Significant Upside Potential for Private Markets

The forces driving success in private markets are aligned in The Lucky Country. Alexandre Schmitz, Managing Partner and Head of APAC at Capstone Partners, explains how stability, sophistication, and growth have created a unique opportunity

Alexandre Schmitz
Managing Partner and Head of APAC

Capstone Partners
www.csplp.com

Founded in 2001, **Capstone Partners** is a leading independent placement agent focused on raising capital for private equity, credit, real assets, and infrastructure firms from around the world.

Alexandre leads the firm's Asia-Pacific operations and is responsible for distribution and client origination in Asia-Pacific.

Australia has enjoyed 29 years of sustained macroeconomic growth, with GDP expanding at a CAGR of 3.2% between 1990 and 2019. Growth has surpassed all other developed economies, owing mostly to its proximity to the powerhouses of China and Southeast Asia.

A robust pandemic response has enabled the country to minimize economic disruption. Bolstered by a furlough scheme and wage subsidies, the Australian Government implemented a stimulus package equivalent to 18% of GDP. This sizable fiscal stimulus kept GDP contraction to a minimal 1.1% in 2020, which is in stark contrast to the falls seen in the US (-3.5%), the eurozone (-7.6%), and the UK (-9.9%). At the same time, the vast majority of the population has adhered to stringent and rapidly evolving lockdown measures, as well as systematic tracking and tracing procedures, helping to slow the spread of the coronavirus and keep fatality rates low.

Looking ahead, what Australian intellectual Douglas Horne called "The Lucky Country" anticipates a more robust economic recovery than the rest of the world, capitalizing on strong financial markets, a highly educated population, sound legal framework, and a propensity for continued innovation.

A Compelling Buyout Market

Australia is one of the few countries in the Asia-Pacific region where investors can put their money to work in private equity control transactions. The country counts over 15,000 businesses that could be candidates for a private equity investment, mainly in the lower middle market. Many of these private companies will experience managerial transition in the coming years, given the demographic profile of their shareholders. More family-owned business founders are looking to private equity as an efficient way to access liquidity options for wealth and succession-planning matters.

Smart buyout managers are adapting to offer tailored solutions, often with a two-stage exit strategy. A partial buyout allows the founding family to monetize part of its wealth in a primary transaction, and then to stay invested alongside a professional investor for a 3-5 year hold period before a final exit to the most viable acquiring entity, either via an international trade sale, listing on the stock exchange, or an auction process with larger secondary buyers. This maximizes the total price of their stake, while reducing the risk. During their tenure, buyout managers may transform the company to boost its strategic value by hiring new executives, improving ESG practices, and optimizing the go-to-market and pricing strategies; and, if meaningful, they may make a few add-on acquisitions.

With such a concentration of closely held family businesses for fund managers to tap into, deal activity in Australia and New Zealand tends to be dominated by primary investments negotiated on a bilateral basis. This is particularly true for the lower middle-market segment where uncontested opportunities can still be identified at attractive valuations. Avoiding lengthy auction processes and secondary transactions means more reasonable EV/EBITDA entry multiples and lower leverage to achieve targeted returns – factors increasingly difficult to manage in the US and European buyout markets. That said, the upper end of the Australian market is characterized by steeper competition; local GPs compete against bigger regional or global buyout firms from a limited pool of fewer than 200 businesses valued at $1bn or more.

The deal flow of buyout managers has evolved substantially over the past few years, in line with the growth of the Australian economy. Although the bulk of buyout transactions from 2000 to 2015 were invested in industrial and cyclical businesses, the past five years have witnessed a sharp uptick in buyout deals for asset-light and fast-growing businesses in the software, proven technology, healthcare, and education spaces. Benefiting from the deployment of private capital, Australia has successfully become home to many innovative businesses with substantial growth potential.

A Dynamic and Changing Investor Base

Led by superannuation funds, Australian LPs are some of the most established and most experienced investors in the world. The supers played an instrumental role in actively participating in domestic and international private markets over the past two decades and setting up proper ESG and diversity & inclusion standards.

But market forces are driving change in this crucial financing market. Over the past decade, the number of superannuation funds has significantly decreased following industry consolidation. This has led to larger institutions being able to reach the critical size needed to have internal teams in charge of alternative investments. Furthermore, following the release of the Cooper Report, supers have been advised to focus on the fees paid to third-party managers rather than the net performance adjusted for risk of the underlying investment strategies. Most of the smaller institutions have decreased their exposure to private equity funds, while larger supers have been pushed to do more direct investments, especially in the infrastructure segment. This trend is expected to continue in the foreseeable future and will force Australian managers to raise more funds from international LPs.

Over the same period, family offices have substantially increased their exposure to private equity investments. We estimate that more than 100 multi- or single-family offices are actively investing in the private markets in Australia. This appetite for private assets will flourish as investors seek more international exposure in their capital allocations. Despite its remote location, Australia is more than ever on the map of fund managers targeting an international LP base.