Private equity through thick and thin

September 2020

In cricket, labelling a batsman a "flat track bully" is a well-honed put-down. It conveys a lack of regard for batsmen that rack up big scores on tame pitches, but serially underperform when conditions are not so much in their favour.

The investment world too has its share of flat track bullies, investments that grab attention, perhaps benefitting from a fad, and do well in benign conditions, but wilt when business dynamics shift.

With that context, investors may be heartened to know that private equity (PE) — assuming equity positions in privately held companies, as distinct from investing in publicly listed companies like Alphabet/Google, BHP and their counterparts — is far from being a flat track bully.

This assertion is particularly salient in the COVID-19 age. Social and economic life are unlikely to return to anything approaching normal until the availability of a vaccine that can be mass-produced and distributed widely, or there is dramatic improvement in therapeutic management of the virus.

This helps to explain why so many publicly listed companies have suspended earnings guidance and cut or cancelled dividends. Consequently, investors may be concerned by the potential for similar stresses across the private equity realm.

However, the evidence suggests that difficult economic times can help to foster strong private equity returns.

Private equity funds, specifically, "buyout" PE funds that raised capital on the heels of the dot com bust and the 2008/09 Global Financial Crisis (GFC) — to acquire controlling equity positions in already established privately-held businesses — outperformed listed share markets (**Chart 1**).

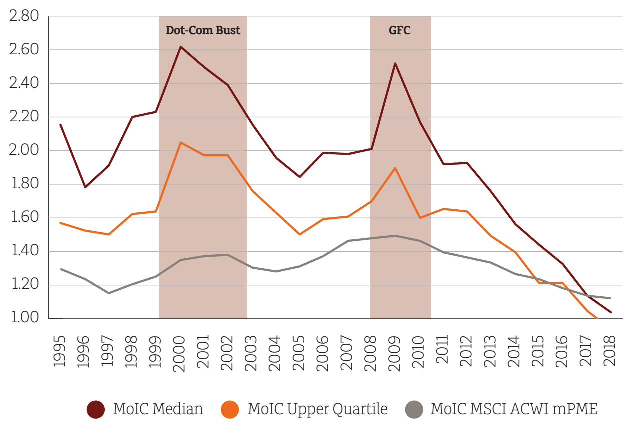
That said, the GFC seems to be a closer comparison to present conditions than the dot com bust. Both now and in the GFC, entire industries required bailouts.

In the US, banks, auto manufacturing and insurance firms benefited from government intervention. Travel, mobility and hospitality firms (amongst others) are vulnerable today and will rely on government interventions.

Moreover, fair market value accounting and mark-to-market rules (such as SFAS 157[1] in the US) were already largely in place for private equity during the 2008/09 crisis, but not yet after the bursting of the technology bubble.[2] Additionally, both in 2008 and in 2019, large buyout valuations and leverage levels were at high levels and fundraising was robust.

Chart 1: Previous economic downturns have fostered strong private equity returns

Global buyout private equity multiples of invested capital by vintage year



Source: Cambridge Associates. MoIC is the multiple of Invested Capital earned. MOIC MSCI ACWI mPME is the Modified Public Market Equivalents Multiple of Invested Capital.

The MSCI ACWI index's shares are purchased and sold according to the Private Equity Fund cash flow schedule with distributions calculated in the same proportion as the Fund.

The modified Public Market Equivalent NAV (the value of the shares held by the public equivalent) is a function of Fund cash flows and public index returns. The modified Public Market Equivalent attempts to evaluate what return would have been earned had the cash flows been deployed in the public markets instead of in private investments.

1 In September 2006, the Financial Accounting Standards Board (FASB) of the United States issued **Statement of Financial Accounting Standards 157**: Fair Value Measurements), which "defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements.".

2 Why private equity, why now? by Industry Expert, 10 July 2020. https://www.moneymanagement.com.au/features/expert-analysis/why-private-equity-why-now, Accessed. Accessed. Accessed 4 August 2020.

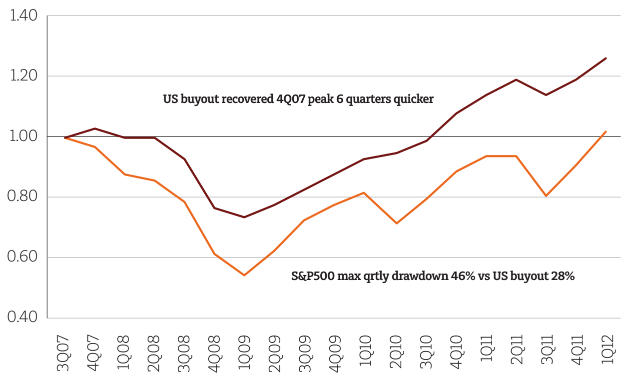
There are other ways of unpacking the issue of private equity buyout outperformance (**Chart 2**). Both US and non-US buyout funds experienced less dramatic drawdowns that their public market equivalents during the dot-com bust, the market turbulence in the aftermath of the September 11, 2001 terrorist attacks in New York, as well as the GFC.

Chart 2: US and non-US private equity buyout funds were more resilient post the dot com bust, 9/11, and GFC

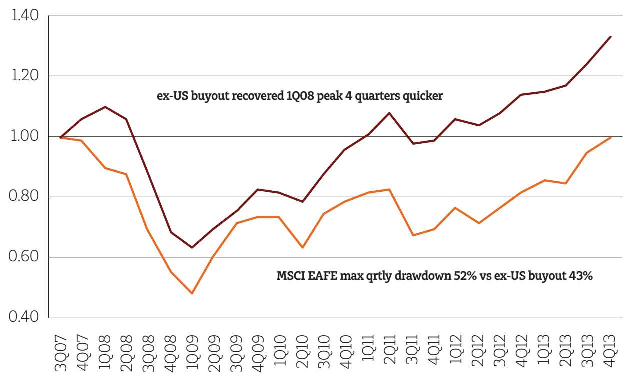
Annualised buyout performance for different regions measured against the relevant index

Global Financial Crisis and Recovery Q3 2007 = 1.00

US Buyout

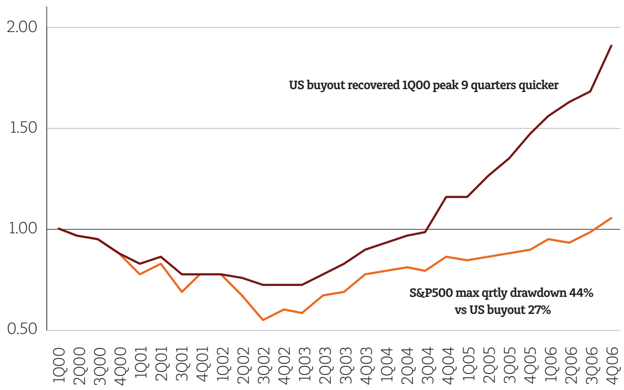


ex-US Buyout

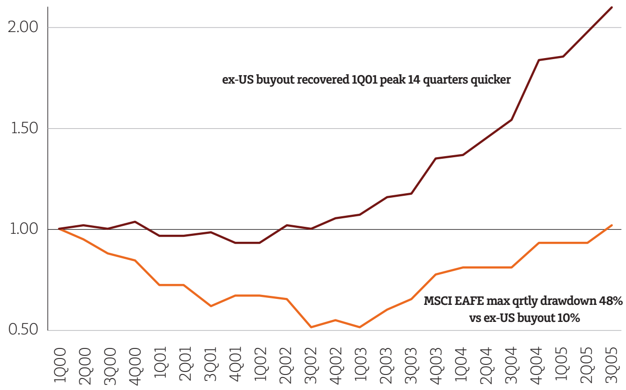


Dot-com Bust, 9/11 and Recovery Q1 2000 = 1.00

US Buyout



ex-US Buyout

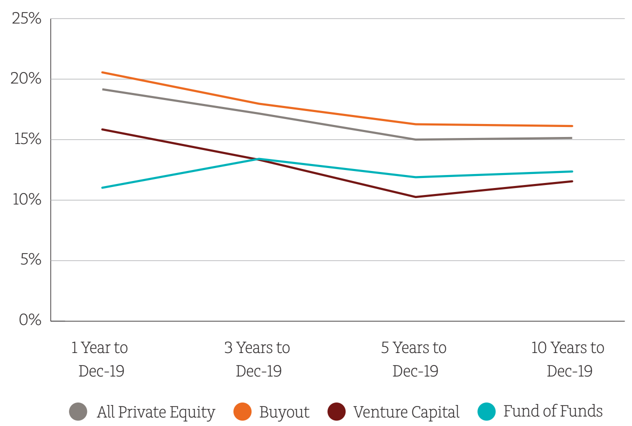


Source: Cambridge Associates, FactSet

The hardiness of buyouts helps to explain why they have on an annualised basis been the best performing private equity strategy across one-, three-, five-, and 10-year time horizons (**Chart 3**).[3] This is particularly relevant for MLC as our private equity program, including our co-investment funds, lean into the buyout segment.

Chart 3: Buyout strategies have historically outperformed other private equity strategies

Private equity internal rate of returns by fund type



Source: Preqin Pro

Early stage or venture capital investments may be more associated with excitement in their quest for the next "unicorn" like the next Google or Facebook, but that's a high risk/high return path. We believe, based on our private equity experience as well as industry evidence, that buying existing businesses and improving and growing them offers a superior risk-adjusted opportunity to the more thrilling parts of private equity.

PE helps to better align investor and manager interests

There are several explanations for private equity's performance premium relative to listed markets. To begin – owners of private companies can influence the strategic direction of investee businesses in ways not possible in public companies.

Even the largest shareholders of publicly listed companies usually only own a small proportion of a company's equity. Consequently, their capacity to influence business performance is heavily constrained.

By contrast, private business ownership is usually accompanied by board seats, the capacity to influence executive appointments and, of course, influence companies' operations to align with investor objectives.

Moreover, the investment timelines associated with private equity, usually five years plus, helps to better align investor and management interests, including by incentivising managers to improve cash flows and operational performance as laid out in business plans.

This contrasts with listed company managers tethered to the demands of the quarterly reporting cycle and daily share price movements.

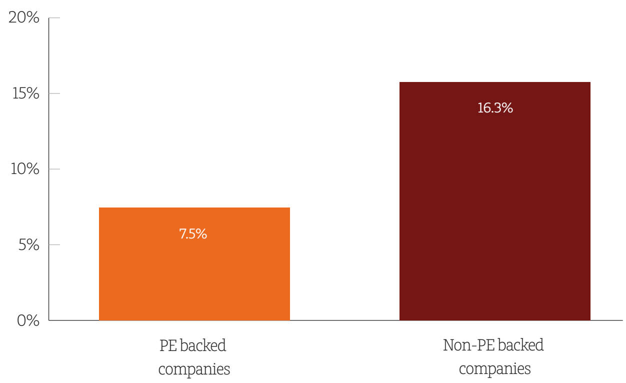
We believe, it's not chance, but rather the ability to act swiftly and decisively that explains why PE-backed companies exhibited lower default rates during the most intense period of the GFC versus non-PE backed companies (**Chart 4**).

Because private equity investors are active managers, they can intervene in the operations of their portfolio companies in times of crisis, rather than be passive stakeholders. This capacity is going to be even more important during the COVID-19 crisis and what follows.

Furthermore, managers of private equity investments during economic turbulence are often more able to negotiate favourable terms. Finally, private equity allows for flexibility with regards to type and timing of company exits – which is not a feature of public markets.

Chart 4: PE companies had lower default rates during the GFC

Default rates 2008-09 PE investee companies vs US S&P 500 Index companies



Source: S&P LCD as of August 2015. Includes default rates for leveraged loans for all companies in the S&P LCD Index.

3 Prequin Quarterly Update: Private Equity & Venture Capital Q2 2020. Insight on the quarter from the leading provider of alternative assets data.

Achieving diversification in an era of "financial repression"

Traditionally, adding "defensive assets" like government bonds to equity-dominated portfolios has been the go-to way of achieving diversification.

Unfortunately, "financial repression" brought about by central bank policies have compromised the capacity of defensive assets, such as government bonds, to protect portfolios. Ultra-low interest rates and quantitative easing (QE),[4] has squashed defensive assets' return potential.

Consequently, investors are being compelled to go further along the risk curve in the search for decent sized returns.

The prices of "risk-free" or near risk-free assets like government bonds, (and even investment grade corporate bonds), have become so steep that, all else being equal, the relative attractiveness of more risky assets (like shares) have improved. "Equity Risk Premium (ERP)" is the term for describing the attractiveness of shares versus other assets.

Right now, the ERP is about as attractive as it has been over most of the past 12 years, a remarkable situation given the decade-long post GFC bull market. But having shares as the only game in town isn't a good thing.

Furthermore, global equity returns in recent years have been driven by a handful of companies, the anthesis of diversification. Like so much of what happens in capital markets, US events cast long shadows across the world and there the share price performance of five companies — Apple, Microsoft, Google, Amazon and Facebook — overwhelmingly explain the performance of the S&P 500 Index (**Chart 5**).

While the market valuation of 495 S&P 500 Index companies has risen only slightly since 2015, the five tech giants have added a stunning US$4.8 trillion to their market capitalisation. This is both breathtaking and a little concerning. At this rate the S&P 500 will have to be renamed the S&P 5!

4 QE, as it's generally referred to, is form of unconventional monetary policy in which a central bank, such as the US Federal Reserve, Bank of Japan, European Central Bank, buys assets such as government bonds from the open market to inject money into the economy.

Chart 5: US share market being driven overwhelmingly by five tech giants

S&P 500 performance

Note: All series are rebased to 1 Jan 2015 = 1.
* Includes Apple, Microsoft, Google, Amazon, Facebook.
** S&P 500 excluding Apple, Microsoft, Google, Amazon, Facebook

Source: BCA Research.

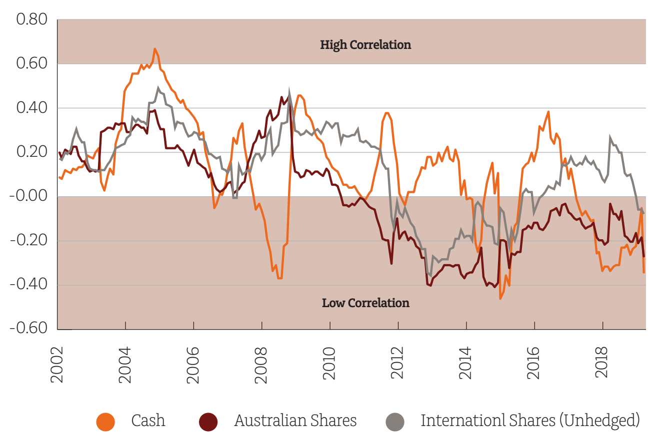
Share market investments dominate many portfolios and the market capitalisation concentration represented by the five tech companies' raise questions over the durability of the current equity market advance.

We believe the addition of private equity assists portfolio diversification by providing a source of uncorrelated (**Chart 6**), or at least lesser correlated returns with shares, and bonds. By doing so, private equity can enhance risk-adjusted returns.

Carefully selected private equity investments, including quality co-investment opportunities, can potentially deliver extra return with a different risk profile to shares and bonds.

Chart 6: Private equity can provide diversification benefits

Rolling 3-Year correlation of monthly returns MLC Private Equity with major asset classes (May 1999 – June 2019)



Source: MLC Asset Management analysis. Benchmarks: Cash = Bloomberg Bank Bill; Australian Shares = S&P ASX 200; International Shares = MSCI World Net (A$)

MLC Private Equity performance figures are based on the private equity portfolios of MLC Ltd Statutory Funds 2 and 4 as advised and managed by MLC Private Equity. All returns are calculated IRRs based on the latest available valuations from MLC's managers, as at 30/06/19. Returns are based on the value of realised and unrealised investments.

How MLC's PE program and co-investment funds are faring

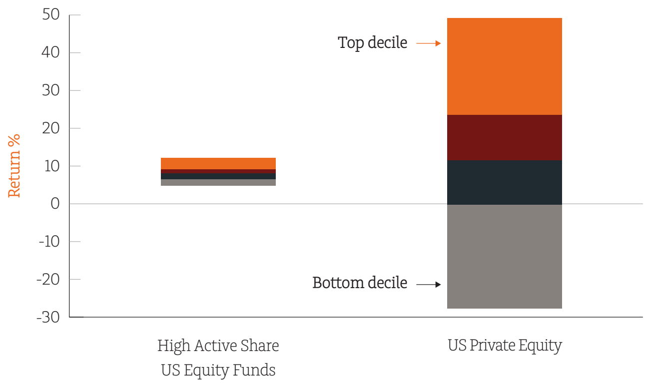
These days, PE is a mainstream asset classes found in many investment portfolios. But that wasn't the case when MLC began offering PE investments to clients in 1997.

Not all investments, or investment managers are equal and this is especially true in PE where there is wide dispersion of returns between the most successful managers, and the rest, compared with listed markets (**Chart 7**).

In other words, partnering with the "right" managers can make or break a PE program.

Chart 7: Large performance gap between best and less capable private equity managers vs listed equity managers

Manager Skill vs Universe Median 2013 – 2018



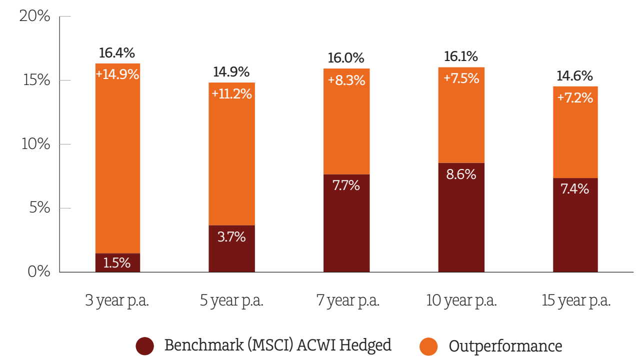
Source: McKinsey Global Private Markets Review, 2019.

MLC has proved its commitment to long-term relationships with some of the world's most renowned PE managers, and not a fair-weather partner likely to look for an exit at the first sign of investment stress.

Moreover, we opted for a global opportunity set from the get-go with our PE program recognising that the US and Europe markets offered more choices for private company investing than Australia.

Chart 8: MLC's PE program has performed strongly versus public markets...

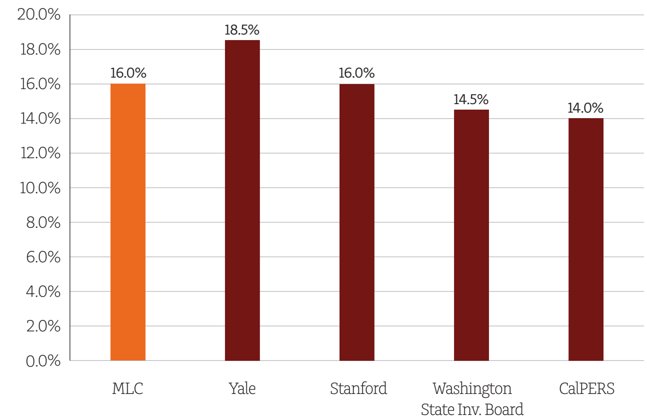
Pooled IRR: MLC vs MSCI ACWI (Hedged) as at 31 March 2020



Source: MLC MySuper. Performance as at 31st March 2020.

Chart 9: ...as well as top US endowments' PE programs

PE IRR performance over 10 years to 30 June 2019



Source: Annual reports for the Endowments and Public Pension Funds.

All returns are presented on a non-time weighted IRR basis to compare MLC against top US endowments on a like-for-like basis.MLC 10 Year IRR as at 30 June 2019, Endowment and Public Pension returns are as at 30 June 2019 (per their reporting year).

The result of these enduring relationships is a PE program that has delivered strong long-term performance compared to public markets as well as leading US endowments (**Charts 8 and 9**).

Two co-investment funds were brought to market in 2013 and 2017 respectively, and capital raising for MLC Co-Invest Fund III commenced in November 2019. See "*Co-investments: the jewel in the private equity crown*" (on next page) for more information on the structure and fee arrangements of co-investments.

Co-investment Fund II, which began deploying capital in 2017, has invested in 21 companies alongside several General Partners, and other "Limited Partner" investors.

Co-investment Fund I, which began deploying capital in 2014, is fully invested in 14 companies, of which eight remain in the portfolio. Six full exits from investee companies have already been made from Co-investment Fund 1 and by doing so repaid all investors' capital.

Both co-investment funds are diversified by geography with investments in Europe, US, Asia as well as in Australia. Investments by industry span health care, information technology, the consumer sector, financial services as well as industrials.

Both portfolios are tracking ahead of our aggregate business case assumptions and performance expectations remain in line with the target return to investors of 15% internal rate of return (net of all fees), or a 2x multiple on invested capital.

See "*Sample of exits and an investee company update*" (on next page) for a snapshot of some investments from Co-investment Fund I and returns.

Co-investments: the jewel in the private equity crown

Sometimes, an attractive company is too large relative to other companies in a private equity fund, or buying the company could result in over-concentration in an industry or region, for instance.

In such instances, the General Partner may approach **some of** its Limited Partners to raise additional capital as co-investors (**Chart 10**).

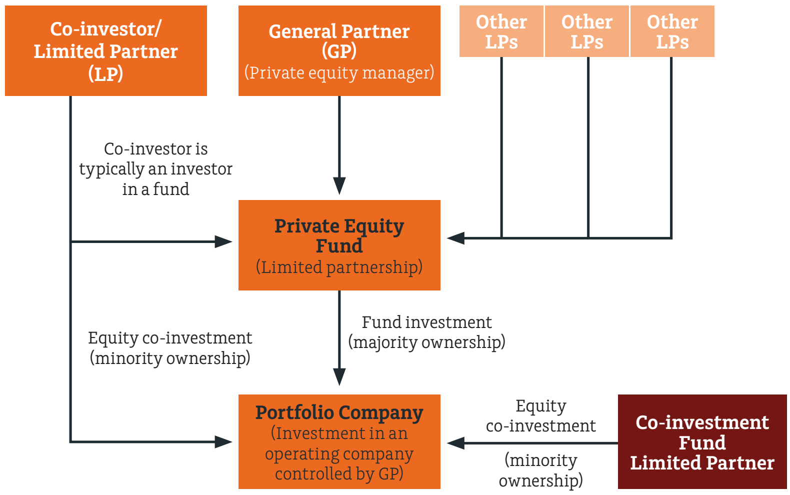
Co-investing has inherent upsides for Limited Partners including:

- Zero fees, and thus potentially higher returns, and
- Greater visibility over the governance and management of the investee company.

However, the inherent upsides of co-investing do not necessarily translate to better investment returns.

Like the famed John West tuna ad of yesteryear that claimed: "It's the fish that John West rejects that makes John West the best", potential co-investments must be forensically analysed and many rejected to ensure that only the best are accepted.

Chart 10: Stylised co-investment structure



Source: MLC Asset Management

MLC has, to date, rejected around 94 percent of co-investments offered by private equity managers. They failed to make it past a combination of our 10-point checklist that acts as a negative screen, and active due diligence.

Only the surviving near 6 percent made their way into MLC Private Equity Co-Investment Fund I and Fund II.

Sample of exits and an investee company update

1. About Siblu

Siblu is the largest manager of owner-occupied holiday parks in France, with 14 parks at the time of investment, mainly in attractive Mediterranean and Atlantic coast locations.

The business has been built up through acquiring premium holiday parks and converting them to the owner-occupied model, in which customers contract with the holiday park owner to lease a plot of land for a minimum period of one year, where the lessor places their own static caravan or mobile home.

Investment by MLC Co-Investment Fund I

MLC invested in Siblu, in December 2015, alongside Stirling Square, a London-based midmarket manager.

Since the December 2015 transaction, Siblu has completed 10 acquisitions: four bolt-ons (purchases of land adjacent to existing parks for development) and four add-ons (bought stand-alone parks for conversion to Siblu's owner-occupier model) in France, as well as two add-ons in The Netherlands.

Investment return

On 30 July 2019, Stirling Square signed a definitive agreement to sell Siblu to Naxicap Partners for EUR470m, returning 3.0x invested capital to Co-Investment Fund I.

2. About ERT

ERT is a Pennsylvania, USA, head-quartered medical technology service provider operating in the pharmaceutical trials industry.

The company is a leading provider of digital Clinical Outcomes Assessment (COA), Cardiac Safety, and Respiratory Efficacy services to pharmaceutical and biotechnology companies. COA allows (electronic) measurement of a patient's symptoms, overall mental state, or the effects of a drug during a clinical trial on patient functions.

Investment by MLC Co-Investment Fund I

MLC invested in ERT alongside Nordic Capital, a Scandinavian manager investing in middle market opportunities.

Investment return

In November 2019, a European PE firm agreed to acquire the ERT via a recapitalisation. The transaction closed in early 2020, for an IRR above 20% and a multiple of 2.5x invested capital to Co-Investment Fund I.

3. About PetSmart

Within the US pet supplies market, PetSmart owns both the largest nationwide network of physical retail stores and is also the leading specialist online retailer.

Investment by MLC Co-Investment Fund I

Co-Investment Fund I invested in PetSmart in March 2015 alongside BC Partners. The initial investment thesis included a continuation of strong revenue growth, as well as cost savings in key areas such as procurement and Selling, General and Administrative Expenses (SG&A).

In May 2017, further capital was invested into PetSmart to support its acquisition of Chewy, a leading online pet supplies retailer. This acquisition greatly enhances PetSmart's position as the leading pet supplies retailer in the US, both through physical stores and online.

Between 2017 and 2019, Chewy's sales grew rapidly and it was listed in June 2019. Chewy continues to record strong year-on-year growth as customers shift to online sales, with FY2020 forecast to be up over 35% on the prior year. The Chewy share price has increased by about 100% since listing.

PetSmart's physical retail stores recorded around 1% same-store-sales growth during February to April 2020, and the company is also executing cost-containment initiatives. The company's physical outlets have continued to operate through the COVID-19 period as physical stores have been categorised as an essential service in the US during most lockdowns.

Investment return trends

As at 30 June 2020, PetSmart was held at 3.3x of invested capital by Co-Investment Fund I. We expect a degree of movement in the valuation, which will reflect listed market counterparts' valuation changes, and currently expect the investment to be held at 3x or better over the medium-term.

M155604-0820