The Senate

Standing Committee on Economics

Private equity investment in Australia

August 2007

ISBN 978-0-642-71861-7

Printed by the Senate Printing Unit, Parliament House, Canberra.

Senate Standing Committee on Economics

Members

Senator the Hon Michael Ronaldson, Chair	Victoria, LP
Senator Ursula Stephens, Deputy Chair	New South Wales, ALP
Senator Cory Bernardi	South Australia, LP
Senator Grant Chapman	South Australia, LP
Senator Annette Hurley	South Australia, ALP
Senator Barnaby Joyce	Queensland, NATS
Senator Andrew Murray	Western Australia, AD
Senator Ruth Webber	Western Australia, ALP

Participating Members

Senator Penny Wong	South Australia, ALP
Senator Steve Fielding	Victoria, FFP

Secretariat

Mr Peter Hallahan, Secretary
Dr Andrew Gaczol, Principal Research Officer
Dr Richard Grant, Senior Research Officer
Ms Stephanie Holden, Senior Research Officer
Mr Glenn Ryall, Estimates/Research Officer
Ms Lauren McDougall, Executive Assistant

PO Box 6100
Parliament House
Canberra ACT 2600
Ph: 02 6277 3540
Fax: 02 6277 5719
E-mail: economics.sen@aph.gov.au
Internet: http://www.aph.gov.au/senate/committee/economics_ctte/index.htm

TABLE OF CONTENTS

Chapter 1

Introduction

1.1 Since 2001, there has been an exponential increase in private equity investment in global markets from just under $US200 billion to just over $US800 billion.[1] The strong growth in private equity in Australia is, however, a more recent phenomena having accelerated only during 2006. Two proposed private takeovers of high profile companies — Qantas and Coles — increased public interest in the issue of private equity in Australia and its potential costs and benefits.

1.2 Accordingly, on 29 March 2007 the Senate referred an inquiry into private equity investment and its effects on capital markets and the Australian economy to the Standing Committee on Economics. The terms of reference for the inquiry are as follows:

> That the Senate, noting that private equity may often include investment by funds holding the superannuation savings or investment monies of millions of Australians, and because of the actual and potential scale of private equity market activity, refers the following matters to the Economics Committee for inquiry and report by 20 June 2007:
>
> (a) an assessment of domestic and international trends concerning private equity and its effects on capital markets;
>
> (b) an assessment of whether private equity could become a matter of concern to the Australian economy if ownership, debt/equity and risk profiles of Australian business are significantly altered;
>
> (c) an assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects;
>
> (d) an assessment of whether appropriate regulation or laws already apply to private equity acquisitions when the national economic or strategic interest is at stake and, if not, what those should be; and
>
> (e) an assessment of the appropriate regulatory or legislative response required to this market phenomenon, if any.

1.3 Given the high level of public interest in the topic, the Senate granted a time extension and requested that the committee report on 20 August 2007.

---

1 Briefing by the Reserve Bank of Australia, 25 July 2007 Chart 1.

Conduct of the inquiry

1.4 In accordance with usual practice, the committee first advertised details of the inquiry in the *Australian* on 4 April 2007. Details of the inquiry were also placed on the committee's website. The committee wrote to a number of organisations and stakeholder groups inviting written submissions and ultimately received 31 submissions. These are listed in Appendix 1. The committee also conducted three hearings: in Sydney on Wednesday 25 July 2007, in Melbourne on Thursday 26 July 2007, and in Canberra on 9 August 2007. The witnesses who appeared at the hearings are listed in Appendix 2.

Acknowledgments

1.5 The committee thanks all those who contributed to its inquiry by preparing written submissions. Their work has been of considerable value to the committee.

Background

1.6 This section provides some background to the private equity industry and the nature of buyouts. It runs through the mechanics of private equity and the types of transactions that are involved. It also refers to two private equity buyouts of Australian businesses in order to illustrate the process. Finally, it considers some of the benefits of private equity.

1.7 Chapter 2 will consider trends in the international and domestic private equity market, as well as the forces that have driven the private equity surge.

Introduction[2]

1.8 Private equity provides a source of capital for enterprises in addition to that available through the public capital markets. The private equity market is highly diverse[3] and every private equity organisation and individual deal contain their own characteristics. The market encompasses everything from funding new company start-ups (venture capital), helping companies grow and develop, through to increasing the operating potential of mature companies, funding mergers and acquisitions and turning failing companies around. It also covers large scale takeovers of mature, listed companies. Private equity firms characterise their funds as venture capital, expansion, buyout or distressed according to the life stage of the companies in which they invest. Individual private equity firms often target deal sizes within a particular range (which naturally correlates to the life cycle stage of their target companies).

---

2 This section is compiled from: Reserve Bank of Australia, Financial Stability Review, March 2007; AVCAL *Submission 17*, ABS, Catalogue 5678.0; *and* Financial Services Authority (United Kingdom), *Private equity: a discussion of risk and regulatory engagement*, Discussion paper 06/6, November 2006.

3 Financial Services Authority (United Kingdom), *Private equity: a discussion of risk and regulatory engagement*, Discussion paper 06/6, November 2006, p. 15.

1.9 Private equity often invests in unlisted businesses. These can include private family companies, other unlisted firms as well as public companies that private equity firms purchase and delist from a stock exchange.

1.10 Private equity investments in venture capital and buyouts share some common features but they involve different levels of investment and carry different risks, incentives and potential gains for investors. Historically, venture capital funds were such an important subset of private equity that the term 'venture capital' used to mean 'private equity'.[4] However, today the market environment is quite different. Although the venture capital segment of the private equity market remains essentially unchanged, the top tier of the private equity market (and to a lesser extent the mid-market) has evolved substantially. The increasing scale and complexity of the larger transactions, some of which is filtering down into mid-market deals, is having a growing impact and a greater profile.

1.11 Private equity buyouts of established firms are the principal focus of the committee's inquiry. Unlike venture capital, these do not attract government incentives to encourage investment.

1.12 Takeovers of mature companies are typically financed partly with debt from third party lenders and increased gearing[5] levels are a prominent feature of the private equity model. This feature particularly distinguishes leveraged buyouts (LBOs).[6]

1.13 Typically when buying an investee company, LBOs use approximately 30 per cent equity, supplemented by around 70–75 per cent debt for the acquisitions.[7] In the larger and more complex deals, the debt component is usually structured into various tranches, depending on its creditworthiness. The more senior debt, which has a claim over assets, is typically about half the overall funding; lower ranking debt such as subordinated debt and mezzanine debt makes up the rest. The gearing ratio is typically over 200 per cent which is a higher level of gearing than is typical for a listed company but it is not so high as to trigger thin capitalisation concerns. This is shown in the following table:[8]

4 Financial Services Authority (United Kingdom), *Private equity: a discussion of risk and regulatory engagement*, Discussion paper 06/6, November 2006, p. 15.

5 Gearing is the relationship between a company's shareholders' funds (issued capital plus retained profits) and some form of outside borrowing. Gearing is generally expressed as a ratio of debt to equity. For example, a ratio of 3:1 means that for every $3 of debt, the company is funded by $1 of equity. An entity that is highly geared funds assets with proportionately more debt than equity.

6 Leverage is using given resources in such a way as to magnify the potential positive or negative outcome. It generally refers to using borrowed funds, or debt, so as to increase the returns to equity.

7 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 3.

8 Briefing by the Reserve Bank of Australia, 25 July 2007, Chart 3.

Typical Capital Structure for Leveraged Buyouts

	Leveraged Buyouts Per cent of total capitalisation	Listed Company Per cent of total capitalisation
Equity	**30**	**60**
Debt	**70**	**40**
- Senior debt	50	
- Subordinated debt	10	
- Mezzanine debt	10	

1.14 The investment by private equity is usually medium to longer term, an average of 4.5 years, and unlike hedge fund investments, normally involves taking control of the company concerned.

1.15 In the past, private equity targets included poorly managed companies that provided the private equity firms with opportunities to turn them around by introducing efficiencies through improved management and cost cutting. More recently, mature companies with good cashflows that are undervalued by the market have increasingly become the focus of private equity bids and the proposed purchase of large, well-known companies (sometimes referred to as 'icons') has raised the public awareness of the private equity industry.

1.16 Private equity pools the funds of investors and substantially augments the funds with borrowings from financial institutions. Through leverage therefore, it can accumulate significant amounts of capital. Investors in private equity vehicles are wealthy individuals or institutions, including insurance companies, university endowment funds, banks and superannuation/pension funds. Institutional investors currently account for around 80 per cent of the investor funds under management.[9]

1.17 There are two broad types of private equity vehicles: those that generally invest directly in investee companies, and those which pool funds and generally invest through the direct investment vehicles.[10]

1.18 *Direct* investment is made by private equity firms in other firms that are seeking expansion capital or have been identified as a buy-out target. The controllers of the private equity firm decide which investments to make and how the investment

9 Reserve Bank of Australia, Financial Stability Review, March 2007, p. 61.

10 Investment and Financial Services Association Limited (IFSA), *Submission 13*, p. 4.

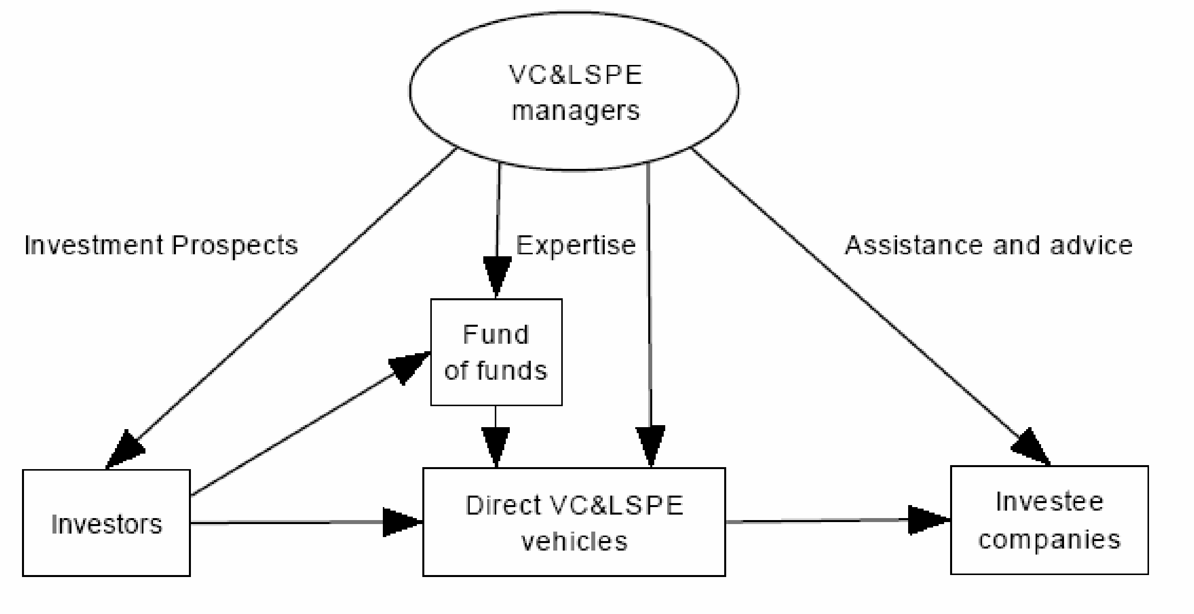
will be financed. Occasionally, several private equity firms combine to form consortia for the particular purpose of acquiring larger companies.

1.19 *Indirect* investment often represents the equity component in the *direct* investment. It represents the capital contributed by those that invest in the funds controlled by the private equity firm/s. These investors do not generally control the underlying investment. Instead, they are typically seeking passive exposure to private equity as an asset class.

1.20 Finally, there is at least a further layer of private equity investment which is more passive than *indirect* investment. This involves investors, institutional or retail, investing in a diversified fund of private equity funds (fund of funds). That is, the fund places its investments with a variety of other private equity funds which invest in unlisted companies. These investors are seeking to minimise and spread the risk of investing indirectly by relying on the skill and vetting of the manager of the fund of funds in selecting the best possible private equity funds in which to invest. This type of investment provides greater diversification of risk than investing in one fund alone.

1.21 The investment decisions of the vehicles are made by a manager, who is often a skilled business person and financial analyst. The manager spends considerable time gathering commitments from investors, as well as evaluating potential targets in which to invest. The manager further provides assistance and advice to the investee company.

1.22 The usual relationship between the investors, managers, vehicles and investee companies is illustrated below (reproduced from the Australian Bureau of Statistics):[11]



11 VC&LSPE refers to Venture Capital and Later Stage Private Equity. This diagram is taken from ABS, Catalogue 5678.0, p. 4.

The mechanics of private equity

1.23 Almost all private equity investment is conducted via investment funds formed by private equity firms specifically for this type of investment. Private equity fund structures can take various forms, but the most common is a limited partnership structure. The limited partnership consists of a 'general' partner who has unlimited liability for the debts and obligations of the partnership and one or more 'limited' partners, whose liability is restricted to the amount of their investment. The general partner is the private equity fund manager and the limited partners are other investors in the fund. Limited partners do not generally take part in the management of the business, though, if they do so, they become liable for debts and obligations incurred during the period of their involvement.

1.24 Investors undertake detailed evaluation of the fund manager, including assessing and monitoring the manager's prior investment performance.[12] The investors also review the fund documentation and have sufficient bargaining power to negotiate terms with the managers. Additionally, they make use of independent expert advisors who are expected to exercise high levels of scrutiny and due diligence.

1.25 Typically, the funds have the following features:[13]

- they are mostly 'closed-end' structures. That is, all investments of the funds will be realised and the money returned to investors within a particular timeframe, usually 5 to 10 years. Investors pledge a certain amount (committed capital) which represents the maximum amount that the fund may drawdown. A drawdown from investors is the amount of capital committed by investors that has actually transferred to a private equity fund in aggregate for the life of the fund;
- the 'J-curve effect'. In most funds' early years, investors can expect low or negative returns, due to the small amount of capital actually invested at the outset combined with the customary establishment costs, management fees and running expenses. As portfolio companies mature and exits occur, the fund will begin to distribute proceeds;
- each fund has a specific investment mandate which details matters such as the stage of the targeted investments, industries and countries that can be invested in, and the proportion of fund assets that can be allocated to any particular investment. As previously mentioned, private equity funds tend to specialise in certain market segments. For example, some focus on purchasing at a discount the debt of companies that are in, or close to, bankruptcy (distressed debt). They then exert influence in the restructure and recovery of the enterprise and are able to sell the debt at more favourable prices. Others

---

12 Australian Private Equity and Venture Capital Association Limited (AVCAL), *Submission 17*, p. 8.

13 Australian Private Equity and Venture Capital Association Limited (AVCAL), *Submission 17*, pp 8–9 *and* UniSuper Limited, *Submission 1*, p. 2.

restrict their investments to management buyouts, or to particular stages of venture capital (eg early stage, development, expansion etc);

- ‘blind pool’ investing. While private equity managers must follow general investment guidelines and restrictions set out in the fund documentation, they still have very wide discretion in selecting particular companies in which to invest; and
- wide divergence of returns. The dispersion of returns between upper quartile and lower quartile managers is significantly wider for private equity managers than for listed equity managers.

1.26 After a fund is closed (ie after it has raised the funds to be managed) the manager invests the fund's capital across a set of investments that fit the fund's investment mandate or focus. The fund is said to be 'fully invested' once this process is complete — typically after three to five years.

1.27 Over the life of a fund, the managers will assess hundreds of potential investments, conduct detailed due diligence on perhaps 10 per cent of these, but only invest in a small number. AVCAL suggests around 10 to 15 investments. Competition for investments is fierce and a fund manager's bid will not always succeed, in which case the time and money expended on assessing an investment and preparing an offer is lost, although in some circumstances break fees may be paid.

1.28 In order to illustrate how private equity operates, two examples of private equity success stories are outlined below.

Pacific Brands

In November 2001, a private equity consortium, including CVC Asia Pacific and Catalyst Investment Managers, bought the Pacific Brands division of Pacific Dunlop for around $730 million. This division held the biggest collection of consumer brands which included Bonds, Grosby, Holeproof, Hang Ten, Candy and 32 other clothing, hosiery, sporting and footwear brands. At the time, the deal was the second largest Australian leveraged buyout (LBO) ever.

The deal was financed by $235 million in equity provided by CVC and Catalyst, and around $500 million in debt facilities.[14]

The new owners increased spending on advertising – from an initial advertising budget of $30 million to about $70 million; increased expenditure on staff training by 163 per cent, strongly focused on working capital, and changed the outlook and

14 Tony Berg, Address to Financial Executives International of Australia, *Can you compete with private equity?*, 15 November 2005, p. 2, (accessed 10 August 2007): http://www.fei.org.au/pdf/051115tonyberg.doc.

strategy of the company.[15] For example, rather than making branded commodities as cheaply as it could and delivering them to retailers to sell, Pacific Brands focused on building brands that consumers would seek out. It shed $90 million of low-margin sales to concentrate on its core brands.

The speed of decision-making was increased under private equity. The initial board meeting to agree on a strategy for the company reportedly took only 90 minutes.[16] Within a fortnight of the buyout, the Chief Executive of Pacific Brands received $20 million for capital expenditure.[17] He says that approval for the funds took less than two hours and his request was contained in a two-page summary outlining the purpose of the funds. This was in contrast to his usual 60 pages to request funds for which he was still waiting a year after submitting the request under the previous ownership structure.

In April 2004 private equity exited the investment. Pacific Brands was listed on the stock exchange at an enterprise value of $1.7 billion and with a market capitalisation of $1.25 billion. The private equity investors made more than five times their initial investment for an internal rate of return (IRR) of 105 per cent.[18]

Pacific Brands listed at a share price of around $2.50.

Bradken

In December 2001, the Smorgon Steel Group sold its heavy engineering division, Bradken, to a consortium of CHAMP Private Equity, US-based ESCO Corporation and Bradken management.[19] At the time of the $185.5 million management buyout (MBO) the company had a turnover of $300 million and staff of 1400.[20] The consortium funded the company with a total of about $200 million, 30 per cent of which came from equity held by management and CHAMP, and 70 per cent from bank borrowings.[21]

15 AVCAL website, Private equity successes, (accessed August 2007): http://www.avcal.com.au/html/success/equity.aspx

16 Stephen Bartholomeusz, 'Private equity has breathed life into fading PacBrands', *The Age*, 28 February 2004, p. 3 (Business).

17 Lucinda Schmidt, 'Surviving private equity', *The Australian Financial Review Boss Magazine*, May 2007, Volume 8, p. 46.

18 Tony Berg, Address to Financial Executives International of Australia, *Can you compete with private equity?*, 15 November 2005, p. 2, (accessed 10 August 2007): http://www.fei.org.au/pdf/051115tonyberg.doc.

19 Bradken, *Corporate Profile: History*, p. 2 of 2, (accessed 10 August 2007): http://www.bradken.com.au/profile.aspx?page=history.

20 Florence Chong, 'When it's time to buy your job', *The Australian*, 31 October 2001.

21 Mr Brian Hodges, Managing Director, Bradken, *Committee Hansard*, 26 July 2007, p. 39.

Bradken remained under private ownership for just under three years. During this period, approximately $25 million of new capital expenditure was invested for capturing growth opportunities and cost reductions. Bradken's EBITDA[22] grew over 60 per cent from approximately $30 million per annum to $50 million per annum at the time of its successful[23] public listing in August 2004. The investment achieved an internal rate of return of 49 per cent[24] and CHAMP retained a 10.1 per cent stake in the company.[25]

Bradken's Managing Director said that the advantages of private equity ownership included the capital injection into the company that the previous owners could not make.[26] Other less obvious advantages included the reduction in non-value adding work for senior managers. People became more focussed and there was a reduction in reporting. 'You do not do as much filling out of monthly reports to send up through the levels of an organisation; you are at the top of the organisation and you talk directly to the people involved.'[27]

Mr Hodges also noted that as Bradken became a stand-alone entity there was a period of three to five years with specific things to do and targets to meet. He also found that the private equity owner was significantly closer to the business and challenged many of the known norms.[28]

There was also an effect on employment levels. Prior to the private equity takeover a number of plants were shut down and people retrenched. Although there was little capital expenditure, efficiencies were driven through work practices and other changes. From 2002 onwards staff levels increased. Currently the company employs around 3,000 people and there have been no further staff reductions.[29]

---

22 EBITDA is an acronym for earnings before interest, tax, depreciation and amortisation are deducted. It is a measure of cashflow of a company.

23 Bradken had to withdraw its first $245 million float due to lack of institutional interest in May 2004 (see James Chessell, 'Bradken's the next to cash in', *Sydney Morning Herald*, 29 May 2004).

24 CHAMP Private Equity, *Profile*, p. 9, http://www.champmbo.com/CHAMP_profile_02_07.pdf (accessed 10 August 2007).

25 CHAMP Private Equity, Selected previous investments, (accessed August 2007): http://www.champmbo.com/html/portfolio_bradken.htm

26 Mr Brian Hodges, Managing Director, Bradken, *Committee Hansard*, 26 July 2007, p. 32

27 Mr Brian Hodges, Managing Director, Bradken, *Committee Hansard*, 26 July 2007, pp 33–34.

28 Mr Brian Hodges, Managing Director, Bradken, *Committee Hansard*, 26 July 2007, p. 34.

29 Mr Brian Hodges, Managing Director, Bradken, *Committee Hansard*, 26 July 2007, p. 33.

Types of private equity transactions[30]

1.29 There are several types of private equity transaction ranging from the purchase of a private company, the purchase of a division of, or entire, public company to the exit from the investment. These transactions are outlined below.

Purchase of a private company

1.30 The most common form of private equity transaction is the purchase of a private company. Owners of private businesses increasingly see private equity funds as an attractive source of expansion capital and management expertise that is needed for the business to expand to a point where it will be suitable and ready for a trade sale or initial public offering (IPO). In such cases, the private equity manager invests capital for a stake in the business and also provides ongoing advice to management of the company.

1.31 Many business owners who are looking to retire after building up a business over many years, are selling to private equity managers in order to realise the capital that they have accumulated in their business.

Purchase of a publicly listed company

1.32 This is the smallest category of private equity transaction. According to the Australian Private Equity and Venture Capital Association Limited (AVCAL), only about a dozen publicly listed companies in Australia have ever been taken private by private equity.[31] Nonetheless, this is the category that receives the most attention, particularly when icon status or economically significant companies are involved.

Purchase of a division of a publicly listed company

1.33 A more common type of private equity investment is the purchase by a private equity fund of a division (rather than the whole) of a listed company. Often the listed company describes the division being sold as 'non-core' and has, for some years, concentrated its attentions (and capital investment) on other divisions.

Sales of businesses by private equity

1.34 Unless they are written off, all businesses bought by private equity are sold, generally via either a trade sale or an initial public offering (IPO) on the stock exchange or, in a small but growing percentage of cases, to another private equity fund.

---

30 This section is based on Australian Private Equity and Venture Capital Association Limited (AVCAL), *Submission 17*, pp 11–12.

31 Australian Private Equity and Venture Capital Association Limited (AVCAL), *Submission 17*, p. 11.

Returns from private equity investment

1.35 The use of debt means that investors can receive a higher rate of return on the capital they have invested in the funds. Private equity investment targets a return of at least five per cent above the return on public equity markets.

1.36 Fund managers receive a management fee based on the size of the fund and they also receive a share in the capital gains delivered to the fund's investors. The management fee is usually calculated as a percentage of the funds under management. The percentage is negotiated between the investors and the manager at the time the fund is raised. An indicative figure is one to two per cent for larger private equity funds. This figure covers the overheads of the business including salaries and the costs of conducting due diligence on investments.[32]

1.37 The manager's share of capital gains (referred to as 'carried interest' or 'the carry') is 20 per cent in virtually all funds globally and is calculated after all fees and expenses paid by the fund have been returned to the investors. The manager only receives a share in capital gains if the fund has delivered a minimum return known as the 'preferred return'. If the target is not met, the manager receives no share in capital gains. AVCAL advises that the preferred return is usually similar to the long-term bond rate, currently about eight per cent per annum.

1.38 These percentages for the returns from the investments are often referred to as the '2 and 20 rule'.

1.39 There is a wide gap between the returns of the best performing private equity funds and the rest. Private Equity Intelligence Ltd states that this gap is around 10 per cent per year between the first quartile returns and the median return of funds.[33] Further, those funds in the bottom quartile return around 10 per cent below the median returns per year. The differences in funds tend to persist over time and this is a consistent pattern across all types of private equity fund, including funds of funds.

1.40 Research conducted by Private Equity Intelligence Ltd indicates that the largest funds outperformed the smaller ones.[34] The difference between the groups in certain years is as much as 20 per cent. It can be explained by the fact that the general partners who manage large scale buyout funds are generally well known, established players with long and successful track records, who have been able to raise increasingly large funds as they become more experienced and have established good reputations within the industry. Limited partners are keen to invest in these funds

32 See paragraphs 1.45–1.46 below.

33 Private Equity Intelligence Ltd, *Private Equity Spotlight*, May 2007/ Volume 3 - Issue 5, p. 03, (accessed July 2007): www.preqin.com

34 Private Equity Intelligence Ltd, *Private Equity Spotlight*, June 2007/ Volume 3 - Issue 6, p. 04, (accessed July 2007): www.preqin.com

because of their excellent returns, as well as their relatively lower risk compared to other forms of private equity investment.

Benefits of private equity

1.41 Private equity generates economic activity through increasing mergers and acquisitions. To make money they have to increase productivity and profitability, which are important for economic growth. The industry argues that it increases jobs and profitability which in turn generate taxation revenue. Further, the deals generate significant fee income for banks, lawyers and accountants.

For takeover targets

1.42 In addition to an injection of capital into buyout targets, private equity offers non-financial skills such as non-executive directors, extensive business networks and management expertise. AVCAL claims that private equity adds value to businesses by ensuring that each investment has the characteristics outlined below.

Alignment of interests

1.43 The foundation of private equity's ability to add value is its closer alignment of interests between all shareholders, owners and management. In contrast to the wide range of investors in public companies, each has a genuine stake in the business and is firmly focused on increasing its value.[35] Private equity-backed companies have concentrated and stable ownership and private equity owners hold at least one board seat (and often control the board) allowing for more effective engagement with management teams and the board if problems arise. Further, the level of management ownership in private companies is significantly higher than in public companies, which creates additional incentives for the managers. In many cases, the senior executive team (and sometimes those lower down) invest alongside their new owners, making them owners too.[36] The executives are expected to invest their own money into the venture — often hundreds of thousands or millions of dollars.

Long-term focus

1.44 Private equity invests with a three to five year horizon which enables private equity-backed companies to invest in new products, new businesses and new employees without concern for short-term earnings effects. This is in contrast to public companies that may be under pressure from analysts and shareholders for shorter-term returns. In addition to their continuous disclosure obligations, public

---

35 UniSuper Limited, *Submission 1*, p. 3.

36 Lucinda Schmidt, 'Surviving Private Equity', *The Australian Financial Review Boss Magazine*, May 2007, Volume 8, p. 48.

companies must issue annual and half-yearly reports, and in some cases quarterly cashflow reports.[37] These obligations can affect a company's day-to-day share price.

Detailed due diligence

1.45 The research and assessment that private equity managers conduct during the investment process provides detailed insight into:

- the strengths and weaknesses of a business, both financial and non-financial;
- the dynamics of the industry in which the business operates;
- the business's potential for growth; and
- the prerequisites for achieving this growth (for example, a change of strategy, operational improvements and capital expenditure).

1.46 The insight from due diligence allows the private equity owners to develop with the management a comprehensive and coherent long-term plan to increase the value of the business. This plan will typically:

- stress the importance of sales growth as well as cost efficiency;
- emphasise cash as much as earnings;
- focus on a small number of essential performance measures;
- include a training and development program for employees; and
- include a capital expenditure program to ensure that the business has the plant and equipment necessary to meet its growth targets.[38]

For investors

1.47 The key benefit of investing in private equity is the potential to earn higher returns than in the traditional asset classes. In order to achieve these returns, investors must accept a higher level of risk and also a less liquid investment.[39] According to UniSuper Limited, super-normal profits are expected to arise from information arbitrage opportunities that result from the market's immaturity, and hence relative inefficiency.[40] However, the strong growth in the size of the private equity market and the increase in the number of managers and investors in these markets may have led to the information asymmetry arbitrage being eroded. As previously mentioned, while some private equity funds yield significant returns, it is not universally the case across

---

37 ASX Listing Rules, Chapter 4, Periodic Disclosure.

38 Australian Private Equity and Venture Capital Association Limited (AVCAL), *Submission 17*, p. 10.

39 Australian Private Equity and Venture Capital Association Limited (AVCAL), *Submission 17*, p. 9.

40 UniSuper Limited, *Submission 1*, p. 3.

the sector and in some cases investors are taking on additional risk without receiving adequate compensation.

1.48 Another benefit for investors arises from diversification. Due to their low correlation with traditional asset classes such as listed equity, property and fixed income, private equity investments can be used to diversify an investment portfolio and, therefore, to reduce the overall risk of the portfolio.

Chapter 2

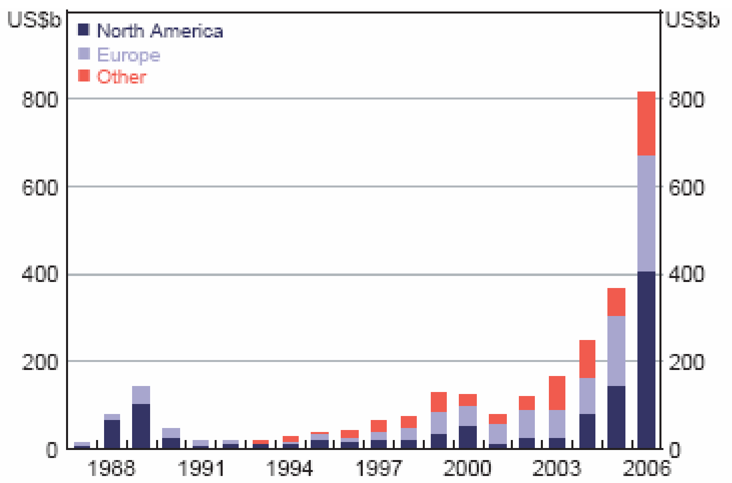
International and domestic trends

2.1 This chapter sets out current trends in private equity activity both internationally and domestically. It considers some of the drivers of this activity and briefly outlines Australian bank and superannuation fund exposure to private equity.

International trends

2.2 In 2006 there was a global surge in private equity. As shown in the following chart, global leveraged buyouts (LBOs)[1] amounted to a little over $US800 billion which was more than double the level in the previous year and more than six times higher than in 2000.

*Global leveraged buyout activity**[2]



* Includes debt and equity. The figure for 2006 includes pending deals.
Source: Thomson Financial

2.3 Despite this very large increase in activity, leveraged buyouts remain a small part of the overall financing that takes place in the world economy. At $US800 billion, it accounts for less than two per cent of the total size of global debt and equity markets. Additionally, it comprised approximately 20 per cent of the total $US3.6 trillion of global merger and acquisition activity in 2006.[3]

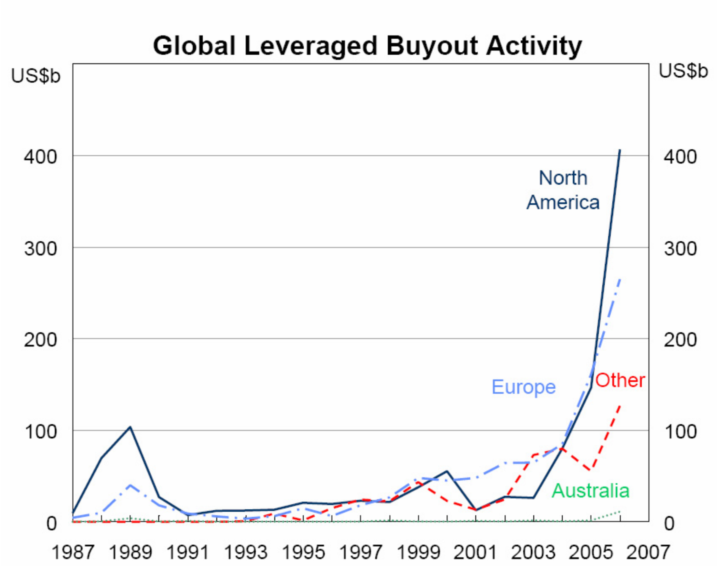
---

1 Private equity buyouts are a subset of leveraged buyouts.

2 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 60.

3 International Monetary Fund, Global Financial Stability Report, *Market Developments and Issues*, April 2007, (accessed 7 August 2007): http://www.imf.org/external/pubs/ft/gfsr/2007/01/index.htm

2.4 As shown in the following chart, the main increase in LBO activity has taken place in North America, which in 2006 accounted for half the global activity. The total value of United States LBOs amounted to approximately three per cent of the total value of equity in 2006.[4] Europe also experienced a large increase in LBO activity, and the 'other' category, which is mainly Asia, had a smaller increase.[5] The largest buyout markets in continental Europe are France, Germany and the Netherlands.[6]



Funds raised

2.5 The bulk of the funds raised globally originate in the United States (69 per cent), with a further 29 per cent from Europe.[7] Institutional investors, including insurance companies, endowment funds and pension funds, currently account for around 80 per cent of the investor funds under management.

2.6 The private equity industry raised $US240 billion in the first half of 2007 and in July seemed likely by the end of the year to eclipse the record amount of around $US459 billion raised in 2006.[8] The fundraising market has recently been dominated by large and mega buyout funds.[9] In 2006, 10 funds of $5 billion or more in size

---

4 Bank for International Settlements, 77th Annual Report, 1 April 2006–31 March 2007, 24 June 2007.

5 Briefing by the Reserve Bank of Australia, 25 July 2007, Chart 2.

6 Financial Services Authority (United Kingdom), *Private equity: a discussion of risk and regulatory engagement*, Discussion paper 06/6, November 2006, p. 14.

7 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 61.

8 'The trouble with private equity', *The Economist*, 5 July 2007, (accessed 9 July 2007): http://www.economist.com/opinion/PrinterFriendly.cfm?story_id=9441256.

9 Private Equity Intelligence Ltd, *Private Equity Spotlight*, June 2007/ Volume 3 - Issue 6, p. 04, (accessed July 2007): www.preqin.com

achieved a final close. The increasing number of large and extremely large buyout funds raised the average buyout fund size from $700 million in 2004 to $1.13 billion in 2006. Six months into 2007, a further eight funds of $5 billion or more reached a final close and there were an additional five funds of similar size in the market. Some funds raised $15 billion, and a commitment close to $20 billion was achieved for one fund.

2.7 Real estate funds, which were previously a small component in the overall private equity fund arena, have grown in importance. They now represent the second biggest fund type (buyout funds are the largest). $99 billion was committed during 2006. Real estate funds have relatively low levels of risk in comparison with private equity funds of other types.

Drivers of the rise in leveraged buyouts

2.8 LBO activity has been a global event and so the reasons behind its rise are global. Favourable macroeconomic conditions including strong economic growth, low interest rates, high levels of liquidity and rising asset prices have driven the increase in private equity activity in recent years.

2.9 Strong corporate balance sheets, along with a reluctance of some publicly traded companies to undertake new investment, provided good targets for mergers and acquisition and LBO activity.[10] The share of profits in GDP began to escalate around 2000 and has risen to roughly 25 per cent above its longer-term average. Corporate cashflows have also been strong. The International Monetary Fund (IMF) suggests that notwithstanding the favourable conditions, the reticence of corporations to invest may reflect some 'lingering cautiousness stemming from the excess capacity and overzealous investment of the late 1990s and the high hurdle rates used by companies in assessing new investments.'[11]

2.10 Additionally, some firms are seen as having capital structures that have a lower proportion of debt to capital than is optimal in an environment of low interest rates and ample funds available for investment. The current wave of mergers and acquisitions can be characterised as an exercise in capital structure arbitrage. Where such firms are in sectors with relatively stable earnings and cash flows—such as utilities, consumer goods, and retail—they make suitable targets for buyouts.

2.11 In some cases, public firms have been 'taken private' to overcome costs (both perceived and actual) of regulatory compliance and shareholder scrutiny. The

---

10 This section draws heavily on the International Monetary Fund Global Financial Stability Report, April 2007, (accessed 7 August 2007): http://www.imf.org/external/pubs/ft/gfsr/2007/01/index.htm

11 International Monetary Fund Global Financial Stability Report, April 2007, p. 11, (accessed 7 August 2007): http://www.imf.org/external/pubs/ft/gfsr/2007/01/index.htm

implementation in the United States of the Sarbanes-Oxley Act has been particularly cited in this regard.

2.12 Finally, the large influx of capital into private equity funds has been a significant driver of private LBO activity. The private equity industry raised $US430 billion in 2006, and in April 2007 it was forecast to raise $US500 billion for 2007. In many cases, private equity funds have been boosted by the distribution of profits and dividends from earlier deals, and these are being reinvested in new deals. Additionally, private equity funds have been generating and distributing returns on their investment at an accelerated pace, as short as 20 months following acquisition, versus a standard length of four to eight years.

2.13 This surge in LBOs differs from previous cycles in that the size of the deals is much larger. In part this is due to a larger number of LBOs being completed by multiple fund managers that pool their resources to back a single transaction (referred to as 'club deals'). This has enabled a significant expansion in the size of transactions that may be undertaken. The degree of leverage in the targeted companies is also rising, although it remains low relative to the 1980s cycle. Additionally, deal funding has favoured leveraged loans over high-yield debt.[12] This in turn has altered the distribution of risks throughout the global economy.

Trends in Australia[13]

2.14 The growth in buyouts in Australia has markedly accelerated in recent years. The increase in Australian private equity transactions lagged the boom in the US and Europe by a couple of years but in 2006, the value of completed private equity transactions increased to around $14 billion, contrasting with an average of around $2 billion for each of the previous five years.

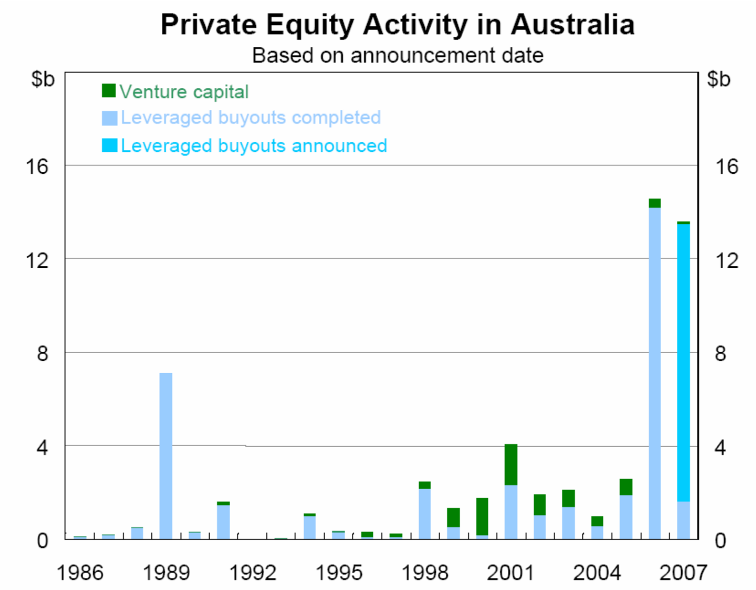
2.15 Between the years 1999 and 2005 venture capital investments and leveraged buyouts were more or less evenly split by value in Australia. However, in 2006, venture capital comprised only a fraction of the value of total private equity investment:[14]

---

12 The IMF defines leveraged loans as loans that carry an interest rate of more than 150 basis points above LIBOR (London Interbank Offered Rate). Unlike bonds, leveraged loans are sold through a process of syndication to a highly professional investor base.

13 Reserve Bank of Australia, Stability Review, March 2007 *and* Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 5.

14 Briefing by the Reserve Bank of Australia, 25 July 2007, Chart 6.



2.16 The value of the leveraged buyouts was equivalent to two per cent of the total assets of the Australian non-financial corporate sector, which the RBA suggests is similar to the corresponding proportion for the United States.[15] Additionally, the increase in the value of LBO activity was due to a sharp rise in the average size of deals, rather than a rise in the number of deals, as is the case internationally. According to the Reserve Bank, there were only twenty-eight of these private equity deals done in Australia in 2006.[16]

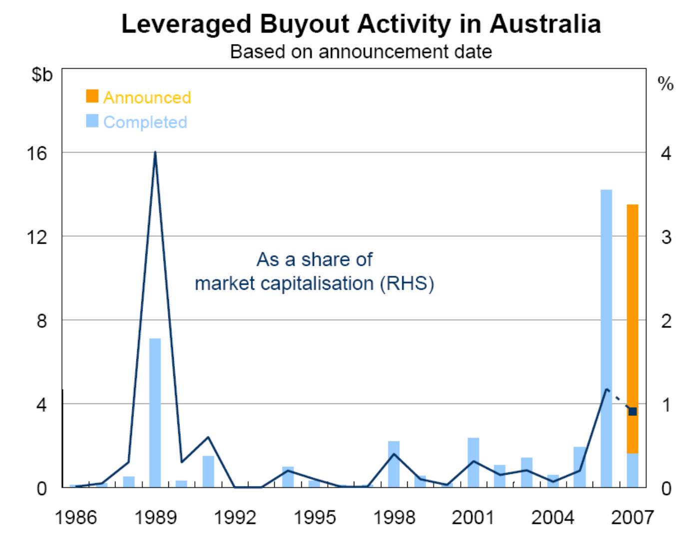
2.17 In 2006, the value of LBO activity as a proportion of Australia's equity market was approximately one per cent. The following graph shows how this proportion has fluctuated over the last two decades. In 1989, the figure was much larger than currently at approximately 4 per cent:[17]

---

15 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 59.

16 Mr John Broadbent, Head, Domestic Markets, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 13.

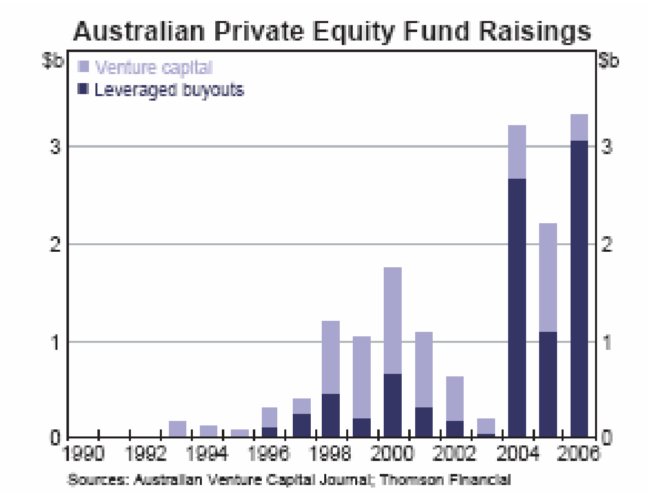
17 Briefing by the Reserve Bank of Australia, 25 July 2007, Chart 7.



2.18 Recent buyouts in Australia have typically resulted in 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. As a comparison, during the late 1980s LBO boom in the United States, debt-to-equity ratios exceeded 500 per cent. If the leveraged buyout increases the purchased company's gearing to such an extent that its credit rating is downgraded, the cost of the debt is likely to increase.

Private equity fund raisings

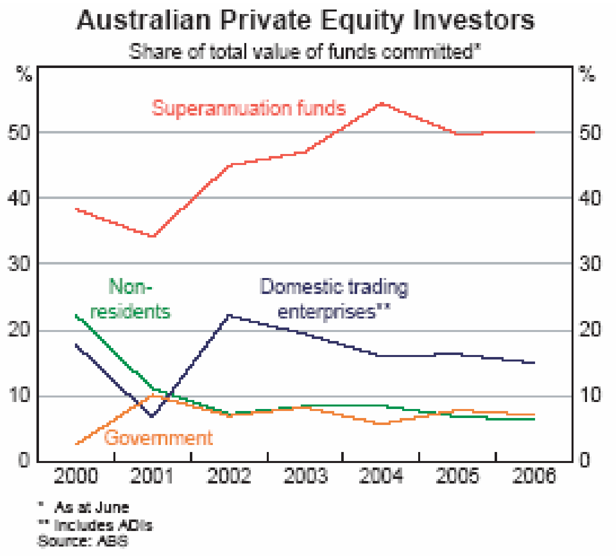
2.19 In Australia, as is the case overseas, there has been a significant flow of money into private equity funds, as shown in the following graph:[18]



2.20 Over the past three years, annual raisings have averaged around $2 billion, with private equity funds now accounting for about 1.5 per cent of Australian funds

18 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 62.

under management. Institutional investors account for four-fifths of the funds managed by Australian private equity funds. Superannuation funds represent the major investor class, accounting for around half the total funds committed to private equity at the end of June 2006:[19]



The Committee notes that in 2007 total superannuation assets reached the $1 trillion mark, backed by strong equity markets and a guaranteed flow of money that some researchers estimate could double in size by 2015.

2.21 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. As at 30 June 2006, total private equity funds under management in Australia was around $22.4 billion.[20]

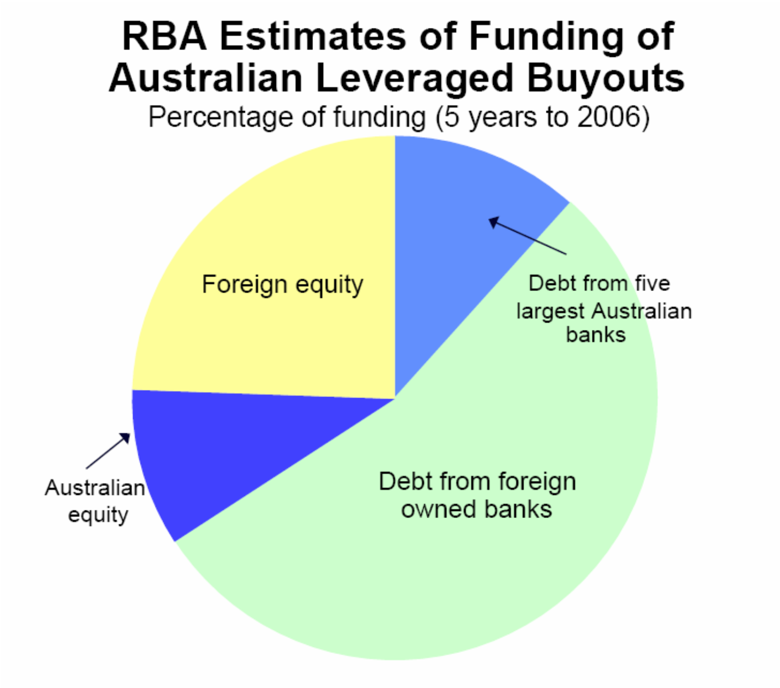
Bank exposures and superannuation fund exposures to private equity

2.22 The bulk of the funds for Australian LBO activity come from borrowings from foreign owned banks. Foreign equity contributes about 25 per cent of the funds. The following graph shows a breakdown of the funding of Australian LBOs. It takes into account the average funding for the deals completed over the past five years:[21]

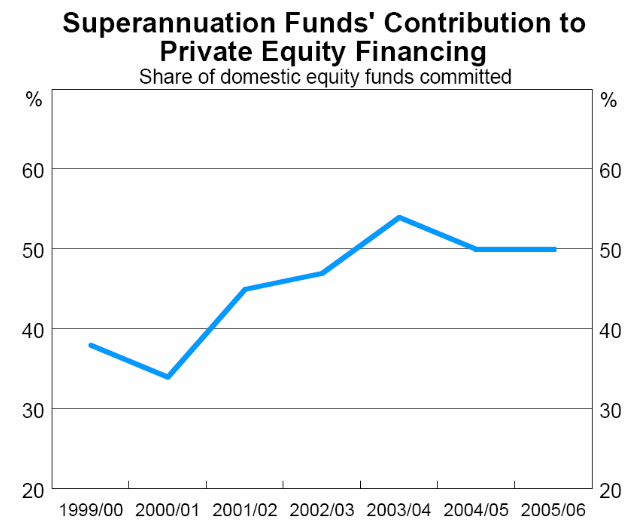
19 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 62.

20 Mr Jeremy Cooper, Deputy Chairman, ASIC, *Proof Committee Hansard*, 25 July 2007, p. 26.

21 Briefing by the Reserve Bank of Australia, 25 July 2007, Chart 8.



2.23 The Reserve Bank estimates that there is probably about $20 billion debt outstanding to Australian private equity companies and less than $5 billion is on the books of Australian banks. This amounts to less than one per cent of their overall lending. Approximately half of the domestically sourced equity proportion for Australian LBO funding comes from Australian superannuation funds, as illustrated in the following graph:[22]



2.24 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 five per cent. Many superannuation funds increased their exposures to private equity and other alternative investments, such as hedge funds,

22 Briefing by the Reserve Bank of Australia, 25 July 2007, Chart 9.

after the share market correction in 2000 because they were looking to achieve more stable returns.[23] In some ways they were looking to copy the successful record that some of the US university endowment funds have achieved as a result of investing in unlisted vehicles, such as private equity and hedge funds.[24]

2.25 Any institutional investment in private equity must be viewed in the context of a fund's overall asset allocation.[25] In such a context, for a typical institutional investor, the aggregate exposure to private equity is small in a relative sense. For example, a typical strategic asset allocation for the asset class would range between 2.5 per cent and 7.5 per cent of total assets. For a $5 billion superannuation fund, this represents an aggregate exposure to private equity of $125 million to $375 million. By way of comparison, if that fund had a 50 per cent exposure to listed equities, with eight managers in the structure, each listed equity mandate would be approximately $312.5 million in size.

2.26 However, a survey by Deloitte found that industry superannuation funds had more than doubled their allocation to alternative vehicles since 2002, while commercial funds slightly increased their exposure to the largely unlisted market.[26] That is, industry funds increased their exposure to alternatives from 7 per cent of balanced fund assets in March 2002 to 15.1 per cent in March 2007, while commercial funds boosted exposure from 0.5 per cent to 3.1 per cent.

2.27 Within their private equity exposures, institutional investors further reduce risk by diversifying their investments by:[27]

- vintage: the portfolio is invested across different vintage years to avoid concentration at any point in time over an economic cycle;
- geography: to avoid over exposure to any one region or economy, the commitments to private equity managers are diversified across Australia, US, UK, Europe and other regions;
- sectors: the portfolio is also invested across all sectors of private equity. These include venture capital, expansion capital (a subset of buyouts), buyouts and special situation; and
- managers: by committing to a range of private equity managers, the portfolio avoids over exposure to any single manager.

---

23 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 6.

24 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 6.

25 UniSuper Limited, *Submission 1*, p. 3.

26 The survey includes everything from toll roads to private equity funds in its alternatives category. Reported in 'Alternatives have appeal', *Australian Financial Review*, 22 June 2007, p. 82.

27 UniSuper Limited, *Submission 1*, p. 4.

Outlook

2.28 There are some indications that private equity activity has approached or is approaching its peak and that the market cycle is adjusting. Anecdotally, there are reports that companies in the United States have had to suspend their plans to raise debt because of its rising cost, and additionally investors may be becoming more cautious about investing in riskier debt issues.[28] The private equity model becomes less viable without access to cheap financing and ready capital.

2.29 The reasons for a reduction in private equity activity include:[29]

- a re-evaluation of risk in response to the problems in the US subprime mortgage market. This increases the difficulties of private equity firms obtaining 'covenant lite' financing,[30] thus reducing the flexibility of their business model;
- the high level of corporate profits suggests there may not be significant gains that private equity can achieve from businesses;
- there may be a shrinking pool of viable targets; and
- an increasing spotlight on the private equity industry may tempt policy makers to take steps to reduce their well publicised profits, or super-returns.

28 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 3.

29 This section is based on 'The business of making money', *The Economist*, 5 July 2007, (accessed 9 July 2007): http://www.economist.com/PrinterFriendly.cfm?story_id=9440821

30 Covenant-lite refers to a reduction in the usual conditions (or covenants) placed by a lender on a loan.

Chapter 3

Effects of private equity on capital markets

3.1 Regulatory bodies such as the Reserve Bank of Australia (RBA) and the UK Financial Services Authority discussed the possibility of private equity reducing the quality and depth of capital markets.[1] The RBA did however indicate in the Financial Stability Review that to date this had not been the experience in Australia.

3.2 The committee's terms of reference ask it to assess the effects of private equity on capital markets. The committee received limited evidence on this matter. However, testimony from the regulatory agencies and other witnesses suggests that there are limits to the growth of private equity that will mitigate against significant equity market effects.

3.3 Capital markets also encompass debt markets. The evidence suggests that activity in debt markets has a greater impact on private equity than the converse. This chapter considers these capital market effects.

Equity markets

3.4 The same economic conditions that have expanded capital markets, and mergers and acquisitions more generally, have driven the escalating numbers and value of private equity transactions. These conditions include low interest rates, high levels of liquidity and low volatility. Private equity provides capital for companies to grow and consolidate; it is therefore in competition with public capital markets to provide these funds. Consequently, some of the concerns about the continuing growth of private equity relate to the implications for the quality, depth and efficiency of public capital markets.

3.5 Some of the ways in which private equity can potentially affect stockmarkets include removing companies from and relisting companies on stock exchanges, as well as by indirectly affecting the quality of the markets through precipitating defensive behaviour by listed companies that are seeking to avoid a private equity buyout.

3.6 Hypothetically, these impacts may raise concerns about whether private equity will reduce overall capital market efficiency, but in Australia the relative size of the private equity industry, in combination with an anticipated slowing of private equity activity, suggests that there will not be significant effects on capital markets.

---

1 Reserve Bank of Australia, Financial Stability Report, March 2007, pp 67–68 *and* Financial Services Authority (United Kingdom), *Private equity: a discussion of risk and regulatory engagement*, Discussion paper 06/6, November 2006, pp 8 and 65–68.

Stockmarket capitalisation

3.7 Theoretically, falling stockmarket capitalisation could lead to more limited non-intermediated investment choices for investors, difficulties raising capital, removal of larger companies from the market as private equity deal sizes increase and increasing risk for investors due to fewer opportunities to diversify portfolios.

3.8 Internationally, there is some evidence that changes to stockmarket composition are occurring. For example, the value of stockmarket capitalisation, after abstracting from changes in prices, is estimated to have fallen in 2006 in continental Europe, the United Kingdom and the United States.[2] However, it is difficult to attribute such effects solely to private equity activity, despite the fact that private equity is more developed in those markets than it is in Australia. While private equity does remove public companies from stockmarkets, companies also delist for various other reasons. Additionally, there are other explanations apart from delistings for falls in stockmarket capitalisation.

3.9 In the United Kingdom, the funds raised by private equity in the first half of 2006 exceeded new capital raised through initial public offerings (IPOs) on the London Stock Exchange. There is also concern that in addition to falls in market capitalisation, an increasing proportion of companies with growth potential are being taken private. Consequently, the growth potential of those companies that are listed may have been fully exploited and this could then affect the quality of the stockmarket overall. Furthermore, the development of a secondary private equity market, may lead to fewer private companies going public.

3.10 Despite these developments, the UK Financial Services Authority considers that while they could be meaningful in smaller markets, to date both public and private markets appear to be deep, liquid and encompass high growth potential companies.[3]

3.11 The evidence received by the committee suggests that private equity is not a threat to the public capital markets in Australia.[4] There are four main reasons. Firstly, despite the surge in private equity activity in 2006, public company buyouts as a proportion of the overall equity market is small — Australian leveraged buyouts (LBOs) in 2006 were equivalent to approximately one per cent of the equity market.[5]

---

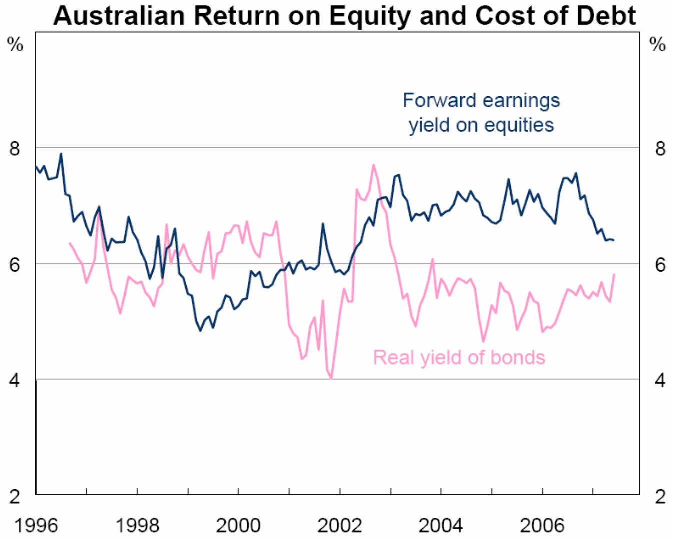
2 Reserve Bank of Australia, Financial Stability Review, March 2007, p. 67.

3 Financial Services Authority (United Kingdom), *Private equity: a discussion of risk and regulatory engagement*, Discussion paper 06/6, November 2006, p. 65.

4 Mr John Broadbent, Head, Domestic Markets, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 22.

5 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 5.

3.12 Secondly, the market is in the process of adjusting to changed conditions, the effect of which is likely to be a slowing in the number and value of LBOs. The Reserve Bank advised the committee that the global boom in LBO activity has been a consequence of the low cost and ready availability of debt. At the same time, returns on equity have been very high, and consequently there has been a large financial incentive to replace equity with debt. The RBA provided the committee with the following graph to illustrate this disparity in yields:[6]



3.13 However, the unusually large gap between returns on equity and debt is starting to close. This is occurring because the cost of debt is rising primarily as a consequence of the problems in the US mortgage market in recent months. The spreads on corporate debt and lower rated debt have widened so it is becoming more costly for investors to raise debt in the US (which is the source of a significant proportion of LBO financing). Globally therefore, the source of funding for these buyouts is starting to dry up and the conditions that gave rise to the surge in private equity in 2006 have receded.[7]

3.14 At the same time, the earnings yield on equities is falling. Mr Ric Battellino, Deputy Governor of the Reserve Bank, suggested that this is because the existing owners of listed companies are starting to ask a higher price in order to be prepared to sell and this pushes down the yield:[8]

> So the returns on equity and debt are coming back more into line. Our feeling from that is that basically we have seen the surge in LBO activity

---

6 Briefing by the Reserve Bank of Australia, 25 July 2007, Chart 10.

7 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 15.

8 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 7.

> and it is unlikely to continue at the pace we saw last year. I think the market has equilibrated.[9]

3.15 Additionally, there are other limits that will restrict how large a proportion of the market private equity can become. For example, Mr David Jones, Chairman, Australian Private Equity and Venture Capital Association Limited (AVCAL), told the committee that private equity can only be relevant in certain circumstances.[10] He suggested that most businesses already attract adequate capital and management attention, and it is only in a minority of situations where private equity can act as a catalyst for change and propose a new direction for a business to its owners that it will become involved in an organisation. This limit on the size of the sector is borne out by the fact that it comprises only around 20 per cent of mergers and acquisitions, approximately 1.4 per cent of the enterprise value of the Australian Stock Exchange in 2006, under three per cent of bank lending, and less than five per cent of superannuation fund investments. Mr Jones advised the committee that these proportions are not markedly different to those in the more developed private equity markets of the United Kingdom and the United States.

3.16 Thirdly, private equity is not a perfect substitute for public equity[11] and there remain many advantages for institutional investors to hold their core equity investments in listed companies,[12] thereby limiting the volume of funds that will be invested in private equity. The key advantage is liquidity. Although institutional investors are often the source of private equity funding, it would be too risky for them to lock away large parts of their portfolio in private equity investments which can tie up funds for up to five to ten years. Mr Battellino suggested that the requirement for liquidity will act as a natural limit on the extent to which institutional investors are prepared to put money into private equity.

3.17 Finally, one of the methods by which private equity firms exit their investments and realise their gains is by listing shares on the stock exchange in an initial public offering (IPO). Over the last five years, approximately 40 per cent of exits out of private equity took place through an IPO.[13] The Investment and Financial Services Association Limited (IFSA) submission suggests that 'it is possible to view private equity as a facilitator of public listings rather than a raider of publicly listed companies posing a threat to the exchange.'[14] In its submission, AVCAL states that

9 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 7.

10 Mr David Jones, Chairman, Australian Private Equity and Venture Capital Association Ltd (AVCAL), *Proof Committee Hansard*, 25 July 2007, p. 67.

11 Investment and Financial Services Association Ltd, (IFSA), *Submission 13*, p. 10.

12 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 8.

13 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 8.

14 Investment and Financial Services Association Ltd, (IFSA), *Submission 13*, p. 11.

private equity complements and enhances the operation of the ASX by building many businesses to a stage where they can be listed.[15]

3.18 In conclusion, there does not appear to be any evidence to suggest that the Australian stockmarket is being adversely affected by the growth in private equity. Over the last four years, the market capitalisation of the ASX has increased 130 per cent, from $0.6 trillion to $1.4 trillion. Over the same period, the number of listed entities grew by 34 per cent to 2,029. Furthermore, in the last financial year, it is estimated that private equity raisings in Australia equated to only 10 per cent of the amount of new equity raised in the same period.[16]

Defensive behaviour of listed companies

3.19 One effect of private equity on capital markets may be in the defensive behaviour of listed companies which try to make themselves less attractive to private equity overtures. To do this, companies increase their gearing, buy back shares, make a large purchase or otherwise draw down cash reserves. Additionally, the increased LBO activity may encourage other companies to take on additional debt in an effort to increase their own returns by replicating aspects of the private equity model. While this behaviour may increase a company's risk, the Reserve Bank's view is that in aggregate the effect on the stockmarket is limited. However, the Bank considers this particular effect of private equity activity to have greater significance than any impact on stockmarket capitalisation.[17]

Debt markets

3.20 The evidence received by the committee suggests that activity in the debt markets influences the level of activity in the private equity market because private equity is heavily dependent on ready access to cheap credit. This state of affairs is most clearly illustrated by the increasing returns now being demanded by investors in debt instruments based on the US subprime market, and the attendant spillover into debt markets more generally, which is reportedly having an impact on private equity deals.[18]

3.21 The debt financing for private equity transactions is generally initiated by banks (in Australia, the bulk of the financing comes from overseas banks). The banks

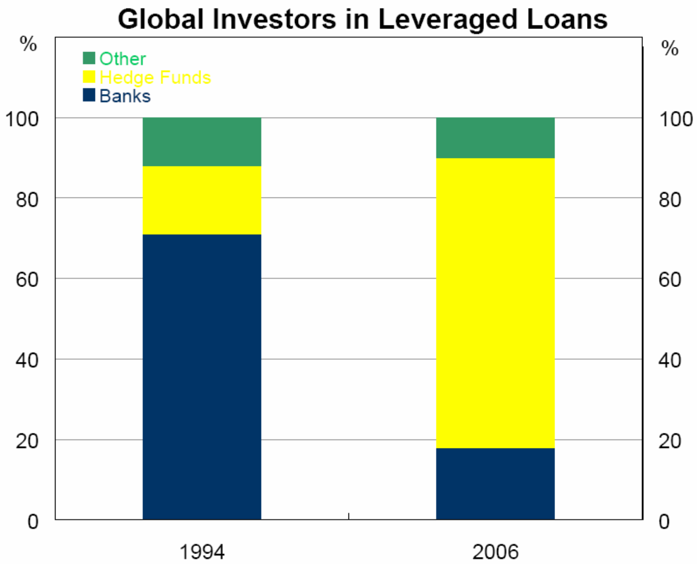
15 Australian Private Equity and Venture Capital Association Ltd (AVCAL), *Submission 17*, p. 20.

16 Mr Jeremy Cooper, Deputy Chairman, *Proof Committee Hansard*, 25 July 2007, p. 26.

17 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, pp 7–8.

18 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, pp 7, 15 and 23; Grace Wong, 'The end of the credit party', *CNNMoney.com*, 27 July 2007, Andrew Cornell, 'Slice-and-dice debt causes gag reaction', *Australian Financial Review*, 28 July 2007, p. 17.

subsequently securitise or sell the debt into the market and ultimately the exposure is held by hedge funds and a few other investors. The following graph illustrates this trend by showing changes in the composition of the global investors in leveraged loans over the past 12 years:[19]



3.22 The graph shows that over the period the bulk of the debt is now held by hedge funds and the share held by banks is down to about 20 per cent of the total. So, although the banks initiate the loans, hedge funds and a few other investors are the main ongoing source of funding. While these practices have an effect on debt markets, it is not possible to separate the impact attributable to private equity activity from that attributable to financial market activity more generally.

3.23 The debt is often structured into various tiers such as senior, junior and subordinated debt which can be securitised and spread throughout the market by being repackaged and sold, including to retail investors. The Australian Securities and Investment Commission (ASIC) is alert to the fact that retail investors, while cognisant about the degree of risk attached to equity and business investments, are often confused about the amount of risk that can be inherent in fixed interest investments. These investments could include the financial products that might flow into the market from private equity deals:

> …there is some risk there, but consumers will misinterpret or misprice the risk that is involved and merely take at face value that it is a fixed interest investment and therefore you cannot lose your money and you are going to be paid that level of interest.[20]

3.24 ASIC told the committee that it is vigilant about the quality of disclosures in the prospectuses for selling these instruments to ensure that they inform retail

19 Briefing by the Reserve Bank of Australia, 25 July 2007, Chart 5.

20 Mr Jeremy Cooper, Deputy Chairman, ASIC, *Proof Committee Hansard*, 25 July 2007, p. 34.

investors about the degree of risk that is associated with the debt. The risk will be dependent on the complexity of the transaction, where the debt ranks in the transaction and the level of security that is attached to the particular debt offering.[21] The Committee notes ASIC's related evidence to the Parliamentary Joint Committee on Corporations and Financial Services where representatives emphasised that its responsibilities in this area relate to ensuring adequate disclosure, and that it does not make judgements in relation to the business that is being carried on.[22]

3.25 Clearly, the existence of active secondary, and leveraged loan markets for debt instruments is very important to enable private equity deals. Hypothetically, if the banks could not remove their exposures from their balance sheets, they could become more reluctant to lend for private equity transactions.

3.26 Recently there have been reports about private equity entities pulling out of certain deals as a consequence of the reappraisal of risk in the US subprime market.[23] Additionally some corporate capital raisings have been postponed and there have also been difficulties for banks in placing certain loans from large private equity buy-outs in the capital markets.[24] There are two aspects to these developments. Firstly, as credit spreads have widened, the cost of debt — especially the more risky tranches — has increased as investors demand a premium for more risky securities. This may mean that a private equity deal potentially will not be as profitable as initially anticipated. Secondly, issuers of securities may be finding some resistance in the market. Nevertheless, the capital markets seem to be in the process of adjusting to changed conditions and these most recent developments may not continue. Predictions about this dynamic area are well beyond the scope of this report.

3.27 In summary, private equity transactions have an impact on debt markets by increasing the supply of debt instruments. However, the attendant supply of financial products is only a subset of the broader pool of instruments issued in financial markets more generally. The greater impact is from debt markets which have a more significant effect on private equity activity through the cost of borrowing and the level of demand for the debt instruments that are created from the deals.

---

21 Mr Malcolm Rodgers, Executive Director, Regulation, ASIC, *Proof Committee Hansard*, 25 July 2007, pp 34–35.

22 Parliamentary Joint Committee on Corporations and Financial Services, *Statutory oversight of Australian Securities and Investments Commission*, *Official Committee Hansard*, 12 June 2007, p. 32.

23 Robert Guy, 'Farewell fast money: the lenders re-write the rules', *Australian Financial Review*, 14 July 2007.

24 For example, banks have reportedly had difficulty in placing the debt from Chrysler in the US and Alliance Boots in the UK.

Other effects

3.28 Private equity practices may enhance capital market efficiency in different but related ways. These enhancements include widening the availability and source of capital to companies, increasing the accuracy of company valuations (for example, factoring in their growth potential), enhancing the efficiency of corporate capital structures, and facilitating corporate development and transformation.[25]

3.29 According to AVCAL, private equity has helped to develop the debt markets in Australia by attracting more international banks to participate in them.[26] Its submission states that the entry of new lenders into the market has increased the availability of funding for Australian businesses and investment products for investors. In addition, private equity activity has helped to build in Australia a liquid market in subordinated debt. These effects have increased the efficiency of Australia's capital markets.

3.30 Private equity, and mergers and acquisitions more generally, also contribute to increased economic activity when they lead to the release of capital that has been tied up in the companies that are taken over. A portion of the released funds will be invested by the ex-shareholders.

3.31 IFSA also suggests that private equity imposes a competitive discipline on public market operators, such as the ASX, to ensure that the cost of compliance with market rules as well as listing and other fees are competitive.[27]

Conclusion

3.32 The committee concludes that although potentially private equity can affect equity markets if it becomes large enough, there are certain characteristics of the sector that should limit its size relative to the public market. At the present time private equity is not having a significant effect on the Australian stockmarket. Additionally, private equity transactions have an impact on the debt markets but it may not be possible to disaggregate these effects from other activity in the markets. Of greater significance is the role that debt markets play in influencing private equity activity.

---

25 Financial Services Authority (United Kingdom), *Private equity: a discussion of risk and regulatory engagement*, Discussion paper 06/6, November 2006, p. 8.

26 Australian Private Equity and Venture Capital Association Ltd (AVCAL), *Submission 17*, p. 20.

27 Investment and Financial Services Association Ltd, (IFSA), *Submission 13*, p. 10.

Chapter 4

Tax revenue implications

Introduction

4.1 Part (c) of the terms of reference asks the committee to make an assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects, resulting from private equity (PE) takeover activity.

4.2 Theoretically, increased private equity investment activity may be expected to affect tax revenue in a number of different areas. These include:

- increased gearing in companies where private equity investment has taken place, which might be expected to have an effect on company tax paid;
- increased gearing on the part of companies that consider themselves to be potential targets for PE takeovers or who are seeking to emulate the PE model;
- capital gains tax receipts may be influenced by ownership shifts to foreign interests; and
- PE takeovers may give rise to general issues with taxation law compliance, for example in relation to GST liability, attribution of profits to capital accounts instead of income, and structuring of deals to derive taxation benefits.

4.3 Most observers, including the Treasury and the Reserve Bank of Australia (RBA), consider that there are few grounds for concern that increased levels of PE activity would affect government revenue levels significantly, at least at the present time. As noted elsewhere in this report, Treasury and the RBA make the point that PE activity only comprises a minor proportion of the overall capital markets, and indications are that levels of large scale PE takeover activity seen in the last year are unlikely to be sustained.

4.4 Treasury conceded however that it does not yet have a clear picture of what the longer term effects might be on taxation revenue:

> The assessment of private equity is that it is not something that we are in a position at this stage to make a call on. …In terms of what the revenue effect is. It is extremely unclear.[1]

4.5 As noted by the RBA in the Financial Stability Review:

---

1 Mr Colin Brown, Manager, Costing and Qualitative Analysis Unit, Tax Analysis Division, Treasury, *Proof Committee Hansard*, 26 July 2007, p. 9.

> The implications for Government revenue are hard to ascertain as there are currently insufficient data to fully model the effects of private equity investment on tax revenue.[2]

4.6 The evidence available to the committee indicates that assessment of the revenue implications resulting from increased PE activity is complex and does not lend itself to analysis of isolated examples. Offsetting factors also need to be taken into account before a reasonable assessment of revenue implications can be made. However, in the absence of hard information about trends in revenue collection, the analysis is somewhat hypothetical and needs to be treated with caution. Actual trends, as observed and reported by the Australian Taxation Office (ATO), can ultimately be the only reliable guide.

Taxation implications of private equity takeovers

Gearing and Capital Gains Tax

4.7 Leveraged buyouts of publicly listed and other companies invariably result in increased levels of gearing. The Reserve Bank of Australia confirms that companies that have been the subject of leveraged buyouts invariably carry higher levels of debt than listed companies:

> 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. 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.[3]

4.8 The interest payments resulting from these higher levels of debt are normally a deductible business expense, although the amount that may be deducted is limited by the thin capitalisation rules.

4.9 In Australia and in many other countries, governments impose restrictions on when, and the extent to which, interest can be claimed as a tax deduction. These rules are intended to ensure that foreign companies do not allocate an excessive amount of debt to their Australian operations, and thereby derive excessive interest deductions. Put simply, under these rules, interest payments arising from debt-to-equity ratios that exceed a ratio of 3:1 are not tax deductible. The rules do not impose a limit on gearing; rather, they impose a limit on the extent to which the interest on debt is tax deductible.

---

2 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 72.

3 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 60.

4.10 The 3:1 debt to equity ratio is not usually approached by publicly listed companies. As pointed out by the RBA above, pre-buyout ratios generally fall well below these levels. Accordingly, if an individual company's profit position remained constant, then the amount of company tax paid might be expected to fall following a leveraged buyout by a private equity company. However, the picture is actually more complex, as factors such as increased profitability, higher listing prices and capital gains tax events generated by a buyout all need to be taken into account.

4.11 A submission made by Mr Robin Speed of Speed and Stracey Lawyers sought to illustrate the possible implications for tax revenue of foreign private equity fund buyouts of Australian listed companies. This submission included estimates of the taxation implications of the acquisition of five listed Australian companies (Coles Myer, Tabcorp, Woolworths, Qantas and Westfarmers) by US private equity funds. The submission claimed that if these companies were taken over, the loss of company tax could be $1.2 billion per annum as a result of interest resulting from increased debt being claimed as a tax deduction against the earnings of the companies taken over.

4.12 Mr Speed argued that the consequences flowing from such buyouts were significant, as company tax (about $49 billion in 2005–06) represented 20.9% of the total tax collected.[4]

4.13 Mr Frank Drenth of the Corporate Tax Association of Australia (CTA) acknowledged that increased gearing associated with PE investment could have an effect on the amount of tax paid:

> The major concern that arises is the leveraging of the transaction. Private equity tends to use more debt and it is possible through the consolidation regime for the debt deductions that arise from the borrowings that are made to offset the debt deductions against the cash flow in the taxable income of the target company. On the face of it, there is an issue.[5]

4.14 However, while broadly agreeing with Mr Speed's analysis, Mr Drenth disagreed with the magnitude of the losses projected by Mr Speed, saying that they were somewhat overstated. Using Mr Speed's example of the five ASX companies, Mr Drenth estimated that the additional deductible interest that would arise would be in the order of $3.06 billion per annum rather than the $5.4 billion projected in Mr Speed's submission, which, at the 30 per cent company tax rate, represents tax of $918 million per annum.[6]

4.15 Mr Drenth argued that improved profitability resulting from PE investment also needed to be taken into account in this equation. He said that improving profitability is what underpins the business model:

---

4 Speed and Stracey Lawyers, *Submission 21*, p. 16.

5 Mr Frank Drenth, Executive Director, Corporate Tax Association of Australia, *Proof Committee Hansard*, 26 July 2007, p. 49.

6 Corporate Tax Association of Australia, Additional Information, p. 2.

> Accordingly, it is in our view not unreasonable to factor in a modest improvement in taxable earnings. Using the $5.8 billion EBIT figures outlined on page 12 of the submission, and assuming 85% of that amount is attributable to Australia ($4.95 billion), a 15% improvement in Australian taxable profits would come to $740 million p.a., or $220 million p.a. in additional Australian tax.[7]

4.16 The CTA's argument extended beyond the area of company tax losses and gearing, providing an overall assessment that PE investment would be positive for revenue when a number of other factors such as CGT gains by shareholders accepting PE offers and the re-investment effect are factored into the overall picture. This argument is examined in more detail in subsequent sections of this chapter.

Defensive gearing

4.17 The impact on revenue of defensive gearing by companies that consider themselves to be potential PE targets, and of increased gearing on the part of companies seeking to increase their own returns by emulating the PE model, is difficult to assess at the present time. The potential effects on the economy (although not specifically on taxation revenues) of such gearing is apparent to the RBA, which noted in the Financial Stability Review that:

> 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.[8]

4.18 Evidence from Mr Battellino, Deputy Governor of the RBA, indicated that behavioural changes in listed companies may be having a larger impact on corporate gearing than leveraged buy-out activity itself:

> I think the bigger impact of LBO activity on corporate gearing is probably coming through from the impact it is having on the behaviour of listed companies. I suspect that quite a number of company boards are themselves looking to increase their gearing in order to protect themselves against takeover. In other words, in order to make sure that somebody else does not take over their equity by using debt, they are using some debt themselves to gear up their positions.[9]

---

7 Corporate Tax Association of Australia, Additional Information, p. 2.

8 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 66.

9 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia (RBA), *Proof Committee Hansard*, 25 July 2007, pp 7–8.

4.19 The committee questioned representatives of the ATO about whether there were any implications for company tax arising out of higher defensive or other gearing by companies. The Commissioner of Taxation, Mr D'Ascenzo, advised that while the ATO had seen anecdotal evidence of this trend, it has not been significant in the scheme of company tax collections at this stage.[10]

Capital gains tax

4.20 A further possible area of taxation revenue impacts is in respect of capital gains tax (CGT). As described elsewhere in this report, the usual pattern of PE investment is that the PE entities generally exit from their investments after a period of time, commonly three to five years. If the PE firm is wholly foreign owned, then it is likely that there will be no CGT paid on a profitable exit.

4.21 Much of the funding for large scale PE activity seen in Australian in the past year has come from overseas. In evidence to the committee, Mr Battellino told the committee that the foreign equity components of the large deals in 2006 greatly exceeded that from domestic investors so that 'this is really money coming from offshore'. Similarly, the biggest providers of the debt component are foreign banks.[11] This debt is generally securitised to other investors, a significant proportion of whom are overseas based.

4.22 Under Division 855 of the *Income Assessment Act 1997*, foreign residents are only subject to capital gains tax on 'taxable Australian property'—that is, real estate situated in Australia; assets used by the foreigner in carrying on a business through a permanent establishment in Australia; and 'indirect Australian real estate interests and Australian mining interests'.

4.23 In his submission, Mr Speed pointed out that PE funds typically plan to sell out after 3–5 years. He said that it is clear that the foreign PE fund will not pay Australian tax when it sells out. Based on a 25 per cent annual return on investment, he estimated that the exempt tax would amount to about $9 billion on a potential capital gain of $29 billion.[12]

4.24 The question is whether this should be a matter of concern and whether there is any need to modify Australia's tax arrangements as a result. A submission from Ernst & Young observed that in any event, foreign investors would be free of Australian tax under Australia's double tax treaties if the non-resident's investment is of an income nature, or if they characterise their PE investment as a short term trading

---

10 Mr Michael D'Ascenzo, Commissioner of Taxation, *Proof Committee Hansard*, 9 August 2007.

11 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia (RBA), *Proof Committee Hansard*, 25 July 2007, pp 5-6.

12 Mr Robin Speed, *Submission 21*, p. 16.

asset. Ernst & Young pointed out that Australian PE investors enjoy similar opportunities in overseas jurisdictions where there is a corresponding treaty.[13]

4.25 The ATO confirmed that the operation of these treaties was the major reason for non-residents such as foreign PE participants not being required to pay CGT:

> For capital gains, obviously, shareholders' shares are purchased. If they sell that, it is a long-term holding, they are not a trader and there will be a capital gains tax effect. At the end of … the leveraged buyout deal—it may well be that, if it is a foreign company or a foreign group, it is not taxable in Australia, not through the capital gains tax non-resident exemption, rather as a result of the business profits article in a double tax treaty.[14]

4.26 The tax amendments in 2006 to exempt non-residents from non-real property related CGT events were also introduced with a specific policy objective, namely to reduce disincentives to non-residents to establish and expand businesses in this country. Questioned by committee members as to whether this change had been a factor in driving PE activity, ATO representatives indicated that this had not been a significant feature in the leveraged buyout deals discussed with the committee at the hearing.[15]

Offsetting factors

4.27 While it is informative to examine each element of PE investment activity to determine its possible impact on taxation revenue, the picture that emerges from such an approach may be misleading. A range of offsetting factors must also be taken into account and this makes assessing the overall effect that PE investment may have on taxation revenue difficult. As emphasised by Treasury and others:

> However, again, with individual transactions such as private equity, you have to be very careful…Not only can you point to potential impacts on the revenue from a particular transaction but also you have to look at what the flow-on effects of that transaction are elsewhere in the economy. Those impacts are often offset elsewhere.[16]

4.28 During the inquiry, some of the likely factors offsetting revenue loss brought to the committee's attention include:

- effects on lenders;
- increased profitability;

---

13 Ernst & Young, *Submission 22*, p. 7.

14 Ms Jan Farrell, Deputy Commissioner, Australian Taxation Office, *Proof Committee Hansard*, 9 August 2007, p. 8.

15 Ms Jan Farrell, Deputy Commissioner, Australian Taxation Office, *Proof Committee Hansard*, 9 August 2007, p. 13.

16 Mr Colin Brown, Manager, Costing and Qualitative Analysis Unit, Tax Analysis Division, Treasury, *Proof Committee Hansard*, 26 July 2007, p. 15.

- CGT events triggered by takeovers; and
- reinvestment.

Effects on lenders

4.29 The RBA has noted that one effect of higher PE investment activity is that to the extent that lenders for these deals are based in Australia, their taxable income is likely to increase and add to tax revenue. In the case of non-resident financiers, there may also be an increase in withholding tax collections, although this depends on the withholding tax arrangements in the bilateral tax treaties.[17]

Increased profitability

4.30 PE proponents argue that a major objective of the exercise is to increase the profitability of the companies taken over. Resulting increased tax receipts may at least partially offset reduced company tax associated with increased gearing. In his critique of the submission lodged by Mr Speed, Mr Drenth of the CTA argued that in the case of five companies used as a hypothetical example of the consequences of a PE takeover, it was not unreasonable to factor in a modest improvement in taxable earnings as an offset to the tax losses resulting from higher gearing.[18]

4.31 Increased profitability may be expected to be apparent as a long term effect, rather than in the short term.[19] An acknowledged characteristic of PE investment is a J-curve effect—initial returns on investment may be low or negative, with profitability expected to rise late in the investment cycle.[20]

4.32 Increased profitability after an LBO is far from guaranteed, particularly where gearing levels increase substantially, and thus cannot necessarily be relied upon to increase tax revenues. As pointed out by Standard and Poors:

> Although very high debt levels can provide management a strong incentive to maximise earnings and capital efficiency, the risks of leverage are substantial. …Debt laden companies have a significantly constrained capacity to accommodate cyclical earnings weaknesses or to respond to changing competitive and market conditions. …the credit ratings of acquired companies typically fall to the "B" or "BB" speculative-grade ratings. At these ratings, the probability of default increases substantially,

---

17 Reserve Bank of Australia, Financial Stability Review, *Private Equity in Australia*, March 2007, p. 72.

18 Corporate Tax Association of Australia, Additional Information, p. 3; *Submission 6,* p. *2.*

19 Corporate Tax Association, *Submission 6*, p. 2.

20 See for example UniSuper Limited, *Submission 1*, p. 2.

> with a "B" rated issuer historically having a one in three probability of default over a ten year period.[21]

CGT events triggered by takeovers

4.33 Where shareholders in a publicly listed company accept an offer for their shares in a buyout, capital gains tax will be payable on any gains realised by these shareholders. The CTA was amongst those who argued that this tax windfall has to be factored into any consideration of the overall effects on tax revenue of PE activity. As pointed out by the CTA, the transaction 'unlocks all at once both pre and post bid unrealised gains on shares which might otherwise have been held for many years – particularly in the case of long term investors.'[22]

4.34 Referring to the submission of Mr Speed, the CTA argued that the tax gains from liquidation of those shares would probably exceed the CGT losses during the period of PE ownership:

> We believe the submission correctly raises the potential loss of future capital gains during the period of private equity ownership. However, we consider that those gains would be rather less than the up-front gains actually realised (ignoring the time value of money). This is firstly because such gains would crystallise much more slowly and they would be smaller. Many long-term shareholders would not be realising any gains in the normal course of events (or at least not within a timeframe that is relevant to this analysis). Secondly, the share price is unlikely, for the reasons outlined in the previous paragraph, to approach the levels brought about by the private equity bid. It would be appropriate to reduce the amount of the up-front gain by a factor which reflects foregone future gains…[23]

Reinvestment

4.35 A proportion of gains realised by shareholders whose shares have been acquired in a PE takeover continue to generate tax revenue. A number of witnesses emphasised that while it is possible that some of the money may be spent for non-investment purposes, much of it remains in Australian investments and continues to generate both taxable income and potential capital gains.

4.36 Ernst & Young submitted that the typical behaviour of shareholders in this situation was to reinvest, and that the income and subsequent disposal of replacement

---

21 Standard and Poor's, Leveraged buyouts in Australia – who really bears the risks, (accessed 13 August 2007): http://www2.standardandpoors.com/portal/site/sp/en/au/page.hottopic/lbo_viewpoint_3_1_hottopic/3,1,1,0,0,0,0,0,0,0,0,0,2,0,0,0.html, .

22 Corporate Tax Association of Australia, Additional Information, p. 2.

23 Corporate Tax Association of Australia, Additional Information, p. 4.

investments continue to be taxed in Australia. The company stated that it 'did not see any reason for concern about the revenue effects here'.[24]

4.37 Mr Battellino of the RBA also emphasised the cyclical nature of investing:

> The question is: what has happened to the capital that has been liberated by the private equity? How much tax are they paying? If I am the owner of some listed shares at the moment, I am getting my returns on dividends and capital gains and I am paying my tax on that. A private equity firm might come along and buy those and may find a way of paying less tax—and we will see about that—but the other question is: what has happened to the money I have got back from that investment? I have gone out and made other investments and I am still paying my tax. You cannot extrapolate from one particular thing to a general macro picture. My conclusion would be that really on a macro scale shifts in the patterns of financing probably do not have a big overall impact on the tax base.[25]

General taxation law compliance issues

4.38 Aside from the structural issues associated with PE activity which might have an effect on future government tax revenue, there are a number of tax compliance issues that also have potential revenue effects.

4.39 At the committee's final public hearing on 9 August 2007, the Commissioner of Taxation, Mr Michael D'Ascenzo, advised the committee that PE would be a major compliance focus for the ATO in the coming year. He told the committee that the ATO had been examining some of the arrangements associated with larger PE transactions as part of the large business program and that the compliance plan for 2007–08 outlined features of PE deals that are likely to attract ATO attention. The Commissioner said that the ATO's focus was on leveraged buyouts, where turnover exceeds $100 million per year. He outlined a range of features of PE deals of particular interest to the ATO from a compliance perspective:

- profit participation arrangements, where payments are received by participants such as executives of the target group, equity participants or their associates, on the successful completion of a deal. The ATO may need to confirm whether a proper characterisation has been made to these returns as being on revenue account or capital account. Where these arrangements result in payments being made to tax haven entities, the ATO is likely to check to ensure that any Australian residents involved are complying with the foreign income attribution regime;

24 Ernst & Young, *Submission 22*, p. 5.

25 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia (RBA), *Proof Committee Hansard*, 25 July 2007, pp 16-17.

- treatment of distribution to investors of unit trusts or other private investment vehicles, and whether the characterisation of those payments as being on revenue or capital account accords with tax law principles;

- transactions fees paid to advisers or participants—the ATO may need to confirm that the value of fees paid to related entities is in line with the arms length principle and is therefore deductible for income tax purposes;

- black hole expenditure incurred, for example by target companies in the course of failed PE bids and whether such expenditure is appropriately characterised;

- where non-residents are substantially operating in ATO jurisdiction, the value of profits properly attributable to any enterprise that constitutes a permanent establishment in Australia;

- cost based uplifts of assets, when structuring into, or out of a newly consolidated group, the nature of tax cost setting process to ensure that appropriate allocations have been made;

- the structure and tax character of debt and equity investments and the nature of any impacts on the thin capitalisation safe harbour measures to ensure substantial integrity of the tax law; and

- whether the making of financial supplies results in GST liability not being charged for the acquisition of services from off-shore entities and where appropriate, review of claims for input tax credits.[26]

4.40 The Commissioner told the committee that these areas are not necessarily peculiar to PE—they have features that are common to many mergers and acquisitions. Nonetheless, they will be a focus for the 2007–08 compliance program. Information derived would be passed on to Treasury so that assessments can be made of whether there is any need to change current policy parameters.[27]

Overall assessment of the revenue impact

4.41 The general consensus among organisations with acknowledged expertise in the likely impact of PE activity on taxation revenue was that the impact on revenue appears to be low and concerns about it overstated. The assessment of the Deputy Governor of the RBA, Mr Battellino, was that:

26 Mr Michael D'Ascenzo, Commissioner of Taxation, *Proof Committee Hansard*, 9 August 2007, pp 2-3.

27 Mr Michael D'Ascenzo, Commissioner of Taxation, *Proof Committee Hansard*, 9 August 2007, p. 3.

> My conclusion would be that really on a macro scale shifts in the patterns of financing probably do not have a big overall impact on the tax base.[28]

4.42 While increased gearing and shifting capital gains tax liability to parties who are not liable to pay it may affect revenue, offsetting effects also have to be taken into account, and it appears credible that these may reduce the extent of revenue losses or even result in additional revenue.

4.43 However, Treasury and ATO evidence indicates that there is insufficient information available to be certain about how increased PE investment activity will affect revenue, if it continues or sparks a more pronounced shift in defensive gearing among companies currently carrying lower levels of debt. The latter is a trend that will require careful monitoring, and the evidence of the Treasury and the ATO is that they are actively doing this already.

4.44 The committee is satisfied that PE is receiving adequate attention from the ATO to ensure that any compliance risks are identified. The current law appears to be sufficient, and the committee is not persuaded that any of the evidence presented during this inquiry is sufficiently persuasive for it to recommend any changes to tax law at this time. However, this is an area that will require close monitoring.

---

28 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia (RBA), *Proof Committee Hansard*, 25 July 2007, p. 17.

Chapter 5

Is current regulation of private equity adequate to protect the economy and the national interest?

5.1 This chapter looks at whether the current regulatory framework governing private equity activity in Australia is adequate to protect the Australian economy, sectors of the economy and the national interest. Most witnesses downplayed concerns that private equity activity may injure either the economy or the national interest. They variously cited the rigour of existing reporting obligations for unlisted companies under the *Corporations Act 2001*, the small scale of current private equity activity in Australia, the difficulty defining which sectors are nationally significant and the power vested in Australian shareholders. The witnesses who expressed concern about the impact of private equity activity on national interest grounds claimed existing reporting requirements are inadequate and the need to regulate private equity ownership of key public services to guard against their failure.

The Reserve Bank of Australia's view

5.2 The Deputy Governor of the Reserve Bank of Australia (RBA), Mr Ric Battellino, told the committee that the spike in leveraged buy-out (LBO) activity in 2006 was the result of 'very unusual circumstances' in Australian capital markets, associated with the low cost of debt. He argued that the influence of these circumstances is—at least anecdotally—waning[1] and that some of the 'covenant-lite' loans are not being accepted by the market. Asked whether there is a need for any regulatory or legislative changes, Mr Battellino replied:

> No, I think that from our point of view we certainly do not see a case for regulatory change in this area. As I say, it was the outcome of a very unusual set of circumstances. Those circumstances are closing, and I do not think there is a lasting problem here at all.[2]

5.3 Mr Battellino suggested that the fundamental structure of capital markets in Australia is unlikely to change significantly. Institutional investors will still favour the liquidity advantages of equity and their debt-based investments will continue to be reinvested on the stock exchange.[3] For this reason, he explained, Australians' savings

---

1 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 3.

2 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 22.

3 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 8

in superannuation are not at serious risk.[4] Further, Australian banks have very low exposure to private debt financing activity and are protected from a private equity buy-out.[5] Mr Battellino concluded that 'the overall exposure of the economy to this particular form of financing is quite low'.[6] He added: '…from our perspective, as a general macro picture, I do not think there is anything worrying the Reserve Bank here.' As the body principally responsible for the systemic stability of the Australian economy, this is a significant statement.

The financial regulators' view

5.4 ASIC and APRA also downplayed any threat that private equity might pose to the Australian economy. In their evidence to the committee, both regulators reiterated the RBA's observations of the small scale and relatively low exposure of private equity activity in Australia. ASIC's Deputy Chairman, Mr Jeremy Cooper, emphasised that the current size of the private equity market in Australia was small compared with the total value of the listed equities market. He also noted that Australian superannuation funds are aiming to maintain their exposure to private equity at about four or five per cent.[7] APRA's Executive General Manager, Mr Tom Karp, told the committee that Australia's five largest domestic banks have private equity and leveraged lending exposure limits of $1 billion to $3 billion, which represents less than five to ten per cent of the total capital for a bank.[8] He estimated that the private equity exposure of Australian super funds regulated by APRA is around one per cent of total assets.[9]

5.5 Both regulators also expressed confidence that the current regulatory framework for private equity activity was adequate to safeguard institutional investors. Mr Cooper noted that the merit of Australia's financial regulation framework is that 'it is flexible and can deal with private equity without having to write a new chapter of the Corporations Act for private equity'.[10] He added that private equity is already 'quite comprehensively regulated' with disclosure obligations for

4 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 19.

5 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 14; Mr John Broadbent, Head, Domestic Markets, Reserve Bank of Australia, *Committee Hansard*, 25 July 2007, p. 19.

6 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 14.

7 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Proof Committee Hansard*, 25 July 2007, p. 26.

8 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 41.

9 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 42.

10 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Proof Committee Hansard*, 25 July 2007, p. 28.

private companies not listed on the ASX.[11] Further, he argued that the current size and nature of private equity activity in Australia does not warrant further powers of new regulation.[12] Indeed, Mr Cooper described private equity in Australia as 'a healthy development' which has forced Australian institutional investors to focus more closely on the value of their investments in listed entities.

5.6 Mr Karp told the committee that the banks' internal mechanisms, combined with APRA's prudential framework, are an effective strategy for dealing with private equity's risks. He told the committee that the banks have their own policies for leveraged lending with formal credit approvals and ongoing monitoring. Lending for private equity is assessed as a higher level of risk given it typically has a higher level of gearing than other investments. Mr Karp also observed that Australian banks' approach to lending for private equity appears to be 'fairly cautious' compared to international banks. In addition, APRA has its own credit risk management processes to ensure that banks hold capital against potential losses.[13] He concluded that 'we do not see any significant prudential risks in private equity to the banks'.[14]

5.7 Mr Karp expressed similar confidence that APRA has appropriate supervision and monitoring of superannuation funds' investments in private equity.[15] In the event that super funds' exposure to private equity continues to grow to become a 'major asset class':

> …that has to be separately identified in annual reports to members so that people are aware of it. We [APRA] would be tracking the returns on it and people would be aware of that.[16]

5.8 Significantly, neither APRA nor ASIC identified any prospect that the banks, superannuation funds or retail investors' current exposure to private equity would have serious ramifications for the Australian economy. Rather, APRA noted that publicly listed companies are also exposed to risks and prone to failure.[17] While high levels of leverage and over-reliance on private equity activity are factors of potential concern to

---

11 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Proof Committee Hansard*, p. 26. See also Mr Malcolm Rodgers, Executive Director, Regulation, Australian Securities and Investments Commission, *Committee Hansard*, 25 July 2007, p. 31.

12 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Proof Committee Hansard*, 25 July 2007, p. 28.

13 These processes have also been noted by the RBA. See Reserve Bank of Australia, *Financial Stability Review*, March 2007, p. 71.

14 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 42.

15 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 43.

16 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 52.

17 Mr Tom Karp, Executive General Manager, Supervisory Support Division, Australian Prudential Regulatory Authority, *Proof Committee Hansard*, 25 July 2007, p. 48.

the regulators, there is no evidence that private equity activity in Australia is currently engaged in these levels of risk.[18]

The adequacy of existing regulations for unlisted companies

5.9 Several witnesses addressed concerns that private equity activity in Australia can escape public scrutiny. Mr David Love, Manager of Treasury's Prudential Policy Unit, told the committee that a private company has the same obligations under the Corporations Act to report its financial position as a publicly listed company. The only difference is that listed companies are subject to the ASX continuous disclosure rules, aimed at determining price signals on a daily basis.[19] Mr Battellino told the committee that the financing of private equity activity is 'all public information' and that 'people are overestimating the amount of secrecy' that happens in private equity deals.[20] The same observation was made by Mr Cooper who described the disclosure obligations of the Corporations Act as 'quite comprehensive'.[21]

5.10 The law firm, Allens Arthur Robinson, also argued that there is already appropriate regulation and laws relating to private equity transactions. Its submission summarised the current arrangements:

> Chapter 6 of the *Corporations Act* provides a comprehensive regime for the regulation of Australian public company takeovers. This regime, in combination with Australia's detailed insider trading, conflict of interest and directors' duties laws, provides an appropriate and satisfactory framework for private equity acquisitions.
>
> The Treasurer, with the support of the Foreign Investment Review Board, has broad ranging powers under the *Foreign Acquisitions and Takeover Act* to review proposed acquisitions which fall above the relevant thresholds. If the Treasurer considers a proposal to be contract to the national interest, the power exists (and has been used) to veto such an acquisition proposal.
>
> The *Foreign Acquisitions and Takeovers Act* law and policy framework has been criticised in the past as unduly fettering foreign investment into Australia. Nevertheless, that framework (together with the 70 per cent debt funding/thin capitalisation rules) remains in force for acquisitions by foreign interests, and governs private equity acquisitions along with all other acquisitions.

---

18 This is not to discount the substantial risks in high levels of debt leveraging. See the comments made by Standard and Poors in Chapter 4.

19 Mr David Love, Manager, Prudential Policy Unit, The Treasury, *Proof Committee Hansard*, 26 July 2007, p. 3.

20 Mr Ric Battellino, Deputy Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 25 July 2007, p. 14; Mr John Broadbent, Head, Domestic Markets, Reserve Bank of Australia, *Committee Hansard*, 25 July 2007, p. 13.

21 Mr Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission, *Proof Committee Hansard*, 25 July 2007, p. 26.

> No further regulation is required to protect Australia's national economic or strategic interest. [22]

The Takeovers Panel's Guidance Note

5.11 The role of the Takeovers Panel is to consider the process under which takeover bids are conducted in Australia, consistent with section 602 of the *Corporations Act 2001*. In particular, the Panel is responsible for making declarations of circumstances that are unacceptable to the purposes of section 602.[23] Mr Nigel Morris, Director of the Takeovers Panel, told the committee:

> The panel's concern is the takeovers process. Our concern is an efficient, competitive and informed market. Our concern is information to target shareholders. Our concerns would be that the people who accepted were going to get paid and that the people who did not accept or were thinking of not accepting were aware of the level of gearing and what the consequences for them as future shareholders might be.[24]

5.12 In this context, the Takeovers Panel has this year issued Guidance Note 19, a copy of which was reproduced in its submission to the inquiry.[25] The Guidance Note was issued in relation to insider participation in control transactions (takeovers). It provides takeover market participants with guidance on situations where there is involvement or potential involvement by the management, directors or external advisers of a target company with the bidder in a takeover bid or potential bid for the target company. These situations include potential conflicts of interests, provision of information to potential rival bidders and disclosure to shareholders.

5.13 Mr Morris told the committee that 'the issues in relation to takeovers that private equity raised were in fact issues that are seen in a lot of other buyer types'.[26] He further explained that the Panel's process is qualitatively no different between a publicly listed company by a private firm and a public company takeover of a public company. Failure to comply with the Guidance Note will risk a 'declaration of unacceptable circumstances and orders'.[27]

5.14 Mr Morris was asked whether any further regulatory changes are needed, given that the Corporations Act already enforces comprehensive conduct and disclosure rules on both target corporations and bidders. He replied:

> Based on our experience so far, we do not see any particular need. We will continue to look. At least since the guidance note was published, we have

22 Allens Arthur Robinson, *Submission 7*, p. 3.

23 Takeovers Panel, *Submission 8*, p. 2.

24 Mr Nigel Morris, Director, Takeovers Panel, *Proof Committee Hansard*, p. 26.

25 Takeovers Panel, *Submission 8*.

26 Mr Nigel Morris, Director, Takeovers Panel, *Proof Committee Hansard*, p. 21.

27 Mr Nigel Morris, Director, Takeovers Panel, *Proof Committee Hansard*, p. 23.

> not seen any matters come before us that have caused us concerns...One of the things about the Takeovers Panel is that it is not just ASIC that can bring applications before it. Rival bidders, unhappy shareholders as well as ASIC can bring issues before the Takeovers Panel. There are additional layers of surveillance and scrutiny with other people out there acting in their own commercial interests. At the moment—touch wood—it seems to be adequate.[28]

The power vested in shareholders

5.15 Shareholders remain the ultimate arbiters of whether a listed company is taken over. A private equity bid fails if sufficient numbers of shareholders do not sell their shares.[29] The details of the offer are the responsibility of the board, which clearly has a powerful role in terms of relaying information to shareholders and recommending or rejecting the takeover offer. It should be noted that there can be strong financial incentives for the various stakeholders to accept the terms of the private equity offer.[30]

5.16 Mr David Jones, Chairman of the Australian Private Equity and Venture Capital Association (AVCAL), was asked whether there was anything to stop a large flow of funds from the United States taking over blue chip Australian companies. He replied:

> …I am really not concerned about that…No-one can just come in and say, 'I will buy your business.' The directors on behalf of the shareholders and then ultimately the shareholders need to form a view about value. We have almost seen here a bit of a reaction where people are going, 'Well, if these private equity guys think this thing's valuable maybe it is.' And you get a rerating and a reassessment.[31]

5.17 Mr Jones also noted that of the 80 companies taken off the Australian Stock Exchange in 2006, only two were privatised through private equity. He added that in terms of fears of a flood of private equity funds into Australia, 'there is just nothing to show'.[32] Further, he noted that Myer, currently owned by a private equity consortium, is opening new stores, attracting capital, lowering costs and increasing profits.[33]

---

28 Mr Nigel Morris, Director, Takeovers Panel, *Proof Committee Hansard*, p. 28.

29 Colin Galbraith, 'Changing control can cause conflicts', *Company Director*, April 2007, p. 31. See attachment to AICD submission, *Submission 2*.

30 These include the promise of higher executive remuneration and 'break fees' which are paid to the private equity consortium in the event that the bid is rejected.

31 Mr David Jones, Chairman, Australian Private Equity and Venture Capital Association, *Proof Committee Hansard*, 25 July 2007, p. 74.

32 Mr David Jones, Chairman, Australian Private Equity and Venture Capital Association, *Proof Committee Hansard*, 25 July 2007, p. 74.

33 Mr David Jones, Chairman, Australian Private Equity and Venture Capital Association, *Proof Committee Hansard*, 25 July 2007, p. 76.

Concerns about the existing regulatory framework

5.18 The committee received comment that current reporting arrangements relating to non-listed companies operating in Australia should be strengthened. The National Institute of Accountants (NIA) identified its main concern with private equity as:

> …the lower degree of transparency in terms of public accountability that may result when an economically significant entity shifts from a status of being either proprietary public company into another corporate structure such as a trust. [34]

5.19 The NIA explained that the current system of reporting requirements is based on who owns the company, rather than the substance of the entity's activities. As a result, a private equity structure is a means by which entities can avoid public reporting obligations. Mr Tom Ravlic, a Policy Adviser with the NIA, told the committee that the accounting profession had argued 'for many years' that reporting requirements should be standardised based on the nature of the company's activity rather than its ownership structure.[35] He contended that it is in the public interest to ensure that all 'economically significant' industries—such as utilities and major transport entities—be required to report publicly. This would give the public confidence and trust in all these industries, irrespective of their ownership.

5.20 In its submission, the NIA recommended that the parliament determine what types of entities should be regarded as economically significant. It should then establish a mechanism for these companies to prepare and lodge publicly available financial statements. The NIA suggested that this could be done through an amendment to the *Corporations Act 2001* providing Treasury with the authority to identify economically significant industries. Alternatively, industry-based legislation could be amended to ensure that all industry players comply with disclosure requirements 'irrespective of ownership structure'.[36]

5.21 Another precautionary approach to national interest concerns was suggested by Associate Professor Frank Zumbo from the School of Business Law and Taxation at the University of New South Wales. He put two proposals to the committee to safeguard the national interest in cases where a private equity entity is seeking a leveraged buyout in a sensitive industry. The first was that consideration be given to either restricting the involvement of private equity firms in sensitive industries on a case by case basis, or by placing restrictions on the level of debt that these firms can accrue in a strategic Australian company. The second proposal was to require private

---

34 National Institute of Accountants, *Submission 4*, p. 1.

35 Mr Tom Ravlic, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants, *Proof Committee Hansard*, 26 July 2007, p. 73.

36 National Institute of Accountants, *Submission 4*, p. 2. See also Mr Tom Ravlic, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants, *Proof Committee Hansard*, 26 July 2007, p. 79.

equity entities to lodge a security bond to cover any costs or losses arising from the disruption of essential services.[37]

The difficulty defining industries of economic significance

5.22 The committee highlights the difficulty in establishing a basis for what constitutes an industry of economic significance. Mr Ravlic himself conceded that outside of utilities, defining an industry of 'economic significance' is a 'woolly area'. When asked to give an example of a sector or industry that is not of economic significance, he replied:

> We would regard any entity which falls under the 'small proprietary company' test in the Corporations Act as not being economically significant. We will fall back to the Corporations Act definition of 'small proprietary company,' because it is extremely difficult once you move out of the area of utilities to begin to pick off entities that are not economically significant.[38]

5.23 He explained that the size of the entity should be a consideration in whether it is economically significant because reporting requirements for small companies may become burdensome. It was not clear whether a small company that is a utility would be subject to the NIA's proposals for stricter financial reporting.

The health and aged care sector

5.24 The committee received comment that private equity activity in not-for-profit and community based organisations was counter to their service-based objectives. This view was put by two submitters—Ms Marie dela Rama from the UTS Centre for Corporate Governance and Dr J Michael Wynne.

5.25 Dr Wynne argued that national interest grounds should apply to protect the health care industries because of the adverse consequences from private equity involvement in the sector. Citing examples from the US, he claimed that the focus on financial outcomes rather than service delivery inherent in the private equity model was unsuited to the health sector, which relied on attention to proper process, probity and an understanding of the community they are providing for.[39] The committee is unconvinced, however, that private equity activity in Australia's health care sector has contributed in any substantive way to problems that have arisen in the provision of private health care services. The connection claimed by Dr Wynne is unclear. The case for greater regulation of private equity activity in the Australian health care sector on national interest grounds is thereby also unclear.

---

37 Associate Professor Frank Zumbo, School of Business Law and Taxation, University of New South Wales, *Submission 23*, p. 18.

38 Mr Tom Ravlic, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants, *Proof Committee Hansard*, 26 July 2007, p. 80.

39 Dr J Michael Wynne, *Submission 3*, pgs. 7 and 9.

5.26 Ms dela Rama's submission highlighted the growing role of private equity in the aged care sector in Australia. It noted that private equity entities have 'turfed out' traditional non-profit organisations as they compete for the same pool of government funds and subsidies. The traditional organisations are now service providers rather than the owners and operators, and their benevolent role has been reduced. Ms dela Rama explained in her submission that the aged care sector is now:

> …an unbalanced, unequal playing field where the short-term investment horizon of private equity investment has placed these players at an unfair advantage against traditional non-for-profit participants. It is a matter of grave concern that a substantial part of the aged care sector is now in the hands of fund managers with little hands-on experience of the aged care sector.

She also expressed concern that government policies do not distinguish between private equity investors and not-for-profit participants in terms of their means or their motives.[40]

5.27 By way of remedy, Ms dela Rama proposed that short-term private equity investors should lengthen the term of their investments, and that government aged care subsidies provided to private equity owned facilities should be reassessed. She concluded that 'the presence of private equity in the sector ought to attract continuous and close vigilance'.[41] These arguments were put to the NIA. Mr Ravlic agreed with the need for stricter reporting in the sector, albeit for different reasons:

> I think we would support the idea that governance in that area [the health sector] would need to be scrutinised or at least monitored a bit more going forward because of the fact that a lot more people are getting older and a greater number of people in the Australian community will be using the services of these entities.[42]

5.28 On the question of differentiating public funding for profit and non-for-profit investors, the NIA simply stated that 'it would be a policy decision for the government'.[43]

Benefits to the Australian economy

5.29 The committee received a submission and took evidence from AVCAL on the benefits and impacts of private equity on the Australian economy. Unsurprisingly, AVCAL identified several benefits from private equity for the wider local economy. Among these are increases in employment, the funds management industry,

---

40 Ms Marie dela Rama, UTS Centre for Corporate Governance, *Submission 5*, pp. 1–2.

41 Ms Marie dela Rama, UTS Centre for Corporate Governance, *Submission 5*, p. 13.

42 Mr Tom Ravlic, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants, *Proof Committee Hansard*, 26 July 2007, p. 83.

43 Mr Tom Ravlic, Policy Adviser, Technical Activities and Professional Development, National Institute of Accountants, *Proof Committee Hansard*, 26 July 2007, p. 84.

productivity and innovation, superannuation savings and business revenue and exports. The following section looks at aspects of the impact of private equity activity on employment levels and the superannuation industry.

Employment effects

5.30 The impact of private equity activity on employment levels is contested. AVCAL's submission cited a 2007 international study by A. T. Kearney which concluded that on average, private-equity financed firms generate employment at a much faster pace than comparable, traditionally financed firms. It found that the average annual employment growth of private equity backed firms was higher in the European Union, the United Kingdom, the United States and Germany. AVCAL also cited a 2006 Australian study by Pricewaterhouse Coopers which concluded that 76 per cent of private-equity backed companies are expecting to hire additional workers in 2007.[44]

5.31 The committee heard anecdotal evidence that the net employment impact of private equity on the company itself is also positive. Mr Brian Hodges, Managing Director of foundry and heavy engineering group Bradken, told the committee:

> …in the years up to and including 2001 where there were roughly 1,450 employees, we retrenched 1,000 people. That was the phase of getting good, where we shut down a number of plants. We had no capital to spend, but we became more efficient through work practices and a lot of change.
>
> Nobody ever made a big company without increasing employment, I think. You can make a better company by having some initial reduction in staff, which we did. We lost 1,000 staff out of 1,400 so that was quite a lot. From that 2002 year on, we have increased staff levels. Today we are just tipping 3,000 staff. We have not had any further reductions in staff.[45]

5.32 Not all the evidence on the employment impact of private equity is positive. In its submission to the committee, the Australian Manufacturing Workers' Union (AMWU) expressed concern that:

> …the very high rates of return required to finance private equity debt driven buyouts can threaten target companies' long-term interests and provision of decent employment conditions and security for employees.[46]

However, the submission did not provide an example of private equity activity affecting AMWU members. Instead, its criticism relied on the UK experience of job cuts and worker protests.[47]

44 This study was commissioned by AVCAL.

45 Mr Brian Hodges, Managing Director, Bradken, *Proof Committee Hansard*, 26 July 2007, p. 33.

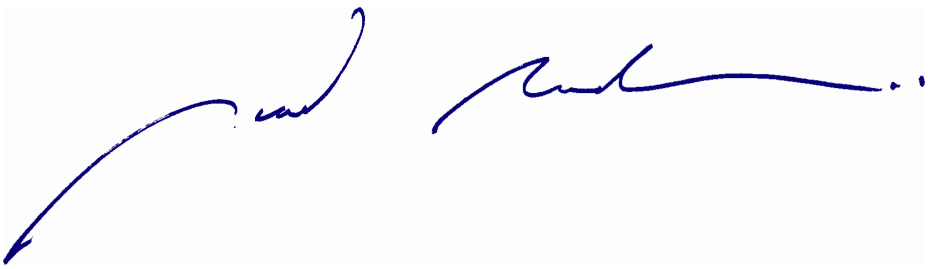
46 Australian Manufacturing Workers' Union, *Submission 16*, p. 3.

47 Australian Manufacturing Workers' Union, *Submission 16*, p. 8.

Conclusion

5.33 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. It recognises and endorses the ongoing watching brief maintained on this issue by the Treasury, the RBA, the ACCC, ASIC and the FIRB. The requirements of Chapter 6 of the Corporations Act, the conflict of interest rules, sector-specific legislation and the FIRB guidelines offer appropriate and adequate protection for Australian companies and the Australian public. The activities of both private and listed Australian companies will continue to be reported under the Corporations Act and through the international accounting standards set by the Australian Accounting Standards Board. Private equity consortiums will themselves be guided in their decision-making by prospects for economic success and growth.

5.34 The committee believes it is important to continue to attract foreign investment into Australia and does not accept the narrowly held view that some sectors of the national economy should be protected from private equity activity. The committee views private equity as an opportunity to reinvigorate underperforming public companies, which will subsequently benefit Australian consumers, shareholders and workers. It does not see the market imperative that drives foreign investors to buy out Australian companies as being inconsistent with the national interest and notes the protections already afforded under foreign investment policy and the *Foreign Acquisitions and Takeovers Act 1975*.



Senator the Hon. Michael Ronaldson
Chair

Private Equity – Labor Supplementary Report

Private equity has been an aspect of international and domestic markets for many years. Labor recognises the importance of private equity's role in the market and particularly the provision of venture capital to support emerging business opportunities. However, of some concern is the sector of the private equity market which makes highly leveraged acquisitions. Evidence to the Committee disclosed examples of gearing levels up to 200 per cent higher than the average company. The portion of the private equity market which related to leverage buyouts increased in 2006 compared to venture capital investment, although leveraged buyouts still only made up about 1 per cent of the Australian equity market.

Labor also notes that recent developments in global capital markets as a consequence of exposure to the non-conforming mortgage sector in the United States has resulted in a re-pricing of risk. Some market commentators have noted that this re-pricing of risk is likely to result in a downtrend in highly leveraged private equity buyout activity.

Although evidence to the committee indicates that investors in the private equity market, including leveraged buy outs, are largely sophisticated investors such as institutional investors, it is still essential that they are full informed of the risks involved in their investment.

There should also be clear guidelines to manage private equity proposals to deal with any conflict of interests issues. Labor welcomes the Takeovers Panel Guidance note 19: Insider Participation in Control Transactions provides a guide to setting up protocols to reduce the conflicts of interests for management involved in any takeover and seeks to address some issues relating to the protection of investors.

Labor agrees with the conclusion of the main committee's view that no further regulation is required for private equity activity at this time. In addition, Labor supports the main committee endorsement of an ongoing watching brief on this issue by the Treasury, the RBA, the ACCC, ASIC and the FIRB. The position that private equity holds in the market as well as any effects on the market should continue to be monitored and reviewed.

Labor members consider that monitoring by the relevant regulatory bodies should take into account:

- any increase of private equity leverage buyout activity in the Australian market as there was in 2006;
- the work of the Australian Taxation Office in terms of taxation implications and compliance as part of its large business program and compliance plan for 2007-08;
- any impact on revenue;

- any concentration of private equity leverage buyout activity in particular sectors and its effects, for example in the health and aged care sector; and
- any impact on employment as a result of private equity activity.

Senator Ursula Stephens
Deputy Chair

Senator Annette Hurley

Senator Ruth Webber

Senator Penny Wong
Participating Member

SENATOR BARNABY JOYCE'S ADDITIONAL COMMENTS TO THE STANDING COMMITTEE ON ECONOMICS: PRIVATE EQUITY INQUIRY

By reason of conclusion 5.33 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 have to submit these additional comments on these premises;

- Private equity involvement in key sectors on the economy in a highly leveraged state means that there is unreasonable stress placed on these sectors and the effect of failure on 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 generally.
- The strategic and unfair advantage that private equity firms have over domestic investors in regard to the construction of a taxation regime where capital gains made by foreign private equity firms or investors are tax free has to be addressed as Australians 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 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, often having substantial market share within the economy, and in the process increasing gearing substantially and with 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.
- Because the premise of private equity is not unusual, its capital gain is higher than the price of debt. It is a plan that will work well no matter what gearing you have as long as your cost of capital increases, or the under pinner of your capacity to realise that capital gain is an active share market. A share market is inherently made weaker if the substantial players and key sectors are removed from it, or where there are interest rate rises, or a major correction in the market. A major correction in the market generally is indicated when the returns of the shares on the market do not match the returns on equity inside the company. This triggers the correction and the 'animal spirits' of day traders, chartist, margin calls, other derivative instruments and sub prime debt financing players accelerate the downward plunge of any market direction leaving investors and shareholders with substantial loses.
- 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 that some listed shares of major Australian companies have, in a very short period of time, exceeded the price of the private equity offer, yet the private equity offer continued to be endorsed by a board, and management whose members were to take an immense personal financial gain from the takeover, leave large unresolved questions marks in the share market's and public's mind. This does considerable harm to investor and shareholder confidence and, consequently, the financial involvement of director and management of target companies in a private equity bid should be prohibited outright in the best interests of those investors and 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 participate 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.
4. Private equity firms should be quarantined from the domestic housing market as this manipulation would be a distinct disadvantaged to the Australian homeowner as the market pressures placed by multibillion dollar buyers against mum and dad investors is intrinsically unfair.

Senator Barnaby Joyce
The Nationals
Senator for Queensland

FAMILY FIRST
Dissenting Report

Inquiry into Private Equity Investment and its Effects on Capital Markets and the Australian Economy

FAMILY FIRST has expressed concern about private equity buyouts and their implications for Australian families.

Private equity deals are often presented as smart business with no consequences for the broader Australian public. FAMILY FIRST disagrees. FAMILY FIRST is concerned that the general public can lose out from the shuffling of money, shares and ownership in private equity takeovers. The public can lose because these deals may mean a loss of tax revenue, a loss of competition in a market and in the most extreme circumstances the failure of a major company.

Last year FAMILY FIRST voted against amendment to tax laws that exempted foreign investors from paying capital gains tax that Australians still have to pay. The amendments are just an encouragement to foreign private equity firms as the new laws allow them to reduce their costs in a takeover.

FAMILY FIRST pointed out that the proposed private equity buyout of Qantas could have cost the Australian public hundreds of millions of dollars in lost tax revenue, placing greater burden on other taxpayers such as families.

Both the Treasury and the Reserve Bank of Australia said they had not made an estimate of the potential loss to tax revenue as a result of private equity takeovers.[1]

Law firm Speed and Stracey made a submission to the inquiry pointing out that the high level of debt in many private equity buyouts means there is a large potential loss to tax revenue:

> In 2005-06 the Australian company tax collected from the 5 selected companies [Coles Myer, Qantas, Tabcorp, Wesfarmers, Woolworths] was $1.2 billion. We estimated that if those companies were taken-over by foreign private equity funds no company tax would be payable - a reduction in company tax collected of $1.2 billion per annum. The greater the number of Australian companies taken-over, the greater the loss of tax. The loss of tax collected occurs because market equity is replaced by a mixture of highly leveraged foreign debt and equity. Interest on the debt is a tax deduction against the earnings of the companies taken-over.[2]

---

1 Committee Hansard, 25 July 2007, page 17 and 26 July 2007, page 9.

2 Submission 21, Speed and Stracey Lawyers.

Associate Professor Frank Zumbo from the University of New South Wales also pointed out that there were other risks from private equity takeovers. For example, a takeover or series of takeovers could lead to a substantial lessening of competition in a particular market:

> While the inadequacy of s 50 of the *Trade Practices Act* in preventing a process of anti-competitive creeping acquisitions in a market is not an issue confined to private equity investments, it would appear that some private equity firms are, over time, acquiring individual companies in the same market or related market with the goal of being the dominant or monopoly player in those markets.[3]

There is also the danger that a company may fail from a botched takeover attempt:

> It is this leveraged buyout of major Australian companies by private equity firms that is of potential concern. In particular, it is a proper understanding and management of the risks associated with leveraged buyouts of major companies that is critical to ensuring that the failure of such private equity investments do not have a disproportionately large negative impact on the economy. While it would be unfortunate for any small start company to fail, it may be much more problematic where a major established company fails as the impact may be magnified throughout the economy. Tens of thousands of customers, creditors and employees could be affected by such a failure … Given that the failure of major established companies can have a disproportionate large negative impact on the economy private equity investments associated with leveraged buyouts of such companies may require additional scrutiny and safeguards.[4]

FAMILY FIRST remains concerned about the highly geared nature of many private equity takeovers and is particularly concerned about the tax burden placed on Australian families as a result of foregone tax revenue. Further regulation should be considered in the interests of Australian families.

Senator Steve Fielding
FAMILY FIRST Leader
FAMILY FIRST Senator for Victoria

---

3 Submission 23, Professor Frank Zumbo, page 14.

4 Submission 23, Professor Frank Zumbo

APPENDIX 1

Submissions Received

Submission Number	Submitter
1	UniSuper
2	Australian Institute of Company Directors, National Office
3	Dr J Michael Wynne
4	The National Institute of Accountants (NIA)
5	UTS Centre for Corporate Governance
6	Corporate Tax Association
7	Allens Arthur Robinson
8	Takeovers Panel
9	Dr David Morrison
10	Law Council of Australia
11	Australian Bureau of Statistics (ABS)
12	New Zealand Private Equity & Venture Capital Association Inc (NZVCA)
13	Investment & Financial Services Association Ltd (IFSA)
14	Securities & Derivatives Industry Association (SDIA)
15	Maheswaran Sridaran
16	Australian Manufacturing Workers' Union (AMWU)
17	Australian Private Equity & Venture Capital Association Limited (AVCAL)
18	International Union of Food, Agriculture, Hotel, Restaurant, Catering, Tobacco and Allied Workers' Associations (IUF)
19	Australian Institute of Superannuation Trustees (AIST)
20	Australian Accounting Standards Board (AASB)
21	Speed and Stracey Lawyers
22	Ernst & Young
23	Associate Professor Frank Zumbo
24	Ms Wendy Erhart
25	Australian & International Pilots Association (AIPA)
26	Australian Chamber of Commerce and Industry (ACCI)
27	Industry Funds Management (IFM)
28	Dun and Bradstreet (Australia) Pty Ltd
29	Union Network International (UNI)
30	Dr S Robinson
31	National Institute of Accountants (NIA)
32	Confidential

Additional Information Received

- Web Reference and Links received via email from Dr Katherine Woodthorpe, Chief Executive Australian Private Equity and Venture Capital Association Ltd (AVCAL) on Monday, 30 July 2007
- Additional Information requested at Public Hearing received via email from Mr Frank Drenth, Executive Director, Corporate Tax Association on Monday, 30 July 2007 [email and attachment]
- Additional Information requested at Public Hearing received via email from Mr Frank Drenth, Executive Director, Corporate Tax Association on Tuesday, 31 July 2007
- Additional Information requested at Public Hearing received via email from Ms Fiona Reynolds, Chief Executive Officer, Australian Institute of Superannuation Trustees (AIST)

TABLED DOUMENTS

- Documents tabled on Wednesday, 25 July 2007 at Public Hearing in Sydney;
  - ASIC Opening Statement (Australian Securities & Investment Commission) from Mr Jeremy Cooper **[3 copies]**
  - IFSA Opening Statement (Investment & Financial Services Association Ltd)
  - Documents from Australian Institute of Company Directors (AICD)
  - Briefing by the Reserve Bank of Australia (RBA) from Mr Ric Battelino
  - Folder with Opening Comment and other material from AVCAL (Australian Private Equity & Venture Capital Association Ltd)
- Documents tabled on Thursday, 26 July 2007 at Public Hearing in Melbourne
  - National Accountant Journal from the National Institute of Accountants (NIA)
  - AVCAL Presentation from Mr Brian Hodges, Managing Director, Bradken Ltd **[2 copies]**
- Private Equity Arrangements document tabled at Public Hearing in Canberra on 9 August 2007 by Mr Michael D'Ascenzo, Commissioner of Taxation, ATO

APPENDIX 2

Public Hearing and Witnesses

WEDNESDAY, 25 JULY 2007 – SYDNEY

BATTELLINO, Mr Ric, Deputy Governor
Reserve Bank of Australia

BROADBENT, Mr John Stanley, Head, Domestic Markets
Reserve Bank of Australia

CODINA, Mr Martin, Senior Policy Manager
Investment and Financial Services Association

COOPER, Mr Jeremy Ross, Deputy Chairman
Australian Securities and Investments Commission

EVANS, Mr Ralph, Chief Executive Officer
Australian Institute of Company Directors

JONES, Mr David Fletcher, Chairman
Australian Private Equity and Venture Capital Association Ltd

KARP, Mr Tom, Executive General Manager, Supervisory Support Division
Australian Prudential Regulation Authority

O'SHAUGHNESSY, Mr John, Deputy Chief Executive Officer
Investment and Financial Services Association

RODGERS, Mr Malcolm, Executive Director, Regulation
Australian Securities and Investments Commission

UPTON, Ms Gabrielle, Legal Counsel
Australian Institute of Company Directors

WOODTHORPE, Dr Katherine Lesley, Chief Executive
Australian Private Equity and Venture Capital Association Ltd

THURSDAY, 26 JULY 2007 – MELBOURNE

AGLAND, Mr Reece, Technical Counsel
National Institute of Accountants

BROWN, Mr Colin Leslie, Manager, Costing and Quantitative Analysis Unit, Tax Analysis Division
Department of the Treasury

COMLEY, Mr Blair Robert, General Manager, Business Tax Division
Department of the Treasury

DRENTH, Mr Frank, Executive Director
Corporate Tax Association of Australia Inc.

GABRIEL, Mr Gary, Head of Private Markets
UniSuper Ltd

HODGES, Mr Brian William, Managing Director
Bradken

LOVE, Mr David, Manager, Prudential Policy, Banking
Department of the Treasury

MORRIS, Mr Nigel, Director
Takeovers Panel

NOLAN, Mr Greg, Director
Australian Institute of Superannuation Trustees

PORTER, Mr John, Chief Executive Officer and Managing Director
Austar

RAVLIC, Mr Tom, Policy Adviser, Technical Activities and Professional Development
National Institute of Accountants

REYNOLDS, Ms Fiona P, Chief Executive Officer
Australian Institute of Superannuation Trustees

ST JOHN, Mr David Campbell, Chief Investment Officer
UniSuper Ltd

THURSDAY, 9 AUGUST 2007 – CANBERRA

D'ASCENZO, Mr Michael, Commissioner of Taxation
Australian Taxation Office

FARRELL, Ms Jan, Deputy Commissioner
Australian Taxation Office

REED, Mr Andrew, Assistant Commissioner
Australian Taxation Office