An introduction to private equity investment

Capital Ideas

If you have any questions or require more information we recommend you talk to your financial adviser or Ask Macquarie.

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A capital idea

What is private equity?

Simply put, private equity investors provide capital for businesses that are not listed on a stock exchange.

Individuals, royalty, aristocrats, syndicates and merchant banks have been providing a form of private equity for centuries. Professional private equity investing dates back to 1946, to the launch of American Research and Development Corporation, a US$4 million fund that pooled individual and institutional money to invest in private companies.

It’s about capital

Private equity investing means putting capital into a business to expand, develop new products or fund changes to ownership and management. Private equity investors do more than buy the rights to share in a company’s return – they provide working capital. As respected investor Warren Buffett puts it: “Buy a business, don’t rent stocks.”

And more than just capital

Private equity investors generally provide their capital in exchange for a sizeable stake in the business. They also invest their expertise – in management, finance, marketing, strategic direction and networks. By exercising some control through board seats and management agreements, private equity investors can protect and grow their investment. This alignment of interests and the ability to add value to the business often means that private equity investors can generate higher returns than those available from traditional “hands-off” equity investing.

The most important features of private equity investing are:

It’s about capital

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New ideas

Many world famous technology companies including Compaq, Sun and Apple were funded by venture capital companies in their early years. Biotech star Genentech and courier giant FedEx are also famous recipients of venture capital (sometimes called early stage capital in Australia).

Growing Cisco

Sometimes private equity is crucial in turning a start-up into a giant. In 1984 Sanford University computer scientists, Sandy Lerner and Len Bosak founded Cisco Systems and financed their new venture using their credit cards. In 1987 Cisco received venture capital funding from Sequoia Capital. At the time they had quarterly sales of around US$1.2 million. At the end of 2002 the company booked net quarterly sales of US$4.7 billion.

Better structures

As a company grows, its management and ownership structures often need to change. A start-up company may be driven by the vision and energy of its founders in its early years but needs more professional management as it matures. Similarly, a company that once benefited from easy access to capital as part of a large conglomerate may be more successful if the owners understand the day-to-day issues affecting the business.

Private equity financing can be a crucial factor in aligning a company’s management and ownership structure with the needs of the business. The change of control can occur through:

- a leveraged buy-out (LBO) where private equity investors use debt to take control of a business
- a management buy-out (MBO) where private equity investors help fund existing management to buy the business
- a management buy-in (MBI) when private equity investors finance a new management team to buy into the business.

Successfully executed, the restructure benefits both the business and the investors – a better performing company means a better return.

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New ideas pass through three periods

It can't be done.

It probably can be done, but it’s not worth doing.

I knew it was a good idea all along.

- Arthur C Clarke

It’s long term and potentially lucrative

Private equity investment is typically long term ranging from 3-12 years. Because the investment manager is investing substantial capital at high risk over a long period they expect to be rewarded with higher returns.

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A winning game

How private equity works. To understand how private equity works you need to look at who is involved.

The investors

Angel investors (such as Australia’s Kerry Packer) invest directly in companies that need capital. They need substantial assets (measured in millions) and must have expertise in finding investment opportunities and structuring financial deals. Typically they also bring useful business skills to the table.

Branching out

Private equity can improve a business by turning managers into owners.

Brown and Dureau is a century-old Victorian pine sawmilling company that was part of the Amcor group.

With private equity funding from an underlying manager of the Macquarie Alternative Investment Trust the management team bought out the business in 1998. With the help of the private equity manager, Brown and Dureau were able to pay off debt faster than anticipated, invest in upgrades to the sawmill and increase capacity, productivity and profits.

The Macquarie Alternative Investment Trust (MAIT) is a wholesale managed fund offered by Macquarie Investment Management Limited (MIML) ABN 66 002 867 003. This fund is closed to new investments.

Private equity funds run by professional private equity managers collect and combine capital from individuals, companies, banks, super funds and fund managers. They seek out attractive companies to invest in and structure a deal that exchanges the capital they’ve sourced for a stake in the company. As many private equity firms are staffed by former bankers, lawyers, technologists or line managers their business expertise can be invaluable.

By providing capital and business expertise, private equity managers aim to aid the rapid growth of a company so that they can exit with a substantial profit.

Fund of funds private equity managers take advantage of the choices that are available by investing in a portfolio of private equity funds. A fund of funds approach gives investors access to a much broader range of underlying companies and allows for diversification of managers and manager styles. Typically a fund of funds manager will invest in around ten funds and give investors access to around 100 companies.

A good fund of funds manager will have an expert knowledge of the style and capabilities of the private equity managers they choose. Ideally they will select quality managers and blend them in ways that maximise diversification and improve the risk/return characteristics of the overall portfolio.
The companies
Private equity offers companies a variety of benefits.
- **Patient capital.** Private equity funding is usually, but not always provided via long-term equity finance. That can ease a company’s short-term financing pressures, free up capital to fund expansion rather than repay debt and allows the company to concentrate on growth. Private equity investors often provide further financing as the company grows.
- **A stakeholder.** The private equity investor shares the company’s risk and rewards. As a result their financing arrangements are often more flexible than the alternatives.
- **An adviser.** Many private equity providers have extensive experience in particular industries. They often provide powerful strategic, operational and financial advice.
- **A network.** Their wide-ranging industry coverage means private equity managers can offer their companies valuable contacts. For 20 years, US venture capital firm Kleiner Perkins Caufield & Byers has run an informal network it calls a Keiretsu, where its technology companies share ideas and contacts, and form alliances.
- **Exit strategy.** Private equity investors make most of their returns by successfully exiting a business by listing on the sharemarket via initial public offerings (IPOs), by buyouts or trade sales. Their experience can help maximise the returns to the business owners.

**Giving something back**
Internet software company Sun Microsystems was founded in 1982. The company received venture capital from technology specialist Kleiner Perkins and went public in 1987 with annual revenues of around US$115 million. Revenues for the fiscal year 2002 were US$12.5 billion.

The founder of Sun Microsystems, Vinod Khosla, has been a General Partner of Kleiner Perkins since 1986 and now sits on the board of companies like Juniper Networks, Kovio and QWEST Communications.

**Types of Private Equity**
Many things change over a company’s life-cycle – the amount and type of capital they need, the management expertise they require, the risks to the business and the potential return they can generate.

As a result, private equity managers tend to specialise in investing at certain stages in a company’s growth. The table below illustrates the interaction between private equity investing and the life-cycle of a company.

**Timing and money**
The companies a private equity manager invests in will depend on the state of the market, economic conditions and the manager’s own size, expertise and style.

**Early stage**
Companies like the venture capitalists of Silicon Valley specialise in providing seed capital and have proven strengths in assessing new technologies and commercialising them.

Typically these investors will be buying into companies when valuations are attractive - when price to earnings (PE) multiples are low – hoping to ride the growth in the company until they can realise its increased value on exit - when PE multiples are much higher.

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### Life-cycle of a company

<table>
<thead>
<tr>
<th>Stage</th>
<th>Source of funding</th>
<th>Time</th>
<th>Source: Macquarie</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seed stage</td>
<td>Seed capital</td>
<td>Initial Public Offers or Trade offers</td>
<td></td>
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<tr>
<td>Start up stage</td>
<td>Start up capital</td>
<td>Expansion or development capital</td>
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<tr>
<td>Expansion stage</td>
<td>Expansion capital</td>
<td>Product/service is established and working capital required for initial expansion and fund additional capacity</td>
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<tr>
<td>Maturity</td>
<td>Maturity</td>
<td>The business is relatively established within its market, has a proven track record and cash flow is stable</td>
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**Source**
Macquarie
Their exit strategy might include listing on Australian or international sharemarkets, a sale to a competitor or foreign conglomerate or involve selling their stake back to management or other owners. Returns from start-up and expansion investments can be extremely lucrative – often multiples of the initial investment. However the risk of failure can also be high.

According to Columbia University Professor Amar Bhide the striking success of many start-ups like Sun, Cisco and Hewlett-Packard reflects the fact that private equity investors were funding already profitable businesses with expert management who were capable of developing new technology and selling it effectively. It was the combination of capital and management, not capital and technology, that drove the success of these businesses.

Buyouts

Some private equity companies are experts at valuing a company via due diligence, at negotiating deals that allow owners to realise their investment and at restructuring businesses. Kohlberg Kravis Roberts is the world’s most famous buyout specialist, largely thanks to a US$31 billion buyout of RJR Nabisco in 1989.

Specialist buyout firms tend to invest in established businesses with reliable cashflow, low operational risk and a strong market position. They often use large amounts of debt to fund their purchases and put in place new management structures designed to grow the value of their companies.

After several years the businesses are sold, with buyout firms aiming to generate a minimum 20% annual return for their investors. As the buyout specialists purchase established businesses and do extensive investigation into the company these situations are less risky than venture capital - and tend to produce lower returns.

From cray fishing to luxury yachts

Austal Ships was launched in 1988 and originally built cray fishing boats for fishermen around Fremantle. Today it is the world’s largest supplier of aluminium vessels and sells to customers throughout Asia, the Mediterranean and the US. It recently sold a 56 metre passenger ferry to its first customer in the Red Sea.

Private equity was crucial to Austal’s expansion. In 1994 the company attracted $15 million of venture capital. At the time it had one product line – 40 metre fast ferries and sales of just $40 million.

Austal used this funding to expand its shipyard operations in Jervoise Bay and as a result was able to invest in the development of larger, faster ferries and car transport ferries.

Austal was listed in 1998, generating an internal rate of return of 36% pa. for investors in the Macquarie Alternative Investment Trust.

Since 1994 Austal’s revenues have increased to A$340 million (end financial year 2002) and the company now produces luxury and custom built yachts and a range of passenger and transport ferries. Austal is increasingly involved in the development of the market for military ferries.

Daring ideas are like chessmen moved forward. They may be beaten, but they may start a winning game.

- Goethe
The private equity industry – big and getting bigger

While the Australian private equity industry is relatively small it is growing rapidly. It now boasts 140 funds and $6.3 billion in capital under management. The private equity industry in the US is now approximately 30 years old and vastly bigger. The industry had approximately US$251.4 billion under management at the end of 2002 (Venture Economics/NVCA).

Long-term returns are higher

Between January 1986 and June 2001 the pooled internal rate of return (key performance measure for private equity) of Australia’s private equity funds totalled 21.7%. In contrast, listed Australian equities (as measured by the All Ordinaries Accumulation Index) gave investors a 12.7% return over the same period (refer graph below).

We can see a similar, if less extreme, return differential in the much larger American market (refer graph right).

Why private equity?

Why now? Why here? Investors have a number of powerful reasons for choosing private equity.

Private equity performance advantage (10 years to June 2001)

Private equity returns1 vs traditional assets2 from January 1986 – June 2001

Private Equity  | Australian Equities | International Equities | Australian Bonds | International Bonds | Listed Property
---|---|---|---|---|---
Australia | United States
0 | 5 | 10 | 15 | 20 | 25

For the full table, please refer to page 11.

Macquarie Direct Investment Ltd and Neverfail

Neverfail is a family business established in 1987 and now a pioneer in the Australian bottled water and cooler rental industry.

Macquarie Direct Investment Limited (MDI) met the company’s founder Harry Hilliam, in late 1989. At the time he was looking for a partner who could provide capital and advice.

Neverfail had a history of fast growth. Experience told MDI managers that Harry Hilliam was a superior entrepreneur who had learnt from the US bottled water industry and was applying those lessons in the Australian market.

Mr Hilliam saw significant capacity for growth in Sydney, Melbourne and Brisbane. In June 1990 MDI invested A$4 million to help Neverfail open a Melbourne branch and fund the continuing growth of its customer base in Sydney and Brisbane. MDI helped Mr Hilliam and his senior management develop a reporting template that tracked key performance indicators in the business. They also provided strategic, financial and acquisition advice to Neverfail as it dealt with its rapid growth, and with finding and funding acquisition targets.

In late 1993 MDI sold its Neverfail holding. Business growth had exceeded expectations and the timing of the sale allowed MDI to reap a rate of return above its target. MDI generated an internal rate of return (pre fees) of 36% pa over the life of the investment.

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Springwater

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More effective diversification

Investors have long known that adding international assets to an investment portfolio can add to returns and reduce risk. Private equity offers investors a similar benefit.

Private equity is a long-term, illiquid investment and it is valued infrequently. Because private equity is so different to listed shares the two asset classes are lowly correlated and therefore don’t tend to rise or fall at the same time. As a result, adding private equity to your portfolio can increase returns while reducing overall risk.

Over the past four years, investing 10% of a typical balanced portfolio in Macquarie’s previous private equity fund of funds (the Macquarie Alternative Investment Trust) would have improved your overall portfolio return while reducing risk.

The time to buy...

The world economy is still trying to digest the effects of the tech-wreck and waiting for the dominant US economy to recover from recession. That may not sound like a good environment for private equity investors, but the experts don’t agree. Columbia’s Amar Bhide (Glueckinger Professor of Business) has done a long study of business growth and concluded that “most successful entrepreneurs start in unstable markets”.

Michael Moritz, a partner at venture capital specialist Sequoia Capital elaborates on this point: “It’s a lot easier to invest today since a lot of the ‘Get rich quick!’ scam artists have disappeared from the scene. The only people foolish enough to start or finance a company today are those who are genuinely interested in building something that lasts” (Newsweek).

A sluggish economy and weak sharemarkets make it hard for companies to list on the market or achieve a trade sale. Seeking a private equity partner can quickly become the most logical alternative.

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Tough economic conditions also pressure larger companies to divest non-core or underperforming businesses – providing opportunities for private equity investors. Weaker economic conditions also bring with them low interest rates – making it easier to fund LBOs, MBOs and MBIs.

The doyen of world sharemarket investors, Warren Buffett, is using a private equity strategy within his investment vehicle, Berkshire Hathaway. A long-term holder of large chunks of companies like Coca Cola and American Express, Buffett has recently expressed his doubts about the medium-term outlook for US shares. Today he is using his massive cashflow to take major stakes in quality private companies (Shareholder Statement, 2002).

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Private equity down under

The Australian private equity market is only around ten years old and still relatively small. Yet in some ways this is an advantage to local investors. As markets get larger, investment data becomes more readily available, averaging down the excess returns available to individual investors. A smaller market can actually generate higher excess returns for investors.

Recent research also suggests that Australian private equity managers have exceeded the returns of their global counterparts – especially those in America where the private equity sector is still suffering the hangover from over-investment between 1998 and 2000. According to venture capital research firm VentureOne, US venture capital funding was down 65% in 2001.

The performance chart on page 11 compares the performance of the Australian and US private equity markets and helps illustrate this point.

It’s personal

Private equity and you

Private equity is still new to many investors. Yet only 20 years ago most investment portfolios were bank deposits and cash. Shares were for only the most experienced investors and international shares were for, well, investors who lived overseas. Today Australia is the world’s greatest shareholding nation. So how do you know if private equity is for you?

How long is long term?

By its nature private equity is a long-term, illiquid investment. It is attractive to companies because it provides ‘patient capital’ – giving them time to develop new products, improve management or explore new markets.

The long-term nature of private equity affects how private equity funds are managed.

Unlike share fund managers, private equity managers are not compelled to invest immediately. Instead they can wait for the right opportunities and stagger their investments. MDI staff met key executives and were impressed by their focused approach to the business and excellent track record. After the initial investment, MDI worked closely with management to develop a financial and strategic plan that allowed for expansion, yet met the particular challenges of a high volume/low margin business. MDI was also closely involved in Cellnet’s initial public offering.

MDI realised some of its investment at listing. Cellnet’s first annual results as a listed company saw it significantly outstrip prospectus forecasts and MDI sold its remaining holdings at this point. The Cellnet deal generated an internal rate of return of 39% pa (pre fees) over the life of the investment.

Fund of fund private equity managers like to invest their capital at intervals through the economic cycle – roughly over five years. Investing across the cycle means that the fund can benefit from both venture capital and buyout investments – and from using managers who specialise in these areas.

Investing across the cycle also gives the underlying companies time to grow, reach attractive valuations and deliver the desired rate of return.

Funds of Funds are not compelled to invest immediately. Instead they can wait for the right opportunities and stagger their investments over time. As managers are looking to exit their investment over 4-5 year periods this staggered entry also leads to staggered exits – and means that funds are realising investments across the cycle.

Macquarie Direct Investment Ltd and Cellnet

Cellnet was a private company that specialised in the distribution of cellular/mobile telephone accessories through customers such as Telstra T Shops, Optus World and Harvey Norman. The company was a market leader, enjoyed excellent relationships with its customers and had a history of strong growth funded entirely from cashflow.

In the mid-90s the principals of Cellnet began to look at leveraging their business model to distribute handsets. With the cellular/mobile phone industry growing at around 30% annually, Cellnet began to explore options to fund this expansion. MDI was asked to fund this plan.

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That’s crucial because market conditions affect whether it’s a good time to be buying or selling. Overheated tech valuations meant late 1999 was a good time to be selling your stake in a technology company – but not to be buying. By contrast, early 2003 could be a window of opportunity for technology investors – valuations are low and technology spending shows signs of recovery. Yet it is not a good time to be selling.

Financial planners suggest that private equity investors need a minimum time frame of 7-10 years and need to understand that the private equity part of their portfolio is likely to be inaccessible for some years.

Do you need income?  
Private equity tends to generate capital gains but not much income. While private equity funds sell assets over the life of the fund, most of their return is generated at the end of the investment period as the majority of their assets mature. Investors who need regular income are unlikely to benefit from private equity.

Are you experienced?  
Private equity investing is complex and can involve a significant risk of loss of capital – so it is more suitable for experienced investors. Your level of experience can guide the way in which you access private equity, either through a direct investment with a fund manager or by using the experience and expertise of a fund manager.

Private equity – its place in your portfolio

What percentage of your portfolio should be allocated to private equity? That depends on your goals, age, risk profile and the shape of your existing portfolio. However, many investment experts now argue that private equity should be an important part of the investment portfolio of true long-term investors.

Asset consultant Watson Wyatt recently went on record urging large Australian super funds to invest more of their capital in illiquid investments such as private equity. Typically US and UK pension funds have between 10% and 15% of their funds allocated to private equity, while most Australian funds have closer to 5%.

The expert view is that private equity pays investors an illiquidity premium – an extra return in exchange for the loss of access to their money. This illiquidity premium could be worth an additional 0.5% to 2% return per annum.

Moving ahead

Established in 1892, Wridgways is the world’s first and only publicly listed removals and storage company. It specialises in corporate and personal relocations and the manufacture of household and commercial furniture.

The company has been owned by both Ansett and TNT but it was a management buyout that saw the company forging its unique place in the market.

In 1997 a private equity manager provided $7 million in financing to the management team in a deal that mixed a $5.6 million loan and $1.1 million in equity.

Two years later the company was listed on the Australian Stock Exchange and delivered an 81% pa (pre-fee) return to investors including the Macquarie Alternative Investment Trust. As is sometimes the case with management buyouts of mature companies with healthy cash-flow, the Wridgways investment also generated some interest returns for investors (via the loan arrangement) and saw some early repayment of capital.

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Scar tissue

The risks. An experienced private equity manager has ‘scar tissue’ if they’ve learnt from their mistakes.

Fund of fund managers look for managers with scar tissue – those who’ve invested through an economic cycle, learned to pick companies, who can add value and know when and how to leave the table.

In private equity the risk you take is that the underlying companies will fail – whether because of bad economic conditions, product failure, poor management or competitive pressure. A company’s failure puts your capital at risk.

How do you minimise that risk?

The first step in managing any risk is to limit the size of your investment. Your financial planner can help you decide on an appropriate private equity exposure given your age, investment experience and financial situation.

The next risk management step is diversification – and there are a number of ways to diversify:

- **By company** – by diversifying across a number of companies you reduce the risk of capital loss if one company fails.
- **By type** – you reduce your risk if you invest in a range of companies that are in different industries and regions and at different stages in their life-cycle.

An individual investor can enjoy both these levels of diversification by investing in a managed private equity fund.

You can gain further diversification by using a range of private equity managers. Each manager has their own style, expertise and approach to managing their portfolio.

Using a fund of funds product can also increase your diversification and reduce your risk. A fund of funds vehicle gives you diversification across all three levels mentioned above.

Buy in, buy out, by whom?

The importance of management. Private equity investing places a premium on having a personal stake – a financial commitment to the success of the investment.

Entrepreneurs who have much of their wealth tied up in their business have this personal stake – so do executives who buy part of a company via a leveraged or management buyout.

Unlike sharemarket or fixed interest investing, private equity returns are not tied to the performance of a market or index – most of the return is generated by the manager’s skill in selecting, directing and then exiting their companies.

Another crucial difference between sharemarket and private equity investing is that a private equity fund pools some or all of the investor capital upfront. It then spreads its investments over time as opportunities arise. This means you don’t know where your capital will be used when you invest it.

As a result, manager selection is crucial. The chart below illustrates the outperformance that a quality manager can generate.

Source: Venture Economics. All funds from 1986 - 1999 (local currency)
Superior managers have proven strengths in three key areas

Selecting
Managers need to have the contacts and the capital to attract quality investment propositions and the experience and judgement to choose the right ones. They need the negotiation and financial skills to structure the investment. Most importantly, they must have the ability to make a deal at the right price that provides incentive for the business owner and maximises the potential return to the fund.

Directing
The success of many private companies is a result of the advice they get from their private equity partner. In exchange for their expertise and their capital, private equity managers will generally seek board seats and some kind of management veto, termination or control agreement to protect their investment.

Exiting
Successful private equity managers are skilled in developing a long-term exit strategy that generates the desired return. They need highly developed financial and business skills to time, price and arrange the exit – whether it’s via a sharemarket listing, trade sale or buyout.

Evaluating managers
Depending on the state of the market and economic factors, specialist private equity managers will occasionally go to the retail market seeking funds. How do you assess these offerings? Firstly you need to talk to a financial adviser experienced in private equity investing. They can help you make an informed judgement. There are some obvious factors you should keep in mind.

Assessing a private equity manager requires financial expertise – and the ability to assess less tangible areas such as a manager’s management and negotiation skills and business acumen.

Private equity is a long-term game – so it’s important to find managers who have a long history in the business, a good reputation and sound capital backing. In essence you’re looking for managers who will be around in 10-12 years time.

How managers evaluate managers
John Brakey, Macquarie Funds Management’s Associate Director in charge of fund of funds private equity investment says – “Simply put, we want private equity managers who can find and buy companies at the right price; work with management to grow them – then sell them at the right time”.

To make sure the managers have the skills and experience they claim, fund of funds managers conduct their own due diligence such as meeting with the managers, going over their deals and examining the structure of their business. They also negotiate the terms of the investment to maximise investor protection.

Often the most important information comes from meetings with the owners, executives and bankers of companies the manager has financed in the past.

How to choose a fund of funds manager
When selecting a quality fund of funds manager you need to consider some of the following factors:

Stability
Does your fund of funds manager have the capital backing, size and experience to provide a true long-term investment alternative? Remember, the funds they are investing your money in could run for at least seven years – you need to be sure that the fund of funds manager you choose will be around for just as long.

Great ideas need landing gear as well as wings.
C. D. Jackson
Access
Just as a good private equity manager will have access to the best private equity deals, so a good fund of funds manager must be able to access the best managers. One of the main advantages individual investors get from using a fund of funds approach is that the manager can get them access to quality funds that may be closed to other investors. Does your fund of funds manager have the size and clout to get you that access?

Selection
A good fund of funds manager will invest with the best private equity managers. More importantly they will be able to combine different types of managers – buyout specialist and venture capitalists, biotech experts and technology gurus, managers who know industry and managers who know mining. Does your fund of funds manager have a track record of successfully combining fund types?

Macquarie Private Equity Trust (MPET)
Launched in 1999, MPET is a private equity fund with the underlying investment managed by Macquarie Direct Investment. The Trust was designed for investors with $200,000 to invest. At December 2002 it had investments in nine companies including JB Hi-Fi and Repco (Automotive Parts Group).

MPET II was launched in July 2002. Both MPET funds are now closed to new investments. A Macquarie Private Equity Trust is typically brought to market every four to five years.

Macquarie Diversified Private Equity Fund (MPDEF)

MPDEF offers investors the benefits of private equity investment with a simple and accessible structure.

MPDEF is a fund of funds product that invests in 8-12 managers. As a result it offers investors diversification across managers and manager styles and across vintage, life-cycle, region and industry in the underlying companies.

The Fund is a tax-paid pooled superannuation trust. It is Australia’s first private equity fund designed for use by complying superannuation funds on wrap and master trust platforms. Self-managed super investors can also invest directly in the Fund (subject to a minimum investment of $20,000).

The Fund is illiquid until the end of year seven, when investors can access their investment if there is liquidity in the Fund. After year seven, investors have annual access to their capital (subject to liquidity in the Fund).

Fashionable returns
Founded in 1992 by Sam Moss, Gary Perlstein and Ian Miller (former Managing Director of Katies) the Miller Group today runs more than 900 clothing stores, mostly in the value end of the business. The group includes Miller’s Fashion Club, Crossroads, Katies, 1626, Go-Lo, Chicken Feed and Crazy Prices.

In 1995 the company attracted private equity funding from one of the Macquarie Investment Trust’s fund managers and began the rapid expansion that has characterised this business. The manager invested $4 million in equity funding and in return received a 35% share of the company. In 1995 Miller’s was generating sales of about $23 million.

Later in 1995 Miller’s sought additional funding and quadrupled the stores under its control - from 44 to around 180. This move enabled the company to increase turnover to around $90 million a year and set the company up for further expansion which included the acquisition of Katies in November 2000.

The private equity manager sold much of its Miller holding in late 1997 (prior to Miller’s listing in 1998) and sold the balance of its holding in 1999 for a total return of just under $10 million. Overall the private equity manager made a 40% (pre fee) return for their investors – including the Macquarie Alternative Investment Trust.

Today Miller’s generates revenue of over $560 million (Dec 2002) and has a market capitalisation of over $400 million (March 2003).

Your way in
How to invest in private equity
As we saw on page 4 there are a number of different ways to invest in private equity – individually, with a private equity manager or range of managers, or through a fund of funds vehicle.

Traditionally, private equity was targeted at institutional investors (i.e. banks, managed funds and super funds) or at very wealthy individuals. However, private equity is rapidly becoming an option for smaller individual investors.

Macquarie Private Equity Trust and Macquarie Private Equity Trust II are offered by Macquarie Investment Management Limited (MIML) ABN 66 002 867 003, the responsible entity of the Trust.

The Macquarie Private Equity Trust Fund is offered by MIML ABN 66 002 867 003, the responsible entity of the Trust.
Distributions
Unlike some managed funds, private equity funds do not generate large amounts of income. However they must pay out capital gains when they are received. As a result investors receive their irregular returns – generally skewed towards the end of the fund’s life.

Calls
Share fund investors expect their capital to be invested straight away. Private equity is different – managers want to spread their investments over the life of the fund (see page 12). Consequently some private equity funds accept investment in regular instalments known as calls. Investors in the Macquarie Private Equity Trust II, invest their capital in four annual tranches of 25%.

Single use of capital
When a share fund manager books a profit on a trade, the proceeds are reinvested in the market. Within private equity funds each deal is a single use of capital – one investment in one company. Once profits on that deal are realized they must be paid to investors immediately. That’s why distributions to investors are irregular.

Valuations
Unlike shares, private equity investments cannot be valued every day on a highly liquid market – especially when they are in a high-growth phase. So while managers can make informed estimates, the value of a private company can often be set by the market only when it comes up for sale.

Macquarie Bank is an Australian listed company specialising in investment banking and financial services. The company employs more than 4700 staff in Australia and overseas and manages assets worth $47 billion.

Macquarie Direct Investment Ltd has been involved in private equity since 1982 – making it one of Australia’s most experienced private equity investors. Over the past 20 years MDI has provided private equity finance for companies as diverse as National Textiles, Millers Self Storage, Sabco Australia, The Reject Shop and Hermes Precisa Australia.

Through products such as the Macquarie Private Equity Trusts and the Macquarie Diversified Private Equity Fund, Macquarie Investment Management Limited has been a leader in bringing both single manager and fund of funds private equity to Australian investors.

To date, MDI has managed committed capital of approximately $570 million, investing in 41 companies. Macquarie Investment Management’s fund of funds products have committed more than $200 million to private equity managers since 1996.

Investments in the Macquarie Private Equity Funds are not deposits with or other liabilities of Macquarie Bank Limited ABN 46 008 583 542 or of any Macquarie Bank Group Company, and are subject to investment risk, including possible delays in repayment and loss of income and principal invested. Neither MMIL, MDI nor any member of the Macquarie Bank Group, including Macquarie Bank Limited, guarantee the performance of any Fund or the repayment of capital of any Fund.