Global private equity

Investment update to 30 June 2023[1]

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

The exposure 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 private equity through different market conditions, since 1997.

MLC's multi-asset portfolio target allocations to global private equity, managed by MLC's Private Equity team are shown in Table 1.

Table 1: Target allocations to global private equity as at 30 June 2023

MLC MasterKey Super & Pension Fundamentals / MySuper	% of portfolio invested in global private equity	MLC Wholesale	% of portfolio invested in global private equity
MLC Conservative Balanced Portfolio	4.0	MLC Wholesale Horizon 2 Income Portfolio	1.5
MLC Balanced Portfolio	5.0	MLC Wholesale Horizon 3 Conservative Growth Portfolio	2.5
MLC Growth Portfolio	5.0	MLC Wholesale Horizon 4 Balanced Portfolio	4.0
MLC High Growth Portfolio	6.0	MLC Wholesale Horizon 5 Growth Portfolio	4.0
MLC Aggressive Portfolio	7.0	MLC Wholesale Horizon 6 Share Portfolio	4.5
MLC Flexible Moderate Portfolio	4.0	MLC Wholesale Horizon 7 Accelerated Growth Portfolio	5.0
MLC Flexible Assertive Portfolio	7.0	MLC Wholesale Inflation Plus Moderate Portfolio	2.0
MySuper Conservative Growth Portfolio	4.0	MLC Wholesale Inflation Plus Assertive Portfolio	2.0
MySuper Growth Portfolio	5.0		

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.

What is private equity?

Private equity involves 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.

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.

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.

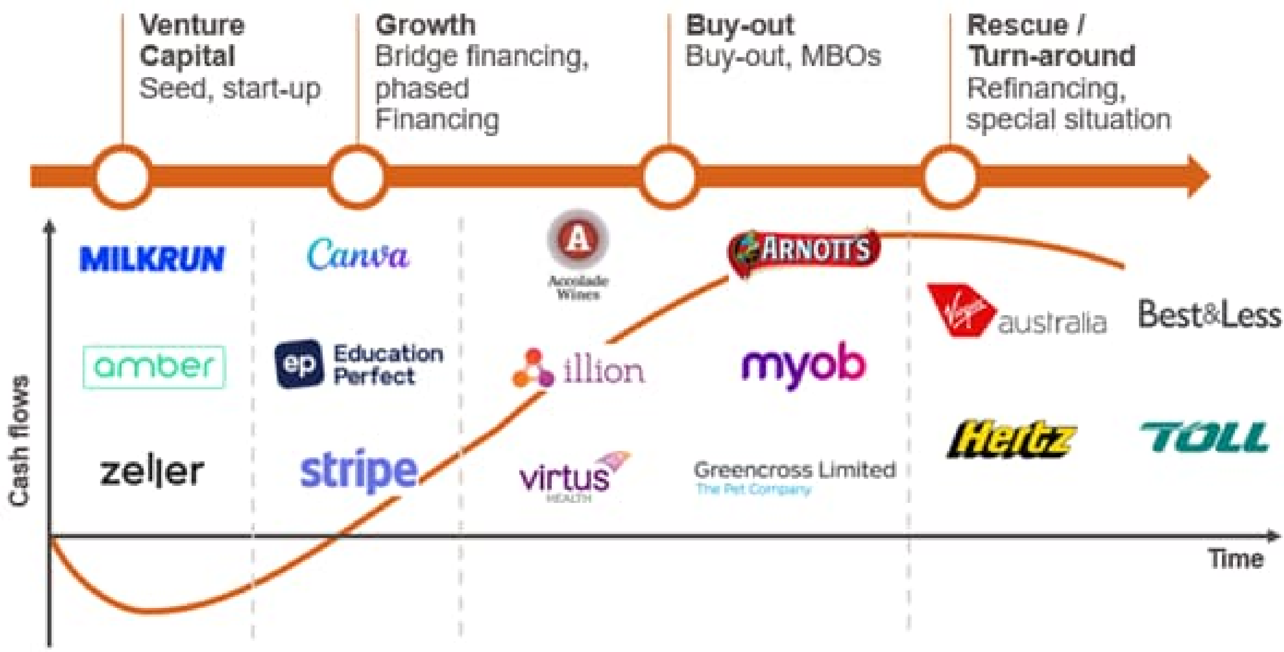
It's an exciting investment category with lots of buzz, especially in places like Silicon Valley. But while the potential rewards can be huge, it's important to remember it's very easy to lose out. The '2022 Preqin Global Venture Capital Report' shows this volatility of returns, with early-stage venture capital nearing double the volatility of non-venture capital private equity.

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.

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.

As an example, the Australian based Five V Capital invested in Education Perfect, a provider of digital teaching and learning toolkits for schools, in 2017 for an undisclosed amount. Five V supported the ongoing growth of the business as it doubled its number of employees, grew revenue >400% and grew earnings 600%. Kohlberg Kravis Roberts & Co (KKR) subsequently took a majority stake in Education Perfect in June 2021. [2, 3]

Buy-outs

Unlike venture capital and growth investments, with buy-out investments private equity funds typically acquire a controlling stake in a company and are in a position to shape a company's business plan and strategy through Board and management appointments. They'll usually have an idea about how they can optimise the business and make back a significant return on their investment in a relatively 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, buy-out manager TPG Capital acquired Australia's largest pet care company, Greencross, in a public-to-private for $970m in 2019. Since then, operational improvements have been made including growing Greencross' company-owned product range and investing in new IT systems. The business also benefited from the pandemic tailwinds of increased pet ownership and pet spend. In 2022, Greencross was valued at $3.5b, with a 45% stake being sold to external pension fund investors. [4, 5, 6]

Rescues or turn-arounds

These are investments in a failing company and/or involve 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, Australian turn-around specialist Allegro Funds acquired the indebted retailer of clothing and household linens Best & Less Group in late 2019. Best & Less was seen as having a tired brand and needing a revamp, with Allegro refocusing the business on kids and babies clothing before listing it on the ASX in 2021 with a market capitalisation of $271m. [7, 8, 9]

How are returns generated?

Private equity returns are based on valuations of the companies, return 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 daily but typically on a quarterly basis. 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 equity strategy (in MLC MasterKey superannuation and pension products) aims to provide MLC's multi-asset portfolios with:

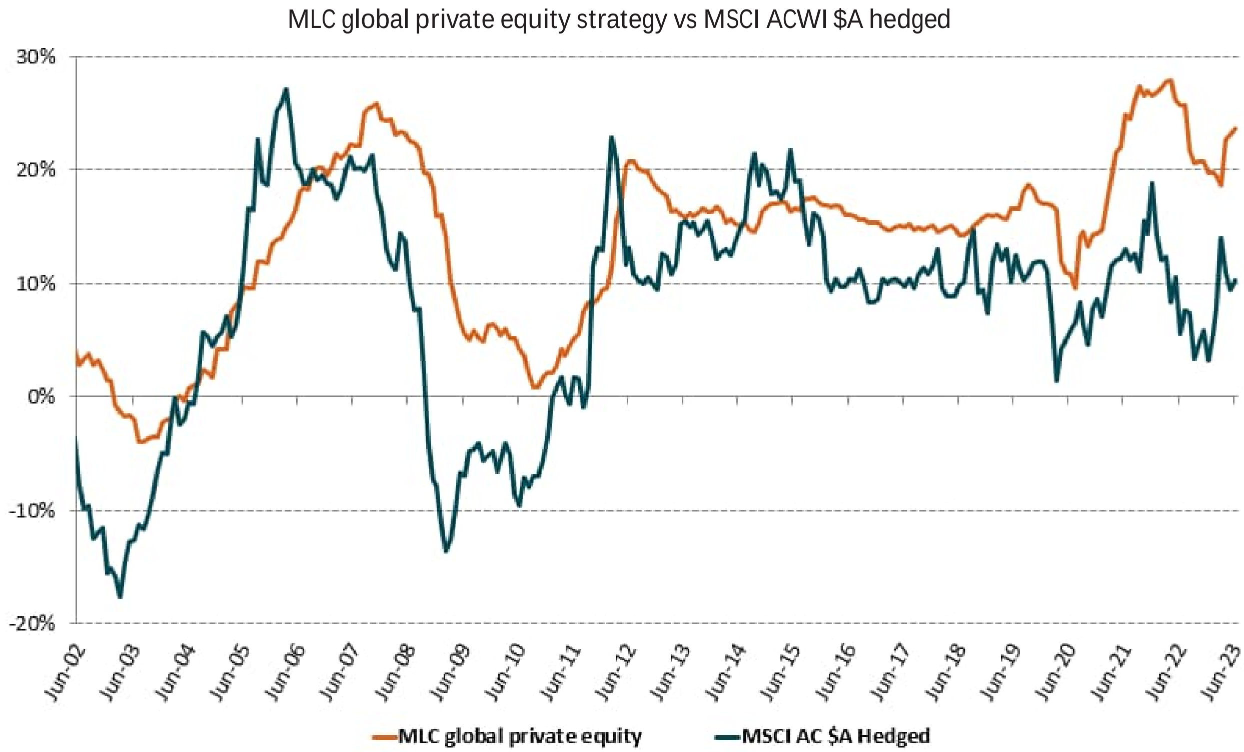
- outperformance of the global listed share market over longer term periods,
- consistent returns through normal economic cycles, and
- preservation of capital through abnormal events (eg the GFC).

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 equities 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.

Global private equity performance in MLC MasterKey superannuation and pension products

Chart 2 demonstrates the performance of the private equity strategy (hedged to the Australian dollar) in MLC MasterKey superannuation and pension products 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 equity 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 equity may underperform listed markets if share markets are rising strongly. Similarly, over the March 2020 quarter where global share markets experienced extreme volatility due to the COVID-19 pandemic, the strategy outperformed. Chart 2 also shows significant swings in returns from private equity, 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 June 2023



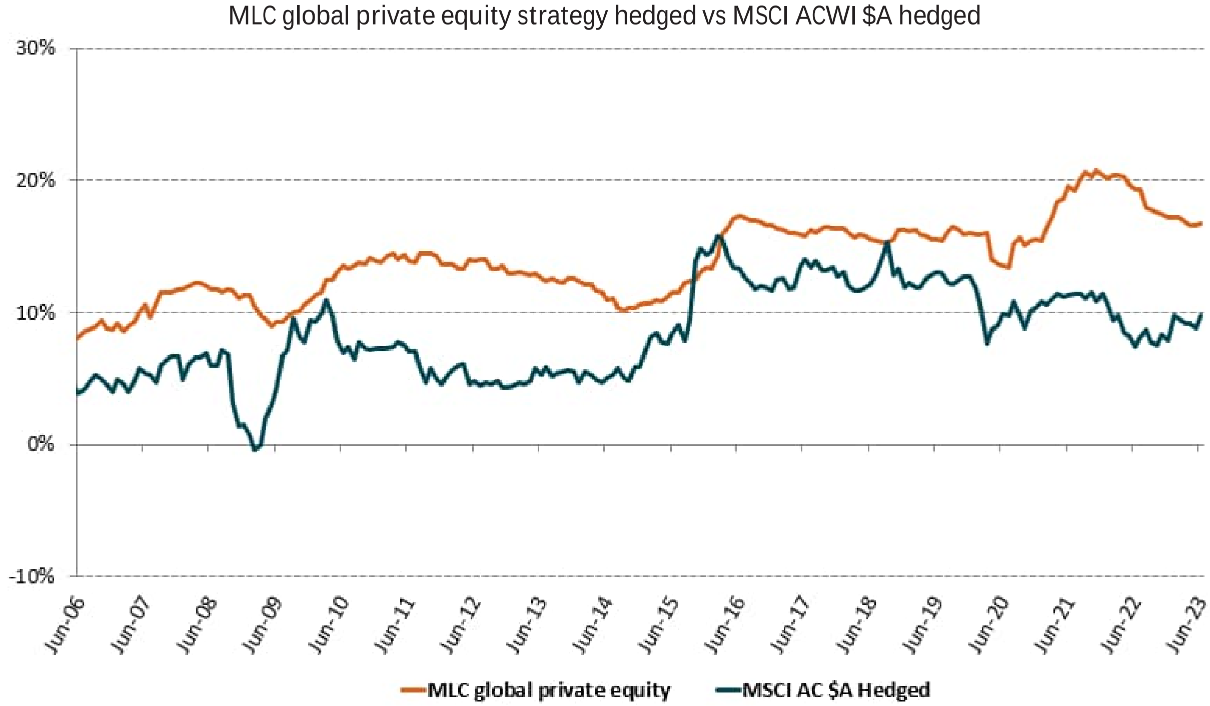
Source: MLC Asset Management Services Limited. Private equity returns are for the MLC MasterKey superannuation and pension products and are net of indirect costs.[10] Past performance is not a reliable indicator of future performance.

Chart 3 and Table 2 demonstrate the success of MLC's private equity strategy in MLC MasterKey superannuation and pension products in meeting its long term 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 equities.

MLC 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 equity strategy has exceeded that of listed share markets.

The strategies won't always achieve their objective of outperforming listed share markets over longer term periods. Most of our investments in private equity have a very long tenure and even over longer time periods (such as seven years), conditions for private equity may not be as favourable as those for listed markets.

Chart 3: Rolling seven year returns compared to its objective to 30 June 2023



Source: MLC Asset Management Services Limited. Private equity returns are for the MLC MasterKey superannuation and pension products and are net of indirect costs.[10] Past performance is not a reliable indicator of future performance.

Table 2: MLC MasterKey superannuation and pension products, private equity strategy returns to 30 June 2023 (before fees and tax)

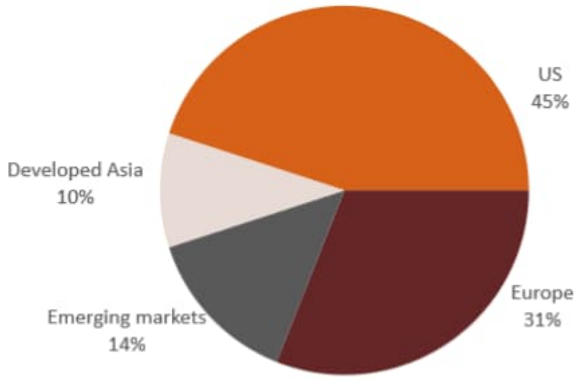
	1 year %	3 years % pa	5 years % pa	7 years % pa	10 years % pa	15 years %pa
MLC global private equity strategy (hedged)	-6.5	23.7	16.7	16.7	16.5	13.8
MSCI All Country World Index (hedged)	14.6	10.2	7.4	9.8	10.0	8.4
Excess return	-21.1	13.5	9.3	6.9	6.5	5.4

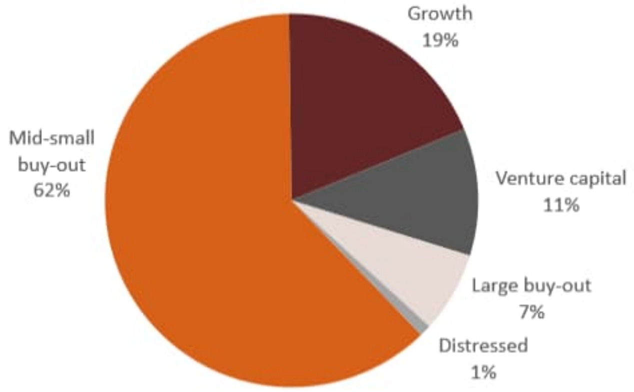
Source: MLC Asset Management Services Limited. Private equity returns are for the MLC MasterKey superannuation and pension products and are net of indirect costs[10]. Past performance is not a reliable indicator of future performance. The value of an investment may rise or fall with the changes in the market. Figures are rounded to one decimal place.

Global private equity diversification in MLC MasterKey superannuation and pension products

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: MLC MasterKey superannuation and pension products. Regional exposures and investments across the private equity spectrum at 30 June 2023





Source: MLC Asset Management Pty 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 equities aren't listed securities, and transactions in them are infrequent compared with listed investments. Contractual terms for private equity normally prohibits investors, such as MLC, from disclosing any information relating to the private equity or any transactions in relation to them.

Global private equity activity in MLC MasterKey superannuation and pension products

MLC made two fund commitments and four new co-investments, with those investments being in:

- a European private equity firm headquartered in London, targeting mid-sized businesses in Western Europe, particularly the UK and Benelux markets. Target businesses are characterised by robust business models, positive sector backdrop, track record of growth, strategic competitive positioning, and clear value creation opportunity.
- a value-oriented private equity manager targeting lower mid-market buyout opportunities in Australia and New Zealand. The firm is generalist in nature, and the historical portfolio composition has included a combination of consumer, industrials, transport, and financial services companies. The firm aims to deliver its target returns to investors whilst incorporating Environmental, Social and Governance (ESG) factors into its investment decisions and management of portfolio companies.
- one of the top UK dealerships with six physical sites, a 10-acre national preparation centre, and an aftersales/ contact centre. The main customer proposition is that it operates large, high-capacity sites, creating an efficient buying experience for customers who can cross-shop different brand/models and view their preferred vehicles side-by-side in a professional showroom setting.
- a diversified aviation services platform, offering a comprehensive suite of services to commercial, cargo, and business aviation. Specifically, the business offers a critical labour management solution to airlines in a manner that is both lower cost and more flexible than an in-house solution.
- a clean-label frozen burrito and breakfast sandwich brand in North America. Products are made with high-quality, simple ingredients without artificial flavours, colours, or preservatives. Recipes are developed by an industry-leading chef and hand-built in small batches at an in-house manufacturing facility. The company is in the early stages of capturing distribution whitespace in grocery, mass, and natural channels.
- an agile coaching and consulting business with DevOps Tooling and Atlassian license resale capabilities. The company is the #1 Atlassian global partner by revenue. It has 800+ customers, with 82.0% based in the US, including marquee logos providing a strong referenceable experience.

Case study

Vibrant Foods is the leading producer and distributor of South Asian foods in the UK and continental Europe. The business produces a range of pulses, spices, flours and other Indian food ingredients which are sold under the Vibrant Food brand.

Vibrant Foods' 2021 ESG Action Plan, established reporting on Quality, Climate, Culture and Community. Vibrant's primary charity is the Felix Project, whom they have worked with since 2020. The charity's chefs and volunteers turn donations into healthy pre-packaged meals to be delivered to charities across London for individuals and families in need. In 2021, Vibrant increased their contribution to monthly deliveries for Felix's Kitchen. This included:

- 7,566kg of pulses, grains, and other veggies which formed the base of over 20,000 meals
- 847kg of spices which were used to flavour over 210,000 meals.

Note: As our investment managers are constantly reviewing and making changes to their holdings, these investments may no longer be included in the portfolio.

Recent private equity market activity

During the June quarter, the aggregate value and volume of private equity deals continued to slide when compared to the March quarter 2023. An aggregate USD134.5 billion was raised across 395 funds in the June quarter 2023 compared with USD175.3 billion across 298 funds in the March quarter 2023. This represents a material decline when compared with the USD242.6 billion raised in the June quarter 2022. Global monetary policies have tightened at an unprecedented pace since mid-2022. As the market adjusts to higher rates, the combination of a more limited financing environment and macroeconomic headwinds has resulted in subdued deal activity.

North America continued to dominate fundraising activity, accounting for 50.0% of aggregate capital raised, followed by Europe (30.0%), Asia (16.0%) and Emerging Markets (4.0%). At USD16.5 billion, TA Associates Fund XV was the largest buyout fund closed during the quarter, representing a material increase to its predecessor fund TA XIV, which closed in June 2021 at its hard cap of USD12.5 billion.

Despite prevailing uncertainty, buyout momentum continues to be strong as larger buyout managers with better access to debt financing continue to complete large deals. During the quarter, 2,132 buyout deals were completed for a combined value of USD193.0 billion, representing an increase of 24.0% in aggregate deal value when compared with the March quarter 2023, which saw 2,077 buyout deals completed, totalling USD155.6 billion.

The sharpest decline in deal volumes was in Asia, with deal volume decreasing by 34.5% to 171 deals. The drop was primarily driven by the contraction in deal activity in Greater China, which was hampered by declining growth and Sino-US tensions. North America and Europe were less pronounced, decreasing by 7.0% to 1,042 deals and by 4.8% to 572 deals, respectively.

In the June quarter 2023, there were 5,061 venture capital deals completed for a combined value of USD69.2 billion. Information Technology, Healthcare and Consumer Discretionary once again retained their top three status in deals by industry, at 45.7%, 15.2% and 14.4%, respectively. One of the largest venture deals of the quarter was the Series G round for fashion retailer Shein raising USD2.0 billion, valuing the company at USD66.0 billion.

Fundraising activity in private equity markets has remained relatively steady in the June quarter 2023. There are now 10,204 funds seeking to raise USD1,776 billion, with an average fund size of USD354 million. By strategy, venture capital accounts for 59.0% of the number of funds raising and 24.0% of aggregate target capital, while buyout represents 11.0% of the number of funds raising and 41.0% of aggregate target capital.

Footnotes

1. This investment update generally provides performance, exposures and commentary for the private equity strategy used in MLC's multi-asset portfolios in MLC MasterKey superannuation products. This strategy has been in place since 1997.
2. KKR to Invest in Leading ANZ Edtech Company Education Perfect, Business Wire, June 2021.
3. Global investor KKR takes majority stake in Education Perfect, Australian Financial Review, June 2021.
4. Greencross board agrees to $970m buyout from TPG, Business News Australia, November 2018.
5. TPG sells 45 per cent Greencross stake to pension funds in $3.5b deal, Australian Financial Review, March 2022.
6. TPG, Greencross step up deliberations on potential vets spin-off, Australian Financial Review, August 2022.
7. Best & Less Group, Allegro Funds.
8. Allegro hires Macquarie Capital for Best & Less, Australian Financial Review, November 2020.
9. Best & Less set to float with a $271.2 million market valuation, The Australian, May 2021.
10. 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.

Appendix 1: Understanding MLC MasterKey superannuation and pension products, private equity strategy fees that are deducted from returns in this investment update

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