MACRO TRENDS

Scaling new heights

The global financial crisis had the effect of dramatically changing the outlook and attitudes of private equity investors worldwide, says Mounir Guen

According to MVision Private Equity Advisers chief executive officer Mounir Guen, limited partners' expectations of anticipated returns from the asset class started to converge during the global financial crisis, when a number of cosy assumptions were shattered.

Fast forward seven years, and while most investors still crave greater diversification for their portfolios, expectations of achievable returns have been tempered.

Previously, investors had broadly been seeking a 2x net return from US GPs, a 2.5x return from European GPs, and a punchier 3x return from Asian GPs. But after the crisis, those numbers converged, Guen says.

"Today, investors protect themselves so they don't have exposure to just one single region and are looking for a two times net return across the board. They demand quality so as a result GPs have to have strong numbers with consistent performance. They are very focused on transparency and reporting of the business.

"Investors are also seeking regular deployment velocity of their capital with a preservation of capital mindset from the GP."

Guen: *investors demand quality from their GPs*

Guen relocated to Hong Kong last year to tap into the vibrancy of the private equity market across the region, where international and local limited partners are still in the relatively early stages of deploying and growing capital.

VAST UNIVERSE

The GP universe in North America is vast, running into the thousands, while Europe has hundreds. By contrast, Asia still has a relatively small number of private equity firms.

Alongside the huge number of US GPs, a huge army of US investors are looking to de-risk portfolios by diversifying geographically.

Large US public pension plans in particular, had ploughed hundreds of billions into the US's equity markets since the late 1990s, but the risk of such a concentration in one market where large tranches of money could significantly move markets sparked a rethink, Guen says.

First they put substantial amounts of capital in Europe, then in recent years to new markets, predominantly Asia. It is important they do this, accessing the right kind of jurisdiction and practices.

"The underlying aspect is the desirability of markets with a strong rule of law and an infrastructure of lawyers, accountants and other related services and regulations."

But while the amount of investor capital looking for a new opportunities continues to rise, Guen points out that the ability to deploy is lagging behind the demand in many markets.

Take India for example, a country of huge opportunity, but one where the asset class structure is still relatively early in formation.

Guen says: "India as a country is over 60 years old but its private equity industry is just 12-15 years old, versus a 40-year-old market in the US, which means the infrastructure is not there to absorb the capital that is potentially interested in investing in its funds. The General Partner will adapt and their business development will catch up quickly, learning from best practices."

THE ASIA DYNAMIC

In Asia, the number of local private equity firms is still relatively small, compared with those from North America and, to a lesser extent, Europe, and most Asian LPs are still in the process of developing their alternative investment capabilities.

"Most Asian investors are putting their portfolios in place, and their programmes will be quite substantial. In Japan, Korea, Taiwan and (significantly) in China, they are growing their programmes, which will accelerate and be extremely impactful over the next five years."

Guen expects the limited partner portfolio weighting in Asia to start off at a 2 percent-3 percent allocation, before moving to 5 percent, "then jumping to 10 percent and settling on between 10 and 15 percent".

"In countries with a sustainable and active local market there is a balance of investing in very large funds and mid-market funds. On a geographic basis, Asian investors are seeking that diversification to protect them through market cycles like their peers in other countries."

The investors' programmes will develop very quickly like elsewhere globally and are likely to utilise fewer GP relationships while deploying more concentrated allocations, Guen says.

GOING DIRECT

Another key trend is the mega investors who need to put large amounts of capital to work in markets on an annual basis. The fund structures are often not able to absorb this capital from one big investor. These large LPs are continuing to build out their own direct and co-investing platforms to help to deploy all that extra capital, which also saves on fees.

"In many of the new large funds, these investors are 'active' partners with the GPs rather than passive investors, and over the last two years, this trend has accelerated, and really changed the dynamic" Guen says.

The move to direct and co-investing is being spearheaded by the large global pension plans, along with the sovereign wealth funds.

By contrast, Guen says, many US LPs have or are developing platforms, also with the aid of consultants and gatekeepers. Will this change over time? Guen thinks so.

And alongside the growing interest in direct investing, he believes many investors are taking a far more focused interest in how their capital is deployed and looking to allocate more to less managers, who can prove a range of expertise in alternatives beyond merely core private equity.

He says many of the more sophisticated LPs will have a grid of markets, sectors and sub-sectors ranging from credit to growth capital, and including primary, secondary and direct opportunities and will assess the areas that are of most interest to them.

"They may say: 'If you could deploy $500 million with a GP that is good at this, we will do it.' Guen believes the global and the US GPs are best placed overall to benefit from this growing demand initially, given the scale and depth of expertise.

GENERAL PARTNERS EVOLVE

"The US has a huge depth of choice with General Partners and is constantly reinventing and replenishing itself. It's model for success is very defined: strong investor relations and reporting, and people who genuinely drive growth, along with specialists who can financially engineer or fix or grow a company."

If one group does not have the skill or has done all it can, the investment company can be passed along to another firm with different expertise, he says.

It is a powerful dynamic in the US and is also done in Europe, although Europe lacks the homogeneity of the vast US market, with different countries imposing different regulations on investing practices.

"The ability to partner with investors from places like Canada, Singapore and Australia needs to be replicated in Europe. However it should be noted that some GPs are more hesitant on European investors due to the regulatory complexity. I view the European investor community as having a very scalable potential in number and in volume. It requires governmental and regulatory initiatives to unlock them."

> **"Today, investors protect themselves so they don't have exposure to just one single region and are looking for a two times net return across the board**

While Spanish and Italian pension plans have yet to fully embrace the asset class in the way the Dutch, Nordic countries or the UK has, Guen says these still have more room to grow.

"The world is a smaller place these days, which allows people to adapt very quickly and to learn new skills and expertise from one another. The same consultants, banks and law firms are available globally and there are organisations like ILPA and Invest Europe that have core agendas to communicate best practice along with excellent local associations."

While Guen believes the main bottleneck remains the ability to absorb capital, the backdrop for private equity remains very supportive, and Asia will rapidly move to adapt many of the best practises and expertise already available in North America and Europe as the industry continues to grow.

"We are very positive on private equity and believe it will continue to offer very good performance. The talent and capital is very dynamic and is constantly increasing." ■