

## Investors should revisit their allocation strategy

Private equity is far from dead, but it has taken a real beating. As the industry faces up to challenges to its traditional model, the indications are it will evolve into a form altogether less enticing – a lower-return, longer-term asset class. And in a post-boom environment of lower leverage, longer exit timetables and depressed portfolio values, it will struggle to deliver the level of returns required by the large pension schemes if they are to meet the 7% to 8% hurdle required to fulfil promises to scheme members.

What does a private equity institutional investor have to do to make acceptable returns? Venture capital is too small, traditional LBOs are hard to finance and take-privates are seen as highly risky without shareholder preapproval – difficult to achieve. That leaves high-growth investment and distressed equity opportunities, both requiring specialist operational skills.

It is time for institutional investors, and the specialist consultants who advise them, to take a fresh look at the possibilities the market offers. At a time when financial engineering has become much less important and transparency more significant, there is a powerful case for investors that have relied on a

**Guest comment**

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traditional private equity model to look at a different approach.

There is a proven model sharing strong similarities with the private equity approach, but, crucially, it offers high returns with low leverage, combining the operational disciplines of the private equity approach with the price transparency and equity consideration offered by the public markets – the listed acquisition vehicle, returning to prominence with the recent £418m (€475) launch of Hugh Osmond's Horizon.

By following an investment approach that concentrates on creating value by delivering real operational performance rather than solely by exploiting balance-

sheet inefficiencies and cheap credit, listed acquisition vehicles have shown they can replicate the enhanced returns traditionally associated with private equity.

The challenge is to exert sufficient influence through a combination of a shareholding, usually a minority investment, and a good, working relationship with other stakeholders – management, investors and debt providers. It is possible to deliver internal rates of return comparable to the most successful private equity strategies without the need for excessive leverage. Marwyn has launched 11 listed acquisition vehicles since 2005, achieving an average internal rate of return of 48%

on exits and returning £596m of equity to investors. This on debt multiples of less than 2.5 times cash earnings.

The key to success is transparency and the ability to work consensually with vendors, management and co-investors. These are not attributes that have been routinely associated with the private equity industry. For their part, managers must be experienced, highly incentivised, operational individuals with strong track records. Yet it is critical they receive a level of support that is normally available only to much larger companies.

Managers will be incentivised to deliver capital growth, usually owning up to 15% of the equity after delivering a threshold return for investors, and will always invest their own capital. It is important that financial incentives, such as capital growth targets, are both transparent and properly aligned as this ensures management and investors share the same vision and focus.

Now that the private equity status quo has been challenged, many allocators are considering their options. With the right strategy and investment manager, a public market-based approach offers institutions a real alternative to their current allocation conundrum.