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Private Equity Insights – What, How and Why? AIST Learning and Professional Development Session

April 2008

Introduction – why are we here

- There is one prevailing reason to invest in PE – the potential for high returns.
- PE can be a good enhancer of performance when done correctly, and offers other less material side benefits.
- But investing in PE is hard to do and the sector has its detractors – this is sometimes fair and sometimes unfair.
- This talk is designed to lay out the facts in an unpartisan way.
- To allow trustees and their advisors to make informed decisions about whether the asset class is suitable for their funds.

Agenda

- **Part One**
 - What is PE, a discussion of asset class characteristics
- **Part Two**
 - PE fund structures and implications for investors
- **Part Three**
 - Program implementation, key considerations.
- **Part Four**
 - Market Outlook

PART ONE - PE explained

- Why is this important?
 - The nature of Private Equity investment causes it to have characteristics that are unique when compared with other asset classes. These affect risk:return, manager selection, program development etc

What is Private Equity

- Private Equity is not just headline deals like QANTAS or Coles. The majority of deals do not make the headlines.
- “Pure” private equity is the creation of value through the acquisition, growth and divestment of businesses in an unlisted environment.
- Financial engineering is part of the equation, but the only sustainable source of driving returns is increasing enterprise value through earnings growth.

Transaction Sources

- Transactions arise for a number of reasons:

Deal	Deal Type	What was done	Return
Repro	Divisional Acquisition	1.New IT systems. 2.Rollout of new stores. 3.Rationalisation of distribution centres. 4.Sold off wholesale parts business.	ASX listing for 5.5x return and 145% IRR
Tempo Cleaning Services	Public to private	1.Brought in operational partner (ISS). 2.Improved tender pricing disciplines. 3.Improved value proposition.	Sold to ISS for 2.1x capital and 111% IRR
Valley Longwall Group	Roll-up	1.Increased export sales & made 6 acquisitions. 2.Grew staff to 400.	Sold to Private Equity for 7.8x and 329.2% IRR
Dotmar	Succession	1.Facilitated founder exit. 2.Appointed key senior management. 3.3 bolt-on acquisitions. 4.Expanded into the NZ market.	Sold to trade buyer for 3.1x and 63% IRR

In addition, PE players provide growth capital for rapidly expanding and new businesses in the venture space.

Private Equity – the main themes

- Private Equity is the purchase of unlisted businesses with the intention of growing or restructuring them to make a profit.
- The nature of PE deals tends to be “company making” – it presents an opportunity for change.
- Three major themes arise from this:
 - **Market inefficiency** → deals are hard to find, structure and negotiate.
 - **Transformational ownership** → Longer hold periods and significant/majority ownership.
 - **Persistence of return** → Manager Skill is important in driving returns

Market Inefficiency

- Lack of a stock exchange means high transaction costs and high search effort → market inefficiency
- But inefficiency can:
 - lead to situations of pricing advantage due to difficulties with finding price benchmarks and illiquidity (although effective intermediaries will combat this to some extent).
 - allow managers to compete on non-price metrics, particularly when vendors retaining an interest in the business.
 - allow discussion of confidential and prospective information and consequently deeper due diligence than purchase of listed businesses.
 - allow managers to structure and negotiate more complex transactions (e.g. deferred settlement, loans and equity mix, earn outs) to mitigate risk and improve alignment of interest with vendors.

Transformational ownership

- Private Equity generally has long (3 to 5 years) hold periods. This allows for transformational ownership (mergers, acquisitions, store roll-outs, restructuring, design wins)
- PE firms usually have significant or majority ownership, allowing for a greater degree of control.
- Control allows PE to run with investment theses like roll-ups and mergers that use the initial investment as a platform for further value creation.
- PE influence would generally infer:
 - Disciplines in reporting systems and governance (PE would have board position).
 - High degree of strategic input and assistance with mergers/acquisitions
 - PE would generally assist with relationships with the bank
- 100 day plans are frequently used for setting the platform for the PE investment thesis – e.g. reporting and governance disciplines, developing the strategic plan for the next 3 to 5 years and exploiting easy value sources.

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Persistence of performance over time

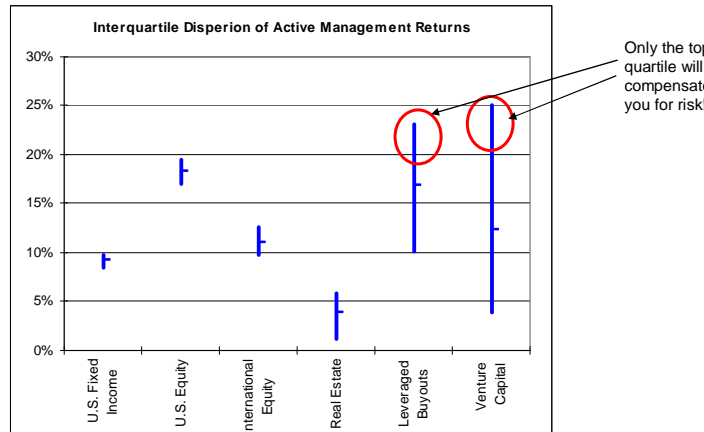
- Market inefficiency, and transformational ownership means that there is an element of genuine manager skill in PE and VC.
- This leads to performance persistence over time. Good managers generally stay good – implications for portfolio construction
- If you invest with a manager that runs a top quartile fund, there is a 42% chance that their next fund will be top quartile, and a 71% chance that their next fund will be better than median
- By contrast, if you invest in a bottom quartile fund, you have a 38% chance that the next one will also be bottom quartile and just a 15% chance that they will learn from their mistakes to become top quartile

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Impact of Manager Skill on returns

- Manager skill leads to a very large spread between top and bottom quartile performance (discussed below)



Implications for manager selection – track record a key indication of likelihood of success

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Part two – PE Fund Structures

Why is this important?

- Structures are very different to those for listed equities – they have evolved to reflect the nature of the underlying markets
- Understanding PE fund structures is important as they give rise to a number of issues, most notably:
 - overcommitments
 - the j-curve
 - liquidity
 - fees

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PE and Listed Market Characteristics

Structures have evolved to reflect the nature of underlying markets. A review of the key market differences provides a good starting point.

Activity	Listed – Public Co's	PE – Private Co's
Find	Known universe Public info - standardised Proprietary views	Unknown universe, 2-4 / 200pa Private info - variable quality Proprietary information
Acquire	2 - 3 months	2 - 3 years
Improve	AGM's and visits Shareholder activism Takeover activism	Control, board participation, 100 day plan, corporatisation, M&A assistance
Exit	Work with brokers Exit via market Via SEATs or a crossing	Find buyers, create competitive tension, manage process

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Market Influence on PE Structures

PE Market	Operational Problem	Structural Solution
Deals are lumpy and infrequent	Syndicating deals is complicated by simultaneous raising and investing	Raise <u>commitments</u> adequate to complete 7-10 deals
Deals take time to find and complete	Sitting on cash is inefficient Managers need adequate funding during deal search	<u>Draw down parts of commitments</u> as needed Pay base fees on commitments
Liquidity on full exits only	Seeking an exit prematurely can destroy returns Investors need to be able to get their money back	Allow no redemptions Single use of capital in a fixed life fund
PE funds have a long life	Need to motivate managers to work for investors Investors need to hold ultimate sanctions	Align manager through hurt money and carry Keyperson and manager termination provisions

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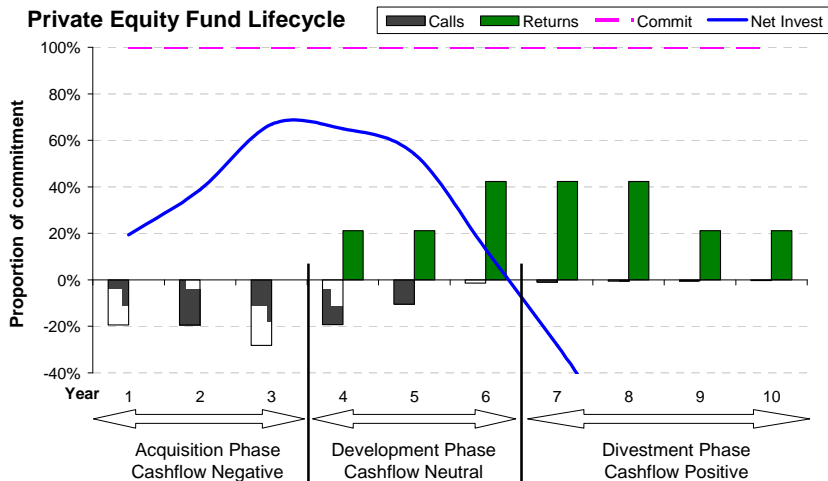
Basic Fund Structures

- Pooled vehicle, commitments not cash, targeting 7 to 15 investments
- Fixed term - usually 10 years
- Just in time cash draw-downs
- Single use of capital, all proceeds returned to investors
- Fees on commitments - 2% of net commitments
- Profit share (carry) – 20% of profits after all costs
- No side income to manager
- Manager invests in fund – generally about 1%
- Investor protections – investing ceases after key person change and manager can be terminated by special resolution

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PE Fund Life Cycle – explains many structural issues

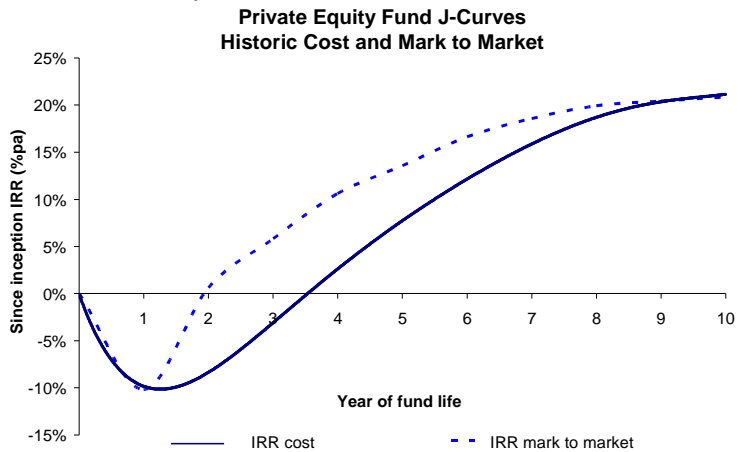
Overcommitment strategies are required because the amount invested almost never reaches the amount committed.



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Private Equity Fund J Curves

J Curve is a consequence of fees on commitments. Assets are held at cost, fees are an expense. Positive IRR does not show until tangible value created. Moving to mark to market valuations reduces its impact.



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J Curve impact can be misunderstood

J-curve has a large IRR effect, but a relatively low dollar effect. Large IRR effect often leads to overestimation of the negative performance contribution during program development

Contribution to total fund performance

Year	Excess vs benchmark	Listed Equities	PE
1	-20.2%	-1.01%	-0.10%
2	-3.7%	-0.18%	-0.05%
3	0.7%	0.03%	0.02%

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PE program liquidity

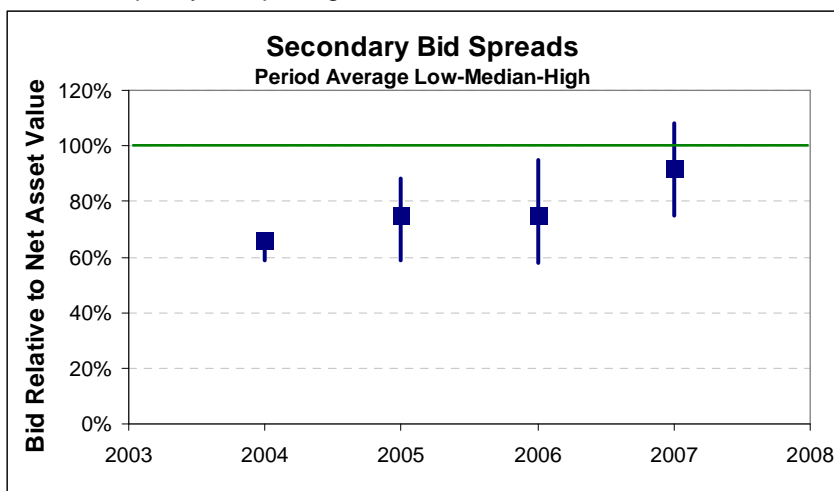
No redemptions is not the same thing as no liquidity

- Cash flow
 - Structure means that managers must distribute proceeds
 - Mature programs can become cash flow positive .
- Secondaries sale
 - Investments in funds are generally saleable securities
 - The market has matured rapidly and is a realistic option for portfolio rebalancing

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PE secondary liquidity improving

Secondaries sales becoming more attractive liquidity option with liquidity and pricing trends attractive for sellers.



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Fees

- Fees are typically 2% of commitments for investment period (5 years), then reverting to 2% of invested amount.
(Averages about 1.5% of commits p.a. over life of fund).
- Profit share (carried interest) = 20% profits
Paid after a preferred return to investors.
Management fees come out of profit calculations.
- All other side income from the companies in the fund should go to the investors: eg directors fees, deal fees, monitoring fees
- The philosophy is that managers live well on the base fees but get very wealthy from profit share only when investors also do well

Flaws in the fee model

- Fee model can be functional:
 - aligns interest well where fund sizes are small
 - feeds manager while they find deals (inefficient markets) and rewards manager for strong performance
- Institutionalisation of PE:
 - very large funds reduce the case for the fee structure
- QP view:
 - model works at fund sizes up to ~\$1B with no side income
 - at this level the fee stream generally does not reward the manager more than alternative careers (e.g investment banking) and the primary mgr reward is profit share
 - above \$1B with side income managers can start to be paid more fees than they would earn anywhere else with profit share less significant.

PE Structures Revisited

- Effective model for exposure to an investment which is a series of deals
- Not a perfect solution but perfection is likely unobtainable
- It's important to focus on the net results
- A close focus on structures and particularly alignment of interest should always be a key focus of each due diligence

PART 3 - Developing a PE program

- Why is this important
 - The nature of the asset class makes it very time intensive, and affects the way you should approach your investment

Allocations

- Reason for allocating:
 - Potential for high returns when done properly
 - Exposure to growth equities outside listed environment,
 - Uncorrelated? Arguable point – assets are still exposed to the broader economic cycle. Valuation lag provides appearance of low correlation.
- Reasons for not allocating:
 - Is a time intensive asset class for a small part of fund allocation
 - Cost. Similar cost structure to hedge funds with MER effects due to progressive drawdown
 - Liquidity constraints – Funds with poor stability of cash flows should be cautious in starting to build up a program
 - Generally rewarding only for those investors who implement properly.

Return Expectations

- Generally accepted benchmark expectation of returns is listed equities plus 5% over the long term
- Many investors in the asset class do not achieve a satisfactory result. Why?
- Generally due to poor program implementation:
 - Manager selection is time intensive. Investment decisions should be made on known universe comparisons, not opportunistically.
 - Transparency is poor for those not in the industry full time – no clear benchmarks. Relationships, access and knowledge are hard to obtain – drives “buy” vs “build” decision for superfunds
- This difficulty leads to poor investment decisions

Implementation Options: “Buy” vs “Build”

Several strategies available for building a PE program:

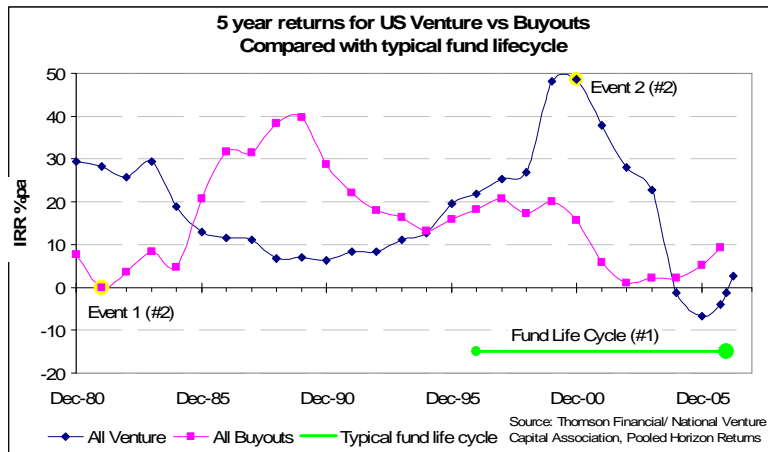
Fund of Funds	Good entry point for first time investors, offers diversification for small commitment. Implementation cost sharing pro rata to fund exposure. Another layer of manager fees, administratively simple.
Advisory	Provides guidance and assistance for those without teams. Typically lower managers fees than FoF, no legals cost sharing, higher admin burden. Typically less diversity or more money required for same diversity.
In house team	Avoids manager fees but with significant overhead (recruitment, staffing, legals, on costs etc). Staff retention an issue – they often leave for boutiques. Suitable for very large programs that can remunerate staff.

Program implementation

- The two most common mistakes in Private Equity investment implementation are around:
 - Market timing. Cyclical nature of returns and long lead times on investment make effective market timing nearly impossible
 - Flawed manager selection. Manager selection in an unstructured way reduces the probability of success.

Market timing: Cyclicity of returns

- Returns are highly cyclical, funds have a long life span



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Market Timing: Managing Cycles

- Lessons From Cycles
 - Aggregate industry returns are usually lower following a fundraising boom.
 - Most of this effect is driven by the poor performance of new entrants.
 - Returns of established funds are much less affected by these industry cycles.
- Response to cycles
 - Success in PE investing requires a systematic and disciplined approach
 - A long-term outlook is a requisite for building a PE program – you shouldn't dip in and out
 - Access to top performing, experienced managers is essential to ameliorate cycle risk.

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Flawed Manager Selection

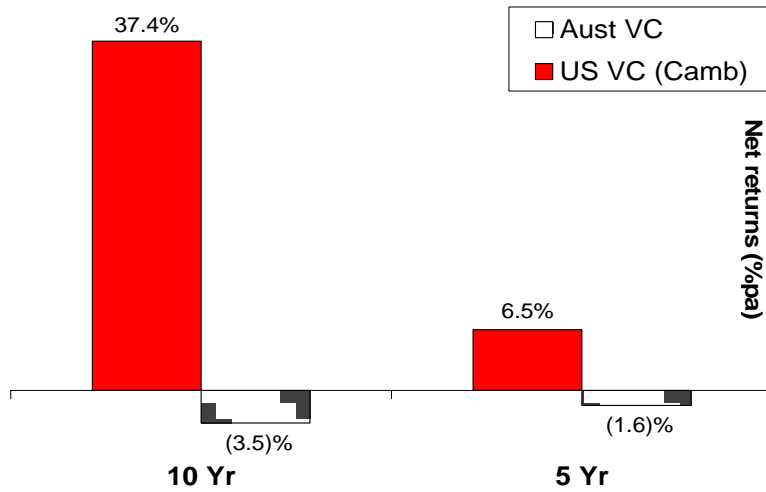
- Finite manager pool with repeated investment opportunities allows deal search patterns to be driven by a comparative rather than opportunistic approach.
- Track record and team stability are the best indicators of potential.
- Biggest mistakes in manager selection are:
 - Buying funds on value proposition alone- no-one has ever gone to market without a compelling value proposition.
 - “Toe in the water” and/or one off manager selection – investors should assess every opportunity by making known universe comparisons with competing offerings.
- Be sceptical: the best managers are frequently limited access. Why are they talking to you?

Part Four - Market Outlook

Why is this important?

- Especially given we recommend against timing markets
- Investors should be aware of circumstance and modify behaviour **at the margin** to avoid obvious traps
- We look at Venture and Buyouts
- The following section includes views held by Quay Partners with which other industry participants may or may not agree

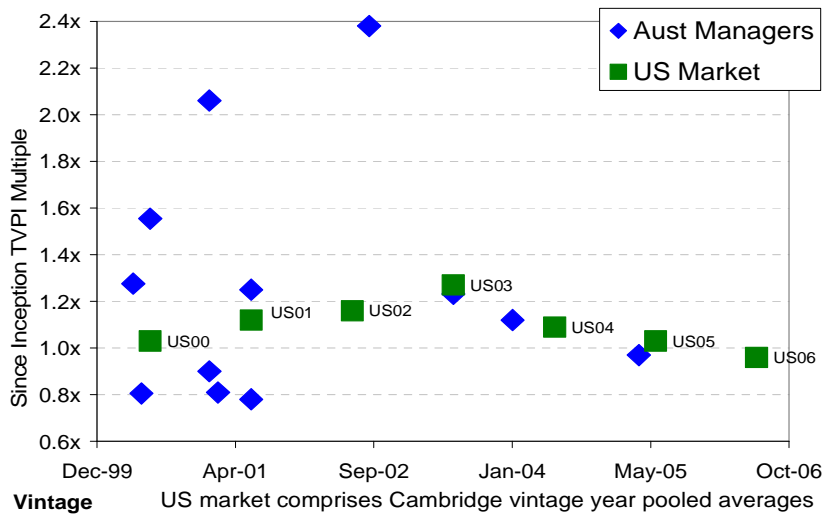
Market overall bearish on Australian Venture due to long term returns



Source: Cambridge Associates; AVCAL 2007 Yearbook
 Note: All returns are pooled net horizon returns.
 Returns are to Jun-2007.

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We are positive with focus on post tech crash fund returns vs US VC Market

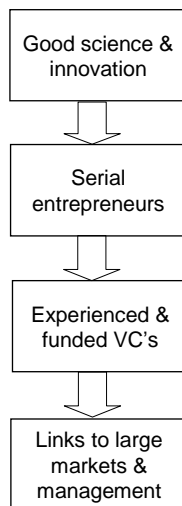


Vintage US market comprises Cambridge vintage year pooled averages

Note: Aust VC performance is based on latest available data, either to Mar-2007, Jun-2007 or Sep-2007. US Market returns to Jun-2007.

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Outlook prospective with market conditions good along VC value chain

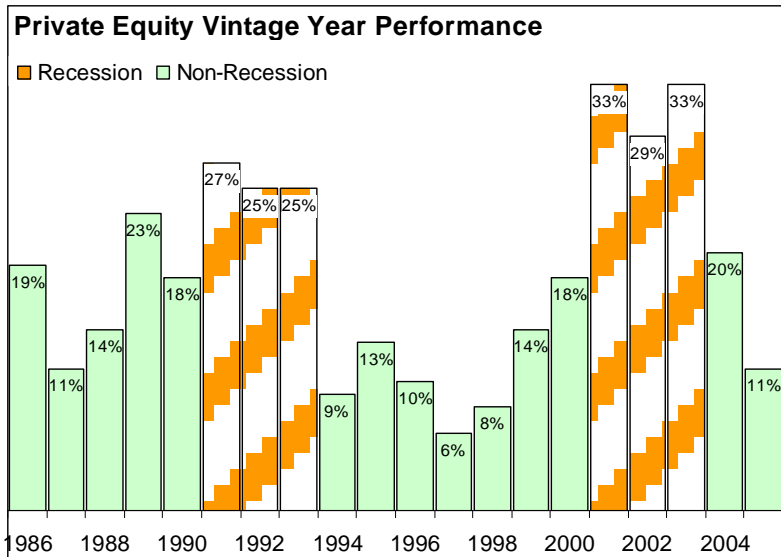


- Centre of excellence in life sciences
- Improved commercialisation initiatives generating strong ICT deal flow
- Second and third generation deals emerging from serial entrepreneurs. Eg. Dennis Hanley in CathRx and Pharmaxis, Neil Weste in Avega & Emotiv, Simon Poole in Optium, Mel Bridges in Impedimed & Osprey
- Teams are now experienced and fund sizes have capacity to support firms
- Active syndication from leading US VC's provides validation of deal quality and also provides links to large markets and experienced management teams

State of the market – buyouts

- Buyouts impacted by credit market disruptions.
- Lenders have normalised pricing & covenants.
- Large buyouts have stalled on vendor price expectations with trade buyers now more competitive.
- Mid market buyouts have seen minimal impact but face a potential risk of large funds reducing deal size

Private Equity – Past Recessions



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Outlook: Quay Partners View

Venture

- We are positive on venture

Buyouts

- We remain cautious of very large buyout funds
- Mid market buyout funds likely to remain strong performers
- Buyout funds started in recession years are likely to produce the best performances.

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Conclusion

- Private equity is a difficult asset class that needs to be done systematically and well
- However, it offers the potential for strong returns through active and transformational ownership of businesses acquired in inefficient markets
- For super funds looking to fund long term retirement savings it is worth looking at because it can make a substantial improvement to member retirement benefits.

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Further information?

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