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Revised Additional Comments

in relation to

The Standing Committee on Economics Report on Private Equity Investment and its Effects on Capital Markets and the Australian Economy

Due to travelling commitments on Monday 20 August 2007, I had no opportunity to review my original comments. On reflection, I wish to replace my original additional comments with the following:

By reason of conclusion 5.3.3 that the committee 'does not consider that any convincing case has been made for any further regulation of private equity activity in Australia at this time', I believe it is necessary to submit these additional comments;

- Private equity involvement in key sectors of the economy in a highly leveraged state means that there is unreasonable stress placed on these sectors and the effect of failure of an individual business has far wider ramifications than purely just that business failing. These wider ramifications include adverse effects on the economy; investor and shareholder confidence; and the stability of the financial system as a whole.
- The strategic and unfair advantage that private equity firms have over domestic investors, in regard a taxation regime where capital gains made by foreign private equity firms or investors are tax free, has to be addressed. Australian domestic investors should not be disadvantaged when investing in their own nation.
- As I alluded to during the inquiry and prior to the share market turmoil, private equity firms are inherently exposed to vagaries of the cost of debt and are overly reliant on capital gains via a share market re-listing. As I stated a major correction is expected and this would put at risk those private equity investments which are currently in progress.
- Private equity should be defined as more than private investing. It should be defined as the specific plan to take into private hands an organisation, having substantial market share in a sector within the economy, and in the process increasing gearing substantially. It would be envisaged a three to five year plan of placing the organisation back on the share market with the intention of receiving substantial fees along the way and then a substantial tax free capital gain upon re-listing.

- The premise of private equity is this; the capital gain has to be higher than the cost of debt. The plan will work no matter what gearing you have as long as your capital base increases proportionally more than the debt. The under pinner of your capacity to realise that capital gain is an active share market. It relies on the continued capacity of a share market, which it is exploiting, to absorb and re-finance its potential capital gain. This anomaly may work while the portion of the share market it is involved with is extremely small (tiny). The moment the private equity involvement is more substantial it inherently destroys the mechanism on which it thrives. Ab absurdo you cannot have a ten dollar share market refinancing twenty dollars of private equity deals. Not that this is envisaged but the greater the degree of the market that is removed to private equity, the weaker is the remaining market and the greater is the threat.
- A share market is inherently made weaker if the substantial players in key sectors are removed from it or where there are interest rate rises or a major pricing correction in the market. A major correction in the market is more likely when the returns of the shares on the market start to be far greater than the returns on equity inside the companies that make up the share market.
- The correction is exacerbated by the 'animal spirits' of day traders, chartist, margin calls, other derivative instruments and sub prime debt financing. The down side is exacerbated by the same derivative instruments which capitalise on an appreciating share market but because the anticipation of the market downturn is far less than the expectation of a continued market rise, the result is more severe and immediate. The pain of high gearing total loss takes market participants out en masse and this itself is a trigger for further market destabilisation.
- Market uncertainty before major corrections is usually prefaced by wide daily shifts in the indices and as this is currently happening, caution should be the utmost.
- Serious questions must be asked of the conflicts of interests that are apparent between a target board and a private equity firm. If there was one thing that stood out beyond all others, it is that this conflict of interest completely breaches the duty of stewardship that is expected by shareholders. The fact exists that some listed shares of major private equity target Australian companies have, in a very short period of time, exceeded the price of the private equity offer. Examples are evident of private equity offers which continued to be endorsed by a board and management who were to profit from an immense personal financial gain from the takeover. These enticements leave large unresolved questions in the share market's and public's mind. This does considerable harm to investor and shareholder confidence and, consequently, the financial gain from involvement of the directors and management of target companies in a private equity's bid should be prohibited.
- The best interests of investors have to be administered by an unbiased board and that bias should not be clouded because one outcome has the board obtaining a large financial gain and the other outcome the

same board obtaining nothing. It seems peculiar to pay a "spotters fee" to the director of the company that he or she manages on behalf of others, surely that "fee" itself should be a remuneration distributed back to all shareholders.

Recommendations:

1. No structure of investment and in particular, no private equity investment should be allowed that puts Australian domestic investors at a distinct disadvantage in their own market.

2. Target company boards and management should not be allowed to participate in any takeover bonus or other financial incentives distributed by the private equity bidders.

3. Private equity firms that are substantial market participants in key sectors of the economy should submit in-confidence reports, on a quarterly basis to the reserve bank and treasury, which contain information that is equivalent to the requirements of a publicly listed company on the Australian Stock Exchange.

4. Private equity firms should be quarantined from the domestic housing market as this manipulation would be a distinct disadvantage to the Australian home buyer as the market pressures placed by multibillion dollar buyers against mum and dad investors is intrinsically unfair.