NAOS

The Increasing Allocation to Private Market Investing

THE INCREASING ALLOCATION TO PRIVATE MARKET INVESTING

At NAOS Asset Management Limited (NAOS), when we review where some of the world's most prominent capital allocators such as Oaktree Capital, Berkshire Hathaway and even the Australian Future Fund are investing, a notable trend has emerged in how they have evolved their investment process to have a greater focus on, and allocation to private investments. What makes this even more notable is that these investment firms would be considered some of the most measured and risk aware given their longevity and strong long-term risk adjusted returns.

Understanding why these trends have evolved starts with understanding the benefits that come from investing in private businesses as well as having a deep and objective understanding of the associated risks. Many investors have historically not considered investing in private businesses due to the perceived risks and therefore may be missing out on the potential for strong risk adjusted returns over the long term from this asset class.

A MISMATCH BETWEEN DEMAND FOR ASSETS & ASSET ALLOCATION

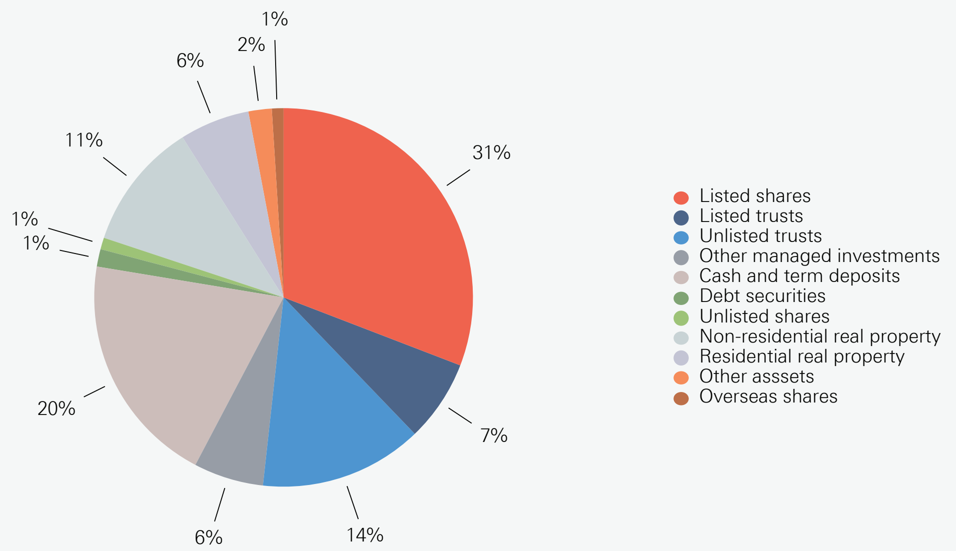
As at 30th June 2021, self-managed superannuation funds (SMSFs) within Australia had total assets in excess of $822 billion, growing by over $230 billion, or 39% in just 5 years[1]. Furthermore, the total sum of all superannuation savings is estimated to be ~$3.2 trillion[2]. To give this value some context, as at 30 June 2021, the total market capitalisation of every company listed on the Australian Securities Exchange (ASX) was ~$2.5 trillion, spread across 2,081 listed entities with tradeable securities[3].

The quantum of funds looking to generate a reasonable risk adjusted return has increased significantly over the past 5 years, but we should ask ourselves this question:

Are the asset classes that contain the majority of our invested funds providing us with a greater opportunity set, or have they just increased in value/size?

On review of the asset allocation of SMSFs, we noted that listed shares and property make up ~43% of all assets. With the inclusion of listed trusts, cash and term deposits, this percentage rises to ~80% of all assets held within SMSFs[4].

SMSF Asset Allocation June Quarter 2021[5]



* Based on GICS® sectors
The weightings for each sector of the index are rounded to the nearest tenth of a percent; therefore, the aggregate weights for the index may not equal 100%

The asset allocation of the Australian Future Fund (AFF), whose stated role is to "generate high, risk adjusted returns over the long-term", has an asset allocation fundamentally different to that of SMSFs. The below table shows the asset allocation breakdown for the AFF portfolio as at 30 June 2021[6].

1 SMSF quarterly statistical report June 2021, https://data.gov.au/data/dataset/self-managed-superannuation-funds/resource/a7990d56-11ba-4ba5-b185-32a9421d3497
2 Superannuation Statistics. Super Statistics - ASFA (superannuation.asn.au)
3 Historical market statistics. Historical market statistics (asx.com.au)
4 SMSF quarterly statistical report June 2021, https://data.gov.au/data/dataset/self-managed-superannuation-funds/resource/a7990d56-11ba-4ba5-b185-32a9421d3497
5 If Managed Superannuation Funds - SMSF quarterly statistical report June 2021 - data.gov.au
6 Portfolio Update at 30 June 2021 Future Fund | Portfolio updates

Australian Future Fund Asset Allocation – 30 June 2021

Future Fund asset allocation		
Asset class	$m	% of Fund
Australian equities	16,805	8.5
Global equities		
Developed markets	35,806	18.2
Emerging markets	18,002	9.1
Private equity	34,485	17.5
Property	11,707	5.9
Infrastructure & Timberland	14,548	7.4
Debt securities	12,982	6.6
Alternatives	26,547	13.5
Cash	25,942	13.2
Total	**198,825**	**100.0**

The AFF's allocation of ~41% to property and listed equities is very similar to the asset allocation of SMSFs. However, the makeup of AFF's 41% allocation is very different compared with the SMSFs allocation. Only ~6% is allocated to property (globally) and only ~8% to domestic equities, whilst there is a significant allocation to global equities in both emerging and developed markets[7].

We would argue that of more significance is the fact that ~18% is allocated to private equities and ~7% to infrastructure, which we assume the majority to be via unlisted investments. In other words, ~25% of the AFF asset base is allocated to purely unlisted assets. So, the obvious question is:

Why is there such a significant allocation by our sovereign wealth fund towards private investing?

WHAT DOES PRIVATE BUSINESS OFFER

Greater Opportunity Set

As mentioned earlier, there are only 2,081 listed businesses on the ASX[8]. If we then filter by businesses generating between $5 million and $100 million in revenue, or what we would class as 'emerging' businesses, this opportunity set reduces to 375 companies[9]. Applying our ESG filter and removing mining and energy companies, just 67 businesses that we would consider as truly 'emerging' remain. When you consider the quantum of capital that is invested in listed equities, particularly in a low interest rate environment, the demand/supply equation is very much in favour of the listed businesses and the valuations they can command.

This is in contrast to the opportunity set within private markets, where there are ~50,000 private businesses[10] with revenues between $2 million and $10 million (the ATO classification for a small company')[11]. There are also many thousands of businesses that generate annual revenues greater than $10 million. Statistically, there will be a larger proportion of private businesses (compared to public companies) that we would not classify as an investment grade business, however the sheer quantity of private businesses means the opportunity set is many times larger than that of their listed company peers.

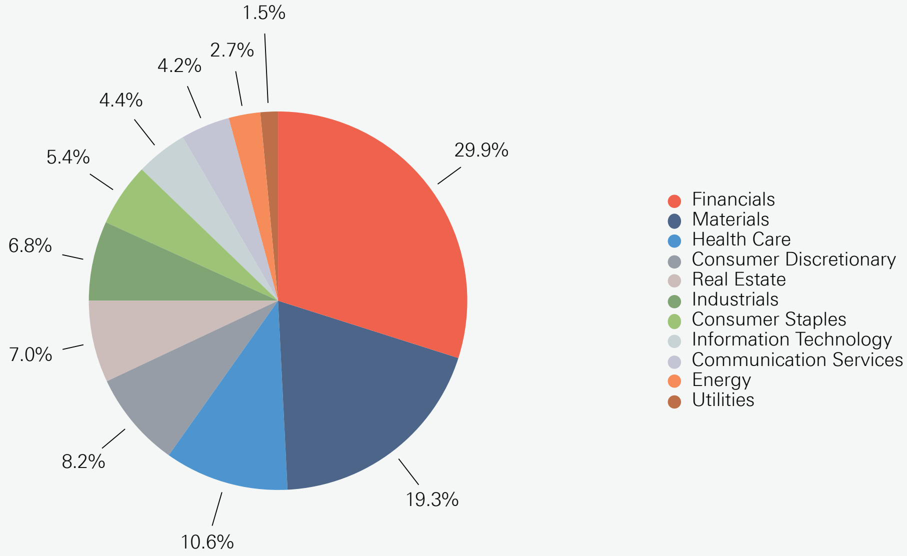
Industry Diversification

One of the most popular reasons for investing in international equities is the diversification it adds to a portfolio, which is in stark contrast to the fundamental lack of industry diversification available via the ASX, particularly in large caps. The combined market capitalisations of the "Big 4" banks, Macquarie Group and the "Big 3" miners totals ~$660 billion, approximately 25% of the total ASX market capitalisation of ~$2.5 trillion. It is a well-known fact that ~50% of the ASX-200 is exposed to the financial and materials sectors, as illustrated in the below chart of the ASX-200 by sector[12].

7 SMSF quarterly statistical report June 2021, https://data.gov.au/data/dataset/self-managed-superannuation-funds/resource/a7990d56-11ba-4ba5-b185-32a9421d3497
8 Historical market statistics. Historical market statistics (asx.com.au)
9 FactSet Screening Data, 2021.
10 Excludes businesses with a 'non-taxable' status
11 ATO Business Statistics Company statistics | Australian Taxation Office (ato.gov.au)
12 S&P/ASX 200 Industries Sector Breakdown S&P/ASX 200 Index Details, Companies and Stocks List by Industry and Sectors - Stock Metric

Industry Weighting of the ASX 200 Index[13]

Sector* Breakdown



* Based on GICS® sectors
The weightings for each sector of the index are rounded to the nearest tenth of a percent; therefore, the aggregate weights for the index may not equal 100%

Diversification is a key element to an investor gaining a more direct and pure exposure to a specific industry or thematic. There are currently many thematics vying for investors' attention, however the ASX doesn't necessarily facilitate the desired exposure, unless it is somewhat diluted due to other revenue lines generated by unrelated business activities. Current examples may include:

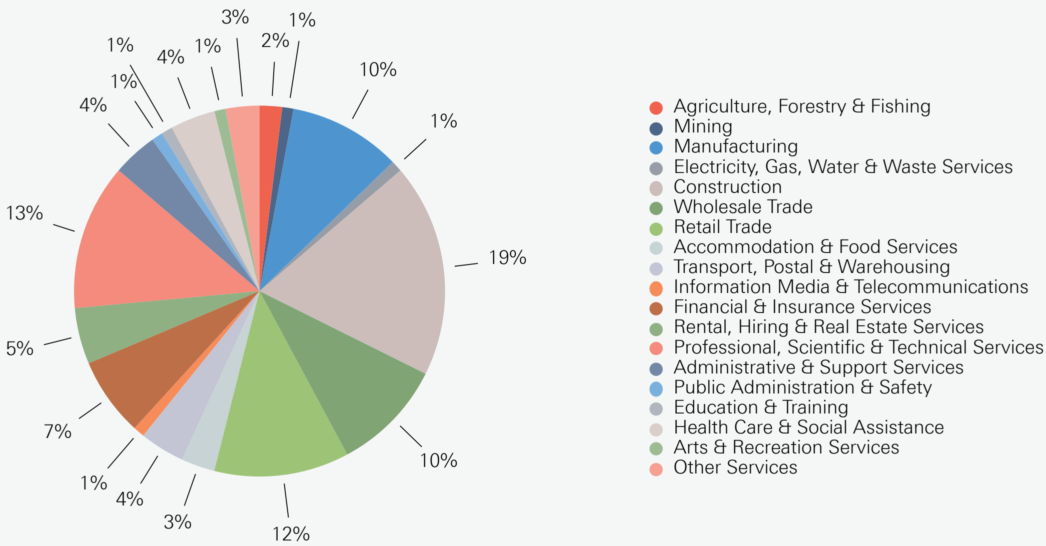
- Developer and manufacturer of vaccines;
- Mental health service providers;
- Products and/or services for domestic pets;
- Tourism service providers;
- Cybersecurity software;
- Vehicle & parts manufacturing.

In our view, if an investor was seeking a sound and meaningful exposure to some of the abovementioned industries or thematics, they would find it very difficult to meaningfully invest with direct exposure. International equities do provide an avenue to access further industries, however it is not the only avenue to achieve this. Whilst certain exposures may not be easily accessed on the ASX, this does not mean that they are not available within Australia.

The below pie graph provides a sector breakdown of the ~50,000 small privately held businesses[14] with revenues between $2 million and $10 million[15]. Whilst this is only a breakdown by the number of companies and the industry classifications do not exactly match those of the ASX breakdown, it is clear to see a far more balanced exposure exists. Given the sheer quantity of small businesses that operate across the wider economy, this is not surprising. Within this opportunity set, we believe the ability to gain exposure to quality long term tailwinds is vast.

13 S&P ASX 200 Index Breakdown Index Finder | S&P Dow Jones Indices (spglobal.com)
14 Excludes businesses with a 'non-taxable' status
15 ATO Business Statistics Taxation Statistics 2018-19 - Snapshot - Table 5 - data.gov.au

Sector Breakdown - Private Businesses



Source: ATO[16]

WHY DO COMPANIES UNDERTAKE A LISTING?

For most people, when they think of a public business, there is a perception that the business must be of a significant scale or has a unique competitive advantage that will propel its growth for many years. However, when we look back at some of the largest IPOs in recent years, we believe the opposite is apparent. In reality, most businesses conduct an IPO with one or more of the following motivations:

- **Selldown** - A vendor (generally a financial sponsor such as private equity) wants to sell part or all of their holding.
- **Debt Repayment** – A business with gearing levels which may be unsustainable or seem too high to carry the business through a period of reinvestment, therefore new equity is required to repay this debt.
- **Working Capital** – As a business grows it does not have the financial resources to support this growth and requires further liquid assets via issuing new equity.
- **Acquisitions** – A business has growth ambitions via acquisitions of other businesses which would be complementary to its strategy and requires equity to execute on a transaction.

When assessing an IPO we believe it is imperative that the vast majority of the proceeds raised are invested into the business to support long-term profitable growth, rather than being used to repay vendors, banks or other large shareholders. Whilst some of the uses of funds for IPOs are typically used to support growth, this is often a lower proportion than perhaps desired by investors. We believe the opportunity set for fundraisings within the private business landscape supports a greater skew of capital allocated towards growth, which can have material compounding effects over time. This is often due to capital being required to take private businesses to the next stage of organic growth when self-funding is no longer viable.

Taking the Long-Term View

It is widely regarded that there is a strong element of short termism applied by the market towards publicly listed businesses. Arguably this trend has continued to gain momentum over time. Whilst there can be many advantages to being a publicly listed business, having to constantly factor in short term market expectations and ramifications to decision making is not likely one of them.

What is good in the short term might not equate to what is best for the business over the longer term. We believe critical thinking on long-term decisions are more easily made when a business is not publicly listed, or at the very least public businesses which adopt a private company mentality.

With an increasingly short-term market mindset, it is commonplace that questions asked of management teams and Boards are focused on the 'today'. This is done so at the expense of understanding the bigger picture over the longer term. Whilst these types of questions may often be very relevant and warranted, it also demonstrates that many of those whom are tasked with managing a listed business often inherit and take on significant short-term pressures.

16 ATO Business Statistics Taxation Statistics 2018-19 - Snapshot - Table 5 - data.gov.au

We firmly believe that these short-term pressures, especially when combined with management teams who are not aligned with ordinary shareholders, can lead to respectable short-term results but at the expense of long-term strategic execution and ultimately long-term value creation.

This belief certainly does not apply to all listed businesses. There are many outstanding examples of publicly listed businesses that have continually compounded shareholders capital for many years such companies include Objective Corporation (ASX: OCL) and Reece Ltd (ASX: REH). We would argue that businesses such as these have been very successful in adopting a private company mentality to a certain degree by focusing their decision making on what is best for the business and shareholders over the longer term.

Understanding and Demystifying Risks of Investing in Private Businesses

We would argue the two main reasons why investors are somewhat apprehensive before investing in private businesses are:

1) A lack of high-quality available opportunities either directly or indirectly via a managed fund product, and
2) The perceived risks associated with investing in private businesses such as:
    - Liquidity risk – the ability to liquidate the investment at a fair market price in a reasonable timeframe;
    - Minority holdings – precluding voting control over key business decisions; and
    - Lack of scale – leading to customer concentration, lack of depth in management teams, restricted access to reasonably priced debt and limited balance sheet flexibility.

Risks are inherent in all types of investing and private business investing brings with it its own unique set of risks. However, we see it as more important to view the risks against variables which can impact the risk-adjusted returns over time. In our view, variables that would minimise the risk profile of private investments include:

- Industry structure in which the business operates;
- The moat of the business;
- Balance sheet flexibility;
- Capital intensity & cash flow generation;
- Capital allocation track record;
- Management & shareholder alignment

Some of the World’s Best Businesses Never Go Public

Investors today would be quick to recognise numerous companies that are household names, with strong brand recognition which are public businesses such as Google, McDonalds, LVMH Group, Apple and BHP. However, there are many exceptional global businesses that have never turned to a public market including IKEA, Patagonia, Bloomberg, Dyson and Aldi. Even within Australia, businesses such as Visy, Meriton, Linfox, Spotlight, Cotton On and Sanitarium have established and grown very successful private businesses.

Almost every business starts its journey as a private business. There is no better way to understand what it takes to run a successful private business and all of their trials and tribulations along the way than by hearing it from the horse’s mouth.

Below are three links to podcast interviews from three founders who we believe have established some of the most significant and highest quality private businesses today.

Patagonia
https://podcasts.apple.com/au/podcast/how-i-built-this-with-guy-raz/id1150510297?i=1000378841890

Dyson
https://podcasts.apple.com/au/podcast/how-i-built-this-with-guy-raz/id1150510297?i=1000402035861

Springfree Trampolines
https://podcasts.apple.com/au/podcast/how-i-built-this-with-guy-raz/id1150510297?i=1000533336893

CONCLUSION

Over the next decade we firmly believe that the private market landscape will continue to grow at a phenomenal rate and the sophistication of that landscape will continue to evolve. This should lead to some of the best businesses in Australia (and even globally) remaining private, as the benefits will likely outweigh the positive aspects of running a publicly listed business. Businesses can spend more time focusing on the execution of long-term strategy and ensuring that the decisions they make are the best decisions for the long-term prosperity of the business and all shareholders.

We are a strong believer that investors will seek to increase their exposures to quality private businesses. Instead of looking for a short-term listing and/or exit, investors will recognise the benefits of providing patient capital which can compound over many years as a successful business grows.

Whilst the opportunity set appears substantial, without a doubt, being successful in accessing the right private markets and allocating capital towards quality businesses will be the most difficult aspect for any investor seeking such an exposure. The NAOS Private Opportunities Fund is our first fund that uses our investment process and beliefs to focus on investing in private investments, and is open to wholesale and sophisticated investors only. We will strive to be a partner and funder of choice across a range of quality private businesses.

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NAOS Asset Management
Level 34, MLC Centre
19 Martin Place
Sydney NSW 2000

Telephone: +61 2 9002 1576

Email: enquiries@naos.com.au