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PRIVATE PENSION FUNDS' ATTITUDES

TO PRIVATE EQUITY IN HUNGARY

HVCA 2010

EXECUTIVE SUMMARY

The assessment of the future role of venture capital among the Hungarian private pension funds is clearly positive. Two thirds of them reported already existing private equity investments or that they plan such investments for the near future. In the medium term, two thirds of the pension funds expect to invest 1-3% of its assets into this asset class. Three quarters of the pension funds find it practical to take advantage of the frames provided by the regulation of investments made into venture capital and private equity funds. This would allow the inflow of fresh capital in the order of magnitude of HUF 150 billion into the private equity sector.

In the selection of the specific venture capital and private equity funds the Hungarian private pension funds consider in the first place the manager expertise of the specific VC&PE funds and their track record. They wished to invest private equity funds of both domestic and foreign locations. They expect the Jeremie-program to make a positive effect on the competitiveness of the domestic VC&PE funds. In the long term, they expect to realize 20 plus % returns from private equity investments, mostly higher than achievable on the stock market.

An important lesson learnt from the survey is that the Hungarian private pension funds are in need of considerable help in gaining information necessary for them to make private equity investments. Pension funds primarily expect the fund managers assigned with the management of their assets to be adequately informed. The participants of the private equity sector – thus, among others, the consultants, fund managers, and the association representing the private equity funds – may also significantly facilitate the joining of the domestic private pension funds to the provision of funds to the private equity sector through improving the supply of information to asset managers. The pension fund executives found the regulation of private equity assets in Hungary basically adequate, although some minor fine-tuning could make such investments easier for them.

Dr. Judit Karsai
The Chairman of the HVCA Statistical Committee

THE PURPOSE OF THE SURVEY

For a temporary period, private equity funds, as shareholders, take part in the aiding of start-up companies, facilitating the expansion of enterprises having significant potentials, in the restructuring of companies, getting equity-marketable companies into the stock exchange, in generational replacement of family owned businesses, selling the subsidiaries and divisions of large companies and transforming the ownership structure of companies wishing to leave the stock exchange.

In countries with developed capital markets, the highest proportion of the capital of venture capital and private equity funds has been made up for years by savings managed by pension funds[1], while pension funds allocate an average of 4.8% of their assets into private equity worldwide[2]. The largest proportion of the capital of private equity funds specialised in Central and Eastern Europe is also committed directly or indirectly by private pension funds[3], although the registered seats of these are not located in the region.

What is the situation in this respect in Hungary? Do the private and voluntary pension funds, making decisions on their investments freely in Hungary within the limits set by regulations, actually take into account the diversification possibility provided by private equity, when they create their portfolio? To what extent are they informed about the investment opportunities, what is behind their possible reserve, and what actions may help change the current situation?

The survey[4] conducted by the Institute of Economics of the HAS in the summer of 2009 wishes to answer the above questions. The survey used an electronic questionnaire to interview the executives of private and voluntary pension funds operating in Hungary on private equity. As the majority of the pension fund executives having completed the questionnaires represented both private and voluntary funds, the completed 12 questionnaires reflected the opinion of a total of 10 private and 9 voluntary pension funds. The pension funds having completed the questionnaires collectively represent close to 80% of the total assets of pension funds.

The questions asked from the executives of pension funds embrace the following six topics:

1. Private equity investments already made and under negotiations
2. Information grounding private equity investments
3. Criteria of the selection of private equity funds
4. Return expected from private equity investments
5. Regulations of investments into private equity funds
6. Expectations related to the role of private pension funds on the private equity market

[1] In 2008, more than one quarter of the fresh capital raised in the given year for the purpose of private equity investments both in Europe and in the USA was provided by pension funds, and thus the highest proportions of the capital of private equity funds was received from these institutions (‚Private Equity 2009', IFSL Research, 2009; ‚Dow Jones Private Equity Analyst', Dow Jones 2009).

[2] Private equity investments are popular among pension funds mostly in America and Europe. In 2008, in the assets of the largest twenty pension funds, private equity reached 8.6% of the value of invested assets. The pension funds operating in North America make up close to half of the pension funds investing into private equity, while close to another one third of the funds are European (‚2009 Preqin Global Private Equity Review', Preqin, February 2009). In Central and Eastern Europe the proportion of private equity is extremely low, and in 2008 in the portfolio of institutional investors – also embracing the pension funds – it reached only 0.1% (‚IPE European Institutional Asset Management Survey 2009', Investment & Pension Europe, June 2009).

[3] Karsai, J. ‚Private Equity in CEE' (VDM Verlag, 2010., p. 12.)

[4] The preparation of the survey was supported by the OTKA tender No. K68471, and Stabilitás Pénztárszövetség /Stability Fund Association/ provided assistance for conducting it.

PRIVATE EQUITY FUNDS IN THE INVESTMENT OF PRIVATE PENSION FUNDS IN HUNGARY

The survey worked with the hypothesis that the opinion of private pension funds on investments into private equity funds is highly influenced by the fact whether or not the funds have come across private equity at all, if there is such an investment in their portfolio and if they conducted negotiations to such effect with the managers of private equity funds. At the time of the survey no comprehensive statistics were available of the occurrence of investment into venture or private capital fund in the practice of private pension funds in Hungary, and the business press also published news related to that sporadically[5,6].

Two thirds of the respondents reported that they already had a private equity investment or plan it for the near future, which indicates the intensifying interest of pension funds in Hungary in private equity. Out of 12 pension fund executives completing the questionnaire two already held investments in private equity funds in the summer of 2009, another two funds were in the process of such negotiations not yet closed and further four funds planned to make investments into private equity funds within three years.

Table 1.

Plans of pension funds to invest into private equity funds

The private equity investment was by the pension fund	Number of respondents checking in the given response (person)
Already realized	2
Just under negotiation	2
Plans within a year	1
Plans in three years	3
Does not plan	4
Total	12

Source: KTI survey

[5] „... venture fund units are lacking from the second pillar's portfolios both in 2007 and 2008." (Kiss, G. D. ‚Venture capital and pension system', http://ssrn.com/abstract=1542122)

[6] According to press news, pension funds in Hungary started to make investments into the domestic private equity funds as early as in 2005 through investments into the regional venture capital fund of a fund manager called Euroventures (‚Emerging Markets Private Equity Grows, but Where are the Local Pensions?', EMPEA Vol. I., Issue 4, Q4 2005, p. 10.). The first Hungarian pension fund undertaking to invest in private equity was the Hungarian pension fund managed by Credit Suisse Asset Management (‚Pension fund may risk ,, Napi Gazdaság, 30 January 2004.) In April 2009 a report on Portfolio.hu implied the realisation of a new investment, when quoted the words of the CEO of AXA Magyarországi Befektetési Alapkezelő /AXA Hungary Investment Fund Manager/: „we committed ourselves and made the investment, but it was not easy „ (‚Courtiers of pension funds are increasingly intent ,, Portfolio.hu, 15.04.2009.).

In the summer of 2009 two thirds of the responding funds partly or fully agreed with the statement that within 3-5 years the pension funds will invest 1-3% of their assets into private equity funds, which also underlines the serious aspirations of the pension funds related to private equity in the medium term.

Table 2.

Medium term expectations of private pension funds related to private equity investments

Do you agree that within 3-5 years the pension funds will invest 1-3% of their assets into private equity funds	The proportion of respondents selecting the given response in the percentage of the total number of respondents (%)
Yes	42
Partly	25
Less	33
More	0
Total	100

Source: KTI survey

TAKING ADVANTAGE OF FRAMES PROVIDED BY THE PRIVATE EQUITY REGULATION

In spite of the positive assessment of private equity in the medium term, the opinion of the private pension fund executives asked was not fully uniform as to it is actually practical for them to take advantage of the framework provided by the regulation of private equity investment. Three fourth of them found it practical to take advantage of the framework, primarily because private equity could improve the diversification of their portfolio, and secondly as they can reach higher returns with private equity compared to other assets, and thirdly as the long-term private equity investments would be well adjusted to the payment obligations of the pension funds. The pension funds voting against taking advantage of the framework provided by the regulation were more reserved as they thought that this area of investments was unknown for them yet. In their opinion, its relatively higher risk was also against private equity investments, as well as the lack of VC&PE funds demonstrating adequate track records.

Table 3.

Advantages and disadvantages of private pension fund investments into private equity funds

Advantages and disadvantages of investments into private equity funds	The proportion of respondents selecting the given response in the percentage of the total number of respondents* (%)
It may improve the diversification of the portfolio	32
Promises higher returns	24
Its time span is well adjusted to the funds' fiduciary obligations	20
It is an unknown area yet	12
It involves high risk	8
There is only few funds with adequate performance	8
Other	8

**Comment: more responses are possible*

Source: KTI survey

INFORMATION GROUNDING THE PRIVATE EQUITY INVESTMENTS OF PRIVATE PENSION FUNDS

Taking into consideration the remarkable interest in private equity, the importance of obtaining proper information, i.e. getting access to information on private equity investments, being a relatively new area for Hungarian pension funds, has grown. The survey reflects that there is a huge number of tasks to be solved in this area, as the pension funds, as they see it, in most of the cases do not have proper information for considering their investments into private equity funds. Only 10% of them indicated to be satisfied with the information. They thought that access to information can be thanked to the participants of the capital market knowing each other and the market well. Clearly it is not an accident that exactly those pension funds were on this opinion, which already have private equity investments or are close to making such investments.

According to close to 60% of the Hungarian pension funds: information necessary for making private equity investments is available only partly. In this circle most of the respondents thought that although the funds have lots of data at hand, still a number of information is missing for being able to make a careful decision. Some think that it is only the domestic private equity funds about which sufficient data are available, while others found this solved just in the case of foreign VC&PE funds. In the opinion of 30% of the pension funds dissatisfied with the information available for making decisions on private equity investments, the pension funds do not know the investment practice of private equity funds, they have no public data available on the performance of funds, and the operation of the private equity market is not transparent.

Pension funds expect to receive information facilitating their private equity investments mainly from their assigned pension fund managers managing their investments, and through the publications dealing with the subject. Financial advisors, the so-called placement agents, as well as the professional organisation of PE investors may also play a role in providing the missing information. A relatively low percentage of the respondents indicated the in-house investment manager of the pension funds as the source of such information that may ground their decisions.

Table 4.

The source of information grounding the investments into private equity funds

Source of information	The proportion of respondents selecting the given response the percentage of the total number of respondents* (%)
Investment fund manager	27
Related publications	24
Financial consultant	12
Placement agent	9
Private equity association	9
In-house investment manager	6
Another pension fund	6
Other	9

**Comment: more responses are possible*

Source: KTI survey

CRITERIA OF THE SELECTION OF VENTURE CAPITAL AND PRIVATE EQUITY FUNDS

In the pension funds' portfolio the adequate selection of the private equity funds is the key issue of the successful investment of private equity. The survey highlights that in the selection of the particular VC&PE funds, the pension funds find the adequate expertise of the private equity fund managers to be the key criterion. The second most important factor of consideration shown by the frequency of answers is the track record of the funds in question. As the third criterion, the pension funds consider those co-investors with whom they together invest into the private equity funds to be selected. Further key criteria of the selection include the special sector, life cycle, and geographical location of the companies planned to be included in the portfolio according to the pre-announced strategy of the private equity funds, and the size of the fund.

Table 5.

Criteria of the selection of private equity funds

Criteria	Rank* (based on the frequency of being mentioned)
Expertise of asset managers	1
Track record	2
Co-investors	3
Portfolio companies' sector	4
Portfolio companies' life cycle	5-7
Portfolio companies' geographical location	5-7
Fund size	5-7

**Comment: more responses are possible*

Source: KTI survey

RETURNS EXPECTED FROM PRIVATE EQUITY INVESTMENTS

A key issue of investments into private equity funds is the realisable return. In addition to diversification, it is primarily the higher return promise that justifies the involvement of private equity into the investment portfolio, which bears significantly higher risk than the stock exchange products. International experience shows that there is an extremely high dispersion among private equity funds regarding the yield they earn; therefore it is a key issue that the pension funds would select the funds in the best performing quarter as the area of their investment.

Out of the pension fund executives interviewed in the summer of 2009, compared to other questions, relatively few declared their opinion on the expected return of investments into private equity fund. According to the answers given, the expectations of the pension funds on the annual level mostly fell into the tier under 10%. In the medium term of 3-5 years, most of the pension funds expected 15-20%, while in the long term 20 plus % return expectation was the most typical. One of the pension funds defining the performance expectation relatively in comparison to public equities expected assets invested as private equity to perform an additional 5-10%.

The year 2009 returns of European venture capital investments, still bearing the effects of the crisis, did not meet the expectations of the pension funds. However, the private equity investments showing an annual return of 3.1%, 6.1% in a five-year period and 8.8% return in the long-term even so outstrip public market comparators[7].

Table 6.

Private pension funds' return expectations from private equity investments

Expected return (net IRR)	The proportion of respondents selecting the given return in the percentage of the total number of respondents (%)
Annual return	
< 10%	43
10–20%	57
20% >	0
3-year return	
< 10%	0
10–20%	100
20% >	0
5-year return	
< 10%	0
10–20%	71
20% >	29
10-year return	
< 10%	0
10–20%	43
20% >	57

Source: KTI survey

[7] "Short term private equity performance improves amid wider volatility" Press Release, EVCA, Thomson Reuters, March 2010.

LOCATION OF PRIVATE EQUITY FUNDS

Looking from the perspective of the capital sources of the domestic private equity funds it is an important question whether the Hungarian private pension funds increasingly interested in private equity investments prefer domestic or rather foreign funds in their investments. The responses reflect that most of the pension funds (more than 40% of the respondents) would intend to invest both into domestic and foreign private equity funds. In the case of investments, an argument for selecting both domestic and foreign funds at the same time is that this way the benefits may be better shared. Those responding pension funds, which already have experience of such investments, prefer both domestic and foreign private equity funds.

One quarter of the private pension funds would rather prefer the foreign VC&PE funds, and among them mostly those pension funds, which do not have private equity investments yet. Out of the total number of respondents those pension funds appeared in the highest proportion that would choose the foreign funds due to their significantly more substantial experience in investments. Another argument for foreign funds is that the domestic market is over-represented anyway in the asset portfolio of pension funds. Finally, more favourable taxation also tips the balance towards foreign funds. An argument for domestic funds is that the size of these is a lot better adjusted to the size of the capital wished to be invested. And last but not least, domestic pension funds know the domestic private equity funds better.

One quarter of the responding pension funds, however, do not wish to invest anywhere, and one tenth of them could not give a response to this question. Stipulating currency translation, which drew the exchange rate risk

Table 7.

The role of the location of the private equity funds in the selection of the fund

Arguments	The proportion of respondents mentioning the given argument in the percentage of the total number of respondents* (%)
Foreign PE funds are a lot more experienced	30
Foreign PE funds decrease the over-representation of the domestic market in the pension fund's assets	15
Benefits can be better shared if using both foreign and domestic PE funds	15
The taxation of foreign PE funds is more favourable in many countries	10
The size of domestic funds is better fit to the asset scale to be invested	5
Domestic PE funds are better known	5
Would not choose either the domestic, or the foreign PE fund	15
Other	5

**Comment: more responses are possible*

Source: KTI survey

of the VC&PE fund portfolios under control, also influenced the selection between foreign and domestic private equity funds since August 2009. This provision, which aimed at facilitating the keeping of the funds' assets on the domestic market in the long term may also decrease the possibility of international diversification necessary for portfolio management in the area of private equity too.

The experience of the survey shows that the executives of the pension funds are not really restricted by this provision for the time being, as relatively few of them have inquired about the opportunities of foreign private equity investments up to date. Among the respondents there was only one such pension fund, which has ever invested into a foreign private equity fund. The limited interest in foreign PE funds is indirectly indicated by the fact those three quarters of the respondents having completed the questionnaire was not able to assess whether the domestic regulation of investments into private equity is more advantageous or more disadvantageous than in the neighbouring countries. According to those who find the domestic regulation better, the existence of dedicated investment opportunities into the private equity funds represents an advantage. Taking into account that a high number of domestic pension funds – although interested in investments into private equity funds, but – are quite inexperienced in this area, an important question is the possibility of investing into VC&PE funds operating in the form of so-called funds of funds, or umbrella funds. These funds, wedged in between the pension and the PE funds are more able to select the proper private equity funds, having the adequate experience. The opinions of pension funds widely vary on that, but a significant proportion of the pension funds admitted of not being able to take a stand in this issue. Among those respondents, who expressed an opinion in this question at all, those were in majority all in all who voted for the umbrella funds. Among those preferring the umbrella funds, the opinion of those dominated according to whom this solution actually helps select a private equity fund, while those against it refer to the fact that the involvement of the umbrella funds will decrease the realisable returns due to the fees payable to the additional level of fund management.

Table 8.

Assessment of the role of umbrella funds

Opinion on the umbrella funds	The proportion of respondents representing the given opinion in the percentage of the total number of respondents * (%)
Does not have an opinion	20
Able to select the private equity funds better than the pension funds	20
They would significantly decrease the realisable returns	13
Would represent more competition for private equity funds	7
Pension funds would be competent in effective private equity investments even without this	7
Through their diversification they reduce the risk of individual investments	7
They have no added value as the domestic funds are small	7
Would be a feasible way for smaller pension funds	7
Other	13

**Comment: more responses are possible*

Source: KTI survey

REGULATION OF THE PRIVATE EQUITY INVESTMENTS OF PRIVATE PENSION FUNDS

The regulation of the private equity investments of pension funds allows the funds to include private equity in their portfolio at all since January 2006, i.e. to subscribe for private equity fund notes.[8] From the aspect of the regulation of private equity investments, the stipulated introduction of the system of selectable portfolios – originally from the beginning of 2009 then prolonging it to the middle of 2011 — further specified the maximum rate of pension fund assets into private equity. Out of the three eligible portfolio classes, the possibility of private equity investment was removed from the classic portfolio, while it was reduced in the balanced portfolio. In the balanced portfolio the proportion of the notes of private equity funds may reach maximum 3% of the invested assets. In the growth portfolio, where the highest risk may be borne, the originally stipulated requirement continues to apply to the pension fund assets. That is, the notes of private equity funds may make up maximum 5% of the invested assets, and the notes of one private equity fund cannot exceed 25% of the assets included in the pension fund's growth portfolio.

The pension fund executives interviewed in the survey are aware that the regulation allows them to invest the assets of their funds through the subscription of private equity. However, they are aware of the „delicacies" of the regulation to the same depth. It is also indicated by the fact that one quarter of the respondents admitted not being able to take a stand

Table 9.

Portfolio investment regulation of pension funds regarding PE funds

Are there such stipulations in the regulation of the operation and investments of pension funds that hinder private equity investment?	The proportion of respondents selecting the given response in the percentage of the total number of respondents (%)
Yes	17
No	50
Does not know	25
Does not answer	8
Total	100

Source: KTI survey

[8] According to the pertaining government decree, the notes of funds regarded as private equity funds, could reach maximum 5% of the invested fund assets with the restriction that the rate of notes issued by one private equity fund could not exceed 2% of the invested fund assets (332/2005. (XII. 29.) Gov.Decree; 293/2005. (XII. 23.) Gov. Decree).

in the issue whether the multi-faceted regulations pertaining to the operation and investments of the pension funds contains such stipulations that hinder private equity investments, and probably for the same reason another 8% of the respondents to the questionnaire did not even answer this question. One quarter of those answering this question thought that such hindering requirements do not exist. 17% of the respondents thought, however, that there are such among the stipulations that are explicitly adverse to private equity. These latter fund executives missed clear-cut regulations in the legal form of foreign private equity funds licensed for investment and in the valuation of assets invested into private equity.

The survey separately requested the opinion of pension fund executives on whether it would be necessary to adjust the regulation currently in effect so that it may better facilitate the investments of funds into private equity funds. It reflects uncertainty that the same proportion of fund executives responded yes and now — 42%-42% — while 16% of them admitted not being able to decide this issue. The arguments of those voting for changing the regulation included several aspects. For instance, as a reason for modification they mentioned that the currently valid regulations do not keep up with the market processes and thus the critical situations are difficult to handle. Another pro-change argument was that the regulation does not specify clearly the prudential requirements and does not differentiate between committed and actually drawn down private equity, and makes it difficult to keep a daily registration of the value of private equity investments, and finally the requirements of the current regulation impose too much burden on pension funds in the area of the providing information to the beneficiaries.

EXPECTATIONS RELATED TO THE PRIVATE EQUITY MARKET ROLE OF PENSION FUNDS

The so-called Jeremie-program is currently affecting the venture capital investment opportunities of the pension funds on the Hungarian market. Within the frames of this in 2009 the managers of 8 venture capital funds in the private sector were granted a licence to set up a venture capital fund according to Hungarian law, adding 30% private sector resources to the funds granted by the European Union, and the Hungarian budget. The setting up of the new Jeremie-funds will boost up the venture capital financing of mostly young, innovative domestic companies in Hungary, previously pushed to the background due to the insufficient availability of venture capital.

As the savings managed by the pension funds may typically contribute to the private sector capital sources of the Jeremie-funds to be set up, the survey aimed at exploring the funds' opinion on that. It is somewhat surprising that one third of the fund executives were not able to answer the question how the Jeremie-program affects the decision of the pension funds made regarding their private equity investments. Those funds that expressed their opinions mostly emphasized that the preferences attached to the Jeremie-program may result in realising higher return on investments made into such funds, and secondly they highlighted the improvement of the range of supply of venture capital funds selectable for them. As opposed to this, other pension funds underlined the fact that the venture capital supplied will significantly grow on the Hungarian market suddenly, and the program will direct the domestic venture capital funds towards such companies that are way too risky for the funds.

Table 10.

Effect of Jeremie-funds on the venture capital investments of pension funds

Expected effect of the Jeremie-program from the aspect of the venture capital investments of pension funds	The proportion of respondents selecting the given response in the percentage of the total number of respondents* (%)
It will realise more favourable returns	32
The supply of venture capital funds will extend	25
Too much venture capital will look for similar targets	12
The venture capital funds will be directed towards too risky companies	6
Cannot assess	25

**Comment: more responses are possible*

Source: KTI survey

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