Partners Group and the private equity drought

The asset management company, Partners Group, regularly delivers good results. Will this well-oiled marketing machine get through the upcoming private equity drought?

BY CYRIL DEMARIA

In July, the asset manager Partners Group announced in Baar its first semester results with a net inflow of EUR 2.1 billion (CHF 1.75 billion). Over this year, the Group expects to gather in EUR 4-5 billion (compared with EUR 4 billion in 2010), and is confident about its future, "since public pension plans are set to increase their allocation", explains Anna Hollmann who is in charge of public relations. This performance is even more impressive (see "Key financial figures") when considering the strong headwinds that the private equity sector is facing as a whole. Partners Group seems so far unaffected.

Given its pragmatism, the odds seem to be in favour of Partners Group. A first example of its ability to change was its switch to a new strategic baseline, choosing to stay away from an approach where private equity and public equity were blended in an 'equity strategy'. But the company faced difficulties in convincing investors to change their asset allocation framework, which differentiates listed and non-listed assets and puts them in different categories. Partners Group hence exited from wealth management and hedge fund management to focus on funds of funds (an investment strategy consisting of holding a portfolio of investment funds, rather than investing directly in private companies). The Group was then private, still nimble and in an uplifting environment over 2000 to 2006.

As Partners Group went public in 2006 (see "Evolution of Partners Group AG's stock price"), private equity was in favour with investors. Major American endowments (such as Yale and Harvard) were showing annual performances above 15%, essentially thanks to alternative investments such as private equity and hedge funds. Nevertheless, pure funds-of-funds strategy became an increasingly tough sell from the 2007-2009 crisis and beyond. The management fees that are charged to investors (so called 'limited partners') are difficult to justify, particularly given the poor performance shown by funds of funds (see "A management fee game") compared to their peers.

To mitigate the impact of management fees, leading endowments and pension funds have developed a policy of co-investing with fund managers – and sometimes taking shares in the fund management companies themselves (so called 'general partners'). Co-investing grants limited partners with an access to the underlying investments themselves (hence reducing the marginal amount of fees paid per euro invested). Partners Group followed through.

Focus, focus, focus… but on what?

As Partners Group derives 91% of its income from management fees[1], this pressure towards a fee reduction mechanism did not bode well for the future of the Group. Firstly, because the fees stream is shorter in the case of direct investments and therefore more volatile: a fund of funds is created for twelve to thirteen years (with guaranteed fees over that length of time), whereas a co-investment lasts only three to five years. Secondly, to have access to co-investments, it is necessary for Partners Group to continue investing in private equity funds. These funds are the key to direct access to co-investment opportunities. As funds of funds are less likely to gather interest due to poor performance, Partners Group may have difficulties in keeping access to private equity funds and hence to attractive co-investment opportunities.

Key financial figures of Partners Group (in million CHF)

	2008	2009	2010
Sales	427.8	418.4	499.3
Operating income	170.0	217.8	280.9
Net income	170.7	204.8	296.2
EBITDA	187.3	222.4	324.6
Total Assets	521.2	639.6	738.1
Total Liabilities	64.3	181.5	165.9

Source: Thomson Financials, Worldscope.

Over the last five years Partners Group has developed infrastructure and real estate programs in order to diversify its offer. The new focus is 'private markets' (hence shifting away from 'equity'). The purpose is to mitigate the impact of the private equity cycles on its product performances, and develop new niches. Another focus is to offer its clients exposure to emerging markets, even though these markets have yet to prove their resilience – just like Partners Group's good fortune. Indeed, by diversifying, the group might lack focus going forward, which according to academic studies is the source of financial performance.

There is size… and size

Indeed, as stated by Katarina Lichtner, head of research at Capital Dynamics, a spin-off and competitor of Partners Group based in Zug, funds-of-funds managers have hence to take a decision on their business model: either remain small niche providers (such as Alpha in Zürich, focused on Eastern and Central Europe) or become globally integrated firms. Partners Group seems to have chosen the latter through organic growth with 14 offices worldwide.

This choice may however expose Partners Group to a lack of momentum, as the competition has launched a wave of acquisitions. Axa Private Equity, which has taken over the private equity activities of the Swiss Winterthur, has acquired private equity portfolios and businesses from Citigroup (USD 1.7 billion in 2010), Bank of America (USD 1.9 billion in 2010), Natixis (USD 718 million in 2010), Mizuho (USD 500 million in 2011) and HSH Nordbank (EUR 620 million in 2011). Axa Private Equity itself is now officially for sale. Carlyle has entered the fray by acquiring AlpInvest in 2011, managing EUR 32.3 billion, in order to prepare its listing and diversify out of direct investments. HarbourVest went public in 2007 and acquired the Swiss listed structure, Absolut Private Equity, (for a total of USD 806 million) over the summer of 2011. Partners Group declined to comment on these acquisitions, but remains singularly out of the news in this concentration game.

Size indeed matters when it comes to regulatory burden

The fact that the private equity sector is headed towards a storm of regulations will necessarily impact Partners Group. The Alternative Investment Fund Manager Directive, the Basel III Agreements for banks, the Solvency II Directive for insurances, the Dodd-Franck Act and the Foreign Account Tax Compliance Act in the US will dramatically change the landscape of practice. According to Anna Holmann, "the increased complexity is a competitive advantage for Partners Group due to [its] global positioning combined with local knowledge [and] large in-house structuring/tax/legal/compliance teams. Partners

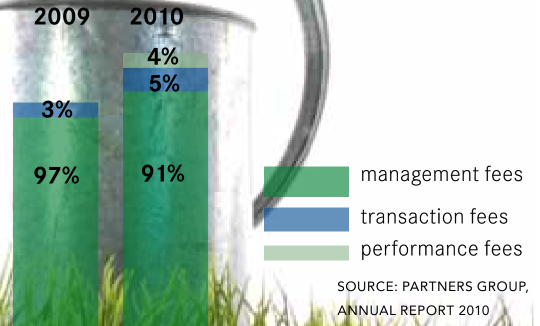
PHOTO:DREAMSTIME

[1]As of 31 December 2010, assets under management are as follows: EUR 15.2 billion private equity (the group does not provide details between secondary investments, direct investments and funds of funds programs), EUR 2.0 billion private debt, EUR 2.5 billion private real estate, EUR 1.0 billion private infrastructure and EUR 0.7 billion in affiliated companies.

Evolution of Partners Group Holding AG's stock price since its listing (March 2006-September 2011) compared to the SMI

SOURCE: SIX SWISS EXCHANGE

A management fee game: only 4% of the results come from Partners Group's performance



SOURCE: PARTNERS GROUP, ANNUAL REPORT 2010

Group is already regulated by several regulators worldwide."

Indeed, the company operates under different regulations worldwide. However, the Basel II Agreements failed to recognise that funds of funds are a risk diversifier for investors. Their risk-return profile is specific and should be treated as such by the solvency ratios. Funds-of-funds managers remained muted, just like for other debates which involve the future of the asset class as such. This lack of interest in communication, lobbying and interaction with the public might backfire strongly.

The disappointing, to say the least, recent evolution of Partners Group's stock price is hinting that the fortunes of the Group remain to be proven under stress. The lack of transparency of its activity essentially lumped in a black box of 91% of its revenues, the absence of the Group in the major concentration operations and the lack of perspectives for internal talents might prove to be a challenge difficult to overcome – and probably not through trial and errors as in the past. The fact that seven financial analysts have downgraded the stock recently (only one upgraded it) confirms that doubts loom over the preparation of Partners Group to face the private equity drought.

GLOSSARY

Alternative investments: an investment that is not one of the three traditional asset types (stocks, bonds and cash). Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of their complex nature, limited regulations and relative lack of liquidity. Alternative investments include hedge funds, managed futures, real estate, commodities and derivatives contracts.

Funds of funds: a mutual fund that invests in other mutual funds. A fund of funds allows investors to achieve a broad diversification and an appropriate asset allocation with investments in a variety of fund categories that are all wrapped up into one fund.

Private equity: consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. Equity capital is not quoted on a public exchange.

Source: www.investopedia.com

PHOTO: DREAMSTIME