

Private Equity-Style Investing in Public Markets

I had the pleasure of speaking with Adrian Warner, chief investment officer of Sydney-based Avenir Capital a few years ago. Adrian shared his insights into public equity investing with a private equity mindset. In doing so, Adrian drew upon more than two decades of experience as a private equity investor in the U.S. and Australia.

Enjoy the conversation:

The following transcript has been edited for space and clarity.

John Mihaljevic, MOI Global: Adrian Warner has a background in private equity and was highly successful in that field prior to starting Sydney, Australia-based Avenir Capital, a value-oriented investment firm in public markets. Adrian, tell us about your path and what motivated you to make the switch from private to public equity.

Adrian Warner, Avenir Capital: I've spent close to 20 years in the private equity industry, both in Australia and in the US. I started out in the early 1990s after spending some years at Bain & Co in consulting. I finished my education in the 1980s, when the efficient market hypothesis was at its peak. I did a First-Class Honors degree in finance, having it drilled into me very firmly that public markets were efficient, and there was no way to effectively beat them over the long term. With that backdrop, I sought otherwise to apply investing in markets I felt were less efficient. Private equity in the early 1990s was such a place. It was still a fairly small and under-the-radar industry, and there were great opportunities there to hunt down businesses available for much less than I felt they were worth. That industry didn't really exist in the Australian market, so I had to move to the US to participate in it.

It was a wonderful industry for many years because it was entrepreneurial and flew under the radar. There were a range of great bargains people could buy, businesses others didn't want because of short-term issues they had or other factors that might have been at play. For many years, it was a productive and profitable industry. I moved back to Australia just as the private equity industry was starting to get some traction. We were able to replicate the success of the early days in the US in the Australian market. I joined a group ultimately called CVC Asia-Pacific, which is backed by the CVC Capital Partners Group out of London. In the late 1990s and the early 2000s, we had the Australian market to ourselves and were able to do a range of very successful deals of increasing size.

It was a really inefficient market, but then many large international groups such as TPG, KKR, Carlyle, and Bain & Co moved into it, and it suddenly became incredibly efficient and institutionalized. It got very hard to find cheap ideas and buy solid businesses with good prospects at a reasonable price. The infrastructure grew up around the industries. There were suddenly lots of advisers from legal,

accounting, and banking, all of whom knew how the private equity model worked, what drove returns, and how to structure transactions. Every transaction became intermediated, so you always had an adviser of some kind between the buyer and the seller, increasing the levels of efficiency in relation to pricing.

I started looking around and thinking where the next evolution of investing was. The private equity market had become incredibly efficient, and I've always felt the public market was incredibly efficient, but I started looking again at the public market with a fresh perspective. The epiphany I had (some could say 20 years late) was that the public market had tremendous pockets of inefficiency due to an increasingly short-term orientation in this investing world. In a strongly liquid market with continual public access to pricing, human nature and human emotions come to the fore much more than in private equity and can drive these short-term dislocations in price. To me, it was somewhat of an eye opener 20 years down the road - having dismissed the public market for so long, I suddenly became a firm believer that there were tremendous opportunities to take a private equity mentality or some of its principles and apply them to the public market. I felt it could be an enormously powerful investing combination. That's what we've set out to do with Avenir Capital - apply some of the key elements of private equity investing but to the much deeper opportunity set and much greater liquidity available in the public markets.

MOI: To what extent do you invest in the Australian public markets versus elsewhere globally?

Warner: When we set the business up, we wanted to maximize the opportunities available to us to find bargains. One of the things we focus on intensely is investment situations where we think there's an extreme mispricing, an extreme dislocation between price and our view of value. To best do that, we didn't want to limit the playing field, so we've chosen a global strategy. While we certainly can invest in Australian opportunities and have done so, we hold the view that it's a big world out there, and you have a much greater opportunity to uncover bargains if you have a broader perspective on the playing field that you can operate within. At the moment, probably about 20% of our fund is invested in Australian assets, about 50% invested in the US, and the remainder is probably split between European and Asian opportunities if we exclude cash. We wanted to keep it as broad as possible to allow us to hunt out those bargains wherever we can find them.

MOI: What applying a private equity mindset to public markets really mean, in your view? How does it differentiate you from some of the other participants in public markets?

Warner: One of the things we observed in the public market is that there seems to be an ever-increasing short-termism in the way people invest. The entire industry seems to be structured around that, with people becoming incredibly fearful of deviating from whatever their relevant benchmark might be, even for the short term. There's a whole infrastructure of gatekeepers, advisers, and fund ratings groups that will pounce on that and start telling their clients that perhaps this fund isn't such a great idea because it has fallen behind the benchmark for a relatively short period of time or its volatility in terms of month-to-month variations in asset value is greater than someone anticipated. It seems to us there's continual pressure, an institutional imperative to avoid doing that. When you avoid doing that, you essentially start to become like everybody else and try to pick those things you think will increase in price the most in the short term. The only way you can try to do it is by guessing what other people will think about the price of an asset, which to us is a very ineffective and difficult way to achieve returns in the long term.

The timeframes are much longer in private equity. Firstly, it focuses on the downside and worries a lot about the probability or the possibility of losing capital in any investment. Private equity portfolios are concentrated, generally employing fairly large amounts of debts so if things go wrong, they can go very wrong very quickly. There's a great deal of emphasis on worrying about what can go wrong in

any investment, which I consider quite a healthy starting point, and fixating on avoiding permanent loss of capital. That's probably the first element of private equity we work really hard on bringing over to the public markets.

Secondly, private equity is a very opportunistic business, so it's strongly focused on a fundamental, bottom-up, deep research approach to investment selection. This makes complete sense to us to remove yourself from trying to second-guess stock prices and focus on what you see as the underlying or intrinsic value of an asset and look to invest only in those situations where you can buy at a very material discount it. This bottom-up approach, which is highly consistent in private equity, is essential to what we do.

Thirdly, the private equity industry focuses on absolute long-term returns. There are no benchmarks in the short term, no liquidity or daily pricing of assets. The focus is very much on what you can buy an asset for now and what you think you'll be able to sell it for in three, four, or five years' time. You don't worry too much about what's going to happen to the price in the short term. This absolute long-term return focus is very powerful, but a lot of the public market industry is trapped in the relative benchmarking mindset, which can be very damaging to focusing on the long-term return, in my view.

Those are the three pillars of our program – focusing on the downside first, being very fundamental and bottom-up in our approach to investment selection, and focusing on an absolute long-term return rather than worrying about short-term performance and volatility. Those things differentiate us from many who have grown up investing in the public markets where they've been continually exposed to the pressures of needing to keep up with your benchmark in the short term. If you don't do something different from the benchmark, by definition, you can't outperform it in the long term. That's how we try to bring our private equity mentality to the public market.

MOI: In terms of the balance sheets themselves, private equity looks to increase returns by layering on leverage. Now that you invest in the public markets, are you still looking for companies with that kind of component to the return or do you try to avoid them? Does it not really matter either way?

Warner: It's a great question because when we tell people we're trying to bring the private equity approach to the public market, they think of two things. One is that we're going to use leverage in our investments, and two is that we are an activist fund and want control. We're neither of those. In most cases, one of the things you give up in investing in the public market is control, which is an immensely powerful element of private equity. We don't have it in most investments that we make in the public market, but that's a tradeoff we're prepared to make given that we have the opportunity to buy things at half price and the liquidity to change our mind and our position size should we see fit.

If you don't have control, leverage becomes a highly dangerous thing, so we're extremely cautious of it. We don't use leverage in the fund, so it is not leveraged in any way. In certain circumstances, we will invest in companies with perhaps more than a normal amount of leverage for a public market company, but that's relatively rare. In most cases, we're quite reluctant to invest in such situations because we've witnessed first-hand in our private equity career that it can be incredibly damaging. If you don't have control, there's not a lot you can do about it, so we are very cautious of leverage.

We will only invest in situations with some leverage if we think the businesses are above average in terms of quality, predictability, and stability of cash flow. We try not to use leverage as a generator or magnifier of returns because that works both ways. In general, we try to look for opportunities where the business is well capitalized and has a strong balance sheet, and we're able to buy it really cheap. That's what generates the returns for us, not the use of leverage. In some situations, leverage can be beneficial, but it's something we're very cautious of. In fact, in most of our investments, you'd see that leverage is not really an important part of the thesis. Most of the businesses we've invested in have

robust, often cash-positive balance sheets.

MOI: Another important criterion for private equity investors is the management team in charge of a company. Many of the best public equity investors also look for highly incentivized, capable management teams. I assume that's also a part of your strategy. How do you go about assessing management? What kind of indicators do you look at to decide whether you've found a management team you want to entrust your capital to?

Warner: One reason private equity has been generally successful over the last decade or two is that it has been very generous in the way it treats the management teams of its portfolio companies, generous in a sensible and thoughtful manner. I'm not just showering them with cash but providing them with attractive equity programs that really align their interests with those of the shareholders. I've seen first-hand in many occasions the power of that and how a simple but carefully structured management equity program can drive powerful and positive behavior from management teams. That's something I spend quite a lot of time trying to assess to understand who the important stakeholders in that investment are, whether it's management or other shareholders. How are they aligned in terms of economic incentives? Do the management team own a significant stake in the business? Are they regular and sizable buyers of shares in their own account?

Those things are essential. I've been burned in the past, making the mistake of investing in a couple of situations where the alignment was very poor or weak. Then you start to see behavior that is arguably not focused on the shareholders' interest but the manager's. This can be highly damaging when you don't have control.

It is difficult to assess management from the outside. In the public market environment, you don't generally get to spend a great deal of time with management, and any time you do spend with them is fairly carefully curated and controlled in terms of duration and form. Often, you're getting canned speeches from people who have said the same things many times before. They want to say what you want to hear and are great at doing it. You have to be careful in how you interact with management and what you take away because you're seeing part of it in a very controlled setting. If you don't have the history with them or the ability to go back in history and see what they've done in previous situations, it can be quite hard to make an accurate assessment of their capabilities, the particular areas they're going to focus on, and how they're going to think about capital allocation and shareholder interests. The clearest and strongest way you can do that is by understanding their economic incentives and whether they are material owners of shares alongside the shareholders. I know from first-hand experience in private equity that this is incredibly powerful in aligning interest. Even in the public market, it's the best way to ensure you will have a manager group thinking about you as a shareholder because they're a shareholder alongside you.

MOI: Could you give us an example of a company representative of the type of business you seek out and what you look for? Maybe you can let us know how the investment evolved after you made it.

Warner: We try to keep things fairly simple. We do have a very broad canvas in which we can operate as we have an international focus, so no matter what's happening at a macro level or with the markets, there are always opportunities to find something mispriced. A big part of what we do is simply rummage around in any area we can to find those few and select examples of mispricing. It's all we need to put together a portfolio. One example that we still own at the moment is an Australian business called Collins Food, the only KFC franchisee in the state of Queensland.

Interestingly enough, it was owned by a PE group for a number of years, and it was listed on the Australian Stock Exchange in the middle of 2011. One of the curious characteristics of private equity exits in the Australian market is that historically, the private equity group has exited 100%, whereas

it's more normal in other markets, including the US, for a private equity or investment group to sell down a partial stake in an IPO, and then exit its position over time. In the Australian market, people have historically gone out 100%, which has meant that, on occasion, the private equity industry as a whole has been accused of gilding the lily somewhat in these exits, selling out 100% and leaving buyers in the IPO to suffer the consequences of an underperforming stock price over time.

This was an example where the private equity group exited. The company put out a forecast and a prospectus in the middle of 2011. Within a few months of the IPO, the management revised down the prospectus forecast by 20% to 25%. As you can imagine, this was quite poorly received by the market. I think it was exacerbated by the fact that a private equity firm was exiting, so the investors reacted with a mixture of shock, anger, and embarrassment at being taken in by a private equity again. The management lost a fair amount of credibility, and the stock, which had listed at \$2.50 a share, collapsed quickly and continued to drop before settling at just over \$1.

Collins has about 93 million shares out, so the market cap had fallen from close to \$250 million to around \$100 million. It was reasonably well capitalized. There was about \$90 million of debt, but that was only just under 2x EBITDA, so it wasn't an overleveraged situation. The management team hadn't sold anything in the IPO and collectively owned about 8% of the business, meaning there was still the economic alignment between shareholders and management. Still, the company was being panned in the press on a daily basis, its IPO called the biggest flop of the year and fund manager embarrassment. No one wanted to have that stock in their books. People were selling it left, right, and center.

That's the kind of situation we look for, where you've got a fairly simple business to understand. Not much has changed in it, but there are circumstances around the business which mean there's forced or somewhat irrational selling. That's how we've been able to generate our best ideas. We looked at whether the business was well managed operationally. Although the prospectus forecast had been reduced materially, the earnings weren't going to be materially behind the last few years, and there was nothing fundamentally wrong with the business. We felt it could generate around \$18 million of free cash flow a year, and it was trading at about \$100 million of market cap. Fairly well capitalized, well run, with a management team that own 8% of the business, so fully aligned. It felt to us that a 20% cash flow yield or not much more than 5x P/E was too cheap for a business of this nature. It also had some growth options in terms of new stores and store refurbishment, and historically, that achieved very good returns on capital. We felt there was the opportunity to continue to get some earnings growth out of the business, but you didn't really need it to make a return.

We started buying at just over \$1. Shortly after, the company paid a \$0.065 dividend. Our all-in price was around \$1, and it's up to around \$1.80 today. We think fair value is probably something around \$1.80 to \$2, so we're probably close to starting to exit. By shutting out the noise and the press reports, we saw a well-run business of reasonable quality with a strong position in a competitive industry. There just seemed to be a disconnect. When you're paying 5x earnings for a KFC franchise, you can't go too far wrong. It has proven to be the case so far, with the investment's up about 80%. It's probably getting back to something approaching fair value now.

MOI: How do you think about valuation? What are some of the key financial metrics you look at to ascertain equity value?

Warner: Our first and most important metric is purely free cash flow. We're always very keen to see what cash is being generated by the business after capex, interest payments, and tax and what cash is coming through to the equity holders. If we can buy a business that's not declining or facing structural challenges for 5x, 6x, or 7x cash flow, we consider it a good starting point, assuming that the balance sheet and the capital structure are fairly robust. When we think about exits, for a business like Collins Food, we try to be very conservative. Historically, we've looked at something like 10x free cash flow as

a reasonable assumption for an exit. If we can buy it at that price and assume 10x free cash flow on the exit and double our money under those assumptions, it starts to look like a potentially very interesting investment for us.

Having said that, one of the things we've increasingly done over time is raise our standards in terms of the quality of the businesses we'll invest in. Our mistakes in the past have been due to investing in businesses where the quality has been too poor and something has been tremendously cheap on a statistical basis but even if the business was not deteriorating or structurally flawed, it was lower quality with very limited barriers to entry. Over time, we've gradually increased the threshold for the nature of businesses we'll invest in, which means we are prepared at times to pay a higher price for a business of much better quality.

We're still very much value investors at heart. We look at profit, market value, what we think a sensible, rational and conservative third party, including private equity, might pay for a business, and that often comes down to what multiple of operating earnings people might be prepared to buy. We apply a highly conservative filter to that because if you're in ebullient or enthusiastic times, you'll see people paying prices that make no sense in the long term. We have to be cautious not to extrapolate some transaction values which have occurred in the market and say, "That's a reasonable value. We'll assume it for an exit." At times, transactions get done at a rational level, so we always try to anchor it back to free cash flow in one form or another.

MOI: You're a bottom-up investor, and ultimately, investing is all about the individual companies you purchase. Speaking of going up on the quality scale, could you tell us what types of businesses you consider of lesser quality? Are there any industries you consciously try to avoid getting involved with?

Warner: Private equity is a very opportunistic industry. My training is to be wide open to most areas and to have the confidence that we can understand the important issues around any industry or any investment.

Having said that, there are some areas I personally feel really uncomfortable with and generally avoid. One of those is resources. Coming from Australia, there's plenty of those stocks around, but I find it very hard to make a sensible and credible assessment of what they're worth. There are too many variables involved to get comfortable with even coming up with some range of potential values. The starting point for our investment process is that if we can't come up with a credible view of what something might be worth, even if it's a range, we can't determine whether there's a significant enough dislocation between price and that value. To me, resources is an area prone to nasty surprises, with too many variables around the quality of the assets, operational issues, and the need to raise further funding in a dilutive manner when you least want to do it. All of those issues I think make me cautious.

I also find retail challenging. There is a fine line between a successful retailer and a struggling retailer in terminal decline. From the outside, it can be tough to determine where that fine is. Without having the flow of information and control over management that you can get in a private equity setting, I treat retail very cautiously.

Outside of areas like that, what we tend to look for is reasonable quality businesses with reasonable predictability of cash flows and a relatively limited rate of change in the industry. Warren Buffett said that change is the enemy of the investor, and in many cases, we believe it as well. If we're looking at a business which operates in an industry with a lot of change going on and it's difficult for us to understand where that change might lead, then we just think there are plenty of opportunities elsewhere, and they go into the "too hard" basket.

MOI: One of the obvious attractions of private equity is the ability to have control. How do you make peace with the fact that you are more passive in the public markets and cannot affect actions, whether it's on the business or the capital allocation side?

Warner: Control is a wonderful and powerful thing. You can invest in situations you wouldn't otherwise invest in if you have control. I certainly don't underestimate its power and consider it one of the greatest strengths of private equity. We do give that up but compensate for it by being able to buy at a discount to fair value. There isn't a more powerful way to generate safe and satisfactory returns than by paying the right price for any investment, whether you have control or not. The ability to buy things tremendously cheaply in the public market makes up for the lack of control.

The other thing is that the public market provides liquidity. In private equity, when you buy something, you're often stuck with it for quite a few years. It's not easy to turn around and sell it if you change your mind six months or a year down the road – you find that things weren't quite as you anticipated. In the public market, you can. You have that liquidity, not necessarily at the price you want, but you can make a decision that you'll find better opportunities elsewhere, the thesis you made your investment on no longer holds, or you made a mistake. You have that liquidity, which is an extremely powerful thing and doesn't exist in private equity.

MOI: You don't consider yourself an activist investor, but do you occasionally try to influence management or at least let them know your views?

Warner: We certainly seek to let our views be known. Having spent almost 20 years in private equity and having a key seat at the table by being in a position of control, you don't change your stripes entirely. We're not shy in letting management or the board know what we think or whether we think they're making missteps, but we certainly don't describe ourselves as activists. The opportunity set is so wide that if you put on the activist hat too firmly, you run the risk of only looking for those situations where you can spoil for a fight and you have conflict. We feel there are enough opportunities out there where management and board are doing the right thing, and we can either be passive investors or benefit from the activities of others who are being more vocal or more active in the way they're engaging with the company. We're certainly not shy about benefitting from opportunities where others are trying to bring about change, but it's not something we're focused on ourselves.

Over time, there will be situations where we feel the need to get a bit more pointed with managements or boards, but I suspect these will be mostly cases where we're already invested in the situation and think the right things aren't happening or there are some capital allocation decisions we disagree with and we're already party to that investment. In those situations, we'll probably stay to get more evolved. What we don't intend to do is start out by looking for ideas which require an activist hand at the wheel. If you do that, you run the risk of limiting your view to those situations and miss out on all the wonderful opportunities where people are doing the right thing, and circumstances have conspired to create a great opportunity to buy a decent quality business at a great bargain, so you don't need to be cracking the whip.

MOI: How do you go about generating ideas to look into further on a global scale?

Warner: The idea generation is an essential part of what we do. It's difficult to be too scientific about, to be honest. We get ideas from a range of sources. We do a tremendous amount of reading – magazines, SEC filings, conference call transcripts, sell-side research. There are groups such as your Manual of Ideas which are wonderful sources of almost curated and pre-screened ideas, so we make sure we're tapped into the better ones to use as a source of idea generation.

A big part of it is making sure your antennas are tuned to those situations where you think there might be opportunity. The starting point for us is to seek areas in which there might be forced or panicked sellers and any rational sellers in some way. These are the kind of situations we look for. Whether we're reading newspapers, watching the news, or talking to colleagues and other investors, our antennas are always tuned to anything that might create an opportunity because of someone selling something for the wrong reason. That's where we start. We look for blood in the water in many cases to find those circumstances and the accompanying extreme mispricing.

The industry has changed a lot in the last five years, but there's no substitute for the leg work. If you don't enjoy reading and scrounging around, I don't think you can hope to be very successful because that's a big part of what we do. If you don't enjoy the hunt, you'll find it hard to maintain the passion and the focus. There are groups like Manual of Ideas that recognize the existence of this voracious market desperate for good ideas and can create viable businesses in trying to bring the best ideas to surface. In a way, it creates more efficiency in the market, which is not necessarily a good thing, but from an idea generation point of view, it can be very powerful. There is a whole range of avenues you can tap into that didn't exist five years ago, so you can sift through those and see which ones resonate with your own approach. As always, we go back to original documents and original sources to develop our own theses.

MOI: Let's talk a bit about how you're building your firm. One thing I found very interesting is the fee structure. I believe you don't charge a management fee but take a performance fee over a 6% hurdle. What motivated you to set up that kind of structure?

Warner: When we started, we were looking to offer something a little different and provide a bit of innovation to the market. First, we felt that the idea of bringing a private equity mentality to bear on the private market is something others have done before us, but it's still relatively in its infancy. Our background was different. We've not grown up in the public market industry, so we've not been swayed or molded by its pressures. That's quite a powerful differentiating factor, in my opinion.

With the fee structure, we are also looking for a way to say we're prepared to back ourselves to generate good sensible returns in the same manner. We looked at what others were doing, and there were people like Mohnish Pabrai, whom we enjoyed watching. He openly stole his fee structure from the early Buffett partnerships of the 1950s and 1960s, so we thought we'd steal it from Pabrai Funds. If you do that, you can't get too far wrong in the fee structure, and it felt like a way to provide a different product to investors. We're essentially saying if we don't generate at least a 6% return per annum, which is meant to be a nominal cash rate, we don't deserve to get paid and shouldn't get paid, and our investors might as put their money in a bank.

It's also aligned with our strategy. We like to be very selective, so we only invest in situations where we think the downside risk is minimal, and we stand a strong chance of doubling our money in two or three years. If we can't find such an opportunity, we'll leave our money in cash. We don't expect people to pay us for keeping their money in cash although we think there's real value in having that discipline if you can't find the best opportunity. When money sits in cash in the fund, people aren't charged.

The quid pro quo is that if we do well, we take a performance fee. Once the fund generates above 6%, we take a performance fee of 25% of the increase in net asset value, so it works out. The fee structure equates to a 2 and 20 structure when you get to very high rates of return, but investors get protection on the downside below 6%.

Another thing is that I have the bulk of my own family's money in the fund, which gives people comfort that we're protecting theirs. Our first goal is to make sure we're able to give investors their money

back when they want it, and our secondary goal is to try and generate an above-market return over time. Since my family's money is in the fund, we align our investment decisions with our other investors because we're not there just to make a fee. We're there to generate returns out of the fund and to protect our own capital, so we take a cautious view to investing. We think the fund structure is a sensible one. It makes sense for investors, it makes sense for us, and it has proven to be really popular.

Adrian Warner is the Managing Director and Chief Investment Officer of Avenir Capital and is responsible for the portfolio management of the Avenir Global Fund. Prior to founding Avenir Capital, Adrian worked in private equity investment in Australia and the United States with an investment record spanning over 20 years. Immediately prior to establishing Avenir, Adrian was Managing Director and part-owner of Catalyst Investment Managers Pty Ltd, a mid-market Australian private equity firm with approximately \$900m funds under management as at December 2009. Before joining Catalyst, Adrian was Managing Director at CVC Asia Pacific Ltd, one of the leading private equity groups in Asia with approximately US\$2.75 billion funds under management as at December 2006 and part of the CVC Capital Partners Group.

Adrian has also worked at Pacific Equity Partners Pty Ltd, the largest Australian-based private equity firm and also at AEA Investors Inc., one of the longest standing private equity groups in the United States. Adrian was also a management consultant at Bain & Company and has worked in Australia, the United States and Asia.

Adrian holds a Master of Business Administration (MBA) from Harvard Business School and a Bachelor of Commerce (First Class Honours) from the University of New South Wales.