# SUPER REVOLUTION CHALLENGES PRIVATE EQUITY

By David Brown *

**THE EXTENT AND PACE OF CHANGE IN THE SUPERANNUATION SECTOR IS NOW SO GREAT THAT PRIVATE EQUITY IS AT RISK OF LOSINGTOUCH WITH OUR PRINCIPAL INVESTORS.**

As anyone in business knows, it is important to understand your customer. What makes the customer tick and what are their expectations? How else can a private equity general partner (GP) pitch to the new breed of Australian limited partners (LPs)?

A survey just released by Private Equity Media (*Australian Institutional Investor Survey of Private Equity & Venture Capital Investing*) gives some insight into the contemporary minds of Australian institutional investors – the LPs – who have supplied capital to this industry from the start.

However, while the survey gives a good snapshot – and in some respects, there are some positive signs – there are also some larger influences that will inevitably shape their approach in the future. Here are our top three influences to watch for and tailor your approach accordingly.

## Increasingly demanding regulation/oversight

Anything to do with the retirement savings of millions of Australians will always be political. The last several years have seen both sides of politics recognise that an industry of $A1.6 trillion (and growing) in an economy with annual GDP of $A1.2 trillion will never more be outside a government's, or a regulator's, watchful eye.

The systemic risks involved and the potential to play out key policy themes will be too great a necessity for governments of either flavour. Change has and will continue to pre-occupy super fund board discussion leaving less time for detailed engagement with investment managers.

Either way, one thing is for sure, increased regulatory scrutiny will result in LPs demanding greater detail, transparency and timeliness of information sourced from all

investment managers – not just private equity.

In assistant treasurer Senator Arthur Sinodinos' first press interview since he was sworn in (as reported in The Australian Financial Review, 26 September) he stressed fidelity with election promises to de-regulate "default options" and a continuation of governance reform.

With respect to private equity – a small, somewhat awkward asset class, requiring patient and stable investors who operate within enough certainty to commit to long term relationships – rapid change following reform is far from ideal.

Against the backdrop of MySuper reforms we now find a superannuation industry facing yet more change. Senator Sinodinos' comments tread softly on a tender issue amongst super fund trustees. The Coalition seems to favour more "independent" or "specialist" directors to join super fund boards. If such a shakeup refreshes thinking and challenges current assumptions that appear to be entrenched, the private equity industry could stand to benefit. However, for this to happen, an effective argument for private equity benefits must be made to these new trustees. If the new "independent" directors are drawn from the corporate world, we may experience some different, but not necessarily positive views, on our industry.

## Growth is transforming the organisations managing super

As the Private Equity Media survey reports, many super funds remain committed to private equity, albeit with modest allocations, and some have materially shifted their focus offshore. Why is this? Why are the funds now seemingly ignoring the good returns local private equity firms have produced while most other asset classes have languished?

A significant reason is that the sheer size and growth in the industry has left Australian LPs verging on the cusp of outgrowing the local private equity industry, unable to make a plethora of small commitments to local funds. Venture has already been critically hurt by this trend, but the bulk of Australian mid-market funds now witness LPs making fewer, larger, commitments, cutting the number of names in their programs.

This trend is affecting all asset classes and changing the organisational structure of the super funds themselves. Innes MacKeand is head of equities at AustralianSuper and was recruited from AEGON Asset Management in Edinburgh

to develop a detailed, staged approach to in-sourcing investment skills across the fund. Starting with listed equities, MacKeand aims to improve outcomes for members and, in so doing, transform the investment approach of AustralianSuper. So rapid has been the industry fund's growth and so large are the expected paths of growth-trajectory in coming years, that their own internal approaches are changing to meet a markedly different scale organisation. In short, these approaches will become more like those of similar size pension funds in other countries.

AustralianSuper is the largest, but their story is not unique. Within this environment, the old system of decision makers at LPs has changed dramatically. While the cost of running internal teams for super funds has no doubt attracted the same scrutiny of MySuper fee-watching that all asset classes have experienced, it appears that their not-for-profit culture, or "cost = lower member returns", has meant that expanding head count is not the preferred option. Instead, super funds have reallocated their limited budgets in favour of areas such as listed equities, credit and infrastructure.

Private equity, by comparison, is a net source of head count and the growing fashion in approach has been to outsource. The due diligence process at large Australian LPs such as HESTA, First State Super, QSuper, AustralianSuper and ARIA has, in part, been outsourced to overseas specialist private equity consultants who now materially influence the choice of GPs for Australian LPs. In terms of reaching as many individuals who influence Australian commitments as possible, a day in San Diego speaking to Hamilton Lane or StepStone may now be a better use of time than a day in Melbourne visiting an LP.

## Remote investment decisions

Secondly, the origin of decisions on capital flows towards private equity has changed. This is for two reasons. Since the global financial crisis, when "mum and dad", members of super funds, pulled their savings from the Default option and transferred it to the Cash strategy – or some other perceived safe haven – the proportion of superannuation invested in the balanced funds, of which private equity was an element, has reduced significantly. While the old rule of thumb was that more than 80 per cent of super would be Default – and the Default was a balanced portfolio, typically containing a 5 per cent allocation to private equity, the new metrics are closer to 65-70 per cent, resulting in around 20 per cent less capital in the nation's default options.

Equally, the shift of large-balance member accounts to self-managed super funds (SMSFs) has continued unabated. This shift in the behaviour of members has been so rapid that super fund trustees and, more importantly, the funds' new regulator (APRA) have questioned how stable the Default pool will be going forward. Naturally, this leads to reduced degrees of freedom when making ten-year commitments to future draw-downs.

In re-thinking strategy, APRA has encouraged trustees to refocus on systemic interactions within their members' funds. Liquidity is an obvious area of interest, but so too are correlations between asset classes. The perception that private equity represents increased (geared) listed market beta, urges justification to maintain exposure.

The result is a noticeable shift to risk models at super funds involving a slew of data in the correct format for making common comparisons alongside other investment asset classes. In this world of time weighted return (TWR) data, the internal rate of return (IRR) sits uncomfortably.

James Dick, head of alternatives at QIC, says the investor has "developed their own factor models because the data is simply not available to use traditional approaches to modelling private equity."

As a result, strategy decisions are now more remote from private equity and handled by people who are less engaged with the nuances of sector, vintage and style.

Capital flow decisions towards private equity are less concerned with steady patterns of re-ups and loyal maintenance of GP relationships, but more concerned with opportunities as they arise and whether they fit in with other competing uses of capital across a range of uses by the fund.

For example, Fiona MacKenzie, head of investments at New Zealand Super, openly talks about a fluid approach. "Rather than filling up pre-set 'asset class buckets', we invest opportunistically," she said. "Any new investment has to stack up against all alternatives. We prefer to invest as directly as possible and to think broadly about which type of access point (e.g. synthetic, direct, external manager) is the best for the job."

This is a very different world to the one just five years ago when our industry habitually engaged with senior decision makers with first-hand knowledge of private equity and its structures. The new decision makers are now more likely to be influenced by data produced in a format

that meshes with risk metrics from listed asset classes.

## New view

So we are left with a new view of the emerging culture of Australian institutional investors. A larger, more mechanised and remote world where risk models and member behaviour decides capital flows into our industry and where the implementers are offshore. Responding to this demand for comparative metrics or to engage with overseas intermediaries on local private equity would therefore seem important.

The best advice in such a changing marketplace is to listen and to respond where we can. Domestic private equity has a good track record, but our style of engagement may not be the same as that of overseas GPs. Our proximity to decision makers has made for a close-knit, informal relationship with LPs. This approach can no longer be taken for granted.

In addition, we should engineer a new set of relationships amongst LPs by getting to know the broader discussions within their industry. Private equity may be able to contribute to these conversations when the one missing piece from this new world may, in fact, be the very piece our industry knows it is best placed to deliver: better returns.

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