



Global private assets strategy

Investment update to 30 September 2019¹

MLC gives investors access to private assets (also known as private equity) all around the world. Private assets are investments that aren't traded on listed exchanges and involve buying shares in private companies.

The strategy is managed by MLC's Private Equity team, which uses a combined multi-manager and co-investment approach to investing. This means they invest into a range of external private equity fund managers, as well as alongside these managers, investing directly into some of their most attractive private companies. MLC has managed the private assets strategy through different market conditions, since 1997.

The following multi-asset portfolios invest in MLC's global private assets strategy:

- MLC Horizon portfolios (MLC MasterKey superannuation and pension products)
- MLC Inflation Plus portfolios (MLC MasterKey superannuation and pension products), and
- MySuper in MLC MasterKey Business Super.

Each fund's allocation to global private assets is shown in Table 1.

Table 1: Target allocations to global private assets as at 30 September 2019

MLC MasterKey superannuation and pension products	% of portfolio invested in global private assets
MLC Horizon 2 Capital Stable Portfolio	2
MLC Horizon 3 Conservative Growth Portfolio	4
MLC Horizon 4 Balanced Portfolio	6
MLC Horizon 5 Growth Portfolio	6
MLC Horizon 6 Share Portfolio	7
MLC Horizon 7 Accelerated Growth Portfolio	8
MLC Inflation Plus Conservative Portfolio	2
MLC Inflation Plus Moderate Portfolio	4
MLC Inflation Plus Assertive Portfolio	7
MySuper Conservative Growth Portfolio	4
MySuper Growth Portfolio	4.5

Source: MLC Asset Management Services Limited. Based on the portfolios' target allocations.

An explanation of how fees are deducted from returns is in Appendix 1.

This investment update provides performance, exposures and commentary for the private assets strategy used in the MLC Horizon portfolios and MLC Inflation Plus Assertive portfolio in MLC MasterKey superannuation products. This strategy has been in place since 1997.

What are private assets?

Private assets involve the purchase of securities in private companies. Companies may be:

- businesses – at any stage of the business lifecycle, from start-ups to mature businesses – that are able to benefit from the infusion of capital or expertise to grow, merge or restructure, and
- public companies which are taken private by private equity firms.

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Many of these investments can't be accessed directly by investors because they are often open only to select institutions or because the average investor simply doesn't have the amount of money or expertise needed to invest directly in them.

While there's no denying private equity is a risky asset class, its benefits are well known and widely proven. When managed well, it can provide excellent diversification and return potential for investors because returns aren't directly linked with the performance of listed global shares or fixed income.

A good way of looking at the private equity investment universe is by breaking it into four categories: venture capital, growth, buy-outs, and rescue/turn-arounds/distressed companies. This is illustrated in Chart 1.

Chart 1: The private equity investment spectrum



Source: MLC Asset Management Services Limited. These companies have been chosen for illustrative purposes only. MLC may not invest in any of these companies.

Venture capital

These are companies in their early stages – they're looking for seed capital and they're in the start-up phase. You're investing in an idea or a business plan, for example, the early days of Mark Zuckerberg demonstrating his first prototype of Facebook, with a few parties willing to invest and provide advice to help the company expand and grow.

It's an exciting investment category with lots of buzz, especially in places like Silicon Valley. But while the potential rewards can be huge, it's important to remember it's very easy to lose out. Harvard Business School lecturer Shikhar Ghosh's research indicates that as many as 75% of venture-backed companies fail.²

Growth

Growth investing is similar to venture capital, but it's investing at a later stage. The company will tend to have revenue streams and profits, but needs finance to help grow further.

With both venture capital and growth investments, you tend to take a minority stake in the business. An important role of private equity managers is to provide advice and guidance to help the company grow, navigate new markets or create new product lines. The best managers tend to be entrepreneurs themselves; they're people who accept failure, understand risk, and want to be alongside the company for the ride and help them make good decisions. For example, private equity managers including Silver Lake Partners and General Atlantic helped founder Jack Ma grow Alibaba into one of the largest e-commerce companies globally and guided the company to a successful US initial public offering (IPO).

Buy-outs

Unlike venture capital and growth, with buy-outs investments are in a controlling stake of the company. The private equity fund managers will run the business plan. They'll usually have an idea about how they can optimise the business and make back a

² Why Companies Fail - and How Their Founders Can Bounce Back: <http://hbswk.hbs.edu/item/why-companies-failand-how-their-founders-can-bounce-back>, as at 16 May 2016.

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significant return on their investment in a short period of time (three to five years). These managers will tend to use debt and leverage to optimise the business and capital structure. For example, Australian buy-out manager Pacific Equity Partners acquired cinema group Hoyts. They transformed the business through fully digitising the cinema network, entering out-of-home advertising and expanding into adjacent vertical businesses, such as Hoyts DVD kiosks and streaming, before exiting the buy-out by successfully selling Hoyts to another company in the industry.

Rescues or turn-arounds

These are investments in a failing company or a complex transaction that a regular investor would avoid. The private equity fund manager often needs to take control, roll-up their sleeves and really help the company transform. Like venture capital, the potential loss rates are high. There are only a handful of private equity fund managers who have proven they can invest successfully in this field. For example, TPG acquired power generation company Alinta in 2010 in the largest debt-for-control restructuring in the Australian market at the time. They recruited a new CEO from AGL Energy and successfully completed the operational turnaround of the company in conjunction with their in-house operations team. However, these are also the types of transactions which tend to hit the headlines when things go badly, eg Dick Smith Electronics.

How are returns generated?

Private assets' returns are based on valuations of the companies, returns of capital from the private equity managers, and realisation of the investment when the remaining capital (and profit) is paid to investors.

Valuing private companies is difficult and, unlike listed companies, it isn't done frequently. As a result, valuations of private equity investments may involve a considerable time lag.

We usually expect to realise the final return on our investments after a period of at least three to seven years, when we exit from the private company and the remaining investment capital and profit is returned to our funds. When we're considering making private equity investments, potential exit strategies is one of the aspects we research carefully, as we aim to maximise the return for investors in MLC funds.

Common strategies for exiting private equity investments are:

- **Initial public offering** – the private equity manager floats or lists the company on the share market.
- **Trade sale** – the private equity manager sells its shares in a company to a trade buyer that operates in the same industry as the company.
- **Secondary buy-out** – the private equity manager sells the company to another private equity manager.
- **Leveraged recapitalisation** – the company borrows funds to pay out equity in the company to the private equity investor ie substitutes some of the company's equity with debt.

Investment objectives

The private assets strategy aims to provide MLC's multi-asset portfolios with:

- outperformance of the global listed share market over seven year periods
- consistent returns through normal economic cycles, and
- preservation of capital through abnormal events (eg the GFC).

Since most private equity investment opportunities lie outside Australia, the strategy seeks to access the benefits of the greater range and quality of opportunities available in the global market. While return, rather than diversification, is the primary driver of MLC's private assets portfolio construction, the outcome is a very well diversified strategy - one that is diversified by managers and regions and across the spectrum of private equity investments.

Performance

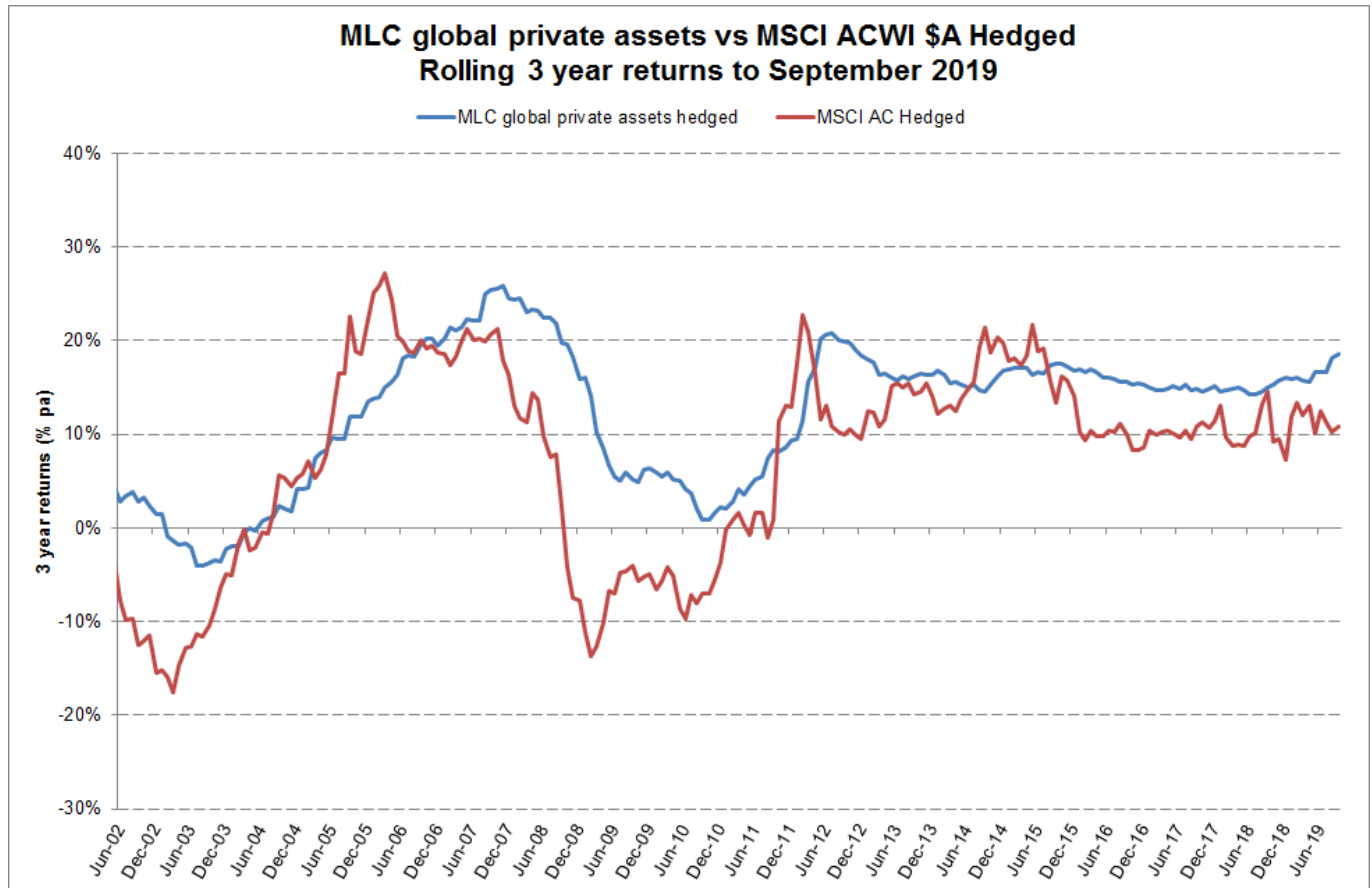
Chart 2 demonstrates the performance of the private assets strategy (hedged to the Australian dollar) compared to the performance of the listed global share market (hedged to the Australian dollar). It shows that it is a particularly helpful strategy in weak share markets. For example, private assets provided a significant cushion to performance during the GFC. It continued to offer returns significantly higher than listed markets for nearly five years, until the rally in global shares, as private assets may

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underperform listed markets if share markets are rising strongly. Chart 2 also shows significant swings in returns from private assets, and their returns tend to have a time lag behind listed share markets.

Chart 2: Rolling three year returns compared to global share markets to 30 September 2019

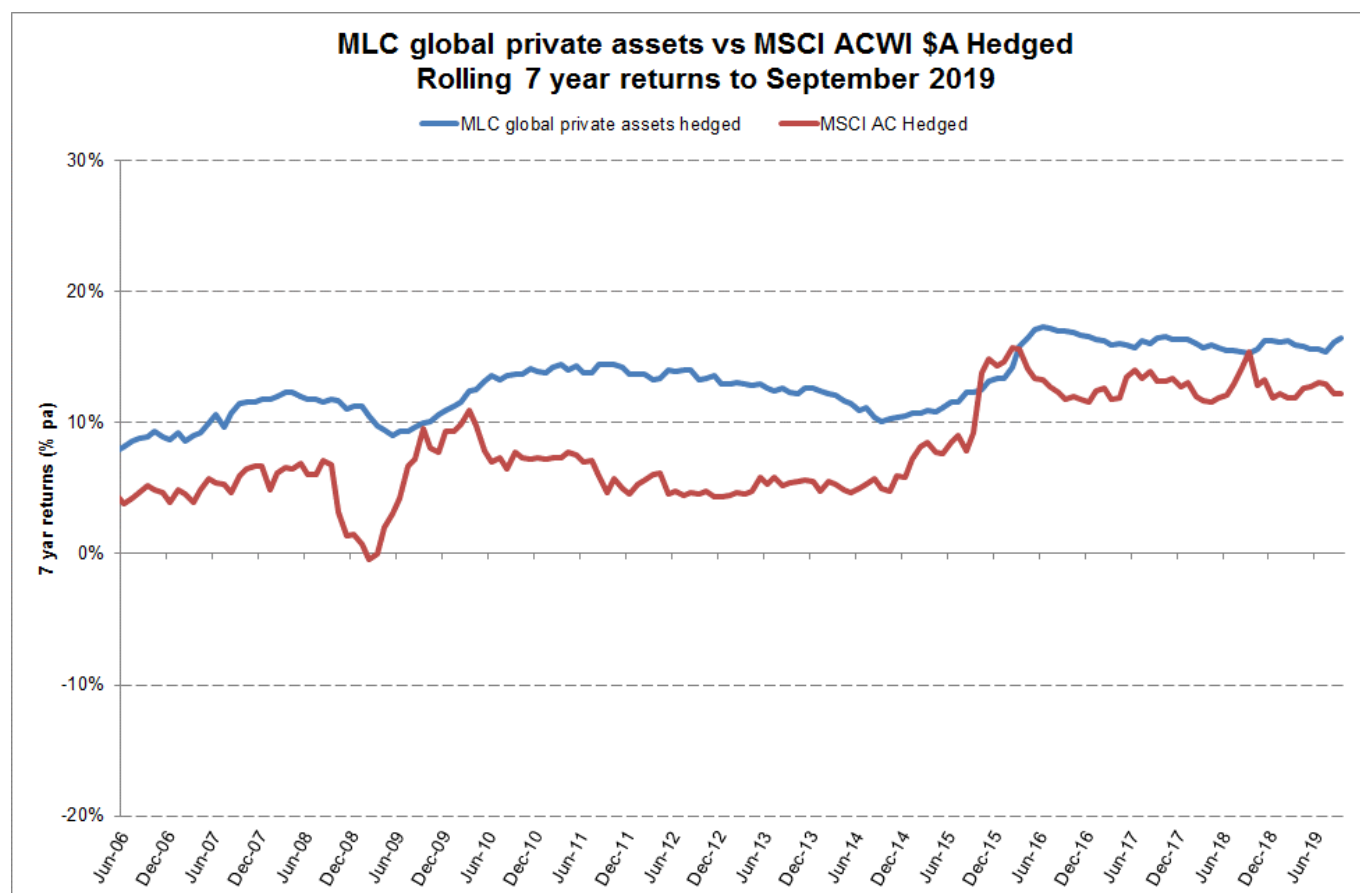


Source: MLC Asset Management Services Limited. Private asset returns are net of indirect costs³. Past performance is not a reliable indicator of future performance.

Chart 3 and Table 2 demonstrates the success of MLC's private assets strategy in meeting its seven-year outperformance objective. The strategy has generally provided substantial benefits to our multi-asset portfolios, even after taking into account the costs involved in investing in private assets.

³ Indirect costs are incurred when a portfolio invests in external investment funds. They aren't additional fees retained by MLC. Indirect costs are in addition to investment fees and are reflected in the unit price of the multi-asset portfolios.

Chart 3: Rolling seven year returns compared to its objective to 30 September 2019



Source: MLC Asset Management Services Limited. Private asset returns are net of indirect costs. Past performance is not a reliable indicator of future performance.

Table 2: Returns to 30 September 2019 (before fees and tax)

	1 year %	2 years % pa	3 years % pa	5 years % pa	7 years %pa	10 years %pa	15 years %pa
MLC global private assets strategy (hedged)	17.7	18.2	18.7	16.2	16.5	17.5	15.1
MSCI All Country World Index (hedged)	1.7	6.5	10.9	9.1	12.2	11.5	9.3
Excess return	16.0	11.7	7.8	7.1	4.3	6.0	5.8

Source: MLC Asset Management Services Limited. Private asset returns are net of indirect costs. Past performance is not a reliable indicator of future performance. The value of an investment may rise or fall with the changes in the market. Figures are rounded to one decimal place.

MLC's global private assets strategy aims to identify and access the best private equity funds globally. As these investments require MLC to invest in external funds, indirect costs are incurred. However, even after taking into account the higher costs involved with these investments, the long-term excess return from MLC's private assets strategy has far exceeded that of listed share markets.

The strategy won't always achieve its objective of outperforming listed share markets over seven year periods. Most of our investments in private assets have a very long tenure and even over a period as long as seven years, conditions for private equity may not be as favourable as those for listed markets.

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Portfolio diversification

This unique strategy is diversified over buy-out, venture capital, growth and distressed sub-sectors, investing in both specialist managers and co-investments. Chart 4 provides more detail on the portfolio exposures.

Chart 4: Regional exposures and investments across the private assets spectrum as at 30 September 2019



Source: MLC Asset Management Services Limited, based on net asset value and undrawn commitments, excluding fund of fund investments.

Notes: We haven't provided the names of the private equity funds and investments as private assets aren't listed securities, and transactions in them are infrequent compared with listed investments. Contractual terms for private assets normally prohibit investors, such as MLC, from disclosing any information relating to the private assets or any transactions in relation to them.

Private equity market activity

The private equity markets in which the strategy operates continues to pick up pace, despite ongoing US-China trade tensions and an impending Brexit.

Total fundraising for the quarter was USD163bn, greatly surpassing the USD109bn raised in the June 2019 quarter. North America did much of the heavy lifting, securing USD106bn in commitments. Fundraising in Asia rebounded from a lull in the first half of 2019 raising USD40bn, surpassing USD38bn raised collectively in the March and June 2019 quarters. In contrast, Europe-focused funds raised a modest USD14bn, down from USD21bn in the June 2019 quarter. During the September quarter, the Blackstone Group closed the largest ever private equity fund, the New York-headquartered firm collected USD26bn for Blackstone Capital Partners VIII.

After a strong showing in 2018, global buyout momentum slowed in the opening quarters of 2019 amid challenging economic and geopolitical conditions. However, buyout deals have rebounded in the September 2019 quarter in terms of value; 1,157 transactions worth a combined USD86bn were made globally. This was primarily driven by an uptick in activity in North America and Europe. In contrast, Asia-based deals experienced a 48% fall in value from USD11bn to USD5.8bn.

Deal-making is not the only challenge facing managers, as buyout exits have also seen an appreciable drop in value and volume this year. There were 408 exits made in the September 2019 quarter for a total of USD74bn, down from USD133bn in the June 2019 quarter. The proportions of IPO and follow-on and restructuring exits have both followed a downward trend over the last few years, while sale-to-general partner (GP) exits have increased from 28% in the September 2014 quarter to 40% in the September 2019 quarter.

BC Partners was involved in two of the biggest buyout deals completed in the quarter. In July, BC Partners agreed to buy a majority stake in Garda World Security, a Montreal-based security services company from Rhone Capital for USD5.2bn. In August, the firm signed an agreement to acquire a co-control stake in Advanced Computer Software alongside Vista Equity Partners, the current owner, for a headline price of GBP2bn.

After a record-breaking June 2018 quarter, venture capital deal activity has declined in every quarter since. The September 2019 quarter saw no respite from this, recording a total of 3,269 deals worth a combined USD52bn. This compares with 4,288 deals for an aggregate USD70bn in the September 2018 quarter.



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As of October 2019, there are 3,637 funds seeking an aggregate USD751bn, compared with 3,749 funds targeting USD972bn in January 2019. The size of this decrease indicates that the fundraising market remains highly competitive. Notably, 2,111 vehicles currently in market have held at least an interim close, securing USD239bn in total commitments so far. While venture capital funds constitute the highest number of funds (2,195) in market, buyout funds are targeting the most capital (USD308bn).

Portfolio activity for the quarter

During the quarter, MLC made two new commitments, comprising:

- one new fund commitment of to a UK lower middle market buyout manager, and
- one new co-investment to an Australian lower middle market buyout manger.

Appendix 1: Understanding fees that are deducted from returns in this investment update

As MLC Horizon and Inflation Plus portfolios invest in the global private assets strategy and a range of other asset classes and strategies, only some of the fees disclosed in the Product Disclosure Statements (PDSs) relate directly to the management of the global private assets strategy. Therefore, the global private assets strategy's performance is reported before deducting most of the fees and taxes disclosed in the PDSs.

Important information

This investment update provides performance, exposures and commentary for the private assets strategy used in the MLC Horizon portfolios and MLC Inflation Plus Assertive portfolio in MLC MasterKey superannuation products.

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