

Deal mechanics

Australian GPs emphasize operational capabilities as they prepare for a downturn



- ▶ Portfolio companies address labour shortages
- ▶ Q&A: Aware Super on its international ambitions
- ▶ Are LPs pulling back from co-investment in Asia?



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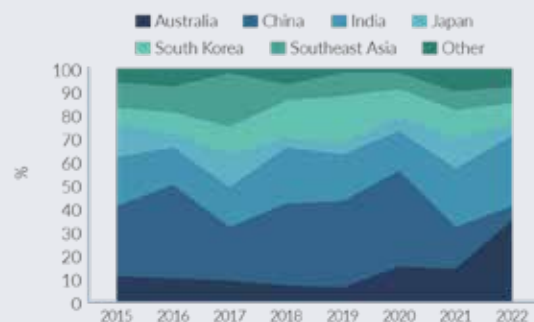
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Australia in six trends

1 Regional significance

In 2022, Asian private equity failed to replicate the highs of 2021, but plenty still got done. Investment reached USD 227bn and exit proceeds hit USD 79.7bn, the second and fifth-largest annual totals ever seen. GPs put USD 47.7bn to work in Australia, down from USD 71.2bn in 2021. However, exits soared past 2021's record high of USD 16.7bn, coming in at USD 28bn. With other geographies floundering, Australia accounted for 35% of the region's overall exit proceeds in 2022. The average for the preceding five years was 10%.

Asia private equity exits by geography



Source: AVCJ Research

Australasia private equity fundraising



Note: Excludes infrastructure funds
Source: AVCJ Research

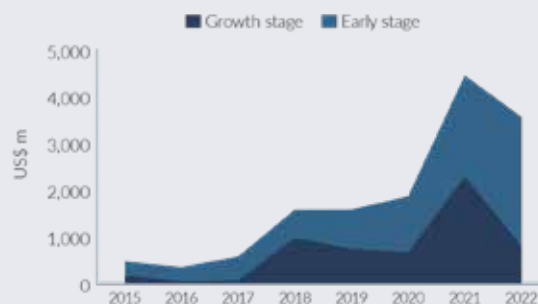
2 Fundraising phenomena

Private equity fundraising in Australia and New Zealand has always been blocky: the total might be outsized in any given year based on how many GPs in a shallow domestic pool were in the market. The likes of BGH Capital, Mercury Capital, and Potentia Capital drove 2022 to a record high of USD 71bn (excluding infrastructure). Do not, however, overlook the role of VC. There were final closes for each of the big three players – Blackbird Ventures, Square Peg Capital, and AirTree Ventures – that pushed the VC total to USD 2.6bn. The venture share was 36%, bettered only by 2020's 40% (which was a quiet year for PE).

3 Growth-stage gap

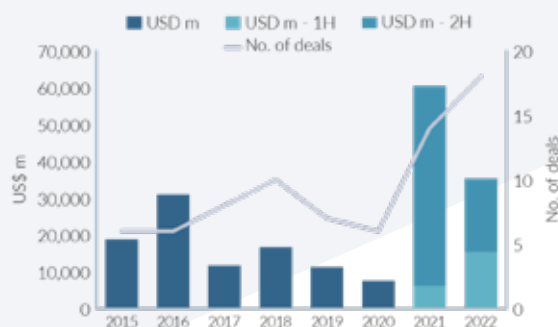
Sequoia Capital Southeast Asia's recent participation in a AUD 27m Series C round for credit and payments platform Shift does not, apparently, signal a return of the overseas growth-stage players. Minority equity investment in Australia and New Zealand's tech sector reached USD 4.5bn in 2021. Early-stage deals contributed USD 2.2bn, a 1.8x increase on 2020, while growth-stage transactions rose 3.4x to USD 2.3bn. Early-stage activity climbed again in 2022, reaching USD 2.8bn. But with overseas investors pulling back, growth-stage tech slumped to USD 801m. The situation hasn't changed thus far in 2023.

Australasia tech investment: early vs growth



Source: AVCJ Research

Australasia buyouts of \$500m-plus



Source: AVCJ Research

4 Buyouts becalmed

Big buyout investors globally filled the boots towards the end of 2021, supported by abundant dry powder and cheap debt. Australia and New Zealand were no exceptions. There were 14 buyouts of USD 500m or more; 11 were announced in the second half of the year and they accounted for 90% of the USD 60.5bn 12-month total. In 2022, deal count increased but investment fell to USD 35.2bn. This was split relatively evenly over the two halves of the year, perhaps reflecting the continued availability of debt financing as other markets ground to a halt.

5 Flight to stability

Asia PE investors responded to the volatility of 2022 by fleeing to tangible assets and developed markets. The investment drop-off in Australia and Japan was less severe than in some places. Infrastructure and utilities, healthcare, and transportation received a larger share of investment. Australia and New Zealand follow this trend – over 40% of capital went into those sectors – but there is some mitigating context. Infrastructure and utilities have traditionally been strong in these markets. And their importance is rising partly due to structural trends, such as digitalisation and energy transition.

Australasia PE investment by sector



Source: AVCJ Research

Australasia PE exits by type



Source: AVCJ Research

6 Between peers

Sponsor-to-sponsor transactions have long played a role in the Australia and New Zealand market. In 2018, when exits reached was then a record high of USD 9.8bn, nearly half of that was one private markets investor selling to another. In 2021, it was one-third out of USD 20.3bn. Last year, the sponsor-to-sponsor share dropped off slightly, but only because of a bumper trade sale involving a Macquarie Asset Management-owned renewables portfolio. Sponsor-to-sponsor deals hit USD 10.7bn out of USD 33.3bn transacted overall with seven of the 10 largest exits over the course of the year fitting this profile.

Value in adversity: Australia's operational challenge

With Australia poised for a rarely-seen period of economic difficulty, the operational capabilities developed by domestic private equity firms will be put to the test

Three years ago, four in every five Australian mortgages was variable rate, compared to one out of 20 in the US and one out of four in the UK. For over a decade, interest rate cuts contributed to benign conditions. And when COVID-19 took hold, the government introduced super-cheap, three-year fixed-rate loans to keep the market moving. The variable rate share slipped to three in five.

Between April 2020 and June 2021, loans amounting to AUD 188bn (USD 131bn) were issued, according to the Reserve Bank of Australia (RBI). In the coming months, they will switch back to variable rate, exposing borrowers to a string of interest rate hikes that the RBI expects to continue.

KPMG calculated that the transition would make homeowners AUD 16,500 worse off per year after tax, based on the average new residential mortgage loan size of AUD 600,000. Moreover, it is expected to be directly responsible for an AUD 20bn drop in household consumption expenditure and a one percentage point decline in GDP growth this year.

"It is the most tangible downside risk you can point to in the Australian economy. There's a lot of household debt, a lot of floating-rate mortgages, and an unusually large number of fixed-rate mortgages that are unwinding," said Anthony Kerwick, a managing director at Adamantem Capital.

"I would be surprised if it didn't have some effect, even though there are some strengths in the economy, such as low unemployment, that could counteract it a bit. As for how dramatic the effect will be, we'll have to wait and see."

The same sense of uncertainty hangs over much of Australia's economy. The RBI admitted in ►



“[Fixed-rate mortgages unwinding] is the most tangible downside risk you can point to in the Australian economy”

– Anthony Kerwick

its monetary policy statement earlier this month that “the path to achieving a soft landing remains narrow.” It wants to curb inflation while keeping the economy on an even keel, conscious that GDP is slowing, the labour market is tight, and rising interest rates are eating into real disposable incomes.

Every projection was caveated by references to a lack of clarity – on how competing forces will influence household spending, how quickly inflation will retreat, how the global economy will evolve.

Even though most private equity investors in Australia expect a moderate downturn rather than a recession, changing conditions can shorten or lengthen value creation levers. Financial engineering and multiple expansion on exit have become less powerful, which places more onus on operational improvement. Yet some managers are still pondering their next moves in this area.

James Viles, head of the Australia private equity practice at Bain & Company, describes a client base looking for input on where to cut costs but unsure of where and when to start.

“In a downturn, you normally have workshops about how to take advantage of these conditions and buy up your weak competitors, but most people aren’t in that mode,” he said. “They

are shrinking back into their shells looking for roadmaps for bringing out cost and becoming leaner, meaner, and more flexible. They want to be ready for growth – but not to pursue it right now.”

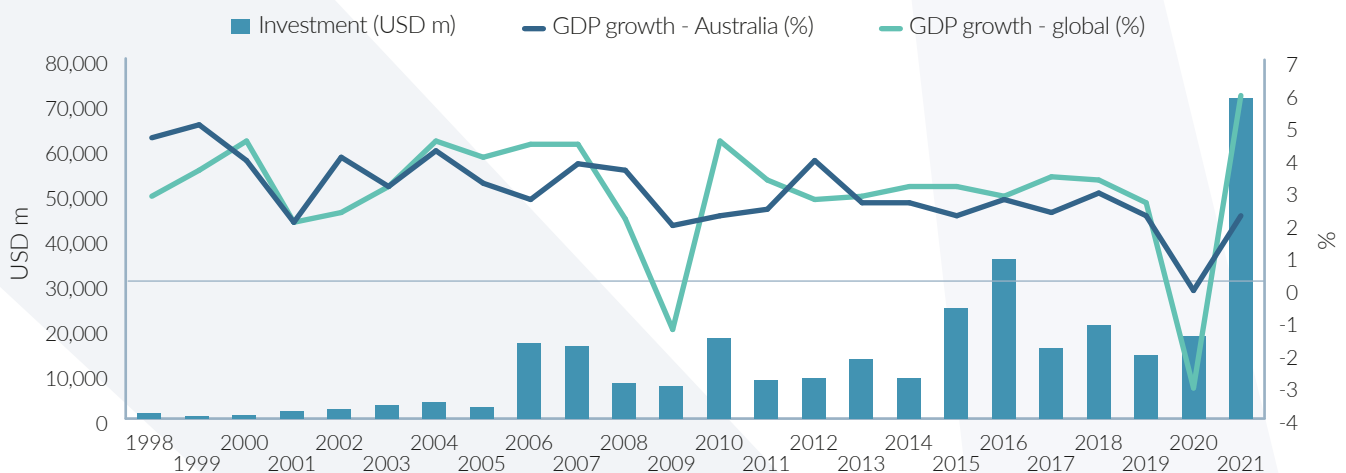
Essential infrastructure

The speed and magnitude of operational transformation in an investment largely rest on bandwidth – the extent to which GPs can devise and execute plans internally or are willing to pay third parties for support. In Australia, like most markets around Asia, country managers have followed their global and pan-regional peers in developing specific philosophies around this aspect of value creation.



Parachuting in experienced executives or consultants with relevant expertise to work alongside management remains part of the playbook. On top of that, private equity firms are developing in-house functional capabilities that can be applied across the portfolio – to the point that some claim to be building genuine intellectual property for business transformation.

Initiatives can proliferate naturally. Viles observed that an initial focus on procurement, if successful, may prompt a manager to expand coverage into areas like digital marketing and pricing strategy. But there are more fundamental ►

Australia – PE investment vs GDP growth



Source: AVCJ Research, World Bank



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“You normally have workshops about how to take advantage of these conditions and buy up your weak competitors, but most people aren’t in that mode”

– James Viles

driving factors, from a recognition that the low-hanging fruit from a return perspective is diminishing to an appreciation that competition for assets is intensifying.

“It’s more important than ever for GPs to maximise value from their portfolio companies, and we see investors leveraging their teams to accomplish this as much as they can,” said Daniel Selikowitz, a partner at Boston Consulting Group (BCG).

“Choosing the right management team is as vital as ever, but we also see a propensity to engage external experts where needed to supplement in-house capabilities and tap into new areas of opportunity.”

Even as internal capabilities grow, that reliance on outsourced support remains. The consensus view among advisors is that local GPs are not set up to insource to the extent that they can co-sign comprehensive value-creation programmes with management teams.

Australia and New Zealand combined simply lack the depth to justify dedicated operations teams equal in scale to those of pan-regional managers – which may have a handful of people in-country and bring in additional resources as required (and those are not always internal resources).

Buyout deal flow alone reached USD 117.7bn between 2020 and 2022, a threefold increase on the three years prior, according to AVCJ Research. But three-quarters of that capital was absorbed by about 20 USD 1bn-plus transactions pursued by

large-scale managers. The sub-USD 500m space in 2020-2022 saw about 90 deals worth USD 14.4bn, up 20% and 50% on the three years prior.

The two largest domestic players, based on most recent fund size, are BGH Capital and Pacific Equity Partners. They have fewer than 20 active private equity investments between them.

Boots on the ground

As a spinout from TPG Capital, the BGH team replicated aspects of its former parent’s operational approach. The operations group, led by the former Asia head of KKR’s Capstone operations unit, comprises a dozen full-time professionals who either work in the field with specific companies or across the portfolio in functional areas like property, procurement, human capital, and technology.

There are also 11 senior advisors, mostly ex-CEO types, who sit on boards and offer input on operational and governance issues as required.

Portfolio companies pay salaries to the field operatives as long as they are in place – if they spend an extended period unattached they become a GP-level expense – and compensate functional professionals based on time spent on projects. “External consultants are more expensive, and they tell you what you need to do rather than actually do the work,” said a source familiar with the firm.

What BGH has done is essentially formalise the informal rolodex networks that investors have long drawn upon. Other firms have developed their own variations on this theme.

Turnaround investors, for example, tend to be heavy on operations because their strategy involves heavy lifting. Allegro Funds has an operations team of seven working alongside its 11-strong deal team, including specialists in ownership transition. Adamantem, a more traditional mid-market player, has nearly 20 working on deals and four in operations, each with functional expertise.

IFM Investors, which is currently deploying a mid-market growth fund and a long-dated fund, takes a dual-strand approach. It employs a six-strong formal advisory team of functional experts – who receive a retainer from IFM plus top-ups from portfolio companies if they go full-time

on specific projects – and maintains an informal network of executives with experience in different sectors.

Three years ago, the firm tried to recruit Leigh Jasper, who co-founded and led construction industry software specialist Aconex until its acquisition by Oracle, for the formal advisory team. Discussions didn't go anywhere because Jasper wanted to focus solely on construction software, but then IFM started pursuing an investment opportunity in Zuuse, which is in the same space.

"We brought him in, he helped us with the due diligence process, and he invested in the company alongside us, and now sits on the board. That's how the informal network operates," said Adrian Kerley, an executive director in IFM's private equity business. "With the formal network, it's more a case of, 'We need you to visit this company next week to do a technology stack review.'"

At smaller PE firms, investment and operational responsibilities are more integrated. Anacacia Capital has an advisory council of senior executives who invest in its funds and serve on portfolio company boards. Operational legwork that isn't outsourced falls to the deal team. This means the same people are involved throughout the life of the investment, which Jeremy Samuel, Anacacia's founder, sees as an advantage when engaging owners of family businesses.

Similarly, Genesis Capital, a healthcare sector specialist that spun out from Crescent Capital Partners, has a large investment team for its size because members spend up to half their time on portfolio work. There are also two functional experts covering human capital and marketing – areas where the clinical trials services businesses Genesis often backs are most likely to come up short.

"It becomes easier to have permanent in-house

resources because the themes are so similar. Generalists don't have enough consistency in the domain areas to just have one person and build up that capability internally," said Chris Yoo, a partner at the firm.

Discretionary dilemma

At the furthest extreme of the market, deal-by-deal operators typically lack the balance sheet capital to develop in-house resources. Asked for a solution, Marcus Lim, a managing director at Axle Private Equity, replied: back strong management teams, invest in robust sectors.

Though intentionally glib – deal-by-deal players can rely on outsourced expertise – the response sheds some light on how Australian GPs think about sectoral exposure and downside risk.

While the country never slipped into recession following the global financial crisis, some investments in cyclically volatile segments performed poorly. In 2006–2007, media and consumer (spanning retail as well as consumer products and services) together accounted for 32% of all deal flow excluding VC. In 2021–2022, consumer and media were 2% and 0.2%, displaced by more defensive assets.

Post-2008, private equity firms became highly selective regarding consumer discretionary assets, if they considered them at all, given the operational complexity of guiding these businesses through difficult periods. Consumer staples are far more palatable, as evidenced by Adamantem's acquisition of Hellers, a producer of processed meats and sausages, in 2019.

"It wasn't where the action was at the time, so we thought we had an opportunity to invest in a business at an attractive valuation, and when the economic cycle turns, it will come to be seen as a safe and consistent asset – the sort of thing that is recession-proof," said Kerwick.

Adamantem recently invested in Retail Zoo, an operator of fast-casual restaurants and juice bars that might be regarded as far more exposed to the vicissitudes of consumer demand. The firm was confident enough in the management plan to look beyond an expected near-term decline in spending, driven partially but not wholly by the mortgage adjustments, and focus on the long term.

"Operating teams want a holistic view, and they want to respond in a more systematic way"

– Timo Schmid



At the same time, the line between discretionary and non-discretionary can be blurred. The RBI is projecting that GDP growth and household consumption to decelerate over the course of this year and not rebound until the end of 2024. Investors believe the likes of apparel, cars, and household goods will be hit hard, but other areas may not suffer.

Axle owns a 180-outlet carwash business and went looking for data points from the post-global financial crisis period in the US. There was no meaningful downturn. BGH owns cinema chains and amusement parks: the former perform well during soft economic periods because they are a low-cost source of entertainment; the latter are benefiting from a domestic travel boom.

"Sometimes the impact on discretionary spending is not what you would expect. For instance, in prior downturns, we have seen at least 25% of consumers display a willingness to trade up across a diverse array of categories. They might spend less on going out for dinner at a restaurant, but will treat themselves to more expensive fresh produce or personal care products at home," said BCG's Selikowitz.

"If a company is highly exposed, it's important to thoughtfully pull levers around pricing, promotion, and loyalty programmes in a way that maintains

footfall and relevance during the downturn, while driving down cost to weather exogenous shocks."

Stepping up

Some of these levers started being pulled a year ago in response to inflationary pressure. Yoo said that Genesis helped portfolio companies offset rising wage costs through analytics-driven efficiency and productivity initiatives. Viles noted that several GPs sought to address cost headwinds by leveraging portfolio scale and synergies. Procurement was the most logical starting point.

Supply chain management and employee recruitment and retention – amid severe labour shortages – have been top-of-mind for many managers. Looking ahead, references to the importance of having a strong capital structure and the virtues of pricing discipline are frequently made.

According to Timo Schmid, who leads the Australia private equity performance improvement practice at Alvarez & Marsal, there has been a step change in the inquiries he's received from managers in the past year. The reactive mindset underpinned by pandemic-related business continuity issues has been replaced by a desire to get ahead of impending economic challenges.

"Operating teams want a holistic view, and



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they want to respond in a more systematic way,” he said. “We are getting requests for downturn management offices. They are asking, ‘What do I need to do upfront if I invest in a company and need to deal with a range of functional topics for a range of 12–24 months? What do I need to plan for? What do I need to invest in during my first 500 days?’”

One of Schmid’s concerns is the lack of experience in an Australian private equity industry largely populated by professionals who haven’t seen a meaningful downturn – it leaves “a gap between seeing the iceberg coming and having the capabilities to bring the ship around.”

There are myriad risks, not least that private equity investors become too defensive in the face of adversity. This is manifested in an unwillingness to invest in growth that could position portfolio companies favourably coming out of the downturn or in a failure to recognise where inflation might be easing and realise benefits in areas that might have been pain points a year ago.

Indeed, David Odgers, an executive director at IFM who previously served as an operating partner at Bain Capital, describes operational improvement as long-term agenda: it responds to macroeconomic developments but is not defined

or unnecessarily distracted by them.

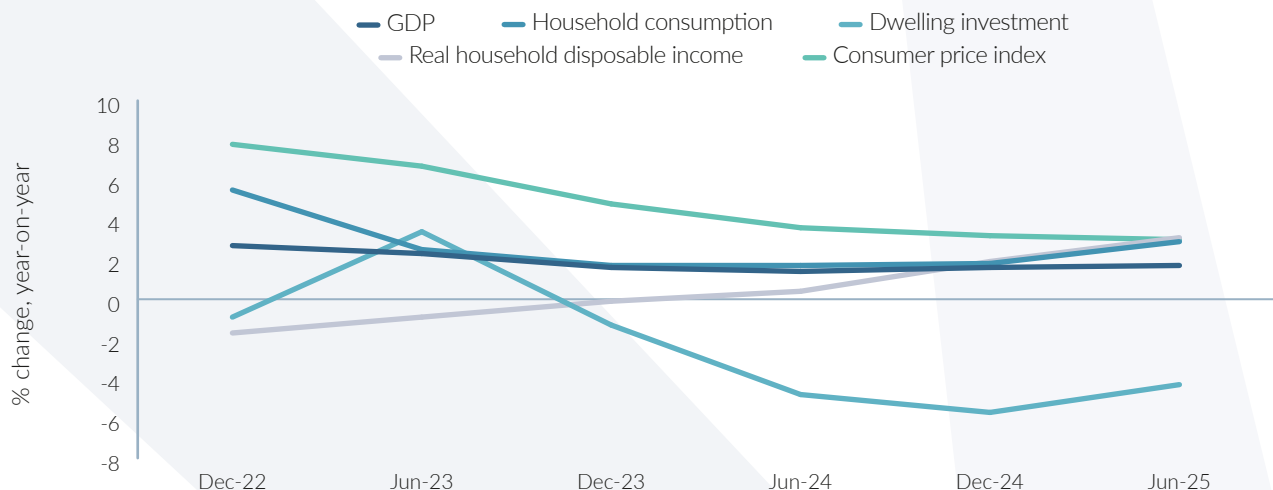
“With monthly board meetings, steering committees, engagement surveys, strategic planning processes and so forth, you should be nimble enough to adapt to what is happening on the outside world as well as to what is happening on the inside,” he said.

“You must consider the external environment and weigh that into your thinking, but the value creation approach doesn’t change; maybe the emphasis changes based on what moves into the ‘urgent and important’ bucket.”

In this context, the economic uncertainty that discourages aggressive action could be interpreted as a positive. Adrian Loader, a partner at Allegro, observes that deciding whether to push ahead with operational initiatives is very situation-specific, yet it is influenced by macro-level planning – and for all the plans being drawn up, no one really knows how different scenarios will play out.

“Since 2020, volatility has been the main game. Shocks are coming from everywhere, so we must be agile and sharp,” he said. “The only thing we can really be certain about is that volatility will continue, from an operational point of view and potentially from a financial point of view.” ■

Australia – key economic indicators



Source: Reserve Bank of Australia

Q&A:

Aware Super's Damien Webb

Damien Webb, deputy CIO and head of international at Australia's Aware Super, on opening offices overseas, internalising asset management, and opportunities at the nexus of PE and infrastructure

Q: Why is Aware Super looking to build an international footprint now?

A: We are a defined contribution fund, not a defined benefit fund, so we must sing for our supper and compete for members who can move between superannuation providers. Our corporate strategy is clear: we must deliver strong returns and lower fees. We also need to invest globally at scale, because our AUM [assets under management] is expected to rise from AUD 150bn (USD 101bn) to AUD 200bn. Part of achieving that performance and fees outcome involves increasing our pathway to internalised assets by at least 50% by 2025-2026 and increasing our private markets footprint. Bring all those things together and we need to have people on the ground in overseas markets to source and manage investments.

Q: What specific targets do you have regarding offices and people?

A: We wanted a targeted strategy at scale, focusing on developed markets. We are going into Europe first and North America second. By the end of this year, we hope to have opened an office in the UK. From London we can source investments in Europe, and it also serves as a good launching pad for the rest of the world. We will then evaluate adding a North American office two or three years thereafter, depending on the success of the UK office. The goal is to have 20 people in London fairly quickly, so the office feels like a good place to work. We don't want it to be seen as a small branch office, more as an extension of our head office operation. We ►



“The goal is to have 20 people in London fairly quickly, so the office feels like a good place to work”

hope to grow to 30-plus people by 2025. It will be focused in terms of asset classes – just property, infrastructure, and private equity.

Q: What are the main challenges when expanding internationally?

A: Culture is important to us, so preserving that. There is also the issue of sourcing deals in competitive markets – we know it won't be easy. I think you will see other Australian superannuation funds seek to set up offices overseas.

Q: How is the internalisation initiative going?

A: We are progressing well. Things like equities and credit – trading strategies, where there is abundant information – can be relatively well supported from the office here with some travel. In real assets, that's property and infrastructure, we've had great success with direct investments and direct platforms, but with a very heavy home bias. We are a large player here, with an emerging brand and a large team, so transactions naturally come to us. The challenge is taking that success in Australia and seeing whether we can replicate it in overseas markets. As for private equity, we are still very much working with GPs and emphasising co-investment. We want to get closer to those GPs in their marketplaces, so we can do more work with them around co-underwriting and additional strategies.

Q: What is the international share of current allocations to different private markets asset classes?

A: Private equity is about 80% overseas deployed, which you expect given there are larger and deeper markets for funds and co-investments overseas. For real assets, it's the opposite – only 20–30% is overseas. You want to have inflation linkage in real assets. Our members are Australian and their superannuation funds, which contribute to retirement savings, are indexed to the Australian CPI [consumer price index]. This lines up the cash flows nicely. However, as we grow beyond AUD 150bn in AUM, we will have to moderate that and do more overseas.

Q: There have been numerous large-cap infrastructure deals in Australia where groups of institutional investors put in most of the capital but bring in a strategic partner to manage the asset. Do those count as direct investments?

A: There is no one set definition of what is direct and what is not direct; there's a bunch of flavours underneath. What we aren't doing much of right now is allocating to pooled funds. We have legacy positions we are happy with, and we will continue to support those funds, especially if they give us additional co-investment. But what we are doing more of is investing in operating businesses or operating platforms that are either existing or we build ourselves from the ground up. Vocus Group [a fibre and network solutions provider acquired by Aware and Macquarie Asset Management for AUD 3.5bn in 2021] is a good example. We put in a significant team alongside Macquarie, and we have direct governance over the asset. There is a role for fund managers, but increasingly we represent ourselves throughout the value chain.

Q: What about the relationship with private equity managers?

A: We want to have meaningful, workable relationships where we are seen as valuable and agile partners to the GP. Often, we make a fund commitment and get a contractual right to a certain amount of co-investment. To do that, you must be meaningful within the fund. A big part of our strategy has been supporting first-time funds or groups seeking an initial cornerstone commitment. We are also investing more in ourselves, so we are not just a financial investor, but a co-investor or co-underwriter. We want to understand more about what GPs are trying to achieve and how we can support them.

Q: Has it become easier to source co-investments given current market conditions?

A: We have noticed that, with equity and debt markets being more challenged in the last three years, the denominator for asset owners has gone down and their private markets exposure has gone up. Some previously very active allocators have ►

moderated their exposure to a degree, especially those on the DB [defined benefit] side with large private markets portfolios. They are tapping the brakes on allocations, which means fewer follow-on investments and co-investments. We are very much in the market – we are underinvested in our asset allocation to private markets – but we are not being inundated with additional deal flow. Good opportunities are always well supported.

Q: With the emergence of core-plus infrastructure – and changes in how it is defined – is the line between private equity and infrastructure becoming more blurred?

A: I am still relatively comfortable that those spheres are still somewhat different from a return

superstructure, and putting in new broadband and digital towers.

Q: Are you pursuing more core-plus infrastructure opportunities?

A: I don't think it's helpful in property and infrastructure to say that is core, that is core-plus, and that is opportunistic. There are rules of thumb, and you can have quick conversations around a profile, but having those hard definitions doesn't necessarily lead to a better portfolio outcome. We want to look at the drivers of each asset's return. You can have elements of core return and elements of opportunistic cash flow in a single asset – how do you think about that? We like hybrid situations, with a bit of complexity, that might scare others away. It is dangerous to be overly wedded to historical definitions that are harder to apply in practice.

Q: Would the infrastructure and private equity teams look at assets together?

A: It's an exciting prospect, although there must be clear accountability for who is looking at what. We have been moving into newer areas like motor vehicle registries and land registries. These are interesting businesses with interesting cash flows, but they don't conform to a classical definition of infrastructure. Sometimes there are cash flows that are private equity-like – that need to be procured and grown – and we talk to the private equity team about how we should think about pricing those cash flows and the chance of success.

Q: Have you considered adopting a total portfolio approach instead of an asset allocation model?

A: There are pros and cons to every model. We like our model because there is great value-added alpha coming from bottom-up sector teams. We want to encourage those animal spirits and have broad mandates that allow those teams to innovate in their space. The investment leadership and the strategy team pull it together and set targets and allocations, which they move or tilt as they see fit. There is also clear accountability with this model. ■

“What's happening more often in infrastructure is we're looking at other sources of revenue that could be private equity-like”

point of view. What's happening more often in infrastructure, when we are putting together consortiums or platforms or business plans, is we're looking at other sources of revenue that could be private equity-like. We like assets that are essential services, have monopolistic tendencies, and high operating margins over EBITDA. On top of that, there could be other value-added services you can seek to monetise over time. For example, long-term storage solutions could include batteries and other forms of technology, and you end up in a space with infrastructure-style solutions but venture capital-style governance. There will be more situations like that. A lot of the additional capital going into infrastructure will target themes like digitisation and energy transition, which wouldn't be considered core infrastructure. We are already laying new wind farms, building new parts of the energy

Labour shortages: A post-pandemic pain

Private equity investors in Australia believe they can withstand extreme labour shortages by relying on policy support and emergency manoeuvres

Australia's labour shortage is well-documented. About 45% of companies are having difficulty finding suitable staff, according to government data. Moreover, the unemployment rate fell sharply in Australia in 2022 from 5.1% to 3.4%, straining operations in private equity hotspots such as consumer and medical services, and leisure and entertainment.

Portfolio companies are feeling the pressure, but PE investors are not unduly rattled. There is little expectation that shortages will translate into weaker returns – in part because entry multiples for the most impacted industries are low. Solutions ranging from rethinking human resources strategy to classic belt-tightening are seen as sufficient.

Australia's labour woes in can be squarely blamed on COVID-19 and as such have come with optimism that the effects will be temporary.

The country's economic hibernation and border closures during 2020 and 2021 prompted many indispensable foreign workers and student visa holders to return to their home countries. There was a net loss of 88,800 migrant workers during this period, official data show.

Amidst a rapid reopening in 2022, immigration infrastructure has been slow to get back into gear and travel expenses have remained high. Long-haul airfares to Australia are still often 3x pre-pandemic levels, reinforcing the market's remoteness. Meanwhile, uptake of automation has not accelerated under COVID-19, with most investors citing survival-mode budgets and cultural resistance to changing consumer behaviour.

"If you surveyed our CEOs, they could sell more if they could get enough people – and that's unique. In most surveys going back in time, the biggest question was how do I sell more? ►



"If you surveyed all our CEOs, they could sell more if they could get enough people – and that's unique"

– Fay Bou

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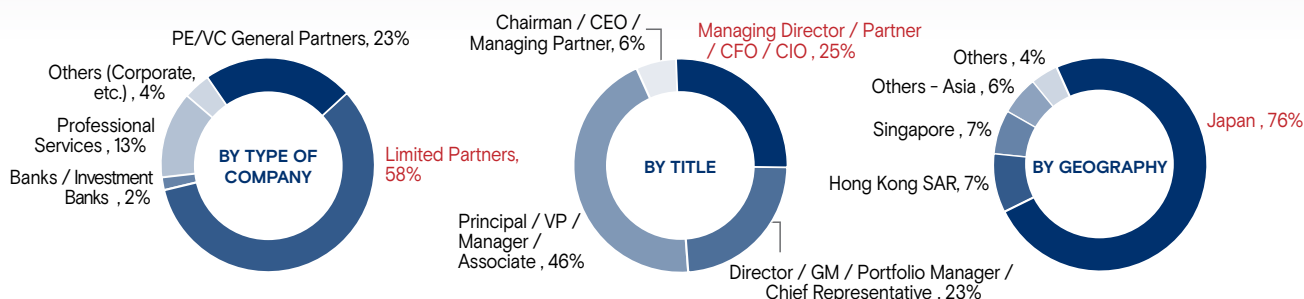
Snapshots at the AVCJ Japan Forum

2022 Delegate composition

• 460+ limited partners from Japan and overseas

• 55 speakers

• 790+ participants from 20 geographies and 365+ companies



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365+
Organizations

20
Geographies

55
Speakers

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Where unemployment rates are now, you just can't get people, so you can't sell more even though the demand is there," said Fay Bou, a partner at Sydney-based Allegro Funds.

"Compounding that is the COVID disruption where you just can't get a consistent workforce."

PE investment in Australia fell 31% in 2022 to USD 48.9bn, but this is still much higher than the annual average for the five years prior to the pandemic. Although widely seen as a natural correction, the slowdown could be partially attributed to labour shortages, at least in the sense that due diligence services are harder to source.

"The accounting firms have been struggling with [labour issues], and we've seen that in terms of the costs and the delays of audits," said Simon Moore, a senior partner at Colinton Capital Partners.

"The ASIC [Australian Securities and Investments Commission] has given extensions on the filing of financial statements of public and private companies. It's just an acknowledgement that there's just not enough arms and legs to get the work done, unfortunately."

Colinton has several portfolio companies in industrial services that are feeling the pinch, which has been exacerbated by a post-pandemic boom in demand. They include an office cleaning services provider, Dimeo, where the workforce is typically two-thirds foreign student visa holders, and a car repair company, AMA Group, which relies significantly on foreign mechanics.

Dimeo has benefited from some policy support, including an extension of the number of hours student visa holders are permitted to work. That extension is set to revert to the usual restrictions in June by which time most foreign students are expected to be back in the country.

AMA offered an opportunity to be more proactive. Colinton has enjoyed some success engaging former employees who have left the country, although all rehires must join a queue to get a visa. The current backlog is around 1m visas.

More ambitiously, the private equity firm set up a three-year training course that has facilitated around 300 apprenticeships in the past year. This is as much about retention as developing new talent, the idea being that improved career pathways improve loyalty. But it's a long-term solution that has yet to bear tangible results.

In the meantime, wages have increased across the market. Pay hikes of 5% to 7% – versus a historical norm of 2% or 3% – were common in 2022 and reflected in the portfolios of investors such as Quadrant Private Equity.

Alex Eady, a managing partner at the PE firm, said, however, that stable demand for goods and services means these costs can be passed on to end customers. This is a key initiative for Quadrant, not limited to salary increases. In the case of top management at risk of poaching, sweeteners include equity ownership programmes.

The practice of relying on robust demand to absorb rising costs is not expected to persist in the immediate macro outlook. But that gloom appears to be increasing the value of job security and thereby stabilising workforces. Meanwhile, a return to immigration normalcy could begin as early as April, when the government is expected to clear its backlog of visa applications.

"Our view is that the demand profile for the consumer is likely to ease in the new year. Employees see interest rates on their mortgages going up," Eady said. "There's less certainty in their environment, and that's leading them to value employment rather than seeking a pay rise. The pendulum is swinging some way to the employer."

Lessons learned?

If Australia's labour troubles indeed last for merely half a fund cycle, there is arguably some risk that the industry will escape the episode without having to learn any lessons.

Moore said he believes it will force GPs to double down on labour substitutes such as robotics as well as employee training and retention tools, including development programmes, productivity tied to pay, benefit plans, and broader equity pools. Eady said a company's capacity to attract and retain labour will be more prominent due diligence factors going forward.

"For active managers, the recent talent shortages could be a catalyst for longer-term innovations such as micro-credentialling, a broader definition of diversity in hiring strategies, utilising the expertise of migrants already in Australia, and looking at opportunities for latter-stage tertiary students," said Australian Investment Council CEO Navleen Prasad. ■

Asia co-investment: Gun-shy LPs?

Overallocation, risk aversion, and troubleshooting existing deals have prompted some LPs to pull back from co-investment in Asia. Others are willing to step in, but the market is selective

Potentia Capital can draw on AUD 220m (USD 148m) in co-investment to support its pursuit of Nitro Software, a listed Australian software developer. The GP submitted its first bid last August, but discussions with LPs about bolstering the war chest began even earlier – partly because of a need to strengthen the bargaining position by accumulating Nitro stock.

HarbourVest Partners contributed AUD 185m to a warehouse facility while an additional AUD 36m came from a co-investment sidecar established by Aware Super, Potentia's largest LP, and L Capital, a specialist co-investor. Potentia is committing capital to the deal from its first and second funds.

Picking up a 19.8% stake in Nitro before and after the initial offer was submitted proved prescient because it enabled Potentia to oppose a rival bid from a strategic investor favoured by the company's board. A breakthrough came last week when an improved bid from Potentia bettered the strategic investor's best and final offer, seemingly putting the private equity firm on course for victory.

"Few co-investors have the risk appetite to do blocking stakes and the ability to move quickly when you have two weeks in the data room to come up with a bid. They effectively co-underwrite it and we would syndicate to others once the deal is done," said Michael McNamara, a partner at Potentia.

"The dynamics are very different for private deals where you have more control over the timeframe, but public markets can be irrationally exuberant one way or the other, which creates opportunities for larger deals. Having co-investors who can move quickly is a real strategic asset for us."

The specialist B2B technology investor studied public markets in the first half of 2022 as valuations ►



“For some LPs, compressed timeframes are a challenge, and that’s why they may be pulling back ”

– Amit Sachdeva

started to weaken. Two of four investments announced from the second half onwards have been blocking stakes in listed companies it wants to take private. HarbourVest is also supporting a proposed acquisition of Tyro Payments alongside two other Potentia LPs, MLC and Cbus.

This activity runs contrary to the prevailing state of wariness in Asian private equity. Macroeconomic uncertainty, higher financing costs, and an uncomfortably wide bid-ask spread remain among the chief impediments to deal flow – especially at the co-investment-friendly large end of the market. And even where co-investment is available, some LPs have become gun-shy.

In and out

The picture is by no means consistent. Experiences vary by manager and target geography, and by LP type. If pension funds pull back from co-investment because they are overallocated to private equity, can't justify the risk, or are dealing with existing problem deals, sovereign wealth funds or fund-of-funds with dedicated co-investment resources may jump in.

"The deals getting done now are the ones where GPs have the highest conviction, where they feel they can deliver the returns they are underwriting," said Amit Sachdeva, a managing director and head of Asia co-investments at Alpinvest Partners.

"This also means they are running harder and asking LPs to move faster. For some LPs, compressed timelines are a challenge, especially when it comes to co-investment, and that's why they may be pulling back. For those equipped to execute on opportunities, we believe there's plenty available."

The likes of Alpinvest and Adams Street Partners claim to have robust investment pipelines globally and in Asia, which typically accounts for about 10% of global co-investment programmes. Deal flow in 2022 was on par or just ahead of the previous year – remarkable given that 2021 was a record year for private equity investment and activity visibly dropped off in the subsequent 12 months.

According to AVCJ Research, Asia saw 50 private equity deals of USD 1bn-plus in 2021. This fell to approximately 30 in 2022, which is broadly in line with the 2019 and 2020 totals. The

same story played out in other mid to large-cap segments. Investments in the USD 500m-USD 999m and USD 200m-USD 499m ranges fell from 76 to 50 and from 219 to 134.

Industry participants noted a sharp slowdown in the second half of the year – 21 of the 30 deals of USD 1bn and above were announced before the end of July – and the pace has barely picked up in 2023. There have been fewer than a dozen transactions of more than USD 200m and only two have crossed the USD 1bn threshold.

Hahn & Company agreed a KRW 1.6trn (USD 1.3bn) acquisition of SKC's industrial materials unit last June and the deal closed in December. Ten co-investors took part. CEO Scott Hahn believes asset quality – the SKC unit is Korea's largest producer of polyester film – and the proprietary nature of the deal were key factors. It is also typical of what his firm does: Hahn & Co. has carved out five assets from SK Group.

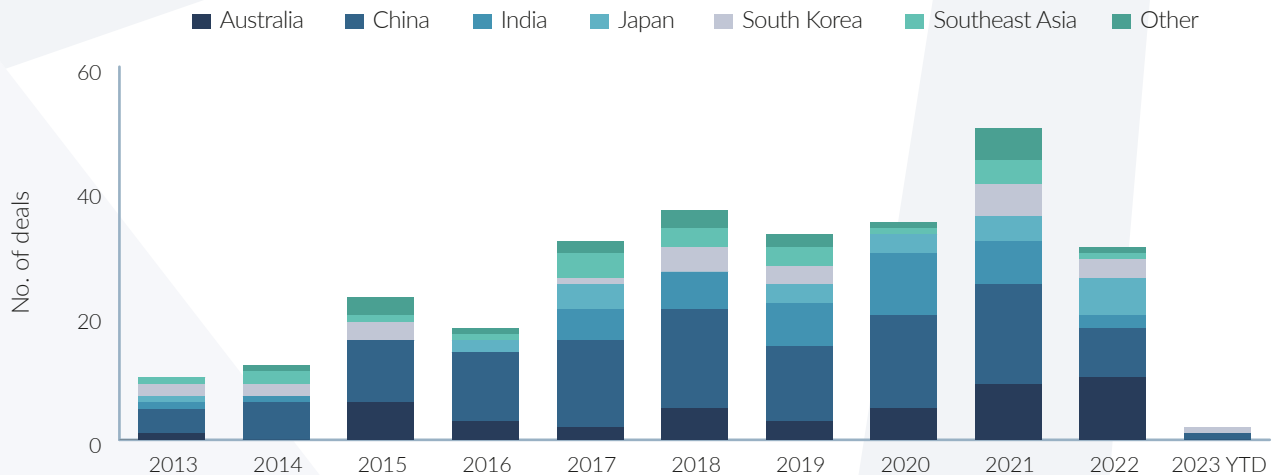
"Appetite for co-investment depends on the quality of the business and the valuation, much more so now than a year or two ago," said Hahn. "There was some strategy drift during the bull markets of 2021, so LPs are now always asking whether a deal is consistent with a GP's strategy."

Assessing the global market, Dave Brett, a partner and head of co-investments at Adams Street, describes it as a mixed bag: some deals are oversubscribed, others are not. One established trend that has accelerated – driven by uncertainties around debt and LP participation – is managers looking to bring in co-underwriters that get involved early on and share the costs of the transaction.

British Columbia Investment Management (BCI) completed six co-investments in the first half of 2022, smaller commitments of USD 50m-USD 100m where it took syndicated pieces of deals post-close. These were followed by three larger co-underwritten transactions in the second half – all in North America – which took overall deployment for the year to USD 3bn.

"We did those deals because no one else was really showing up. When there is too much noise or volatility in markets, co-underwriters are more likely to retreat to syndicated deals and I know of investors who participate in syndicates cutting back from USD 25m-USD 50m to USD 10m-USD 15m or stopping altogether," said Jim Pittman, ►

Asia PE investment volume, USD 1bn and above



Source: AVCJ Research

global head of private equity at BCI.

"It comes down to resource, appetite, and risk measurement. If you don't have the resource, most likely you can't do the risk assessment, so it's a case of whether you like the GP and the sector."

Big vs mid

Situations become more challenging when there is a need for relatively wide syndication and co-underwriters alone cannot fill the gap. Jean Eric Salata, head of BPEA EQT, noted that availability of equity can be just as problematic as availability of debt when taking on a USD 10bn buyout.

"It's not just the terms of the debt, but also the equity syndication because a lot of investors have pulled back from direct co-investments," Salata said, adding that upsizing BPEA EQT's latest Asia fund to USD 11.2bn, from USD 6.5bn in the previous vintage, represents a competitive advantage because there is more capacity to underwrite large equity cheques.

For most middle-market managers looking for co-investment cheques that rarely surpass USD 100m, there is no shortage of demand – although many LPs are wary of China and to a lesser extent India and Southeast Asia. BCI's Pittman rejects all three markets at present, preferring to focus

on Korea and Japan. Fund-of-funds with co-investment pools will consider China, but they are highly selective.

India's ChrysCapital Partners has completed two buyouts in the past 12 months that drew heavily on co-investment: it acquired IDFC's asset management business for INR 45bn (USD 593m) and software engineering specialist Xoriant for USD 350m. Kunal Shroff, a managing partner at the firm, said the biggest challenge is satisfying every LP's appetite for deal flow while deploying a larger fund.

Anthony Kerwick, a managing director at Australia's Adamantem Capital, saw more caution in the market from the second half of last year, especially from LPs concerned about the denominator effect. Nevertheless, Adamantem's investors are still keen. "If I plotted the proportion of LPs interested in co-investment over the course of my career it would be a line that went up to the right," said Kerwick.

Korea's IMM Private Equity is relatively unusual among the country-focused managers that make up the bulk of Asia's middle market in achieving a near 1:1 ratio for fund deployments versus co-investments over the past three years. Recent activity includes investing KRW 200bn to a KRW 450bn round for managed cloud service provider ►

Megazone Cloud. Co-investors put in KRW 50bn.

Joseph Lee, CIO at IMM, notes that LP demand has never wavered. One possible explanation is that syndication is rare. The private equity firm works with a core group of about 10 LPs that essentially participate as co-underwriters, ensuring a degree of stability from an early stage in each process.

“Having done co-investments in five of our last eight deals, we have several very active co-investment partners, international and Korean, who have been ‘running the engine’ with us in reviewing deals,” said Lee. “We discuss our pipeline with them almost every quarter. This communication and cooperation is a competitive advantage in the current environment.”

Nevertheless, investors claim they are being approached with increasing frequency by PE firms of all sizes looking for co-investment in Asia, even though they have never worked with them before. The implication is that some might be struggling to mobilise existing LPs into co-investments.

Potenum Partners, an institutional advisor established by a team from Australia’s Future Fund that works with LPs on tailored PE programmes, including co-investment, has openly expressed interest in a certain type of asset. They were recently approached by a Southeast Asia-based team under a global manager that had a relevant opportunity. Potenum knew of them but had never met them.

AlpInvest is also receiving more approaches from non-relationship GPs, although 90% of the firm’s co-investments are with pre-vetted managers. “They might be in the market with a new fund and using co-investment as a carrot to get fund commitments or perhaps because existing LPs are

not stepping up. Others might be using it as a long-term relationship-building exercise,” said Sachdeva.

Debt dynamics

Difficulty rallying LP support for a co-investment is not considered a deal-killer. The bigger obstacles typically involve valuation multiples (sellers are still anchoring to 2021 valuations) and financing (the secured overnight financing rate, or SOFR, was 0% in early 2022, which meant senior debt for Asia buyouts was available at less than 5%; now SOFR is 4.5%–5% and debt costs 8.5%–9%).

In markets like Australia that have shifted towards covenant-light or covenant-loose in recent years, the terms attached to those covenants have tightened. However, Peter Graf, a managing director at Ares SSG, a direct lender in Australia and New Zealand, the most profound behavioural change has been a refocusing from net leverage to interest coverage ratios.

“With base rates going up and margins getting wider, only a certain amount of cash flow generated by a business can be used to service the debt. This means the debt comes down based on the math. As you think about underwriting the equity thesis, it becomes a question of finding the right balance of adding additional equity alongside a more expensive interest cost line,” he said.

Rising base rates feed into a higher cost of mezzanine capital as well. There is evidence of some structural creativity in Australia – hybrid equity-debt instruments that offer additional upside on exit – but this doesn’t necessarily extend across the region. Manas Chandrashekar, a partner at Kirkland & Ellis, notes that sponsors often look at the pricing and resolve to wait until the cost of capital falls.

In most of the deals that have secured financing in the Australian market, sponsors increased the equity contribution on day one, according to Krish Vaswani, a member of Partners Group’s private debt team in the country. This reassured lenders, but it meant lower leverage levels.

“If it’s a platform buy-and-build play and the equity return is derived from the M&A story on top of organic growth, you could use the M&A to solve for your required equity returns. Or you could refinance when market conditions improve,” he said.

A further adjustment in valuation multiples ►

“It’s a question of finding the right balance of adding additional equity alongside a more expensive interest cost line”

– Peter Graf

would help address the problem by reducing the debt and equity requirements. Otherwise, some GPs envisage relying on co-investment to fill the gap. IMM's Lee is among those endorsing this approach in response to rising financing costs.

Even LPs that remain active co-investors have become more careful in their sector exposure. Momentum plays like growth-stage technology are out of favour as the focus intensifies on more resilient industries where there is less concern around input costs, pricing power, and customer retention. For Adams Street, this began in 2018–2019 as entry valuations began to surge upwards.

"We knew interest rates eventually had to rise, we knew there would eventually be a recession, and these two events would probably be related.

"LPs want more co-investment, especially in sectors where we have proven ourselves"

– Kunal Shroff

The question became: 'Are we comfortable enough with our base case to hold this asset during a recession?'" said Brett.

"We've done much less retail and consumer for those reasons. We are doing more predictable businesses – technology, healthcare, recurring business services."

Being vigilant

Heightened risk awareness extends into manager assessment as well. Co-investment has taken off in Asia because more LPs want it as a means of doubling down on standout deals while reducing their overall fee burden. GPs recognise this and so investor relations teams are conditioned to present opportunities with a view to cementing relationships and securing future commitments to funds.

Co-investment is also responsible for liberating managers from the constraints of fund size. Many are developing deeper domain expertise that

leads them to opportunities where they have the relevant expertise but the equity requirement is beyond the capacity of their funds. Co-investment allows them to flex up and pursue bigger paydays on bigger deals.

ChrysCapital, for example, didn't offer any meaningful co-investment until 2018. It featured in one deal apiece from the firm's seventh and eighth funds. Within six months of activating Fund IX, USD 850m in equity had been pumped into the IDFC unit and Xoriant. Only USD 300m of that came from the fund, which has a corpus of USD 1.4bn.

"LPs want more co-investment, especially in sectors where we have proven ourselves. We appreciate co-investors as they allow us to punch above our weight in our sectors of specialisation," said Shroff.

The concern for LPs is that managers are simply biting off more than they can chew, which leads to scrutiny of whether the GP is a good fit for the asset, based on track record and internal capabilities. A rapid scale-up in deal size from USD 100m to USD 1bn would likely be viewed negatively.

"That is difficult for us to digest," said Sachdeva of Alpinvest. "However, if they have shown progression over time and have ramped up in deal size, we believe there is more proof of their ability to manage those opportunities."

These considerations become more pressing during downturns when lapses in discipline from previous upcycles can be exposed. Co-investment teams might be unable to pursue new deals because they have become acutely risk-averse or they are fighting fires in the existing portfolio.

Steve Byrom, a founding partner at Potentum, observes that misalignment with GPs on co-investments is always a danger in the current environment. He also notes that buyouts and growth capital are very pro-cyclical investment categories and co-investment is most widely available at the top of the market.

"A lot of people got their fingers burned in 2006–2007," Byrom said. "When we started reviewing co-investments globally [at Future Fund] in 2010, we looked at the track records and some of them were dire. GPs had just offloaded risk to LPs and LPs had lapped it up. Part of the reason there's a pullback today could be that some of these programmes are underwater." ■

Q&A:

Blackbird Ventures' Rick Baker

Rick Baker, co-founder of Australia's Blackbird Ventures, on pricing adjustments in the tech space, fundraising and secondaries, valuing unicorns, and the rise of ChatGPT

Q: There was a drop-off in growth-stage activity last year as overseas investors backed away from Australia. Any sign of them coming back?

A: Not yet. Before the boom years of 2020 and 2021, overseas firms tended to join later-stage rounds, usually Series C and beyond. Then they started coming way earlier. A lot of late-stage funds were doing everything from seed to Series A, and then when the market turned in 2022, there was a quick retreat from everything. We are almost back to that pre-boom time, with sporadic activity from the global players. However, there is still a recognition that the Australian ecosystem is creating global companies that can deliver venture and growth-like returns.

Q: How did you respond to global players moving earlier?

A: We have always tried as hard as we can to be the first investor – we are happy to write a AUD 500,000 cheque for a pre-product company if we like the founder and area they are operating in. In 2021, we saw prices increasing significantly in some cases, and we had to act quickly to match term sheets from overseas. Prices are now coming down in the later stages, but there is still a lag effect. Founders are still anchoring to those 2021 raises and a lot of them are waiting to grow into their valuations. They don't want to do down rounds. Prices haven't gone down as much in the earlier stages; they have normalised at a long-term average.

Q: Presumably, most start-up founders in



“We are almost back to that pre-boom time, with sporadic activity from the global players”

Australia have no previous experience of the threat of down rounds...

A: Not many have been through a down round situation – they’ve enjoyed more than a decade of very strong tech company valuation growth – but that is also the global trend. There is a growing realisation that prices go up and down and it doesn’t necessarily reflect poorly on your company if the price today is lower than what it was at the peak of 2021.

Q: Is there a playbook for helping companies through these challenges?

A: We have tried hard not to create a standard playbook that we roll out across our portfolio. It is company specific; what’s right for one could be a bad plan for another. We are not in a situation of no fundraising and companies eking out their existing cash. There is dry powder in the market, people are investing. Good companies that are still able to grow, have their burn under control, and have good unit economics can still raise capital, but pricing must be reasonable.

Q: How widespread are down rounds?

A: We are not seeing a lot, it’s every now and again. Most of the time it’s priced externally. Existing investors tend to do convertible notes or some sort of structuring that doesn’t force a down round. Companies in danger of having down rounds are still extending their runway, so it will be interesting to see what happens in the second half of the year. Some of these companies are growing, so they might grow into their valuation or just do a small down round.

Q: Do unicorns like Canva, Safety Culture, and Culture Amp have enough critical mass that they don’t need to raise more capital?

A: Those three especially have control of their own destiny. They have strong balance sheets and financial metrics. It’s a great position to be in. Will they choose to fundraise at some point to grow the business in a new way? Maybe. There is a lot of talk about how you set yourself up to cement

your place as a market leader when it is more difficult for competitors.

Q: Does that mean they will embark on M&A sprees?

A: It’s more a case of looking for opportunities to grow the product base by potentially acquiring one or two companies. All of them have done some acquisitions and understand how these can help. We will see more of that over the next 12 months as they turn into platforms with real product synergies.

Q: Blackbird closed its most recent set of funds on AUD 1bn (USD 673m) in November 2022. Was the process longer or more difficult than expected?

A: We launched at the end of 2021 and had a series of rolling closes. We wanted to wait until we hit AUD 1bn before making an announcement. We are lucky that most of our capital comes from Australian superannuation funds, which are an amazing, resilient source of capital. They put a lot of effort into the due diligence and have consultants working on it as well. The big step up was ESG [environment, social, governance] due diligence in addition to commercial and operational due diligence.

Q: Canva’s valuation volatility attracted a lot of attention last year, with the Australian Prudential Regulation Authority questioning several industry superannuation funds on their approach to valuing the asset. How did this impact your relationship with those LPs?

A: The fundamental need came from the superfunds themselves. They price their funds daily, so it’s important they can place a fair value on their assets. Several of them have large positions in Canva. We came into this from more than a decade of growing asset prices. In that context, our policy of holding at the prior round valuation is conservative. It tends to be than the mark-to-market because the market is rising. However, when the market comes down, those valuations get stale very quickly, and this was the ►

problem the superfunds highlighted. We agreed to put our material growth companies into a separate bucket and get them valued independently based on last round, secondary transactions, public market comparables. We are one of view PE or VC firms globally doing this. Australia is starting to lead the way in terms of getting more mark-to-market valuations.

Q: What is a material growth company?

A: It must be big enough that we can find some good public market comparables. If it's a SaaS [software-as-a-service] company it must have

“We agreed to put our material growth companies into a separate bucket and get them valued independently based on last round, secondary transactions, and public market comparables”

enough revenue for you to build a basket of companies that are listed – usually in the US – and are similar in terms of size, cash flow, growth, and efficiency of growth. We have a small number of material growth companies that make up a large portion of our portfolio.

Q: How many different valuations do LPs receive and are you reporting them more frequently?

A: It's a single valuation, instructed by those different methods. The most instructive so far has been mark-to-market because there haven't

been a lot of secondary transactions and market movements mean last-round valuations are stale. Reporting is still quarterly. What we are trying to do is ascribe a fair market valuation to an illiquid private company that doesn't have frequent trading in its shares. If we did that more frequently than quarterly, everyone would be chasing their tails.

Q: In 2019, Blackbird carved out a portion of each Fund I investment into a fund backed by secondary investors. In 2021, you tried to do a single-asset continuation fund involving Canva, but it failed to transact. Any plans to try again?

A: When your fund gets to a certain multiple it's prudent to take some capital off the table and return it to LPs. We tried to do it with the Canva holding, which had got very big, but the timing wasn't quite right. Although the secondary market is challenging right now, we want to continue using it as a tool to create liquidity. It gives us some control over when we create liquidity rather than being in a timeline for companies listing or getting acquired.

Q: What do you find interesting from an investment perspective at present?

A: The most obvious one is all the incredible progress around AI [artificial intelligence]. It's a crowded space, so we are wary, and often these companies are features of other platforms rather than actual platforms. Having said that, we see how AI can unlock new applications that couldn't be unlocked before or only in very large companies. Healthcare and the digitisation of healthcare is also a strong theme, and we are making investments in that space. It's very much a matter of being broad and looking for pockets of excellence.

Q: When you say AI applications that plug into other platforms do you mean ChatGPT?

A: Yes. Every day we see a new one popping up and we must be careful not to get carried away with the hype. I think most SaaS products will find ways to build on top of these models, mixing in their own data for specific applications. It will be very interesting. ■

Asian private equity and venture capital intelligence

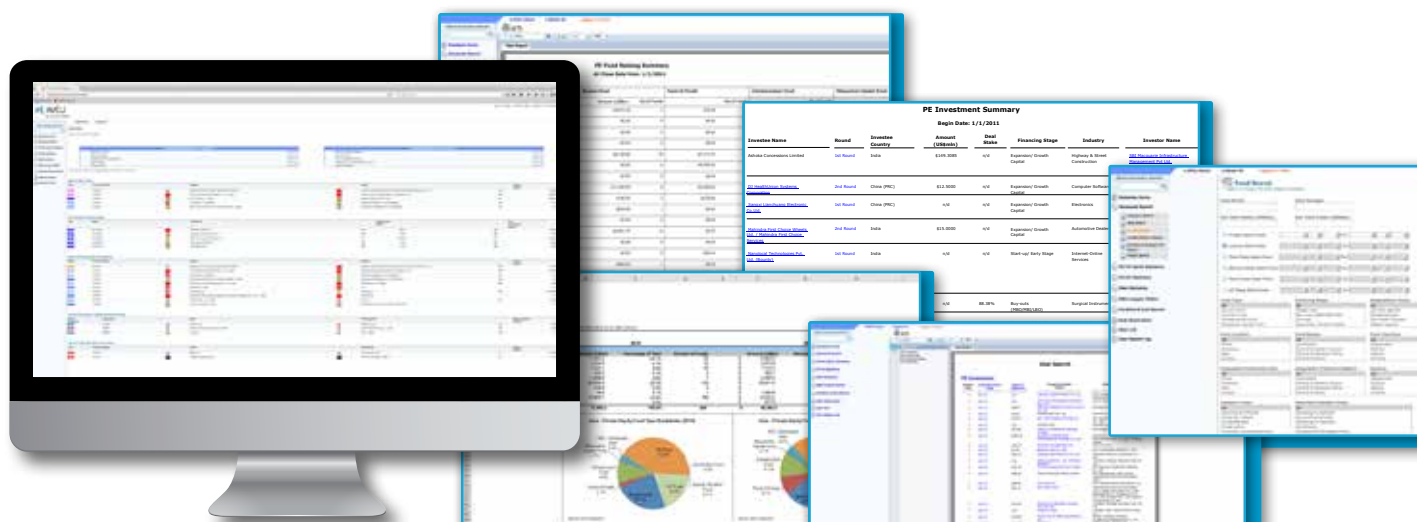
The AVCJ Database is the most comprehensive database on the private capital of Asia and spans the full spectrum of the private markets including private equity, venture capital, distressed debt and real estate funds. Updated on a real-time basis, the AVCJ Database is an important business tool used by leading private equity GPs, institutional investors, management consultants, investment banks, corporate dealmakers, and legal advisers in their day-to-day business analysis.

Some of the key features for the AVCJ Database include:

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- An extensive LP search of more than 4,600 limited partner profiles including company overviews, investment preferences and performances, fund commitments as well as their portfolio of direct/co-investments
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- Information on more than 110,700 M&A transactions
- League table rankings and advisor details including in-depth profiles and deal histories

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Case study:

Loam Bio

Soil carbon sequestration specialist Loam Bio's Series B is the largest ever seen in Australian agricultural technology. The company's backers expect it to go big and go global

Loam Bio, Australia's best-funded agricultural technology start-up, has developed a scientifically complex and globally unique approach to climate change mitigation based on enabling crops to extract more carbon dioxide from the air and store it in the ground. From a practical application perspective, however, the solution couldn't be more straightforward.

Farmers get access to a potentially lucrative second source of income via the carbon offset market simply by coating their seeds in Loam's powder-based product. The process is no different from what the farmers are already doing to protect their crops from pests.

"The key overlay to this technology is that it doesn't require a change in behaviour from the farmer," said Tim Bishop, co-founder of climate-focused investor Wollemi Capital, which recently led a AUD 105m (USD 73m) Series B for Loam with US-based Lowercarbon Capital.

"The competition today in essence requires the farmer to do something else, such as regenerative farming practices or cover cropping. Loam's technology allows them to still plant their seeds as they ordinarily would and till the soil as they ordinarily would. The one thing they must do is put this liquid or powder in the same bucket as the seeds are and make sure they are coated."

Loam has enjoyed international and domestic support from the outset. Salesforce CEO Marc Benioff's Time Ventures led a Series A round of AUD 40m in late 2021. This also featured Lowercarbon and Acre Venture Partners from the US, Hong Kong's Horizons Ventures, and local players Main Sequence, Clean Energy Finance Corporation (CEFC), and Grok Ventures. ►



"The key overlay to this technology is that it doesn't require a change in behaviour from the farmer"

– Tim Bishop

They all re-upped in the Series B and were joined by Hawktail and Thistledown out of North America as well as GrainInnovate, an agtech fund established by Australian investor Artesian and the government-backed Grains Research & Development Corporation (GRDC).

This interest crystallised into what is easily the largest funding round seen in Australia's agtech space. But Mike Zimmerman, a partner at Main Sequence, adds that Loam is exceptional in that the company sits at the nexus of agriculture and decarbonisation – which translates into relevance to a wider subset of climate-focused investors – and it has a solution capable of global impact.

"There is a lot of talk about the potential of different decarbonisation solutions – it's like there's a Holy Grail, some kind of carbon removal tech that is scalable and cost-effective," he said.

"Loam delivers high-quality and predictable carbon removal, and it is scalable and cost-effective. They are talking about gigaton-level carbon removal. The company could contribute 10% of the carbon removal required for Australia to meet its 2050 net-zero target."

Relevant theme

McKinsey & Company projects that global carbon markets will be worth USD 1trn by 2050 and soil represents the planet's largest terrestrial carbon sink, holding 3x more carbon than the atmosphere. Paul Hunyor, Wollemi's other founder, cites research findings that an additional 25 gigatons of carbon – or 10% of all emissions generated by human activity – could be captured in soil.

Tegan Nock, co-founder and chief product officer at Loam, played down the company's specific climate ambitions, but she was frank about the scale of the addressable opportunity. If Loam's product were applied to every hectare of soy currently being cultivated in the US alone, annual cumulative emissions reductions would be enough to mitigate the aviation industry.

"We have a long way to go, and a lot depends on mass uptake, but the potential is significant," she added, speaking as Loam formally launched its commercialisation programmes in Australia after years of trials involving third-party verification.

Established practices for enhancing soil carbon capture focus on regenerative farming. Intended to

rebuild broken carbon cycles by mimicking native ecosystems, they include maintaining continuous vegetation cover, eliminating tillage to reduce soil disturbance, and restoring diverse microbial life by reducing the application of chemicals.

These efforts stepped up with the onset of what Hunyor refers to as "the revolution in microbials," characterised by agtech start-ups pursuing more scientific solutions. Pivot Bio, which is backed by the likes of Temasek Holdings, has developed a biological substitute for nitrogen-based fertiliser, while Loam claims to be a pioneer in microbial-enabled soil carbon sequestration.

A farmer coats seeds with a microbial inoculum before sowing and the plants and microbes work together to build carbon in the soil. The technology is designed to increase carbon capacity within microaggregates – compound soil structures comprising mineral, organic, and biotic materials bound together by various processes – and thereby support long-term storage.

Trials indicate that Loam's inoculum is capable of building 3 tons to 6 tons of carbon dioxide equivalent per hectare per year. According to Nock, this is 200%–300% more than would be achieved purely through conservation-driven farming practices. It can also lead to improved soil health, nutrient-rich crops, and higher yields.

"What we like about this form of carbon capture is it comes with many additional benefits. It makes farming more sustainable, regardless of how that is monetised. Offsets are one monetisation option; another is insetting, where you charge a premium for crops because they are part of a carbon-neutral supply chain," said Hunyor.

"There is also an exciting degree of permanence to Loam's carbon capture. When you look at their scientific data, a high proportion of the carbon capture they get is MAOC [mineral-associated organic carbon], which is more permanent. That was an important element for us."

The core technology originated from a University of Sydney research project into the kinds of fungi best suited to enabling carbon sequestration in a soil microbiome. The project received funding but then lost it, the professor in charge retired, and the work was nearly thrown out.

However, New South Wales-based agronomist Guy Webb had come across the research



Loam Bio's Tegan Nock (left) and Guy Hudson

Photo credit: Rachael Lenehan Photography

at an industry conference and recognised its commercial potential. He contacted Guy Hudson, previously a managing director at agriculture and food technology accelerator SparkLabs Cultiv8, who put together a non-profit organisation that assumed responsibility for the project.

Nock had studied agricultural science and worked for the GRDC and appeared destined for a career on the family farm when she was invited to participate. Hudson, Nock, and Webb were the three co-founders of what became Loam; now Hudson is CEO and Webb is head of agronomy.

The company has run trials in Australia and the US. In each market, it targets the most widely cultivated crops by land area – wheat, barley, and Canola in Australia and corn and soy in the US.

"There is no standard product you can apply across different soil types: the biome of the soil and the biology of the crop has an impact on how treatments interact with the soil. Loam is doing a lot of work sequencing naturally occurring microbes in the soil to identify what works in different situations," said Main Sequence's Zimmerman.

Spread the word

Nock acknowledges that effectiveness levels will

always vary, but notes that trials have generated "relatively comparable results" across different geographies and soil types. Loam works closely with farmers to track performance. These interactions also offer insights into the target customer base's understanding of carbon building and how it can integrate with existing agricultural inputs.

Outreach efforts have been formalised under a project advisory unit known as SecondCrop, which helps farmers understand their carbon footprint, how to build stable carbon into their soils, and the value of carbon as a new commodity. The advisory unit also provides end-to-end services, essentially plugging farmers into carbon projects and handling tasks such as measurement and validation.

"For growers, it's really about understanding what carbon markets have to offer and the nuances of the carbon building process. We want to help them make the right decisions for their business, but we are starting from a point where there is limited awareness," said Nock.

In this sense, Loam's expansion challenges are twofold: penetrating fragmented farming industries and spreading the word about the value of its product, and scaling up manufacturing to cope with the consequent rising demand.

Wollemi is confident that Loam can become one of several global leaders in the microbial field, citing the ease of product adoption and the ability to produce high-quality carbon offsets that are compliant with the demanding Australian regulatory regime. Moreover, the firm believes it is only a matter of time before soil carbon sequestration is regarded as a sub-class of infrastructure.

Founded 18 months ago, Wollemi has a corporate rather than a fund structure, raising capital for through new share issuance. This positioning is intended to facilitate investments of long duration and maximum flexibility – and Loam is representative of the type of company it wants to support.


"We are not PE, VC, or infrastructure, and there is no close-end nature to our vehicles, we are permanent capital," said Hunyor. "We want to work with these businesses, de-risk them, and turn them into an investable asset class. They can be like the wind and solar of the future – heavily de-risked and well understood." ■

2023 Conference Series Asia Schedule of Events

Global perspective, local opportunity

 PRIVATE MARKETS PLATFORM	Event details
Private Equity & Venture Forum Australia & New Zealand 2023	Sydney, 7-9 March 2023 community.ionanalytics.com/avcj-australia-2023
Private Equity & Venture Forum Southeast Asia 2023	Singapore, 26-27 April 2023 community.ionanalytics.com/avcj-southeastasia-2023
Private Equity & Venture Forum Japan 2023	Tokyo, 27-28 June 2023 community.ionanalytics.com/avcj-japan-2023
Private Equity & Venture Forum China 2023	Beijing, 5-6 September 2023 community.ionanalytics.com/avcj-china-2023
ESG Forum 2023	Hong Kong, 13 November 2023 community.ionanalytics.com/avcj-esg-2023
Diversity & Inclusion Forum 2023	Hong Kong, 13 November 2023 community.ionanalytics.com/diversity-inclusion-2023
Asian Private Equity and Venture Capital Awards	Hong Kong, 13 November 2023 community.ionanalytics.com/avcj-awards-2022
36th Annual Private Equity & Venture Forum	Hong Kong, 14-16 November 2023 community.ionanalytics.com/avcj-forum-2023

 INFRASTRUCTURE PLATFORM	Event details
Infralogic Investors Forum Australia 2023	Sydney, 15 March 2023 community.ionanalytics.com/infralogic-australia-2023

 M&A PLATFORM	Event details
M&A Forum Australia 2023	Sydney, 16 March 2023 community.ionanalytics.com/mergermarket-australia-2023
M&A Forum Southeast Asia 2023	Singapore, 25 April 2023 community.ionanalytics.com/mergermarket-singapore-2023
M&A Forum Japan 2023	Tokyo, 29 June 2023 community.ionanalytics.com/mergermarket-japan-2023
M&A Awards Australia 2023	Sydney, 25 October 2023 community.ionanalytics.com/mergermarket-ma-awards-2022-australia
M&A Forum Hong Kong 2023	Hong Kong SAR, 6 December 2023 community.ionanalytics.com/mergermarket-hong-kong-2023

 LEVERAGE CAPITAL MARKETS PLATFORM	Event details
Debtwire Forum Asia Pacific 2023	Hong Kong SAR, 10 October 2023 community.ionanalytics.com/debtwire-asia-pacific-forum-2023

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