the process of working with the government. The government gets revenue and cost savings through digital enhancement, and we generate revenue through capital gains."

Telkom's interest in fintech is direct and indirect. It established LinkAja last year in collaboration with 10 other state-owned enterprises, including four banks. The goal is to create a default national e-wallet by combining Telkom's existing TCash offering with those of the banks. MDI will invest in the ecosystem that builds around this as well as back start-ups in other verticals that leverage fintech.

Telkom already has an incubator, and MDI has closed one fund for Series A rounds and another for Series B and beyond in the past couple of years. These are generalist vehicles that focus on fintech alongside technology-enabled healthcare, logistics, commerce, and travel plays. However, the firm is also raising a fintech-focused seed-stage fund. This is a collaborative effort with sector specialist Finch Capital.

The embedded approach

Aldi Adrian Hartanto, a partner with the new fund, known as Arise, notes that much of the low-hanging fruit in terms of consumer-facing platforms – across payments, e-wallets, lending, and business financing – has been harvested. He is more interested in the financial infrastructure that makes these platforms work.

"Every industry has financial services, so we look at it as an enabler, which has to connect to different platforms," Hartanto explains. "How do you serve this segment and solve this pain point? By building businesses on top of them. It's not B2C or B2B, but B2B2C or B2B2B – you are enabling multiple transactions through APIs [application programming interfaces]."

This is also a focal point for SC Ventures, albeit through its venture building unit. Nexus was developed as a white label banking-as-a-service (BaaS) solution for e-commerce marketplaces that don't want to build their own infrastructure. By plugging Nexus into these platforms, Standard Chartered effectively acquires more banking clients. Indonesia's Bukalapak and Sociolla were the first to be onboarded.

"Bukalapak said, 'We are happy to provide our network and client base, but can you bring the capacity, technical capability, and the licensing regime to the fore to allow us to implement and execute at speed,'" says Gakim Solomons of SC Ventures. "We run open platform, so there is no disintermediation or disaggregation. We will work with anyone, provided the business model makes sense. Nexus works with smaller banks that don't have the capability to develop our capacity, as well as e-commerce platforms."

BaaS is one of six themes pursued by the venture building unit, alongside digital banking, health, wealth, and lifestyle (responsible for Hong Kong digital bank Mox, among other things); small and medium-sized enterprise and supply chain finance (it launched a B2B marketplace and supply chain financing platform in India); environment, social and governance (ESG) screening; and digital assets.

The sixth is online digital payments, where Assembly stands out as an example of SC Ventures acquiring a capability and pursuing a roll-up strategy, rather than developing it from scratch.

There are two more workstreams: an accelerator, which includes Fintech Bridge, a platform that connects bank divisions with a community of start-ups that can offer solutions to problems as requested; and an investment program, which is currently deploying a $100 million fund aimed at integrating technologies and capabilities into the bank. There have been 12 investments to date.

To qualify, companies must be partners or vendors of the bank, so SC Ventures can prove a use case. The portfolio mix reflects where the bank is spending its procurement dollars. In the first year, there was a focus on artificial intelligence and risk management tools as part of efforts to improve transaction monitoring and know-your-customer (KYC) systems. In year two, authentication, network management, and security came to the fore – key areas for an organization working remotely.

Securing a bank as a customer is a powerful endorsement of a start-up's product offering.

Although they are notoriously slow to move – trusting a company with a limited operational history and perhaps only a partially proven business model is a big ask – banks are sticky customers.

"Banks are sitting on legacy infrastructure, and they are looking for partners to help them move faster and compete with innovators who are building systems from the bottom-up. If you can find businesses that solve problems, particularly on the infrastructure side, and enable banks to serve their customers better, they are going to love you," says Louis Casey, a principal in KKR's growth-stage technology team.

"And once you win that first blue-chip customer, it generates new customer flow. When one bank uses a product, it can create a referral flow and other banks start doing the same."

The opportunity set is broad. At one end of the spectrum are KYC processes that involve a relatively low level of technological complexity, but there are inherent inefficiencies to keeping it inside the bank. At the other end is back-end infrastructure for a range of different payment trails and services.

"It's a combination of the app helping the consumer and the regulated bank. These entities need to talk to each other through APIs, so there is an entire infrastructure being developed to make sure front-end apps communicate with regulated banks and regulated insurance companies," says Tilman Ehrbeck, a managing partner at early-stage fintech specialist Flourish Ventures. "If you are a retail broker app like Robinhood, there's a lot you need to do, dozens of functions that must be performed."

With a suite of 600 APIs that enable financial institutions and other entities to build payments initiatives, Episode Six claims a place among the more sophisticated operators. Over 100 plug-ins, each with multiple extensions, allow a high degree of configuration on a single code base. The goal is to remove barriers associated with legacy technology, such as having multiple versions of the same software tailored for different clients.

The company, which is based in the US, found a shortcut to the acceptance issue by purposefully targeting two large accounts in Asia: HSBC's PayMe small payments platform in Hong Kong and a neo-bank established by Japan Airlines. Having proved the robustness of its technology backbone, Episode Six progressed to a wider rollout. It now serves more than three million end-users, and HSBC and Japan Airlines are responsible for less than 20% of accounts. HSBC went on to invest in the business.

Banks represent the largest addressable market – such is the burden of their legacy platforms with software built on decades-old coding languages – but there is demand from modern technology platforms of all kinds. Investors expect these players to become big consumers of fintech in Asia.

"A lot of unbundling has happened in the financial services industry: everything has been converted into APIs and boxes. Fintech start-ups have emerged in each area, and now the fintechs themselves are unbundling. Across different geographies, there is an unbundling of the industry or a re-bundling of the fintechs," says Amit Anand, founding partner at Jungle Ventures.

"Fintechs have become so large, they are facing the same kinds of issues as existing institutions, so they will buy new fintech."

Front-end to back-end

This unbundling process – elsewhere described as an unpeeling of certain internal capabilities from banks into independent service layers – still has some way to go. Moreover, it typically only applies to processes like KYC that are cost centers for banks rather than points of differentiation.

Separate battles are being fought in front-end engagement and distribution and in back-end servicing, where banks believe they can offer real value-add. They are likely to invest more in these areas and might be keener on retaining ownership, which has implications for relationships with start-ups as well as for the roles played by different corporate investment programs. On the back end, several Asia-based groups are pushing into blockchain, but opinion is divided as to how this will turn out.

SC Ventures has made strategic investments in digital asset custody solutions, and it expects ▶

to launch a fund dedicated to digital assets. The venture building team is also working to ensure the bank has the tools and infrastructure to take advantage of any changes driven by blockchain, in the prime brokerage and financial markets space, as well as in the retail space.

SCB10X was established two years ago by Siam Commercial Bank and tasked with exploring a broad range of investment opportunities. It soon homed in on blockchain and decentralized finance. Interests span blockchain infrastructure and business models that parallel traditional financial services such as blockchain-based wealth management platforms.

"Taking deposits and making loans is what banks do, it's our bread and butter," Mukaya Panich, chief venture and investment officer at SCB10X, says of the wealth management platforms. "We need to understand how it is done with digital assets because we probably want to do this one day. And we see clear product-market fit – users want to hold digital assets for the long term, but they also want some cash flow, and they can't get that if there is no platform."

Reinventure was quick to act, participating in a Series C round for cryptocurrency exchange Coinbase in 2015. The company listed on NASDAQ in April and currently has a market capitalization of $54.5 billion. Reinventure exited with a 120x return and proceeds of approximately A$550 million. The proceeds came from its first fund, which had a corpus of A$50 million.

Nevertheless, Westpac was reluctant to make the investment, and Gilligan is skeptical about banks ever getting an appetite for blockchain in its true disruptive form, citing widespread misperceptions concerning the risks. Investments in the space currently being made by banks do not meet Reinventure's standard criteria for decentralized infrastructure.

"It is not true crypto," Gilligan says. "It is blockchain where they maintain control, but the entire point of these new crypto economies is they are not controlled. For a number of these new protocols, they are dissolving corporations and moving to decentralized autonomous organizations. These technologies are built by communities, not leaders, and that is too foreign a notion for corporates with traditional control structures to get their heads around."

This philosophical divide will have implications for Reinventure's fourth fund, where the plan is to deploy at least half the corpus in crypto and decentralized finance-related businesses. In Funds I through III, Westpac accounted for 99% of the commitments. In Fund IV, for which Reninventure is targeting A$150-250 million, the bank will have a minority interest. ■

Private wealth: Choosing channels

The swelling bank balances of Australia's high net worth individuals and family offices are an attractive target for private equity. Access is becoming increasingly formalized across the spectrum

Australia is, by one measure, the richest country in the world. Median wealth per adult is $238,070, according to Credit Suisse's 2021 global wealth report. Even in terms of mean rather than median – median favors markets with lower levels of wealth inequality – Australia still ranks fourth globally.

The number of millionaires resident in the country totaled 1.8 million in 2020, trailing only China and Japan in Asia Pacific. By 2025, there are expected to be more than three million. While there's no question that private equity firms are trying to tap into this growth, it is unclear how best to access Australia's affluent and to structure their exposure.

"Global GPs and allocators have realized that private wealth is an important part of the market. If they are targeting family offices or individuals that can tolerate minimum commitment requirements, that's fine," says Martin Randall, head of alternatives at Crestone Wealth Management.

"But if you've got a wealthy client with $20 million in investable assets, a GP can't approach them, even with a minimum commitment as low as $1 million. That's just too much exposure to an individual GP if the client is running a diversified portfolio."

Crestone is among the beneficiaries of the rise of the mass affluent. Formed in 2015 through a spinout from UBS, the firm has grown from A$250 million ($184 million) to A$2.5 billion in assets under advisory for high net worth individual (HNWI) clients. Approximately 11% of these assets are in alternatives – private markets, unlisted real assets, and hedge funds – against a target of 20%.

It and fellow insurgents like Koda Capital

> "If you've got a client with $20 million in investable assets, a GP can't approach them, even with a minimum commitment as low as $1 million. There is just too much exposure to an individual GP" – *Martin Randall*

and Escala Partners are battling for market share with incumbents such as Morgan Stanley, JBWere, and Macquarie. Online platforms such as iPartners and iCapital Network also form part of the landscape, as competitors or service providers to local wealth managers. Much depends on how one slices and dices a market that varies considerably in terms of the size, sophistication, and needs of end-user clients.

Nevertheless, within the wholesale investor segment – where target customers must have at least A$2.5 million in net assets – the broad distinction, between larger family offices that go into funds directly and HNWIs that do not, rings true. And, historically, the latter have been underserved when it comes to accessing private equity.

"Australia is a bit behind the rest of the world, but the market is evolving quickly. Some clients are larger than the smallest superannuation funds and running institutional-style portfolios," says Phil Cummins, a venture partner at Greenspring Associates, which advises institutional LPs on VC exposure. "With self-managed super and personal savings, it's going to be a A$1 trillion opportunity."

Pain points

Minimum commitment levels are one of several obstacles when bringing HNWIs into products structured for institutional players. Ensuring investors are comfortable with the illiquidity that comes with a closed-end fund and helping them manage capital calls are among the most pressing.

Capital calls have been an industry pain point for years, specifically the need to draw down the full commitment upfront, which creates a massive cash drag. Under a typical incremental drawdown structure, no more than 70% of a commitment would be called at any one time because distributions normally begin to trickle in before the end of the investment period.

"It is cash drag on cash drag, which leads to diminished returns based on what you might otherwise get on the underlying," says one advisor, who previously addressed the problem. "We tried a three-tranche structure, with the second called when the first was 70% drawn. Sometimes, we obtained leverage, didn't have to call from the client, and could mimic the return profile of the underlying."

Australia is said to be moving towards more progressive structures. Wealth management platforms generally need an allocation of at least A$50 million to justify the administration and custodian costs of establishing a feeder vehicle that aggregates HNWIs under a single fund commitment. Randall says Crestone is now able to break down capital calls into 20% chunks.

Three years ago, the firm went a step further by establishing a A$100 million separate account with Roc Partners, a local fund-of-funds, to target Australia's middle market. Requirements included staggering capital calls over a set timeline, reducing the minimum commitment size to A$100,000, and deploying half the corpus in secondaries and co-investments to minimize the j-curve effect.

A portion of capital was called upfront, so the cash drag wasn't eliminated, but Crestone maintains that it has given clients exposure to a set of managers and assets that would have otherwise been beyond reach. A second iteration is expected to launch later this year. A similar structure was established with Brookfield Asset Management for real assets.

Horses for courses

The net worth of Crestone clients ranges from A$2 million to A$1 billion, with an average of A$8 million. Koda typically starts at A$5 million, reasoning this is the minimum required for a diversified portfolio. Not all clients, therefore, are suited to fund feeders or separate accounts. While there are smaller local fund-of-funds that cater to HNWIs, open-ended structures are increasingly popular.

Partners Group made the key breakthrough in 2011 with the launch of an Australia feeder for its Global Value Fund, which is invested across direct deals, primary fund commitments, and secondaries. It is semi-liquid, accommodating monthly applications and redemptions through a 20% allocation to liquid assets. This creates a drag on returns, but the advisor argues that a net return of 11-14% compares favorably with 17-20% on a closed-end fund, given the monthly dealing dates.

There is always the risk of liquidity not being available when investors need it the most – Partners Group can gate redemptions if insufficient liquidity is available – but this hasn't stopped a rush of similar products. Hamilton Lane launched an Australia feeder for its Global Private Assets Fund in 2019, followed more recently by similar offerings from Schroder Adveq and LGT Capital Partners.

Crestone is invested in Partners Group and seeded Hamilton Lane's vehicle. Koda uses Partners Group as its core private equity offering and then creates feeders to access specialist strategies.

"We want each strategy to deliver a unique risk profile in the context of the overall client portfolio. Partners Group gives overarching exposure that covers all the risk and diversification areas, so beyond that we are looking at niche areas like healthcare rather than multi-billion-dollar raises," says Paul Heath, founding partner and CEO of Koda.

"The best PE funds aren't domiciled here, so we must look globally, often at funds that primarily focus on institutional mandates. We spend some time knocking on doors asking to be let in."

Wealth management platforms use off-the-shelf products where they are applicable. Randall of Crestone believes semi-liquid funds will remain the go-to core offering because they deliver a combination of diversity and cost-efficiency to clients that cannot achieve the same by going direct. In addition, growth in global secondaries has facilitated more liquidity options for these funds.

"Previously, we never had funds that were in PDS [product disclosure statement] format that you could apply into with A$25,000 lots," he says. "If you can make the case for public equities, you should be able to make the case for private equity as a longstanding outperformer. The problem for things like self-managed super is they haven't been able to access it."

Solo operators

Self-managed super funds exist within an outside the HNWI community – they are vehicles through which investors might access private equity, alongside trust and corporate structures. There is more money in self-managed super funds than in retail super funds in Australia, the pool having grown from A$569 billion in 2015 to A$822 billion as of June. The average account balance was $637,000.

"A lot of these people have 5-10 blue chip Australian stocks and then property, they will buy a house as part of the super," says David Chan, a private equity portfolio manager at MLC, which has some self-managed super accounts come into its comingled superannuation funds.

"Private equity doesn't factor much into their thinking, although it's probably an underserved ▶

Country rankings by wealth per adult

	Median wealth	
1	Australia	238,070
2	Belgium	230,550
3	Hong Kong	173,770
4	New Zealand	171,620
5	Denmark	165,620
6	Switzerland	146,730
7	Netherlands	136,110
8	France	133,560
9	UK	131,520
10	Canada	125,690

Median wealth	
Switzerland	673,960
US	505,420
Hong Kong	503,340
Australia	483,760
Netherlands	377,090
Denmark	376,070
Belgium	351,330
New Zealand	348,200
Sweden	336,170
Singapore	332,990

Source: Credit Suisse

segment. It's also harder to market to. Most HNWIs have a financial advisor, but that upper tier of income earners using self-managed super do not. They just have an accountant, go to an online broker, and buy shares direct. There isn't much room in that equation to pitch other services."

Some investors opt for self-managed super because they want to avoid traditional fee-driven asset management space. As Ken Licence, a managing director at placement agent Principle Advisory Services, puts it: every self-managed super fund wants to be treated as an individual, but every aggregator wants to treat self-managed super funds with commonality and simplicity.

Pushing down costs by launching technology-enabled wrap platforms and broadening product choice within investment programs is one solution, but the watershed moment has yet to arrive. As it stands, a portion of self-managed super money – no one is quite sure how much – filters into private equity through existing wealth management channels and other aggregators, or just by chance.

"Self-managed super is a huge opportunity because it's vastly under-allocated to private equity," says Marcus Lim, a managing director at Axle Equity Partners. "We see some of that money, but you are effectively targeting an individual and they are using a self-managed super account to come in."

Family matters

Axle is part of a vanguard of deal-by-deal operators in the lower to middle reaches of Australian PE. They are supported by family offices and HNWIs, chiefly groups that eschew blind pool funds in favor of investing directly. Lim has spoken to wealth management platforms about investments, but there was deadlock on due diligence requirements and fees. More progress has been made with outsourced CIO groups that represent several family offices and bring them into deals.

The likes of Armitage Advisors and Proserpine Capital Partners have tweaked the deal-by-deal model, raising committed capital from individual groups so they have the resources to pursue opportunities. This capital covers some of the equity and they rely on family office networks for the rest. But Damian Berry, a director at Proserpine, notes that family offices are difficult to deal with "because they are experts in everything."

It is one of a number of observations from across the industry that capture the fragmented and informal nature of these networks. Cold calling is pointless, and even when introductions do open doors, they might be quickly closed because of differences over strategy or the level of involvement the family office seeks at the portfolio company level.

That said, once relationships are established, they tend to be sticky. "They say, 'We trust you, you've done well for us in the past, we will back you to find opportunities.' It's like a blind pool approach even though it's not a fund," Lim explains.

The likes of Mercury Capital and Five V Capital have won support for blind pool funds from HNWI channels on this basis. Mercury has introduced institutional LPs over time, but Five V continues to rely on private wealth. GPs with deep enough networks can raise capital quickly and with minimal due diligence. Some Five V investors commit without even opening the data room, such is their faith in the manager, according to a source familiar with the situation.

Just as MLC's Chan argues that self-managed super participation in private equity won't become meaningful until more account holders appreciate the basics of portfolio management, family offices that go direct must institutionalize to complete the journey from informal to formal engagement. Licence of Principle Advisory believes this is already happening, albeit gradually.

"Most family offices have done a lot of direct investing and a certain amount of money has been lost. With that comes a realization that you can make money out of funds by getting into areas you previously couldn't access and getting the right level of exposure," he says. "Family offices are building up teams and experience, recruiting from consulting groups and asset allocators. As a result, they are getting more exposure to funds." ■

Profile: A principled approach

After swapping a career in private equity for a role in philanthropy, Rob Koczkar returned to the asset class with Adamantem Capital – but brought strong beliefs on sustainability and inclusion with him

From 2009 through 2010, Rob Koczkar was simultaneously pursuing distributed power provider Energy Developments for Pacific Equity Partners (PEP) and helping a charity consortium revive ABC Learning, a childcare center operator that had plunged into bankruptcy. "We had our third child in the middle of that," he observes. "There was plenty going on."

The two deals couldn't be more different. Energy Developments was a hostile takeover that ebbed and flowed as PEP sought to overcome resistant minority shareholders. ABC came about because the company collapsed under the weight of its debt in 2008 after expanding aggressively to nearly 1,000 centers. Mission Australia, The Benevolent Society, Social Ventures Australia (SVA), and the Brotherhood of St Laurence acquired ABC out of receivership and turned it into a non-profit known as Goodstart Early Learning.

If Energy Developments represented Koczkar's past, then ABC mapped out his future. He was invited to chair the newly created non-profit and within four years had left PEP to become CEO of SVA. A return to private equity came in 2016 when Koczkar established Adamantem Capital with Anthony Kerwick, a fellow PEP alumnus. However, aspects of what took him into the world of philanthropy have arguably shaped Adamantem as much as its middle-market investment proposition.

"One of the unique things about private equity is you are entrusted by investors to stand in their shoes and work very closely with the executive teams of the businesses you invest in," he explains. "The idea I could come back, step into boardrooms again and use my learnings from SVA to help create companies that are environmentally and socially sustainable as well as being really good investments, was a really interesting proposition."

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– Rob Koczkar

Adamantem has since established itself as one of the most proactive midcap players in Asia on environment, social and governance (ESG) issues. It was the first local GP to employ a dedicated ESG officer; it wants to have 40% female representation across the firm by 2024, including at the leadership level; and it is committed to becoming carbon neutral at the GP level and putting portfolio companies on a path to doing the same.

Koczkar doesn't claim sole credit for this approach; there are other ESG advocates at Adamantem, and irrespective of that, LPs increasingly want managers to incorporate it into the investment process and demonstrate tangible results. But it would be naïve to suggest that his experiences in the social sectors are not a strong contributing factor.

Seeing the world

Born to Australian immigrant parents, Koczkar's plans to study medicine were curtailed by a last-minute change of heart and he opted for engineering at the University of Melbourne instead. This was inspired, at least in part, by an acquaintance who got a job designing rockets for space shuttles on completing his PhD. Koczkar's summer placements in the oil industry were decidedly less interesting, so on graduation, he applied to consulting firms.

If these decisions suggest a pursuit of intellectual stimulation, there was an underlying recognition of the importance of job security. "My dad came to Australia as a refugee at the end of World War Two," he reflects. "You've always got to figure out where your place in the world is going to be because sometimes stuff happens, and you don't know how you're going to move forward."

Joining Bain & Company in the early 1990s presented opportunities to see the world. Koczkar enjoyed stints in Boston and Singapore, as well as numerous other trips working on projects for global clients. However, his next career move emanated from Bain's Sydney office, where several partners had decided to launch a private equity firm. Koczkar was asked to join them, and PEP raised a debut fund of A$150 million ($117 million) in 1998 with support from Bain Capital.

After a couple of years, and having just turned 30, he began to get itchy feet. Koczkar and his wife had never lived overseas, so they moved to London in 2001. He found employment with TPG Capital, thanks to referrals from contacts at Bain Capital, and spent the next three years in the portfolio group, working on operational initiatives with companies across Europe.

"There were larger investments than at PEP – the clients were more like those at Bain & Company – and they were dealing with a lot of operational complexities," he says. "This gave me a much clearer sense of what it is like to effect change at portfolio companies. TPG were always leaders in not just buying on a momentum basis but thinking about a business and what you could do with it, and then putting in resources and management to effect change."

When raising Fund II, PEP offered him a route back to Australia, this time at managing director level. This proved more tempting than staying in Europe with TPG or accepting a job with one of TPG's portfolio companies in North America.

A decade later, he decided to move into philanthropy. This was an unusual career switch, especially at that age, but it was the definitive outcome of a gradual transition that Koczkar traces back to fatherhood. His eldest daughter was born in 2006, and while well-positioned to provide for her financially, he started questioning what values she would take from him and how she would assess his contribution to society.

Looking for answers, Koczkar was introduced to Toby Hall, then CEO of Mission Australia, one of the country's oldest non-governmental organizations. Hall put him in touch with Lincoln Hopper, head of Mission Australia's community services division and they would lunch once a quarter. When Mission Australia got involved in the ABC bid, which was essentially a leveraged buyout supported by bank debt and social capital notes, Koczkar brought a private equity skillset to the table.

He describes those lunches with Hopper as his bachelor's degree in the social sector and ABC-Goodstart as his master's. Credit is also given to the PEP leadership for supporting this part-time – though time-consuming – immersion in philanthropy.

Koczkar decided to leave PEP before taking ▶

the CEO role at SVA, although the social sector was always a likely destination. Michael Traill – who became SVA's founding CEO in 2002 after 15 years with Macquarie Group's PE arm – tapped him for the job on hearing he might be available.

While SVA's core mandate was to invest in projects that generate education and employment opportunities for disadvantaged Australians, it had expanded into consulting and impact investment. Koczkar's first task was to define a unifying objective for the organization (creating an Australia where all peoples and communities can thrive) and establish what that entailed (by focusing on housing, education, employment, working with First Australian communities).

The "How do we do that?" question was harder to address because the industry dynamics had changed. "We declared victory on the idea of venture philanthropy. We found many others were doing it: foundations had been established, professional trustees were there, and people were backing social entrepreneurs with risk capital," he explains. "We didn't have to do that anymore. What we could do was invest in system-change infrastructure."

The best example of this is Evidence for Learning, a comprehensive online resource that aggregates the best educational research from around the world and makes it available to teachers. It proved so popular that the government has taken on responsibility for the project and committed A$250 million in funding. Through initiatives like these, SVA positioned itself in between policy and frontline service delivery, ensuring resources are allocated in a way that delivers the best social return.

The organization's impact investment assets under management grew from threefold to A$120 million during Koczkar's tenure and headcount rose from 60 to 100. Notably, the consulting team tripled in size as the emphasis shifted from working directly with entrepreneurs – because others were doing that – to the strategy and advocacy space.

There and back again

If a recognition of the impact philanthropy can have on the way governments spend money was one key learning from SVA, the other was that creating a community that is both environmentally sustainable and accessible to all involves engaging with multiple stakeholders. Philanthropy, while effective in influencing government, had less of a grip on the corporate sector. Investors were the key players in that constituency – and this led to a return to private equity with Adamantem.

Koczkar and Kerwick stayed in touch after they left PEP, and the former was aware of the latter's evolving middle-market thesis. The idea was to target companies that needed a supportive shareholder and capital partner, working alongside other stakeholders to deliver growth. It wouldn't be a pure buyout strategy; they were also willing to back smaller listed businesses facing growth bottlenecks. Koczkar felt that his combination of PE and social sector experience could contribute to this strategy.

Adamantem raised A$608 million for its first fund, making investments that range from aged care provider Heritage Lifecare to horse feed manufacturer Hygain Holdings to data analytics business Servian. Earlier this year, Servian became the first exit. By then, Fund II was already up against its A$725 million target, having received strong support from new investors despite travel restrictions limiting the scope for on-site due diligence. A final close of A$790 million is expected in June.

"One of the great things about leaving a firm and having a couple of years out is you get to reinterpret all your experiences," says Koczkar. "Anthony and I did that in two dimensions. First, we were honest with ourselves about where we had been lucky and where we had been good in terms of outcomes. Second, we distilled down what parts of the process had evolved over time and were important to our replicating deals that had a high probability of being financially successful."

They emerged with clear criteria as to what they wanted to invest in – companies with enterprise valuations of A$100-500 million, focusing on consumer staples, B2B services, healthcare services – and how they would effect change. ESG also came into focus, partly because they identified past investments in which risks around climate change, regulation, workforce dynamics and consumer preferences hadn't been properly identified, and they got away with it.

While it has taken time to reach a scale at which dedicated resources could be justified, ESG was incorporated into Adamantem's strategy from day one. Its impact can be gauged in investment opportunities passed up – such as an agricultural supply chain business with substantial fixed infrastructure likely to be left stranded as climate change prompts farms to move south – as well as the proactive stances on issues like emissions reduction and workplace diversity.

Integrated approach

"We talk about responsible investing in terms of environmental sustainability, participation, and transparency. Many different conversations are happening in different geographies, driven by mum-and-dad investor dialogues," Koczkar observes. "There is a momentum among consumers, employees and investors that creates a positive opportunity for companies to embrace positions on the environmental and social sustainability curve, which gives them a positive market position as well. It didn't exist 15 years ago."

Regarding climate change, independent consultants have already conducted measurements of scope-one and scope-two emissions, which cover direct emissions and emissions from purchased energy, of Fund I portfolio companies with a view to developing a 10-year net-zero glide path for each one. Some of them – as well as Adamantem itself – have already achieved net-zero. The same is expected to happen for Fund II.

Koczkar puts it in the broader context of due diligence evolution. The starting point for private equity investors used to be interviewing the CEO and finance director of the target business, but now proactive distribution of vendor due diligence packs is commonplace in Australia. While ESG oversight is further down the curve, whoever acquires a Fund II portfolio company a few years from now will not pay a premium unless they see granular information.

Adamantem's approach has already gained notable traction with LPs, with Australia's Clean Energy Finance Corporation (CEFC) agreeing to invest A$80 million in Fund II – its first commitment to a private equity vehicle. This was partly based on studying Adamantem's Fund I record on emissions reduction and concluding the organizations are philosophically aligned. Early initiatives include the creation of an emissions reduction sub-committee below the Fund II LP advisory committee (LPAC).

"We put in the fund charter that they would be on the committee alongside at least one other LPAC member," he adds. "In the end, eight of the nine institutions on our LPAC wanted to be on the committee – some because they had something to say and others because they wanted to learn. We are already contributing to the debate by creating this transparency and visibility." ■