Global private assets strategy

Investment update to 31 December 2018[1]

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

The strategy 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 the private assets strategy through different market conditions, since 1997.

The following multi-asset portfolios invest in MLC's global private assets strategy:

- MLC Horizon portfolios (MLC MasterKey superannuation and pension products)
- MLC Inflation Plus portfolios (MLC MasterKey superannuation and pension products), and
- MySuper in MLC MasterKey Business Super.

Each fund's allocation to global private assets is shown in Table 1.

Table 1: Allocations to global private assets as at 31 December 2018

MLC MasterKey superannuation and pension products	% of portfolio invested in global private assets
MLC Horizon 2 Capital Stable Portfolio	2
MLC Horizon 3 Conservative Growth Portfolio	4
MLC Horizon 4 Balanced Portfolio	6
MLC Horizon 5 Growth Portfolio	6
MLC Horizon 6 Share Portfolio	7
MLC Horizon 7 Accelerated Growth Portfolio	8
MLC Inflation Plus Conservative Portfolio	2
MLC Inflation Plus Moderate Portfolio	4
MLC Inflation Plus Assertive Portfolio	7
MySuper	5

Source: NAB Asset Management Services Limited. Based on the portfolios' target allocations.

This investment update provides performance, exposures and commentary for the private assets strategy used in the MLC Horizon portfolios and MLC Inflation Plus Assertive portfolio in MLC MasterKey superannuation products. This strategy has been in place since 1997.

What are private assets?

Private assets involve 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.

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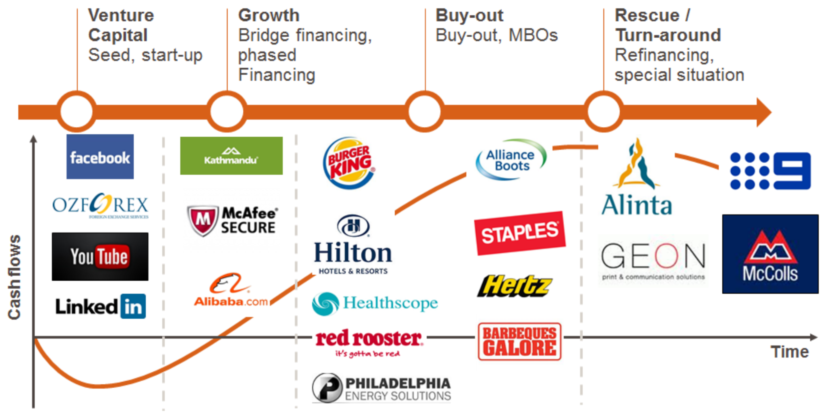
While there's no denying private equity is a risky asset class, its benefits are well known and widely proven. When managed well, it can provide excellent diversification and return potential for investors because returns aren't directly linked with the performance of listed global shares or fixed income.

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.

Chart 1: The private equity investment spectrum



Source: NAB Asset Management Services Limited. These companies have been chosen for illustrative purposes only. MLC may not invest in any of these companies.

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. Harvard Business School lecturer Shikhar Ghosh's research indicates that as many as 75% of venture-backed companies fail.[2]

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. For example, private equity managers including Silver Lake Partners and General Atlantic helped founder Jack Ma grow Alibaba into one of the largest e-commerce companies globally and guided the company to a successful US initial public offering (IPO).

Buy-outs

Unlike venture capital and growth, with buy-outs investments are in a controlling stake of the company. The private equity fund managers will run the business plan. They'll usually have an idea about how they can optimise the business and make back a significant return on their investment in a 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, Australian buy-out manager Pacific Equity Partners acquired cinema group Hoyts. They transformed the business through fully digitising the cinema network, entering out-of-home advertising

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[2] Why Companies Fail - and How Their Founders Can Bounce Back: http://hbswk.hbs.edu/item/why-companies-failand- how-their-founders-can-bounce-back, as at 16 May 2016.

and expanding into adjacent vertical businesses, such as Hoyts DVD kiosks and streaming, before exiting the buy-out by successfully selling Hoyts to another company in the industry.

Rescues or turn-arounds

These are investments in a failing company or 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, TPG acquired power generation company Alinta in 2010 in the largest debt-for-control restructuring in the Australian market at the time. They recruited a new CEO from AGL Energy and successfully completed the operational turnaround of the company in conjunction with their in-house operations team. However, these are also the types of transactions which tend to hit the headlines when things go badly, eg Dick Smith Electronics.

How are returns generated?

Private assets' returns are based on valuations of the companies, returns 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 frequently. 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 assets strategy aims to provide MLC's multi-asset portfolios with:

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

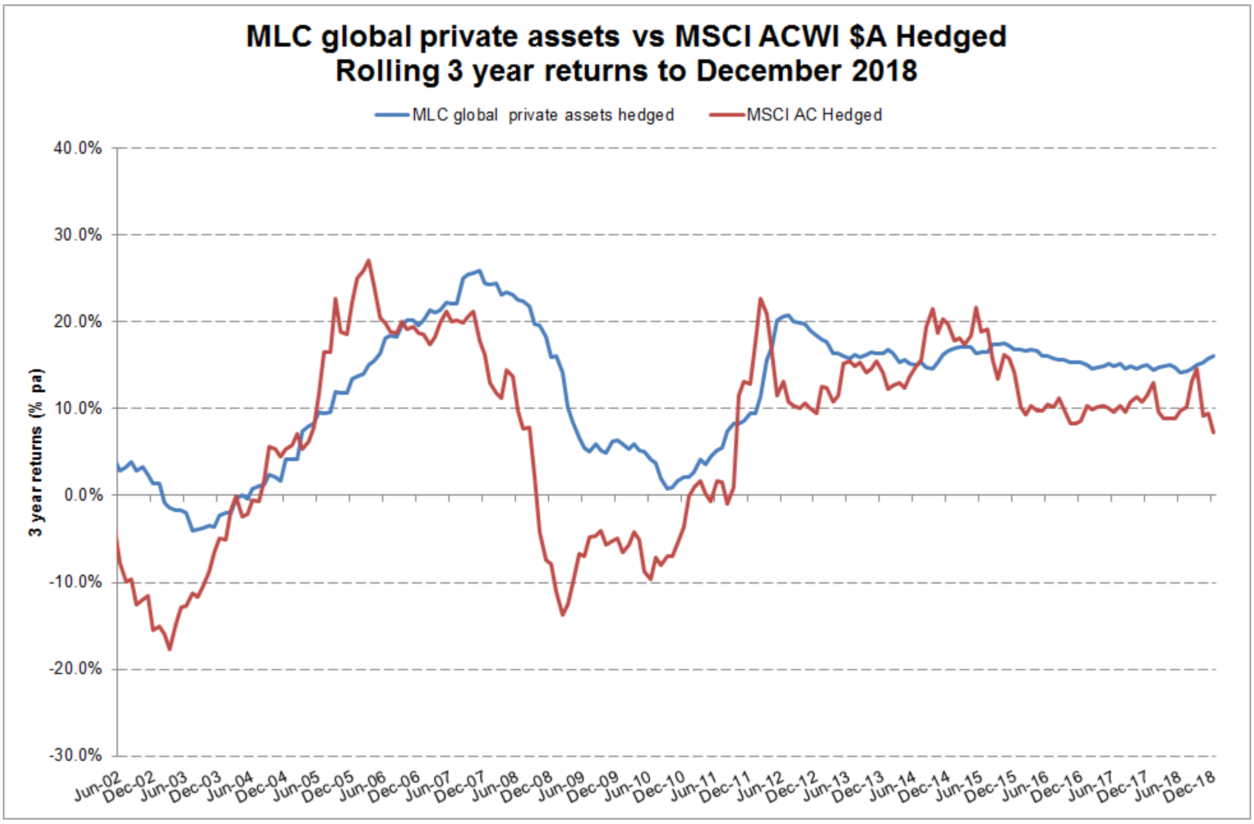
Since most private equity investment opportunities lie outside Australia, the strategy seeks to access the benefits of the greater range and quality of opportunities available in the global market. While return, rather than diversification, is the primary driver of MLC's private assets portfolio construction, the outcome is a very well diversified strategy - one that is diversified by managers and regions and across the spectrum of private equity investments.

Performance

Chart 2 demonstrates the performance of the private assets strategy (hedged to the Australian dollar) 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 assets 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.

However, private assets may underperform listed markets if share markets are rising strongly. Chart 2 also shows significant swings in returns from private assets, 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 31 December 2018

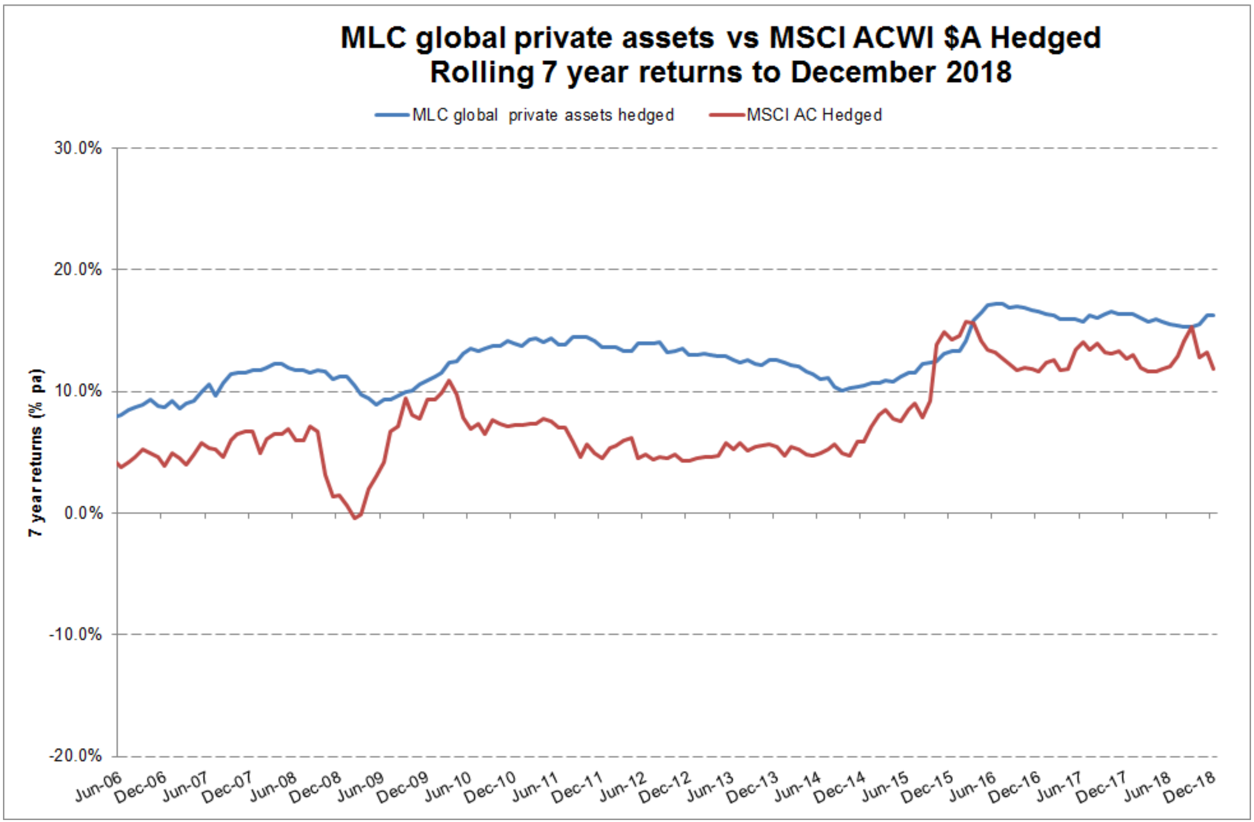


Source: NAB Asset Management Services Limited. Private asset returns are net of indirect costs[3].Past performance is not a reliable indicator of future performance.

Chart 3 and Table 2 demonstrates the success of MLC's private assets strategy in meeting its seven-year 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 assets.

[3] 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.

Chart 3: Rolling seven year returns compared to its objective to 31 December 2018



Source: NAB Asset Management Services Limited. Private asset returns are net of indirect costs. Past performance is not a reliable indicator of future performance.

Table 2: Returns to 31 December 2018 (before fees and tax)

	1 year %	2 years % pa	3 years % pa	5 years % pa	7 years %pa	10 years %pa	15 years %pa
MLC global private assets strategy (hedged)	18.4	18.9	16.1	16.8	16.3	14.2	15.4
MSCI All Country World Index (hedged)	-7.9	5.7	7.3	7.4	11.9	12.2	8.7
Excess return	26.3	13.2	8.7	9.4	4.4	2.0	6.7

Source: NAB Asset Management Services Limited. Private asset returns are net of indirect costs. 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.

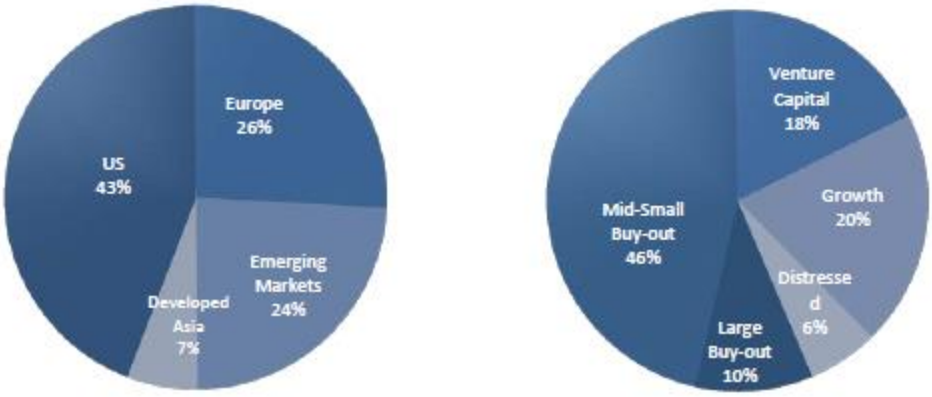
MLC's global private assets strategy aims to identify and access the best private equity funds globally. As these investments require MLC to invest in external funds, indirect costs are incurred. However, even after taking into account the higher costs involved with these investments, the long-term excess return from MLC's private assets strategy has far exceeded that of listed share markets.

The strategy won't always achieve its objective of outperforming listed share markets over seven year periods. Most of our investments in private assets have a very long tenure and even over a period as long as seven years, conditions for private equity may not be as favourable as those for listed markets.

Portfolio diversification

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: Regional exposures and investments across the private assets spectrum as at 31 December 2018



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

Private equity market activity

Buyout investment activity in 2018 was the second highest since the Global Financial Crisis, totalling 5,106 deals announced for a combined deal value of USD456bn. Further analysis shows that the buyout segment continued to be dominated by mega deals out of North America, and that add-on transactions continued to be a large part of the strategy. Add-on transactions represented 42% of the total deals in 2018, and accounted for 24% of the aggregated deal value.

The spread of deals across different sectors was relatively diversified in 2018, with Industrials representing 14% of aggregate deal value, Information Technology 15%, Health Care 13%, Telecom 12% and Business Services 12%. The largest deal of the December 2018 quarter was the buyout of Johnson Controls' Power Solutions led by Brookfield Business Partners for USD13.2bn and the largest deal of 2018 was the formation of Keurig Dr Pepper by an investor group led by BDT Capital Partners and JAB Holdings for USD21bn.

Buyout exit activities were roughly in-line year over year, with 1,958 exits announced in 2018 for a combined value of USD326bn. The largest exit of the December 2018 quarter was the sale of StandardAero from Veritas Capital to Carlyle for USD5bn and the largest exit of 2018 was the sale of BMC Software to KKR for USD8.3bn.

The venture capital market continued to be active in 2018 with 14,889 deals representing USD274bn of aggregate deal value, up slightly from 2017. Of the regions, North America led the largest number of deals for the highest percentage of aggregate deal value, followed closely by Greater China. By sector, Internet represented 29% of aggregate deal value followed by Software & Related at 15%.

While China led the largest private equity backed venture deals for both the December 2018 quarter and 2018, the US and India led the largest venture exits for the quarter and year.

In the December 2018 quarter, Beijing Bytedance Technology Co raised USD4bn from an investor group including KKR, Primavera Capital and Softbank China and in 2018 Ant Financial Services Group raised USD14bn from an investor group led by GIC and Temasek Holdings.

In the December 2018 quarter, Qualtrics (US company) was sold by an investor group including Accel, Insight Venture Partners and Sequoia to SAP for USD8bn and in 2018 Flipkart (Indian company) was sold by a large investor group which included Accel, Tiger Global and Iconiq Capital amongst many others to Walmart for USD16bn.

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In 2018, private equity funds raised USD426bn of capital compared to USD552bn in 2017. Consistent with prior years North America was the most active region with 639 funds securing USD240bn, followed by Europe with 196 funds securing USD90bn and Asia with 250 funds securing USD80bn. The average fund size reached USD363mn surpassing 2017's USD339mn and represents the highest level since 2007. The largest fund closed in the year was Carlyle Partners VII at USD18.5bn.

Portfolio activity for the quarter

During the quarter, MLC made seven new commitments, comprising:

- four fund commitments (being a European mid-market generalist buyout manager; a US mid-market fund focused on media and software; a US mid-market manager focused on health care and technology companies; and an Australian mid-market generalist buyout manager), and
- three co-investments (being a technology-enabled health care business; a leading designer and retailer of specialty footwear products; and a diversified operator of health care services).
