

Private Equity in Australia

Introduction

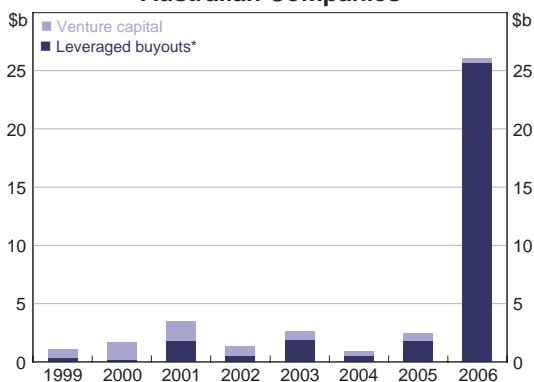
Over the past year there has been a significant increase in investments by private equity funds in Australia. This increase has focused public attention on a number of aspects of private equity, including the implications for investors and the broader economy, the efficiency of public capital markets, the potential for conflicts of interest and the current regulatory arrangements for such investments. Given the broad and overlapping nature of these issues, the Council of Financial Regulators – which draws together the heads of the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC), the Australian Treasury and the Reserve Bank of Australia (RBA) – has recently examined various aspects of private equity in Australia. This report presents the main facts and discusses a number of related issues.

The Size of the Market

There is no precise definition of private equity, with the term generally used to describe two types of investment. The first is often known as ‘venture capital’, with investors providing equity funding to small and relatively high-risk companies with strong growth potential. The second is the acquisition of a public company by a group of investors who take the company ‘private’, delisting it from the stock exchange. Typically, a significant percentage of the financing for such buyouts is in the form of debt, so that private equity is often associated with leveraged buyouts (LBOs).

Until 2005, the value of private equity transactions in Australia was broadly evenly split between venture capital investments and LBOs (with the former being particularly popular during the tech boom). This changed markedly in 2006, with the value of private equity transactions announced and endorsed by the target company’s board surging to \$26 billion, up from an average of around \$2 billion over the previous five years, with all of the increase accounted for by LBOs (Graph 1). In total, in 2006, the value of announced LBOs was equivalent to 2 per cent of the total assets of the Australian non-financial corporate sector, much the same as the comparable number for the United States. Over the year, LBOs accounted for around a

Graph 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 Journal; Thomson Financial

quarter (by value) of all mergers and acquisitions of Australian companies, compared with less than 5 per cent in previous years. The transactions included the actual or planned purchase of a number of high-profile Australian companies, including Qantas, PBL Media, DCA Group and the Seven Media Group.

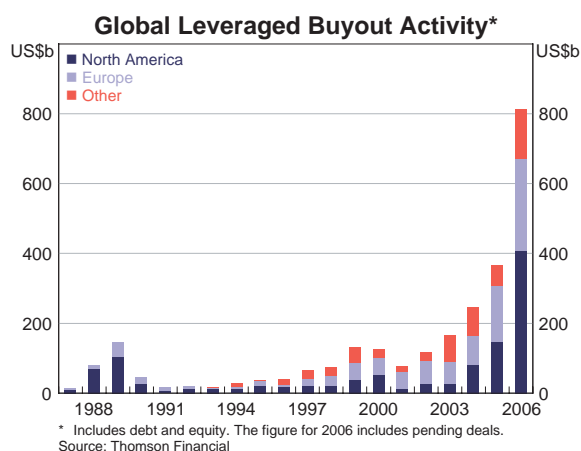
The increase in the value of LBO activity is accounted for by a sharp rise in the average size of deals, rather than a rise in the number of deals (Table 1). In total, there were 28 completed or pending deals in 2006, with an average value of \$0.9 billion. The largest transaction, with a value of \$11 billion, was the planned buyout of Qantas.

Table 1: Leveraged Buyouts of Australian Companies*

| | Number | Average deal value \$m | Total value of all deals \$m |
|-------------------|--------|---------------------------|---------------------------------|
| 1999-2004 average | 21 | 42 | 880 |
| 2005 | 29 | 62 | 1 792 |
| 2006 | 28 | 917 | 25 670 |

* Includes debt and equity funding of deals completed and pending; excludes existing debt of bought-out company.
Sources: Australian Venture Capital Journal; Thomson Financial

Graph 2



The strong growth in private equity in Australia follows a boom in private equity transactions globally (Graph 2). Unlike the situation in Australia where the value of LBO activity increased markedly only in 2006, the boom elsewhere has been underway for a number of years, although it has clearly accelerated recently. In 2006, global LBOs amounted to a little over US\$800 billion, more than double the level in the previous year and more than six times higher than in 2000. Unlike the previous boom in private equity

in the late 1980s, the current boom has seen strong activity in Europe and Asia, not just in the United States.

The Funding of LBOs

LBOs are financed through a combination of equity and debt. In recent years, buyouts in Australia have typically resulted in debt-to-equity ratios (known as gearing ratios) of around 250 per cent, compared with pre-buyout ratios of around 50 per cent and a gearing ratio for the non-financial corporate sector as a whole of 65 per cent (Graph 3). This degree of leverage, while very high, is lower than during the late 1980s LBO boom in the United States, where it was not uncommon for debt-to-equity ratios to exceed 500 per cent. Notwithstanding this,

in the most recent Australian LBOs the purchased company's gearing has increased to such an extent that the company's credit rating has become sub-investment grade.

Equity Funding

The equity component for an LBO is typically provided by a private equity fund which raises money from a range of investors. The investment is generally made through a limited partnership, with the general partner (often the manager of the fund) making decisions about management of the fund's assets. Investors in private equity funds are typically required to lock their money away for periods ranging from seven to 10 years, or until divestment has occurred.

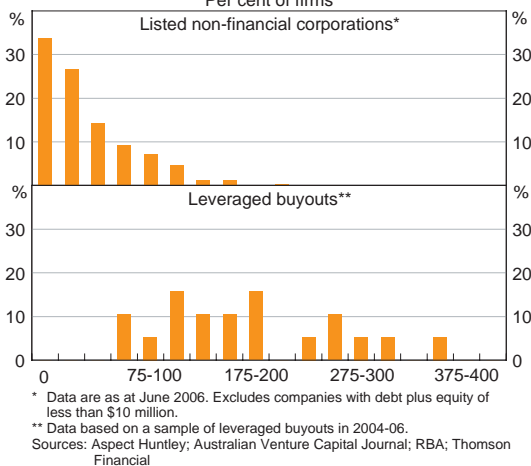
The increase in global LBO activity has been underpinned by very large inflows into private equity funds over recent years. In 2006, LBO funds raised more than US\$250 billion, with the largest private equity managers raising more than US\$15 billion each (Graph 4). This aggregate inflow is more than double the inflow experienced in the

previous peak in 2000. The increased size of individual funds, and their increasing tendency to combine resources for specific deals, has facilitated buyouts of some very large companies. This can be seen in the fact that nine of the 10 largest LBOs have occurred in the past two years (the exception is the purchase of RJR Nabisco in the late 1980s).

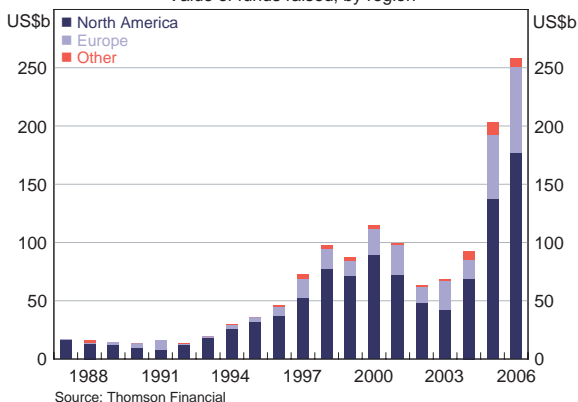
The bulk of the funds raised globally have come from the United States (69 per cent), with a further 29 per cent from Europe. Institutional investors, including insurance companies, endowment funds and pension funds, currently account for around 80 per cent of the investor funds under management.

In Australia, there has also been a significant flow of money into private equity funds (Graph 5). Over the past three years, annual raisings have averaged around \$3 billion, with private equity funds now accounting for about 1½ per cent of Australian funds under management. Institutional investors account for four fifths of the funds managed by Australian

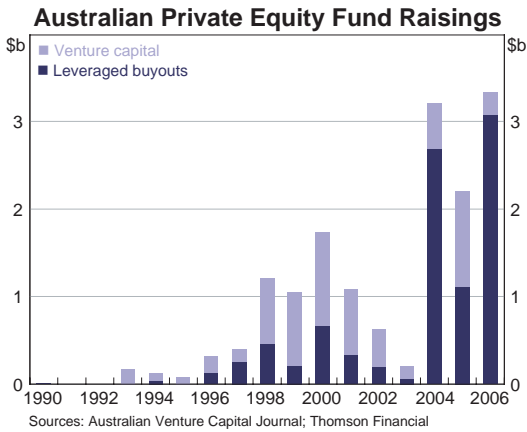
Graph 3
Distribution of Gearing Ratios – Australia
Per cent of firms



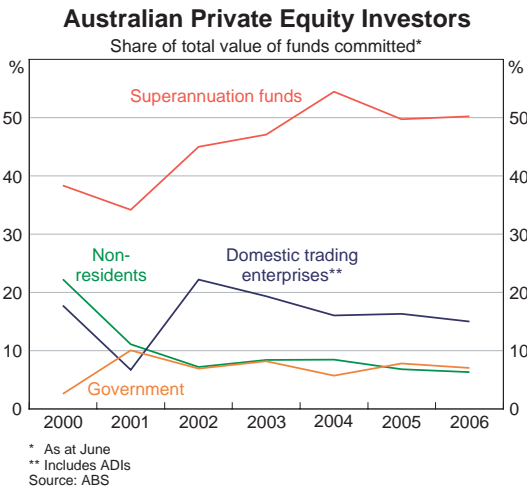
Graph 4
Global Leveraged Buyout Fund Raising
Value of funds raised, by region



Graph 5



Graph 6



private equity funds. Superannuation funds represent the major investor class, accounting for around half the total funds committed to private equity as at the end of June 2006 (Graph 6). The available evidence suggests that more than half of the largest superannuation funds have a portfolio allocation to private equity, with an average allocation of around 5 per cent. Over the past decade, 35 per cent of investor inflows in Australia have been through ‘fund of funds’ – pooled vehicles in which a private equity fund invests in a range of domestic and offshore private equity funds – whereas in the United States this figure is closer to 10 per cent.

The prevalence of institutional investors reflects, in part, the fact that private equity funds require a relatively high minimum subscription. Most private equity firms have multiple funds, with a number of the larger vehicles having funds under management in excess of \$1 billion. Retail investors in Australia have some access to private equity funds,

either through the funds management industry, with minimum subscriptions as low as \$1 000, or through a limited number of private equity investment companies listed on the Australian stock exchange. The latter cover a wide range of investments including private equity fund of funds and investments in both listed and unlisted companies. A third of the 20 or so private equity investment companies listed in Australia have been established in the past two years, with each being heavily oversubscribed.

Notwithstanding the significant inflows into Australian private equity funds over recent years, the largest transactions in Australia have often involved overseas funds, either acting alone or through a ‘club’ arrangement with Australian or other foreign funds.

Debt Funding

In recent LBO transactions, debt has typically accounted for around 70 per cent of the funding used for the purchase, with the debt generally having sub-investment grade status. In large deals it is usual for the debt to be split into senior and subordinated components.

In recent deals in Australia, senior debt has typically accounted for about two thirds of the debt raised. The bulk of this debt is provided initially by large Australian and overseas banks, usually through a syndicated loan, with the participating banks then seeking to on-sell part of the loan to investors (including other banks, insurance companies and superannuation funds) or hedge the credit risk using derivatives. To date, there has been little senior debt issued in the form of bonds.

The subordinated debt is typically provided by institutional investors (mainly offshore) such as insurance companies, pension funds and hedge funds, although Australian retail investors have some involvement, most notably through the purchase of hybrid securities. Smaller LBOs often do not have a tiered debt structure, with the debt financing provided entirely by banks, with loans usually only syndicated if they are greater than \$100 million.

Given the credit rating of the debt, the acquired companies typically pay around 200 basis points above the comparable swap rate on their senior debt, and 400 to 450 basis points above the swap rate for subordinated debt.

The use of non-amortising debt, where no capital repayments are made for a pre-agreed period of time, is becoming increasingly common in large transactions. Such a structure minimises the effect of the higher gearing on the company's short-term cashflow and therefore allows the company to bear a significantly higher amount of debt financing than it might otherwise have been able to afford, although it has a negative effect on cashflows once the repayment of principal falls due.

Reflecting competition amongst lenders, the conditions attached to some of the debt are gradually being eroded. Loan covenants in which lenders' rights are triggered solely by a missed interest payment, rather than by a deterioration in the financial condition or performance of the target company, for example, are increasingly common.

Bank Exposures

APRA recently surveyed banks operating in Australia about their exposure to the private equity market. This survey suggested that these exposures are generally spread across the largest Australian and foreign banks and are subject to appropriate credit controls. Overall, private equity exposures amount to less than 3 per cent of total loans in the Australian banking system.

At end December 2006, the sum of the individual exposures to private equity transactions reported by the largest Australian banks was nearly \$15 billion. This, however, is an upper bound on the aggregate exposure, as the figure includes joint underwriting commitments held by multiple banks. At least \$2 billion of the exposures are to overseas transactions (primarily New Zealand and UK companies). More than 80 per cent of the exposures relate to senior debt, with Australian banks tending to avoid subordinated debt (including mezzanine debt) owing to its substantially higher risk; some banks do, however, permit limited subordinated lending if the bank is also involved in the distribution of senior debt. For both senior and subordinated debt, maturities generally range from five to seven years, though in recent times this debt has tended to be repaid within two to three years.

The Australian banks most active in private equity funding tend to have a fairly well diversified portfolio of exposures, while the smaller institutions have exposures to only a handful of transactions, or none at all. The banks involved in underwriting the new debt generally hold a portion of the debt to maturity – though their short-term underwriting commitments may be much larger – while other banks may acquire a participation in the loan syndication. Some large banks cite overall portfolio risk limits on private equity debt and leveraged lending generally in the range of \$1-3 billion, which is less than 5-10 per cent of total bank capital in most cases.

Several banks also manage private equity funds, which are open to both retail and institutional investors. These activities do not represent direct exposures of the bank itself. Life insurance companies owned by banking groups also invest in private equity funds, though the reported amounts are not large.

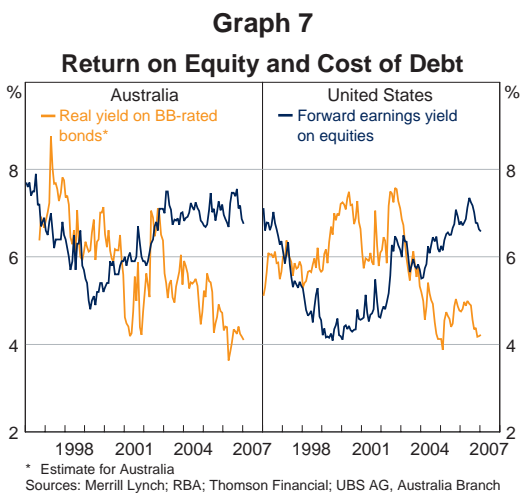
In aggregate, the Australian branches of foreign banks (or their non-bank capital markets subsidiaries) reported a total exposure to private equity of \$20 billion, with more than half of this consisting of short-term underwriting exposures. In the case of 20 recent private equity deals, around two thirds of participating banks were foreign banks. The most active foreign banks tend to underwrite larger amounts than the Australian banks – as much as \$2 billion each in some recent Australian private equity deals – owing to their larger global distribution networks and balance sheets.

Why has Private Equity Increased?

To a significant extent the Australian experience is simply part of a global trend, which has been largely driven by the very favourable macroeconomic conditions and low global interest rates of recent years.

The world economy has experienced four consecutive years of above-average growth, interest rates have been below average, and volatility in financial markets has been unusually subdued. Not surprisingly, profit growth has been strong, with returns on equity having been high and relatively stable. Reflecting these developments, the forward earnings yields on equities have been above their decade-long averages for several years, while at the same time, the cost of debt

has been unusually low, influenced by historically low government bond yields and credit risk premiums (Graph 7). The corporate sectors in a number of countries, including Australia, have also been relatively conservatively geared for more than a decade, following the debt problems in the early 1990s. In this environment of stable economic growth and relatively low interest rates, investors have been prepared to move further out the investment risk spectrum, seeking alternative



investments such as private equity funds and hedge funds. They have also been prepared to invest in more leveraged investments, particularly given the low cost of debt.

Another commonly cited driver of the increase in private equity investments is the potential for private ownership to allow better management of a particular company. A number of reasons have been advanced as to why this might be so. These include the ability of a private firm to take decisions in the long-term interests of the firm even if they adversely affect its short-term performance, the reduced governance burdens on management under private ownership, and the potential to better align the incentives of managers and owners.

The claim that under private ownership a firm can more easily take decisions that maximise long-term value reflects the fact that investors in private equity funds are usually obliged to remain committed for periods of up to 10 years. In some cases, being away from the public gaze and the need to meet short-term performance targets may allow a company to improve its operations in a way that might be seen as more difficult under public ownership.

Overseas, analysts have also pointed to the perceived benefits of avoiding new governance requirements imposed on public companies by the 2002 US Sarbanes-Oxley legislation and ongoing scrutiny of markets and public investors. The emerging conventional wisdom is that a private company faces far fewer distractions on management time and energy than do public companies, notwithstanding the fact that private equity fund managers may be as, or more, demanding than shareholders or market analysts with respect to regular reporting and profit-generation. While the Australian ‘principles based’ approach to corporate governance contrasts with the more prescriptive approach in the United States, any publicly listed Australian company wishing to list debt or equity in the United States must meet those requirements.

Analysts also point to the possibility of a better alignment of incentives between the owners and executives of the firm. Private equity firms normally retain existing management and provide them with a significant equity stake to contain the principal-agent conflicts inherent in large companies. It has also been speculated that high leverage provides better incentives for management to improve operational efficiency in the face of high regular debt repayments. In addition, private equity sponsors are often able to work closely with the target company’s management in directing and restructuring the company’s operations. As part of this, the private equity firm may be able to provide relevant managerial expertise and experience (some of the larger funds, for example, employ industry experts).

The evidence as to whether private ownership delivers higher returns than public ownership is, however, mixed. Academic research, based mainly on the US market, points to both under- and over-performance relative to returns (after fees) on listed equity markets. There is more agreement, however, on the significant dispersion of private equity fund returns. In the United States, for example, data from Thomson Financial suggest that the spread between the annual returns of a 25th percentile and a 75th percentile LBO fund has averaged around 35 percentage points over the past decade (the comparable spread for surviving companies in the US S&P 500 index is around 10 percentage points). Similarly, there is reasonable support in the academic literature for persistence in fund performance, with funds that outperform in one period likely to also outperform in the next.

Policy and Regulatory Issues

Private equity can play an important role in promoting the efficient allocation of capital. The threat of a takeover by a private equity firm, or another entity, provides a critical discipline on existing management to manage their company's assets as well as possible. In addition, takeovers, including by a private equity fund, are an important way in which investors are able to take control of firms that they view as underperforming. As such, private equity can help to promote an efficient, dynamic and innovative business sector in Australia.

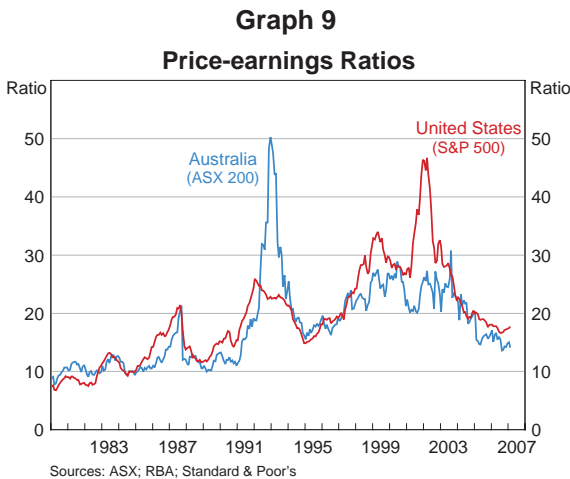
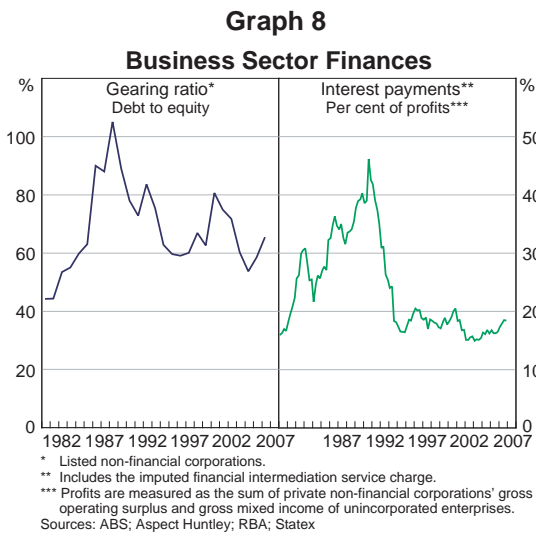
Notwithstanding these positive aspects of private equity, recent developments do raise a number of public policy issues. These are discussed below.

Corporate Gearing

Private equity transactions typically result in a significant increase in the leverage of the acquired company. In addition, the increase in LBO activity may encourage other companies to take on

additional debt either as a defensive strategy, or in an effort to increase their own returns by replicating aspects of the private equity model. This increase in leverage, if it became widespread, could cause problems for the economy as a whole at some point in the future.

While the increased leverage inherent in LBOs clearly increases the riskiness of the specific companies involved, at an aggregate level, corporate gearing in Australia is currently relatively low (Graph 8). Australian companies have tended to be conservatively geared since the mid 1990s, following the spate of corporate collapses in the late 1980s. They have also benefited from the decline in interest rates that occurred following the fall in inflation in the early 1990s, with interest payments currently equivalent to 18 per cent of profits, less than half that at the end of the 1980s. From this perspective, the current level of corporate gearing does not appear to represent a significant risk to the health of the Australian economy. Furthermore,



there is little evidence that the private equity boom has led to the stock market becoming overvalued, with the price-earnings ratio for the market as a whole currently standing at 14, below its average level of the past two decades (Graph 9).

While this aggregate picture is broadly reassuring, the increase in LBO activity is leading to some pockets of much higher leverage within the corporate sector. The experience of the late 1980s suggests that very large losses by a few highly leveraged firms have the potential to affect the wider economy. From this perspective, it is important that developments are monitored closely, both at the aggregate and disaggregated levels. This is particularly so, given that the current structure of balance sheets and the economic outlook means that it would not be surprising if there were a further increase in gearing over the coming years.

Depth and Quality of Public Capital Markets

A second issue is the implications of the growth of private equity for the quality and depth of public capital markets. The issue has received increased attention recently, given that the value of stock market capitalisation, after abstracting from changes in prices, is estimated to have fallen in 2006 in continental Europe, the United Kingdom and the United States. Furthermore, in the United Kingdom, the inflow into private equity funds in the first half of 2006 exceeded new capital raised through initial public offerings (IPOs) on the London Stock Exchange. In contrast, in Australia \$8 billion of new capital was raised through IPOs on the Australian Stock Exchange in 2006, compared with inflows into private equity funds of \$3 billion.

One concern is that private equity transactions involving the acquisition of listed companies result in a lessening of the public reporting obligations of the newly private companies. In particular:

- the continuous disclosure provisions no longer apply;
- half-yearly financial reporting is not required (though annual reporting obligations remain); and
- some disclosure requirements in annual reports no longer apply (for example, director and executive remuneration provisions).

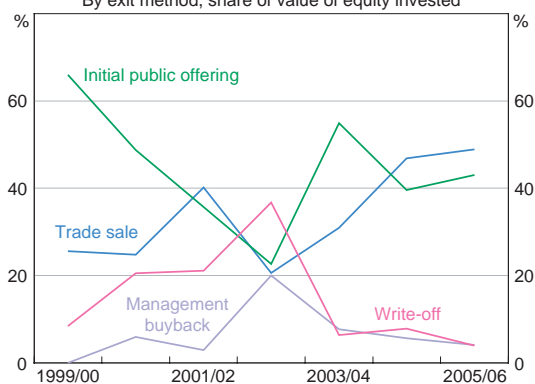
Notwithstanding the reduction in public reporting obligations, firms under private equity ownership are still required to report regular and detailed financial information to their owners and lenders in the same way as do the vast bulk of Australian companies that are not listed on a stock exchange. To the extent that there is less information available to the wider investing public, investors may have more difficulty in comparing the performance of companies within and across sectors, and this may have implications for the efficiency of the allocation of capital. More generally, a large-scale reduction in the size of public markets would result in a smaller non-intermediated investible universe for ordinary investors.

One factor mitigating concerns about a possible decline in public capital markets is that private ownership is typically seen as a temporary state of affairs. Many funds seek to sell their investments after a number of years, hoping to capitalise on the high return on equity that they have been able to generate. It has not been uncommon overseas for such sales to occur through an IPO or a trade sale to a listed firm. In Australia, while to date there have been relatively few large divestments by private equity funds, data from the Australian Bureau of Statistics (ABS)

Graph 10

Exits of Private Equity Investments

By exit method, share of value of equity invested



Source: ABS

suggest that around half the value of LBO and venture capital investments exited in 2005/06 were through a trade sale, with a further 40 per cent through an IPO (Graph 10).

A key question in the debate about the future role of public capital markets is whether companies under private ownership are able to generate superior returns, and if so, why. As discussed above, the evidence is unclear, although commentators cite a variety of reasons as to why private ownership may offer some advantages,

including: the ability of private owners to take a longer-term view; the less onerous governance requirements that apply under private ownership; and the potential to better align management and shareholder interests.

The strength of these various arguments, and any implications for regulation, are difficult to assess at this point in time. The issue of ‘short termism’ in markets is a long-standing one, and the growth of private equity can be seen partly as a response, if it allows decisions to be made that deliver long-term shareholder value that might be more difficult under public ownership. Whether or not this is the case, and why it might be so, are topics worthy of ongoing investigation.

Corporate Conduct

In Australia, transactions by private equity funds are subject to the same regulation through the *Corporations Act* as other transactions; directors and officers of the target corporation and of the bidding vehicle (if incorporated in Australia) are subject to comprehensive conduct and disclosure rules, as is the mergers and acquisitions process (involving either a takeover or scheme of arrangement). The conduct of intermediaries and advisers involved in the transaction is also fully regulated through the *Corporations Act* licensing regime. Reflecting this, private equity transactions do not of themselves raise wholly new regulatory issues.

Nonetheless, some private equity transactions may create pressures that alone or in combination, can lead to poor behaviour or misconduct that threatens the integrity of the markets in which transactions take place. While the same issues arise in many other capital market transactions, private equity transactions may create incentives for misconduct in areas not always present in more traditional mergers and acquisitions activity.

In LBOs in which senior executives are offered the opportunity to participate in the bidding consortium there can be a tension between their personal interests and their duty to act in the interests of the existing shareholders. Conflicts can arise, for example, if these executives:

- participate in decisions that are directly or indirectly relevant to the consortium's proposed acquisition;
- have access to confidential information that is relevant to the consortium's valuation of the company; or
- are unable to devote sufficient attention to the duties to the company as a result of their involvement in the bidding process.

Managing these conflicts is not always straightforward, particularly if limiting the participation of conflicted executives in key management decisions is not in the best interests of the current shareholders. In some situations, it may not be possible to adequately manage a conflict. In that case, the appropriate course of action is to ensure that the conflict is avoided.

Conflicts of interest can also arise for advisers. This is particularly evident in a situation in which a person who is engaged as an adviser to a company wishes to participate in, or provide advice to, a consortium bidding for the company. The potential for conflict can also arise if an adviser:

- has multiple private equity clients who are interested in pursuing the same company;
- places more importance on establishing or maintaining a close relationship with a private equity firm, which can generate lucrative fees on an ongoing basis, than on maintaining existing relationships with target companies;
- has the opportunity to participate in the consortium as a debt or equity provider, thereby increasing its potential earnings from a particular transaction; or
- has established a relationship with senior executives in an advisory role, and uses that relationship to work with those senior executives on a buy-out proposal.

In Australia, advisers to private equity transactions, including investment banks or corporate advisory firms, need to hold an Australian financial services licence. Licensees have a duty to manage, or if necessary avoid, conflicts of interest. APRA's recent survey of large banks confirmed that the major Australian and foreign banking institutions have formal conflict of interest policies in place that would apply to their private equity activities. These policies require separation of duties and consultation with legal counsel and prevent information sharing between staff working on different aspects of a given transaction, for example, senior versus subordinated debt tranches. More generally, it is important that conflict of interest policies extend across the range of potential roles that an institution may have in a private equity transaction, including debt and equity participation, as well as other activities, such as funds management.

Private equity transactions can also increase the risk that price sensitive information will be improperly disclosed or misused. Unlike much traditional takeover activity, a private equity takeover can involve a consortium of bidders, each with its own advisers, and each conducting its own due diligence. Further, as discussed above, private equity takeovers depend on a high level of debt funding, potentially involving a number of lenders. Accordingly, there are often a large number of people who are aware of a proposed transaction. The risk of individuals trading on this information may be heightened where potential bidders or lenders drop out of the process, ceasing to have an interest in the success of the proposed bid.

Under the ASX listing rules and the *Corporations Act*, a listed company has an obligation to inform the market about price sensitive information. However, a company does not need to disclose information that a reasonable person would not expect to be disclosed, that is confidential and that concerns an incomplete proposal or negotiation. Companies have taken a variety of approaches as to when details of a potential private equity transaction should be disclosed. Where adequate disclosure has not taken place, there is greater potential for insider trading. On the other hand, premature disclosure may run the risk of creating an uninformed market based on speculation.

The regulatory issues discussed above are currently addressed by the *Corporations Act* for both private equity transactions and other transactions. Many of the potential problem areas noted above can be dealt with by ensuring that advisers and participants in private equity transactions have robust and effective information barriers such as those described above. It is the responsibility of private equity funds, directors, advisers and others involved in private equity transactions to ensure that their conduct is appropriate and complies with all legal requirements. ASIC will continue to monitor developments in the private equity market.

The Exposure of the Banking System

A fourth issue is the exposure of the Australian banks to private equity, and, more generally, to a more highly leveraged corporate sector.

As noted above, to date the Australian banks' exposures to private equity are relatively small and mainly restricted to senior debt, albeit of a low credit rating. Given this, and the generally healthy state of business balance sheets in Australia, it is difficult to see current business sector exposures causing serious difficulties for the Australian banking system, although clearly the profits of some banks would be affected by a deterioration in the quality of individual borrowers. Looking forward, however, this situation could obviously change if corporate leverage were to increase significantly.

While from a banking stability perspective the current situation seems relatively benign, recent developments have raised a number of issues for regulators and for financial institutions.

One of these is whether the pricing of current deals adequately compensates lenders for the risks that they are assuming. As noted above, risk spreads around the world have been compressed over recent years and growth in the Australian and world economies has been strong. In this environment, there is some possibility that risk is being underpriced, and that in less benign conditions, credit losses could turn out to be significantly higher than expected. Such an outcome is made more likely by the recent trend towards a loosening of terms and conditions to make loans more consistent with US and European standards. The trend toward 'covenant lite' leveraged lending in the United States, in particular, may be driving down creditor protections across a range of deals.

A second issue is the management of the underwriting risks. In many cases, underwriting exposures are typically much higher than limits on final positions (regulatory requirements for banks to set aside capital are less onerous for underwriting exposures than for debt). To date, Australian banks have been able to successfully sell down these positions within the target timeframes. However, in the event of market disruption, credit ratings downgrades or negative

rumours about the purchased company, the underwriting bank could be left with a large and illiquid position. While in some cases banks are able to effectively hedge this risk with credit derivatives, this is not always possible.

APRA's approach to banks' activities in this area focuses on ensuring that sound credit risk management processes are in place and that appropriate capital is held against potential losses. Currently, the banks that are most active in private equity have well developed approaches to credit risk management, and with the introduction of the so-called advanced approaches of the Basel II capital framework in 2008, regulatory capital required to be held against debt associated with private equity transactions will be more sensitive to the banks' assessment of their risk of loss. APRA would be concerned if smaller, less sophisticated banks were making forays into private equity without adequate lending policies and credit risk monitoring processes in place.

The Exposure of Retail Investors to Private Equity

A fifth issue relates to the exposure of retail investors to the private equity market. While direct access to private equity funds by retail investors is currently somewhat limited, increasingly investors are able to access these funds through the funds management industry, or through the purchase of shares in listed private equity funds (though as noted previously, the latter can also include investments in listed companies). The responsibility for disclosure to investors about the risks rests with the fund manager through the Product Disclosure Statement and on financial advisers when recommending a fund.

Retail investors also have considerable indirect exposures to private equity through superannuation funds. While these funds are managed by trustees, fund members do have some capacity to vary their holdings in particular classes of investments, including investments in private equity and hedge funds. Decisions as to which private equity funds the superannuation fund invests in, and how the risks associated with the investment are managed, rest with the trustees. In March 2006, after extensive consultation with the industry and the Government, APRA issued a circular that sets out its expectations with respect to investment management decisions by superannuation funds. In particular, trustees need to consider, and be able to document and justify, how all investments made under an investment strategy are consistent with that strategy and must achieve a level of diversification which is reasonable having regard to the circumstances of the fund. With respect to private equity, APRA noted that:

“Non-traditional assets, such as infrastructure, private equity and public-private partnerships, are acceptable in a diversified portfolio, provided the trustee has considered their expected return and diversification effect on the portfolio and can demonstrate appropriate expertise and process to manage such asset classes within a superannuation fund portfolio.”

In APRA's on-site reviews of superannuation funds, a key objective is determining the trustees' understanding of their investment strategy, particularly in the case of alternative asset classes.

Like other alternative investments, understanding the risks involved in private equity is often complicated and pricing is less transparent than for many other investments, in many cases being based on models maintained by managers. The complexity of many private equity deals can also make it difficult to obtain comparative information when assessing fund manager strategies and performance. For superannuation funds and other institutional investors, private equity funds often involve ongoing commitments, requiring the investor to have access to liquid

assets to meet these commitments. It remains important that all investors understand the nature of these risks and that they have the capacity to effectively manage the risks.

Taxation

A final issue is the role of tax in determining the structure of private equity deals and the impact of these deals on the Government's fiscal position.

Given the potential for the tax regime to influence the structure of transactions, the Australian Taxation Office (ATO) has been working with some of the businesses where private equity takeovers have been completed or announced in 2006. The aim of this exercise is to understand the tax outcomes of private equity deals at the earliest possible point, particularly given the complexity of some arrangements. The ATO has also sought, as part of its 2006/07 Compliance Program, to ensure that:

- tax deductions related to financing arrangements are appropriate;
- payment of international related-party fees are appropriately characterised for tax purposes and the level of these payments accords with the OECD's arm's length principle;
- following the takeover, Australian entities with offshore operations or foreign-controlled Australian entities do not allocate an excessive amount of debt to their Australian operations (and so meet the legislative limits in the thin capitalisation rules);
- security distributions are taxed appropriately, and withholding tax payments are made;
- the tax values of assets, post-restructure, are appropriately assigned, especially where divestments are made during the period of private equity ownership; and
- there is appropriate disclosure of capital gains on any disposals by the investors and the target entities.

The implications for Government revenue are hard to ascertain as there are currently insufficient data to fully model the effects of private equity on tax revenue. While higher levels of debt, all else constant, are likely to result in reduced tax payments by the purchased companies, there may be offsetting effects. In particular, to the extent that lenders are based in Australia, their taxable income is likely to increase and add to tax revenue. Furthermore, where lending arrangements are with foreign-domiciled financiers, withholding tax collections may also increase, but this depends on the withholding tax arrangements in bilateral tax treaties with Australia. The purchased company may also achieve operational efficiencies and improved profitability over time, again adding to tax revenue.

Conclusions

Private equity can play an important role in ensuring an efficient and dynamic business sector. The threat of a takeover by a private equity fund or another group of investors is an important element in helping to ensure that the existing managers of firms have a strong incentive to manage the assets under their control as efficiently as possible. Private equity funds also provide one among several vehicles for investors to purchase and restructure firms that they view as underperforming, and may potentially help overcome some of the problems arising from the 'short termism' that is sometimes evident in financial markets. Evidence is mixed, however, on

the extent to which a private equity structure improves risk-adjusted returns to the ultimate investors in businesses.

While the recent increase in LBO activity in Australia has led to some pockets of increased leverage within the corporate sector, it does not appear to represent a significant near-term risk to either the stability of the financial system, or the economy more broadly. The exposure of the Australian banking sector to private equity is well contained, and both the leverage and the debt-servicing ratios for the corporate sector as a whole remain relatively low. Looking forward, however, it is likely that the increase in business leverage that is currently underway has some way to run. Given this, together with the potential implications of LBO activity for the depth and integrity of public capital markets, as well as the importance of investors understanding the risks they are taking on, the agencies that make up the Council of Financial Regulators will continue to monitor developments closely. ✎