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A GUIDE TO:
PRIVATE EQUITY INVESTING IN NEW ZEALAND

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INTRODUCTION

Over the past few decades, the international investment markets have grown increasingly more sophisticated and provide a wide variety of investment strategies that investment fund managers can employ to meet their investment objectives. As global liquidity has increased and capital markets have become more efficient, the returns from traditional asset classes are expected to decline relative to historical experience. In view of this, many asset managers have diversified their investment portfolios beyond derivatives and wider global equity markets to include alternative assets in order to achieve their investment return requirements. Typically alternative assets are less efficiently priced than traditional marketable securities, and therefore provide opportunities to exploit market inefficiencies through active management.

This paper has been written from the perspective of providing institutional investors with an insight into why private equity, as a subset of alternative assets, should be part of a diversified portfolio. It is the result of market research undertaken by New Zealand Venture Investment Fund Limited (NZVIF).

Firstly it reviews the technical aspects of investing in private equity in order to provide an understanding of the theoretical rationale for investing in private equity. Secondly it examines how institutional investors access private equity and identifies the different options that are available to investors. Thirdly it looks at the current level of institutional investment in private equity in New Zealand and compares this with the global experience. Finally it seeks to outline the key reasons why New Zealand institutions have not made any significant allocations to private equity and looks to identify potential solutions that would assist New Zealand institutional investors to gain exposure to this opportunity.

PART ONE: BACKGROUND TO PRIVATE EQUITY

Institutional Investing in Private Equity

Institutional investors as a group have widely disparate clients with differing risk/return profiles, and as a result employ a wide variety of investment strategies to address the specific needs of their clients. Whether this is a pension fund looking to provide for a future pensioner's retirement savings or an endowment fund looking to maintain a stream of charitable donations, the overarching objective of most institutional investors is to grow their clients' assets faster than the rate of inflation in order to meet some future liability. To achieve this purpose, institutions target a return from their investments that exceeds a benchmark return. Thus the investment objective for institutions is to maximise returns in a prudent manner in order to minimise the risk of capital loss.

In order for institutional investors to meet these risk/return profiles, they have relied heavily on standard asset classes, that is equities, bonds, derivatives of these assets and cash. However, many in the industry have argued that the long-term outlook for these assets (especially the equities market) is a future where returns are decreasing as the cost of capital decreases and information costs are reduced, leading to more liquid and efficient markets[1]. Accordingly institutions have started to broaden their asset allocation to include assets that either provide diversification for their existing portfolios or outperform standard asset classes.

An emerging trend in the past few years has been an increasing awareness of, and allocation to, so-called alternative assets. Alternative assets are non-traditional asset classes. They include private equity, venture capital, hedge funds, physical commodities and property. The different types of alternative asset are outlined in Figure 1 below.

Figure 1: Alternative Investments[2]

Many institutions include alternative assets in their asset allocation strategies in order to increase the diversification and growth potential of their portfolios. Whilst there is a perception that these assets are risky, in practice the addition of alternative assets to a portfolio, rather than increasing the overall risk, often brings the portfolio closer to the 'efficient frontier'. This concept defines the range of best combinations of risk and return available by distributing different percentages of a total allocation across multiple assets, and forms the basis of the modern portfolio theory that is used by institutions to develop their investment strategies. For investments in alternative assets, institutions are generally seeking returns of 5% per annum above listed equity investments over the long term.

Alternative assets provide access to sectors that have rather different characteristics from more liquid investment assets such as listed equities, bonds or cash. There is a premium for this access and it tends to be

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[1] Global Evidence on the Equity Risk Premium, Dimson, Marsh and Staunton, *Journal of Applied Corporate Finance* Vol. 15, 2003.

[2] *Why and How to Invest in Private Equity*, European Private Equity & Venture Capital Association (EVCA).

attractive to institutions and their clients that have few immediate liabilities, strong positive cash flows and long investment horizons.

Globally, institutions are seeking exposure to alternative assets of between 10% and 25% of their total portfolios, depending on their specific risk profiles. Strong returns in the past few years by American university endowments funds that have allocated significant portions of their portfolios to alternatives have helped boost interest amongst other institutions.

Background to Private Equity

Private equity is a subset of alternative assets and reflects all equity investment in unlisted businesses, and public companies where the investment has the character of a private equity transaction. Private equity offers the opportunity to access the large amount of business activity that is not captured by listed companies. Indeed, in the New Zealand context, the paucity of quality investment opportunities on the listed market makes it more important that a prudent investor gains exposure to investments in the private equity and venture capital sectors.

Private equity is broadly split into two subcategories[3]:

- Venture Capital – is equity investment in companies that have undeveloped, or developing, products or revenue with high growth potential.
- Buyouts – is a leveraged investment (both equity and debt) in typically more mature companies with established business plans, which are in need of capital to finance expansions, consolidations or spinouts of divisions or subsidiaries.

See the Appendix for a more detailed description of the range of investments that private equity encompasses.

The Attraction of Private Equity

Investors typically make allocations to private equity to improve the risk/reward characteristics of a portfolio. Private equity offers investors high returns whilst providing portfolio diversification. Two key elements lie behind this strategy:

- Historical Out-Performance – as the following table shows, private equity returns offer a premium to public equities' performance.

Table 1: Global Private Equity Returns Comparison – 30 June 2006[4]

	3 Year	5 Year	10 Year
Australia Private Equity	29.4%	14.8%	12.6%
S&P/ASX 300	23.9%	12.3%	12.8%
US Private Equity	13.4%	3.6%	11.4%
S&P 500	9.2%	0.7%	6.6%

[3] The term private equity is often somewhat confusingly used to refer solely to buyouts. For the purposes of this occasional paper the term private equity is used in its broadest meaning to include venture capital, buyouts and special situations.

[4] Thompson Financial.

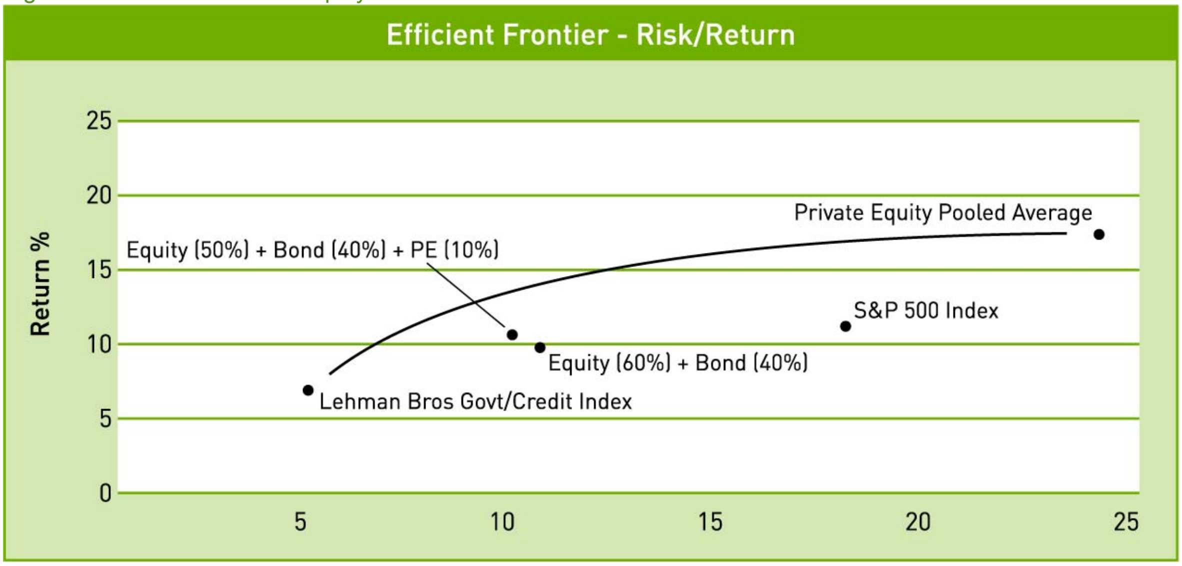
Portfolio Diversification – As discussed above, the introduction of an allocation to private equity to a portfolio can offer further diversification by enhancing returns and lowering total portfolio risk.

Table 2: Risk/Return of Asset Classes from 1994 to 2003[5]

	Annualised Return	Annualised Std Deviation	Correlation
S&P 500	11.1%	17.8%	1.00
Lehman Bros Govt/Credit Index	7.0%	4.7%	-0.24
US Private Equity	17.3%	24.0%	0.67
Portfolio 1 (60% S&P + 40% LBG/C)	9.9%	10.4%	0.98
Portfolio 2 (50% S&P + 40% LBG/C + 10% PE)	10.5%	9.7%	0.98

Based on the data in Table 2, the following chart depicts how including an allocation to private equity in an existing portfolio can improve the risk/return trade-off by moving closer to the efficient frontier.

Figure 2: Effect of a Private Equity Allocation on a Standard Investment Portfolio[6]



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[5] Thompson Financial.

[6] Fort Washington Capital Partners.

There are a number of ways to achieve additional diversification within a private equity programme, including:

- Stage – there is a negative correlation (-0.05)[7] between buyouts and venture capital, thus diversifying by stage should reduce risk within a private equity programme.
- Vintage – timing has a significant impact on the performance of private equity funds as both the buy and sell decisions are influenced by the economic climate. Investing consistently across a number of years will avoid having to time the market.
- Geography – investors can diversify by investing across countries or regions.
- Manager – investing across a number of managers will reduce manager-specific risk.
- Industry – when investing in venture capital, diversification by industry is possible as funds often focus on specific sectors (e.g. biotech, ICT).

Therefore, as with other investment portfolios in general, private equity investment decisions are undertaken with portfolio theory in mind. As a result, institutions that instigate private equity programmes tend to long-term allocations to the sector. Within this programme allocations are made to each of the components of private equity, the most significant allocations going to buyouts[8].

[7] Venture Economics – based on a period of 17 years.

[8] Within a standard private equity programme it would be unusual for an institution to allocate more than 30% of its total capital to venture capital funds.

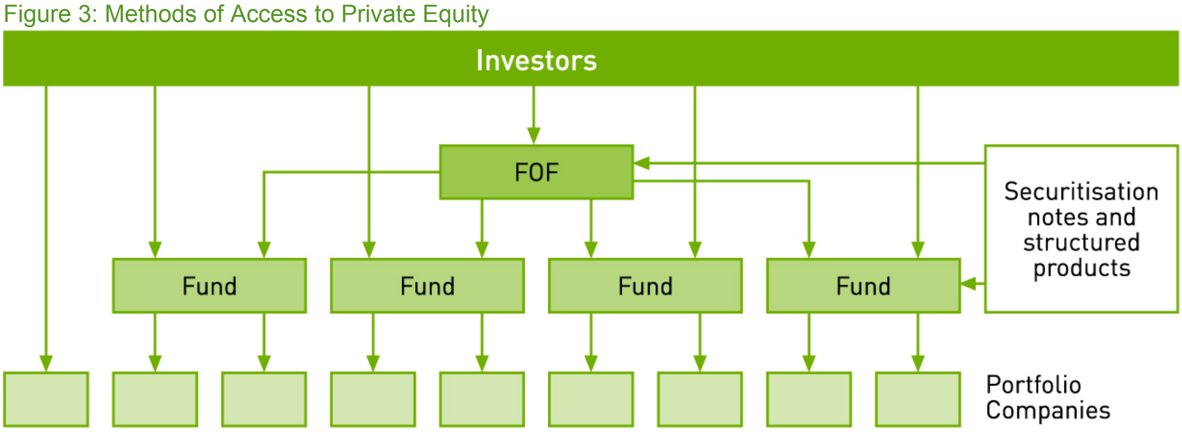
PART TWO: HOW TO INVEST IN PRIVATE EQUITY

Investing in Private Equity Funds

Private equity is an expert market, where the right skills, experience and resources are vital in order to succeed. The private equity fund is the intermediary that provides investors with safe access to the asset class and is the way that institutions typically access the sector. The funds management team has the right skills and experience to undertake direct private equity investments in companies, called portfolio companies, on behalf of the investors who have equipped the fund with the necessary capital resources. The objective is to sell the portfolio companies after a few years of value development for a higher price, and to generate profit for the fund's investors.

Figure 3 shows how investors gain exposure to private equity financing on a company level. By far the most important access channel is directly investing in funds, which themselves invest in companies. Depending on their needs and constraints, some investors choose to invest in private equity fund of funds, which in turn invest in private equity funds. About 20% of the capital provided to funds comes from funds of funds vehicles. The investor can also go via other alternative investment vehicles such as securitised or structured products, but again the capital ends up in the hands of fund managers. Finally, the investor can gain exposure to private equity by buying fund or fund of funds investments second-hand (commonly known as the secondaries market) or by investing in a secondary fund of funds. The different types of investment not only are different ways to access private equity funds but also have very different risk profiles.

Figure 3: Methods of Access to Private Equity



Private equity has certain features that may not appeal to all investors, primarily that it is a long-term asset class and resource intensive and that fund manager selection is critical. For institutional investors, many of these constraints can be mitigated through portfolio structuring and partnering with private equity funds of funds.

Benefits of Funds of Funds

Investing in private equity via a fund of funds is an established method of accessing private equity globally, and a number of key advantages are apparent:

- Portfolio Construction – investors often perceive private equity as a risky asset class. This is certainly true for direct investments in companies, especially in the venture capital segment, where the total loss rate of private equity direct investments is very high. However, investments in private equity funds are far less risky than one direct investment. In addition, investors often invest in several private equity funds to gain exposure to a range of portfolio companies where the gains on a few would more than compensate for the losses on others. Other investors who do not have the skills or resources to invest directly in a sufficient number of funds choose funds of funds or other alternative vehicles.

  Figures 4 and 5 illustrate the differing risk profiles of private equity investments in a company, directly into the company, into a fund or via a fund of funds. Based on data from the United States' venture capital and buyout markets, it is clear that whilst about 30% of all direct investments have a multiple of zero (which is effectively a complete loss of the capital invested), and around 10% of all fund investments have a multiple of less than one, a fund of funds investment nearly always returns the capital invested.

Accordingly the method of accessing the asset class is a key component of the decision on how to invest in private equity and the likely risk/return profiles. To conclude, private equity might be a risky asset, but a private equity investment is not necessarily so.

Figure 4: Risk Profile of Venture Capital Investment Vehicles[9]

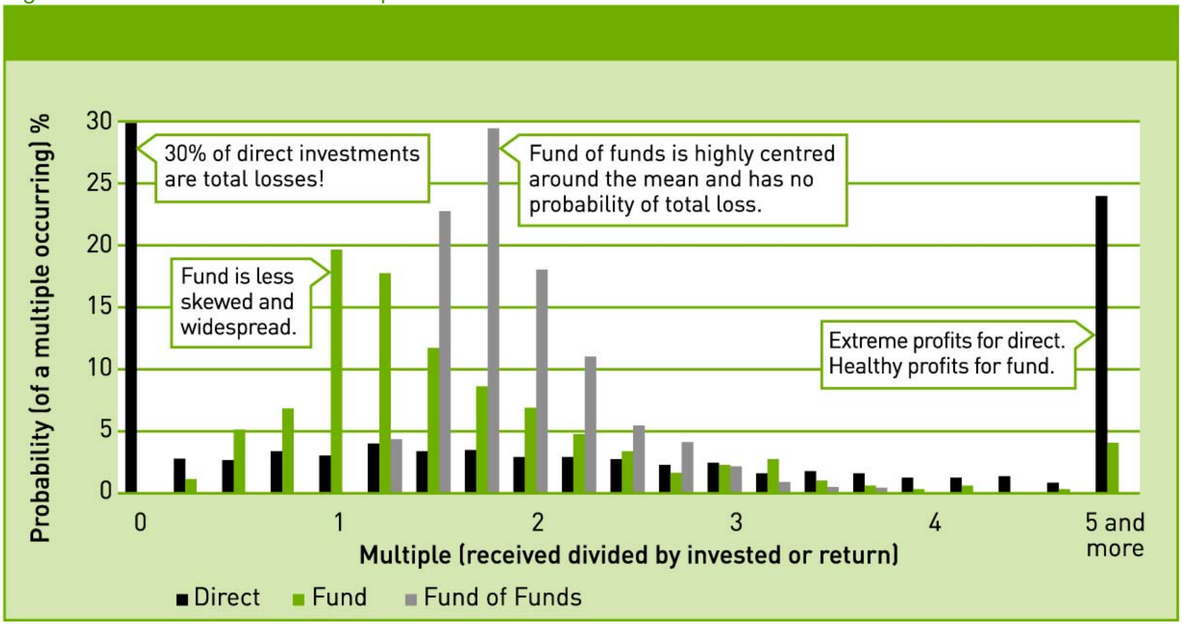
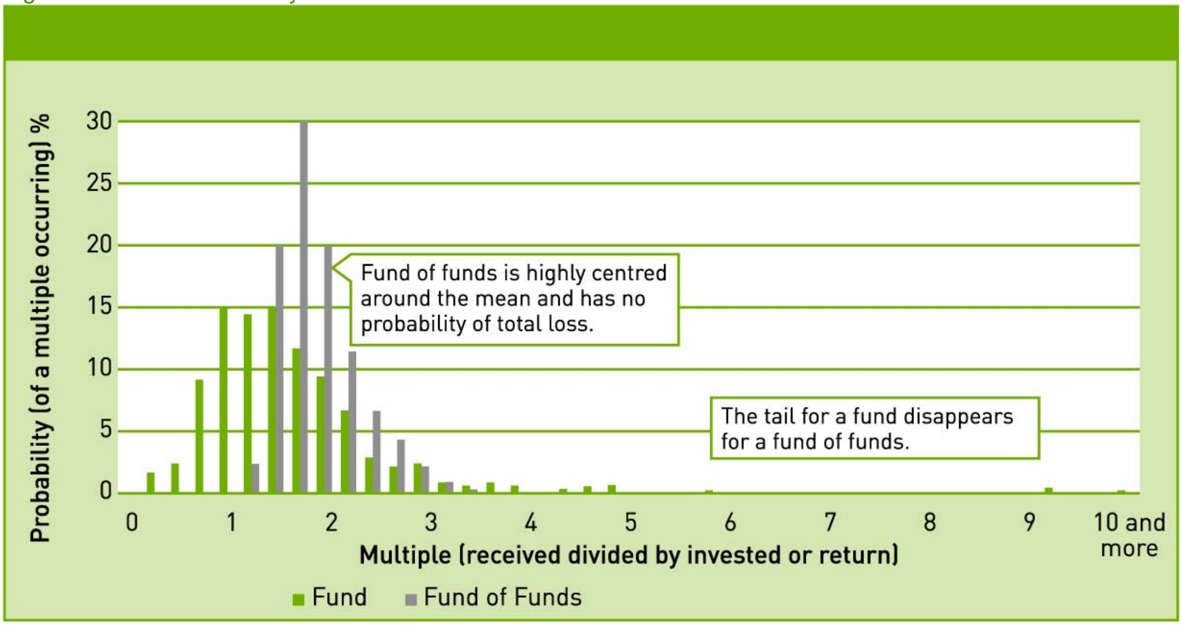


Figure 5: Risk Profile of Buyout Investment Vehicles[10]



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[9] *The Risk Profiles of Private Equity*, Weidig and Mathonet, EVCA, 2004.

[10] *The Risk Profiles of Private Equity,* Weidig and Mathonet, EVCA, 2004.

- Illiquidity – private equity investments are long-term investments and have long holding periods (three-plus years). This illiquidity means investors are limited in their ability to withdraw invested capital during a fund's life. In general, private equity has two sources of liquidity – inherent and manufactured[11]. Inherent liquidity flows from the contractual requirement of funds to divest their underlying assets by the termination date, usually 10 years with scope for extensions to carry out orderly exits. The other interesting aspect of inherent liquidity is that committed funds and invested funds can be very divergent numbers. Fund products mitigate some of the illiquid nature of direct private equity investing by just-in-time drawdowns of capital from investors, which are invested over a number of years. The return of funds, coupled with cash receipts from successful exits, means that as a rule of thumb no more than 50% of the committed capital is likely to be invested at any one point in time.

  What this means for institutional investors is that by staggering their investments into several funds, or fund of funds products over several years, they can quite accurately develop a 'stable and predictable cash cycle'[12] for their private equity programmes.

  Manufactured liquidity refers specifically to the buying and selling of shares in funds on a secondaries market. More specifically, the ability of funds of funds to purchase shares in more mature private equity funds builds earlier cash flows into the overall portfolio, generating more liquidity. The ability to trade positions on a secondaries market is now an established feature of the private equity marketplace and allows institutional investors a mechanism to manufacture liquidity should they wish to.

- Resource Requirements – investing in private equity is a specialist field that is much more resource intensive than investing in public markets. The choice of investment manager is critical in determining the outcome of an investment decision, however information is difficult to access and making comparisons between different managers is complex and subjective. Fund of funds managers are established to undertake these specialist functions and are able as a result of greater scale to offer the investor a service that they typically are unable to replicate cost effectively unless they have a scale of operation that is often in excess of $10 billion. These specialist skills are needed due to a number of features that distinguish private equity from public markets, including:

  - Publicly available data is limited and an investable index is not available for investors to track, hence investors must make active asset-allocation and manager-selection decisions.
  - The lack of data means that investors must use qualitative methods and informal networks to assess investment opportunities. The qualitative data that is available is open to interpretation and the underlying assumptions must be taken into consideration by investors.
  - Unlike in public markets, access to private equity funds is restricted to 'open to buy' periods when the fund is being raised. Increasingly, gaining access to private equity funds is becoming difficult for investors who do not have existing relationships with fund managers.
  - Investors need to compare private equity funds with other offerings either currently in the market or in the future in order to invest in the best funds in each subcategory of the asset class.
  - Post-investment monitoring of private equity funds is resource intensive, with the need to actively monitor the activities of the funds, including attending investor governance meetings.

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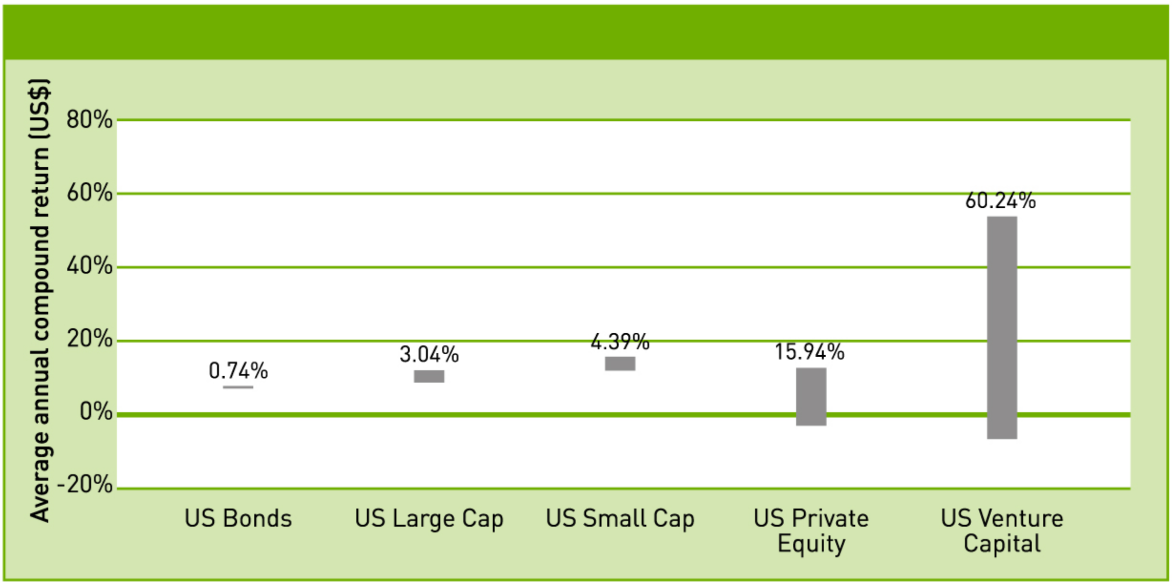
[11] *Understanding and Managing Liquidity in Private Equity*, Quay Partners, August 2006.

[12] *Understanding and Managing Liquidity in Private Equity*, Quay Partners, August 2006.

- Wide Dispersion in Fund Manager Returns – the spread in performance between upper- and lowest-quartile managers is much more significant for private equity managers than for managers of public securities. When investing in private equity, manager selection is critical, as shown by the following chart:

Figure 6: Comparative Asset Class Manager Returns 1994 – 2003: Spread between Top and Bottom Quartile Performance[13]



The selection of performing managers via robust due diligence processes is therefore critical to the returns being generated via private equity portfolios. Fund of funds managers with their focus on this market are often in a better position to evaluate potential manager performance.

In summary, investing through a fund of funds is an established method of achieving an exposure to private equity and is particularly relevant to those investors and institutions that do not have the resources to develop their own internal fund investment teams.

[13] Cambridge Associates (USA).

International

Institutional investing in private equity has increased substantially in the past few years, with the advent of low inflation and interest rates spurring private equity activity on a significant scale worldwide. As a result, private equity is playing an increasingly important role in institutional portfolios as it is recognised as important to the development of a diversified portfolio. The average strategic portfolio allocation for investment by endowment funds and corporate and public pension funds in private equity for 2005 was forecast to range from 4.5% in Europe to 6.3% in Australia and 8.2% in North America[14]. The same survey also indicated that endowment funds had significantly larger allocations (an average of 14.2% in 2003 for North America) than public pension plans (5.9%) and corporate pension plans (7.7%).

In recent years, fundraising for private equity has substantially increased, with €112 billion raised in Europe in 2006. In the US, the 2006 figure was US$25.5 billion invested, with US$131.4 billion raised. This increased activity has also been replicated in Australia, with AU$8.4 billion being raised in the June 2007 year, continuing a strong 2006 year in which AU$4.1 billion was raised. This fundraising activity has been accompanied by the emergence of new fund managers and the creation of follow-on funds.

International experience evidences a widespread acceptance of the place of private equity as part of a balanced long-term asset allocation strategy by institutions.

Australia

In Australia, there has been spectacular growth in managed funds, with investment funds under management quadrupling between 1991 and 2006 to exceed A$1 trillion[15]. This increase in liquidity in the Australian market has seen an increase in the allocation to alternative assets. According to a March 2007 survey of Australian superannuation funds by SuperRatings Pty[16], the average allocation to alternative assets has hit 9% of average balanced funds and is climbing.

The extent to which Australian institutions have increased their exposure to alternative assets, including private equity, is illustrated by Figure 7, which shows that increasingly Australia is becoming a significant private equity market in the world, in terms of capital allocations to it by its institutions and the use of the funds in investments in Australia and New Zealand.

Figure 7: Select Comparison of Australian Managed Funds

Fund	Comments
Funds SA (South Australia) Size: AU$10 billion	As of June 2006 it had AU$354 million in a 'diversified' strategy of which 65% is invested in private equity. This constitutes 2.2% of its overall portfolio.
Public Sector and Commonwealth Superannuation Scheme (PSS/CSS) Size: AU$15 billion	It has invested a significant amount in domestic and international alternative investments including private equity schemes. The total as of June 2006 was AU$420 million (4.2%) invested with commitments of AU$1.244 billion (8.3%).
Telstra Super Pty Limited Size: AU$9.5 billion	As at June 2006, it had invested AU$201 million in private equity funds representing 2% of its overall portfolio.
Qantas Superannuation Plan Size: AU$5.64 billion	It has 2.7% of its assets invested in private equity representing AU$152 million.
Victoria Funds Management Corporation Size: AU$38 billion	It has 3% invested in alternative assets, which equates to AU$1.14 billion. This programme of investment has been in operation for 15 years.

[14] *Report on Alternative Investing by Tax-Exempt Organizations 2003: A survey of organizations in North America, Europe, Australia, and Japan,* Goldman Sachs and Russell Investment Group.

[15] Investment Managers, Australian Bureau of Statistics, *Managed Funds*, March 2006.

[16] March 2007 Fund Results – Media Release, www.superratings.com.au.

New Zealand

The size of the New Zealand managed funds market as at 30 June 2007 was $65 billion[17]. This includes the NZ Superannuation Fund and unlisted retail and wholesale funds. A recent investment survey of managed funds indicated that the average alternative asset allocation for New Zealand fund managers was 1.8%[18]. Of particular note, these allocations were not widespread but concentrated in a small number of funds and these allocations were primarily made offshore, typically to hedge funds. One significant exception to this is the NZ Superannuation Fund, which has a long-term allocation target of 35% to alternative assets[19]. Of its alternative allocation, the NZ Superannuation Fund currently has invested 1% of its portfolio in private equity[20].

Whilst the NZ Superannuation Fund has an especially long tail in terms of its expected liabilities compared to other funds, this large allocation to alternative assets recognises the mainstreaming of these assets and international asset allocation trends.

Why are New Zealand Institutions Not Investing in Private Equity?

New Zealand institutions have been somewhat notable by their absence in investing in alternative assets and private equity. NZVIF has undertaken extensive market research into New Zealand institutions' asset allocations and has developed key observations from this research that provide an insight as to why there is limited investment by New Zealand institutional investors in the private equity market. The reasons for this are varied and will be explored below.

- Lack of Scale – the New Zealand institutional investment market is fairly small by international standards. The lack of compulsory superannuation or significant incentives for saving through managed funds, combined with New Zealanders' propensity for property investment, has resulted in a relatively small market and many institutional managers can only make small allocations. Of the 576 registered superannuation schemes in New Zealand, only 77 have assets in excess of $50 million with an average size of $225 million[21]. The challenge facing domestic institutions is that investing in private equity is more expensive than investing in bonds or equities. The level of information asymmetry for alternatives means than proportionately more time and money need to be spent on due diligence, investment personnel and other expenses.

- Retail Nature of Managed Funds – another interesting feature of the New Zealand market is the retail nature of most managed funds. Essentially this means that most investment products have redemption options allowing investors to remove their funds at short notice should they wish to. This retail nature forces managers to have higher allocations to more liquid assets such as bonds and equities to meet potential redemptions. This also makes it hard for managers to maintain their strategic asset allocations, so for example a 5% allocation to private equity may well rise as redemptions reduce the overall size of the fund. The introduction of KiwiSaver plans that require contributions to be held until retirement should reduce volatility for fund managers.

- Illiquidity – private equity tends to be a long-term investment and has long holding periods (three-plus years). This inherent illiquidity means investors are limited in their ability to withdraw capital early. Given the retail nature of funds in New Zealand, this is a real issue for institutional investors.

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[17] *2007 Annual Review*, The Investment Savings and Insurance Association of New Zealand Inc, www.isi.org.nz.

[18] *Investment Survey June 2007*, Melville Jessup Weaver, www.mjwactuary.co.nz.

[19] NZ Superannuation Fund includes property and commodities as alternative assets.

[20] *NZ Super Fund Performance and Portfolio Update*, November 2007, www.nzsuperfund.co.nz.

[21] *Report of the Government Actuary*, 30 June 2007, www.isu.govt.nz.

- Lack of Understanding – in general, a lack of focus on the alternative asset class by institutional investors has ensured a lack of understanding of private equity in general, as many New Zealand institutional investors have a background in standard assets and do not employ specialists in this field. This has led to a significant lack of understanding of the benefits of a private equity strategy.

- Resources – investing in private equity is much more resource intensive than investing in public markets. This is because information is difficult to access and making comparisons between different managers is more complex and subjective. Furthermore, post-investment monitoring of funds is more resource intensive. For a fund that intends to allocate, say, 5% on a $1 billion fund size, the costs of running an in-house alternative investment programme may prove to be prohibitive. Given that the majority of New Zealand institutions have assets of less than $5 billion, many institutional investors do not currently have the resources to employ in-house private equity expertise.

New Zealand institutions will increasingly look to widen the scope of their investment strategies as it becomes increasingly difficult to generate their target returns from existing investment strategies. Overseas experience shows that institutions will look to include allocations to alternative assets, including private equity, in the search for excess returns.

How can New Zealand Institutions Access Private Equity?

New Zealand institutions could look to access private equity in three ways: by directly investing into companies, by investing in domestic and international private equity funds, or by investing in a fund of funds.

Given the barriers to investment that have been identified above, investing directly into companies is an option available only to the largest of institutional investors, typically sovereign funds and very large institutional investors[22]. The scale, resource and capability that are needed to employ such a strategy are not present in the New Zealand market at present.

Investing in international and domestic private equity funds still requires a significant in-house capability to assess the quality and skills of a fund manager coupled with knowledge of the private equity market. This is due to the large qualitative component of any assessment compared with the more usual quantitative assessment of a public market manager. There are a small number of New Zealand institutional investors that have this capability, due to their scale, and ability to resource sufficiently skilled investment personnel.

The last option for institutions is to invest through funds of funds. This allows the institution to gain access to a portfolio of private equity funds by providing a mandate to a fund of funds manager who will then allocate this to private equity funds after rigorous due diligence and the application of a stated investment strategy. It is our view that, given the scale and structure of the New Zealand investment landscape, this option is most suitable for institutional investors in New Zealand.

[22] Some recent examples of this in the New Zealand context are the purchase of Yellow Pages by a consortium including the Ontario Teachers' Pension Plan, and the offer by the Canadian Pension Plan Investment Board (CPPIB) for Auckland International Airport.

CONCLUSION

Private equity is increasingly becoming a meaningful part of institutional investor portfolios. Globally, private equity has provided investors with superior performance relative to public markets along with added portfolio diversification. Allocations to private equity have been rising internationally and this trend has been mirrored in Australia. However, in New Zealand, institutions have been slow to adopt a similar approach due to structural issues such as the scale and structure of the New Zealand investment landscape. Given these constraints, it is our view that the most suitable method for institutional investors in New Zealand to access private equity is via a private equity fund of funds. This allows the institution to gain access to a portfolio of private equity funds in a cost-effective manner by providing a mandate to a fund of funds manager who will then allocate this to private equity funds after rigorous due diligence and the application of a stated investment strategy.

About New Zealand Venture Investment Fund Limited

New Zealand Venture Investment Fund Limited (NZVIF) is a Crown-Owned Company established under the Companies Act 1993 and incorporated in June 2002. Based in Auckland, the Company is governed by a private sector Board of Directors and managed by a dedicated management team. NZVIF is contracted by the New Zealand Government to administer two investment funds:

- $160 Million Venture Capital Fund of Funds – investment through privately managed venture capital funds.
- $40 Million Seed Co-Investment Fund – direct co-investment into companies alongside angel investors.

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APPENDIX: STAGES OF PRIVATE EQUITY

Early Stage			Expansion		Buy-out/in	Turnaround
Seed	**Start-up**	**Early Expansion**	**Expansion**	**Late Expansion**	**Mgmt Buyout**	**Workout**
Capital will enable the development, testing and preparation of a product or service to the point where it is feasible to start business operations.	Capital will enable actual business operations to get underway. This includes further development of the company's product(s) and initial production and marketing.	Capital is provided to initiate or expand commercial production and marketing but where the company is typically or likely to become cash flow negative.	Capital is provided for the growth and expansion of a company which may or may not break even or trade profitably. Capital may be used to finance increased production capacity or market or product development, or provide additional working capital.	Capital is provided for financing the expansion of a company that is producing, distributing and increasing its sales volume and to help a company achieve critical mass to position it for an initial public offering.	Capital is provided to enable operating management to acquire an established business or product line.	Capital is provided at a time of operational or financial difficulty with the intention of turning the company around.