



## PRIVATE EQUITY - AN ANALYSIS

**S**ome recent high profile instances of private equity buyouts, or attempted buyouts, of major Australian companies, has focussed the attention of policy makers and the public on the advantages and disadvantages of private equity financing. ACCI recently made a submission to a Senate Enquiry looking into the issue.

### BACKGROUND

Generally, private equity is considered to be the direct investment in businesses where the equity is not traded through the share market. Instead, the businesses and assets are owned by private equity investors who can directly manage the businesses, particularly by appointing boards of directors.

Private equity vehicles may themselves be traded on the sharemarket (for example KKR in the United States).

Some private equity investors buy into a company that is listed on the stock market and de-list the company from the stockmarket. The investor then undertakes significant restructuring of the business and re-lists the business a few years later, hoping to make a significant gain on their original investment.

Private equity investment can have large levels of debt. Where this investment occurs in an existing company, this is called a leveraged buyout.

Private equity that invests in a new business is generally called venture capital. There is little difference in concept between private equity investment in new businesses compared with existing businesses. This means that it may be hard to regulate private equity for existing businesses without harming venture capital, which is often important in the growth of new businesses, particularly in technology fields.

### TRENDS IN PRIVATE EQUITY

Private equity is a growing phenomenon in Australia.

The Reserve Bank of Australia (RBA) has analysed private equity in a number of publications, including:

- the RBA's Financial Stability Review (FSR) for March 2007, which had a special section on private equity; and

- recent RBA Statements of Monetary Policy which have focussed on leveraged buyouts (LBO) - a particular type of private equity involving high debt levels.

The RBA shows a very large growth in private equity investment in 2006, as shown in Figure 1.

Some interesting facts from the RBA's analyses include that:

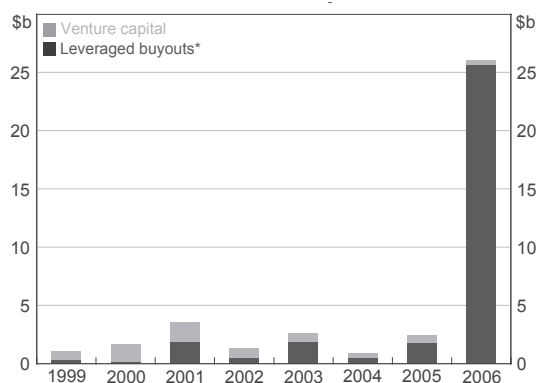
- private equity investment in 2006 amounted to only 2 per cent of the total value of the corporate sector. The RBA noted that this is the same as in the United States;
- a surge in private equity occurred in 2006 in Australia but occurred earlier in other countries and appears to be occurring in most of the developed world and Asia; and
- the increase in LBO activity in Australia was due to an increase in the size of the average deal, rather than an increase in the number of deals. There were 28 deals in 2006 compared to 29 in 2005.

### REASONS FOR GROWTH IN PRIVATE EQUITY

The reasons for an increase in private equity include:<sup>1</sup>

- high rates of world economic growth, along with strong profit growth and low market volatility;
- the low cost of debt, particularly relative to equity, as shown in Figure 2, from the RBA, below (the light colour is bond yields, the dark colour is equity yields):
  - The low cost of debt combined with the low borrowing ratios of some Australian companies has made these companies attractive for LBOs which increase borrowing substantially;
- higher debt levels in some private equity deals means

**Figure 1**  
**Private Equity Investments in Australian Companies**



\* LBOs by domestic and offshore private equity funds. Includes debt and equity funding of deals completed and pending; excludes existing debt of bought-out company. Sources: *Australian Venture Capital; Thomson Financial.*

that free cash flow is reduced, limiting the ability for management to make poor investments and increasing the incentives for cost cutting;

- the potential for private equity to improve management, for example:
  - management may find it easier to take decisions that reduce short term value but improve long term value (these strategies may not be favoured by some market analysts and day traders); and
  - continuous disclosure to the market is not required for companies that are not listed. The announcement of some decisions to the market may benefit competitors.
- the greater regulation of public companies compared to private companies. In the US, complaints have particularly been raised about the prescriptive Sarbanes-Oxley regulations. While a better regulatory system operates in Australia, it still can be quite onerous:
  - an example of an area where regulation has increased significantly (and unnecessarily) in Australia is the Financial Services Reform Act; and
  - the Australian Institute of Company Directors (AICD) submission to the Senate inquiry into Private Equity argues that the increased regulation of public companies has increasingly meant that boards of directors spend more time on compliance rather than strategy.
- private equity can offer a greater alignment of interests

between owners and managers (and a reduction in agency problems). In public companies management can become quite distant from owners;

- major decisions can be made more swiftly as owners are often in day-to-day contact with management;
- management spends less time “selling” the company to investors; and
- there has been a very large increase in money flowing in to private equity funds, which has enabled these funds to increase their investments substantially. In Australia, about half of the money flow into private equity has come from superannuation funds.

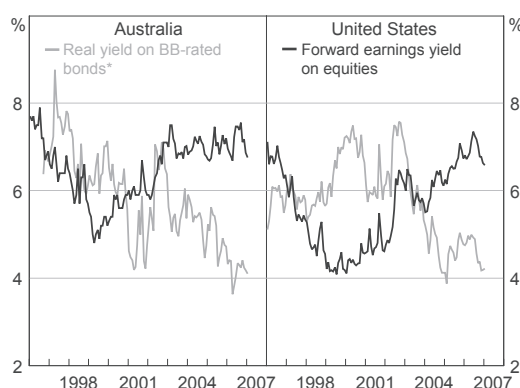
The RBA argues that the evidence on whether private equity delivers higher returns is mixed, but others argue that private equity does provide significant benefits.

However, ACCI believes that the role of Government should not be to promote or restrict a particular type of investment based upon whether it provides good return to the owners.

The Government should not prevent investors from making poor investment decisions and it should only regulate if by doing so it can improve the performance of the market.

We also note that private equity substantially increases the competitiveness of the “market for control” of companies. This provides additional incentives for productivity and performance of existing companies.

**Figure 2**  
**Return on Equity and Cost of Debt**



\* Estimate for Australia. Sources: *Merrill Lynch; RBA; Thomson Financial; UBS AG, Australia Branch.*

## ISSUES WITH PRIVATE EQUITY

### Debt Levels and Private Equity

The RBA notes<sup>2</sup> that:

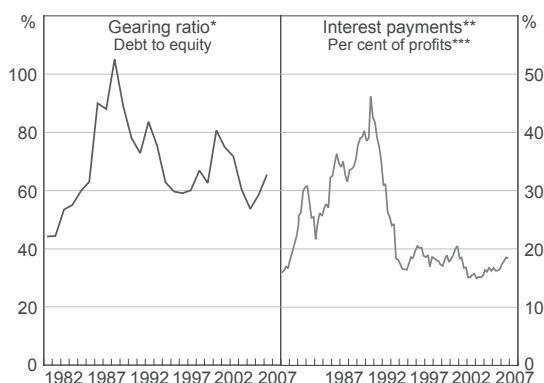
- recent LBOs have substantially increased gearing ratios in target companies, but not as much as the previous LBO boom in the United States;
- in Australia, debt has traditionally provided about 70 per cent of the funding for LBOs. The interest rate on LBO debt is 2 per cent higher than the swap rate for senior debt and 4-4.5 percent higher for subordinated debt; and
- total lending for private equity represents less than 3 per cent of Australian bank loans. The RBA argues that bank exposure is fairly well diversified.

With more recent Australian private equity deals, the lending from Australian banks has fallen and lending from foreign banks has increased. This has reduced the debt concerns but may have increased the tax concerns.

The RBA noted that corporate gearing (debt to equity) and interest to profit ratios have increased recently, but are low by historical standards (see Figure 3).

This increase in gearing is largely because of an increase in gearing of companies with low levels of gearing, while companies with high levels of gearing have reduced their gearing, as described in the RBA's *Statement of Monetary Policy* for November 2006 at page 49.

**Figure 3  
Business Sector Finances**



\* Listed non-financial corporations.

\*\* Includes the imputed financial intermediation service charge.

\*\*\* Profits are measured as the sum of private non-financial corporations' gross operating surplus and gross mixed income of unincorporated enterprises.

Sources: ABS; *Aspect Huntley*; RBA; *Statex*.

The RBA argues that the current situation is “relatively benign” and it is hard to see the current exposures of Australian banks to private equity causing “serious difficulties” for the Australian banking system.

However, the RBA raises a concern that lenders may not be sufficiently compensated for the risks they are facing.

It has also indicated that it will continue to monitor developments closely in case this situation changes.

It should be noted that banks have very strong incentives to make sure that their loans to investors are repaid. There are no indications that loan defaults are at risky or high levels.

Based on this data, ACCI considers that there is no indication that private equity is substantially altering the riskiness of the Australian economy.

### Effect on Stock Markets and Public Information

Concerns have been raised that private equity has an adverse effect on stock markets by reducing liquidity and information disclosure.

This may also reduce the quality of public information, because listed companies have to publicly release accounts whereas private firms may not.

If there are concerns that delisting imposes significant costs on the community, then this means stock markets provide a public benefit – and Government regulation appears contrary to this argument.

There are many regulations that impose significant costs on stock market listing, for example continuous disclosure requirements and reporting requirements. Regulators actually act as if stock market listing needs to be restricted.

If stock market listing is good, then listing by any company should be promoted, particularly those that have never been listed. There are no reasons to restrict companies from leaving the stock market if there are no incentives for companies to list in the first place.

Therefore, if regulation is diverting investment away from the share market, the appropriate response is to reduce the regulation on the share market, not increase regulation on alternatives.

We also note that private equity investments often re-list their investments after a few years, so any effect on stock markets would only be temporary.

## Corporate Conduct

Private equity transactions are largely subject to the same regulation as other transactions. It has not been shown that market mechanisms and current regulations cannot deal with concerns over the conduct of private equity.

For example, Australian super funds have been successfully investing in private equity for over a decade, without any major concerns being raised by regulators.

Another issue is conflicts of interest between different parties to private equity deals (particularly between the buyers and the current management and board). These need to be managed carefully and regulators are monitoring this issue.

In order to prove more regulation is needed in this area, clear evidence is required to show that the benefits of regulation outweigh the costs. This has not occurred.

ACCI supports the conclusion of the AICD that there is sufficient regulation of markets to provide proper oversight of directors', officers' and senior managers' involvement in private equity investment transactions.

## Taxation and Private Equity

The effect of leveraged private equity (or LBOs) on tax revenues is not likely to be large.

The main concern raised is that LBOs have high levels of debt and therefore can claim significant interest deductions, reducing the tax paid by the business that is being bought out.

To the extent an LBO is funded by Australian borrowings, interest payments will be taxable in the hands of the lenders. This is likely to offset the value of interest deductions in the target business. Thus the effect on revenue is likely to be small.

To the extent an LBO is funded by foreign borrowings, the effect on Australian revenue may be larger. However, offshore borrowings can be subject to thin capitalisation rules, restricting the ability for unlimited use of deductions in Australia. In addition, interest payments to foreigners are mostly subject to interest withholding tax and the Australian imputation system actually can create an incentive for companies to increase taxable income in Australia.

As noted above, the lending from Australian banks for private equity has recently fallen and lending from foreign banks has increased. While this has increased the tax concerns, it has reduced the concerns about systemic risk to the Australian economy.

In other words, a higher tax risk from offshore borrowing reduces the extent of the systemic risk from domestic borrowing.

In addition, ACCI notes that:

- private equity transactions themselves can generate substantial revenue through Capital Gains Tax (CGT) because most private equity deals are at a substantial premium to the market price. The transactions may also generate substantial stamp duty revenue. While the sale of assets by non-residents is largely exempt from CGT under 2006 changes, many exemptions already existed in double tax agreements before 2006; and
- any improvement in the performance of companies because of private equity will add to tax revenue.

## CONCLUSION

Private equity plays an important role in improving the efficiency of companies and the capital market.

There is no evidence that private equity is having adverse effects at the moment or is likely to do so in the foreseeable future.

Increased regulation of private equity could affect all privately held companies, which would be a severe overreaction.

If anything, the growth in private equity is usefully highlighting the adverse effects of excessive regulation of public companies.

Instead, governments around Australia would be better advised to examine the current level of regulation of public companies and limit this regulation to ensure that all forms of investment are treated fairly.

<sup>1</sup> This section is based upon the RBA's *Financial Stability Review* (FSR) for March 2007 and the AVCAL submission.

<sup>2</sup> RBA (2007) *Financial Stability Review* for March 2007.

*This article is an edited version of a recent ACCI Submission to a Senate Economics Committee Enquiry into Private Equity Investment. The full submission is available on the ACCI website at [www.acci.asn.au](http://www.acci.asn.au).*