James Thomson

j.thomson@afr.com

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PEP's $10b moment in PE's new era

With each week bringing reports of another major private equity deal, it can be easy to forget this sector is only 40 years old.

But with the avalanche of capital into the industry showing no signs of slowing, Australia's private equity pioneer, Pacific Equity Partners, believes the sector is on the cusp of a new era, where the traditional "buy, fix, sell" model is expanded to allow businesses and investors to reap the advantages of private ownership for longer periods.

Having previously delivered Australasia's first public-to-private deal and first private equity IPO, PEP has now launched its first continuation fund. This vehicle will allow existing investors in the PEP-backed smart meter business Intellihub to roll their stake into a new fund that will continue to hold the business, instead of cashing out and taking profits.

While continuation funds are popular offshore, this is the first example in Australia. And it is set to take PEP's assets under management, currently the largest in Australia for a domestic fund at $8.6 billion, to $10 billion.

At one level, the establishment of the continuation fund helps to solve a simple problem for PEP – how to hang on to great businesses that have further room to grow.

"Over the years, we've noticed that we've had a disproportionate number of businesses that we'd love to have kept, but it wasn't possible in the context of the technology at the time," explains PEP's co-founder and managing director, Tim Sims, who joined fellow PEP deal makers Cameron Blanks and Alex Ovchar in a rare interview with *The Australian Financial Review*.

But the creation of the new fund has greater import than that.

Being able to own assets for longer than private equity's traditional hold period of five to 10 years helps PEP's push to transform itself into what Ovchar describes as "a diversified alternative asset manager, which is quite different to our roots as a single product private equity firm".

More broadly, the global trend towards continuation funds speaks to a growing belief among institutional investors that private ownership may be a better alternative to the public equity model that has dominated financial markets for centuries.

Clearly, this shift in thinking among investors has been driven by returns.

"If you look at the top quartile of private equity funds, what you can see is that the average returns over the last 20 years have been in the mid- to high-teens, and there's never been a year of significant loss. It's a consistent pattern of higher returns," Sims explains.

But a philosophical shift is at play too. While the public company model has clearly served society well, its more recent history has been marked by an increase in attempts to regulate the problems that the system can throw up.

The regulatory and compliance burden faced by public companies is well intentioned and, in many cases, warranted. But there is an argument that it can also dull productivity, innovation, risk-taking and, ultimately, growth.

A system that wants to avoid executives being overpaid, for example, uses regulation to establish norms around compensation, and the base salary and bonus model becomes ubiquitous.

But while this model is eminently sensible, it can be argued it encourages management to set manageable and achievable targets, rather than attempting

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>
> Tim Sims, co-founder and MD, Pacific Equity Partners

to maximise profits. Privately owned companies, which operate away from scrutiny in public markets, can avoid public market norms around risk-taking and incentives, and thus take bigger risks to chase bigger returns.

Whether this is the theory that has led big investors to increasingly shift capital to private markets isn't clear. But you only need to look at the support of big superannuation funds for deals such as the privatisation of Sydney Airport and KKR's tilt at hospital giant Ramsay to understand which way the wind is blowing.

As Peter Costello, Future Fund chairman (and chairman of the *Financial Review's* publisher, Nine Entertainment Co) said in September: "We think we'll have to allocate more into private than public markets because there will be more productivity and innovation there.

"A lot of the reason why private equity takes a public company private is that it doesn't have all the disclosure obligations ... it can restructure and wear short-term downturns easier because it's not having to continuously report and mark-to-market."

Continuation funds also represent a further shift away from what Sims describes as the cartoonish image where a firm "buys businesses, does some sort of asset stripping, creates some false alchemy and holds assets for a very short period of time".

"In real life that doesn't work," he says. "If you're in a business over many years, you have to sell quality assets that have real value to the buyers."

And the logical next step of this thinking is finding assets that you and your investors want to keep for much longer than in the past.

"We can [currently] own assets for up to 10 or 12 years, which we've done in the past," Blanks says. "But this enables us to go beyond that timeframe."

All of which begs why the continuation fund model hasn't arrived in Australia earlier?

Sims says it has taken time for the model to be proven overseas and to be adapted by PEP to the local environment. "Strangely, there's nothing more conservative than the large institutional international investment market," he says.

Blanks says private equity's historical context is important, too. "Private equity in Australia is 25 years old from when we started, and in the US, it's probably 35 or 40 years old. So yes, it's a big and growing industry, but it's still evolving, and it's still developing, with a lot of runway to go."

Another small example of this evolution can be found in PEP's new Gateway product, which will offer individual investors with as little as $100,000 the chance to invest in – and, importantly, move in and out of – an open-ended fund that includes top private equity funds and fund managers from around the world.

"The world's most sophisticated endowment funds and pension funds allocate as much as 50 per cent of assets under management to private markets, but individuals less than 5 per cent in terms of their allocation," Ovchar says. The rollout of the product will gather momentum as the year progresses.

If there's one question hanging over the private equity sector, it's how returns will look in an environment of rising interest rates and broader market volatility, which could make it more difficult to sell a business when the time comes.

Bank of America's ultra-bearish chief strategist Michael Hartnett is among those who argue that private equity, as a beneficiary of loose monetary policy, will be hit hard by the tightening going on around the world.

Sims isn't ruffled by suggestions of a tough environment ahead and says while PEP is alive to the potential for volatility, its expertise lies in picking businesses, rather than market conditions.

"Experts are terrific at assessing the past, pretty good at describing the present, but often not all that effective at forecasting the future," he says.

"We're sensitive to the implications of all of those things, and we take them into account whenever we look at a business.

"What we are ultimately banking on is that we have found a business with a strong underlying commercial model, resilient products and services that customers need and want, that will respond well to a change of governance, to courageous equity that will back all new projects that have an interesting return, and that is underpinned by attractive incentives to make that happen.

"So, we think we have a set of tools that we can apply to resilient businesses that will cause those businesses to thrive in a range of different economic circumstances."

▶ Companies index p2

Rear Window

Joe Aston & Myriam Robin

joe.aston@afr.com.au; Twitter:@mrjoeaston
myriam.robin@afr.com.au; Twitter:@myriamrobin

If only Nick Warner was still spy chief

Retired Canberra mandarin turned gun for hire **Nick Warner** thrust himself into the federal election campaign on Friday with an opinion piece in this newspaper lamenting the Morrison government's diplomatic failure in allowing Solomon Islands to sign a security pact with China.

As Warner sees it, "sometime after 2015, it became clear in Canberra that China was looking at sites for a naval base in the South Pacific. Oblivious until that point, we were sleepwalking into a new and dangerous strategic environment."

At this time, incidentally, Warner was the longstanding director-general of the Australian Secret Intelligence Service, our equivalent to the US Central Intelligence Agency.

"With good and timely information, nimble and well-funded government action, and clever and sensitive diplomacy, none of these and other Chinese hopes for a base came off."

However, "it was clear that if we slipped

Changing history: Nick Warner.

up, were too slow, or were less adroit with our diplomacy, we would wake up one morning to the news that China had signed a security agreement with one of our neighbours. And, of course, that is what happened a week or so ago. I don't know what went wrong, which part of our response was deficient – I'm out of that loop."

The chronology Warner paints here – of Australia's majestic external affairs apparatus deftly preventing geostrategic catastrophe then, deprived of his sublime leadership, promptly malfunctioning – is as deluded as it is self-serving.

After his eight years leading the Australian Sleepwalking Intelligence Service, Warner was appointed Australia's most senior intelligence official in December 2017, which he remained until December 2020.

In September 2019, Solomon Islands ended diplomatic relations with Taiwan.

In October 2019, Solomon Islands signed up to China's Belt and Road Initiative and Prime Minister **Manasseh Sogavare** was feted in Beijing, treated to a full honour guard outside the Great Hall of the People,
Continued p37

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