Australian Private Equity &
Venture Capital Association Limited

29 March 2016

Senator the Hon. Chris Ketter
Chair, Senate Economics References Committee
Senator for Queensland
PO Box 6100
The Senate, Parliament House
CANBERRA ACT 2600

SUBMISSION IN RESPONSE TO SENATE ECONOMICS REFERENCES COMMITTEE INQUIRY INTO THE CAUSES AND CONSEQUENCES OF THE COLLAPSE OF LISTED RETAILERS IN AUSTRALIA

Dear Senator Ketter,

The Australian Private Equity and Venture Capital Association Limited (AVCAL) is very pleased to be able to put forward this submission to the Senate Economics References Committee *'Inquiry into the causes and consequences of the collapse of listed retailers in Australia'*.

As you know, AVCAL is the national industry body for private equity and venture capital firms in Australia, who together manage a combined A$28 billion in capital for investors such as superannuation and pension funds, sovereign wealth funds, insurance companies, and university endowments.

The private equity industry in Australia has a long and successful track record of investing billions of dollars into small and large retail and consumer products businesses. Many of those businesses have gone on to become some of the nation's most recognised household brand names, with market-leading positions. Any suggestion, therefore, that private equity has impeded the growth of businesses in the retail sector, or is in any way responsible for systemic failures of retail businesses, is completely unsupported by the facts set out in this submission.

The terms of reference for the Committee's inquiry provides us with an important opportunity to share information and case studies about the way in which private equity firms add value to businesses within the retail sector, and how our industry contributes to significant economic activity and employment across a wide range of market sectors.

We would be very happy to provide the Committee with any additional information to assist in its inquiry over coming weeks, and to participate in any public hearings convened as part of the process.

If you would like to speak about any matter relevant to this inquiry, please contact me directly.

Yours sincerely

Yasser El-Ansary
Chief Executive

Level 10, Kyle House, 27-31 Macquarie Place, Sydney NSW 2000, Australia • T +61 2 8243 7000 • ABN 84 056 885 708 • avcal.com.au

Australian Private Equity &
Venture Capital Association Limited

The Retail Industry and Private Equity

Submission to the Senate Economics References Committee

March 2016

ABOUT AVCAL

The Australian Private Equity and Venture Capital Association Limited (AVCAL) is a national association which represents the private equity and venture capital industries. AVCAL's members comprise most of the active private equity and venture capital firms in Australia. These firms provide capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies.

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EXECUTIVE SUMMARY

Australian retail and consumer products sector

Australia's retail sector is an important part of our economy. A well-functioning and sustainable retail sector is an essential ingredient in harnessing our ability to drive economic and jobs growth into the future. This inquiry should examine the best ways of ensuring that our nation's retail sector continues to grow and improve its competitive position within the global marketplace.

The Committee is seeking to identify the causes and consequences of the collapse of listed retailers in Australia, and as part of that, look at the role of private equity firms within the market.

In this submission, we have set out a comprehensive base of information to support the significant and important role that private equity plays in our economy. Over the last decade, our industry has contributed billions of dollars of capital investment into thousands of Australian businesses.

In the retail sector specifically, private equity has invested more than $5 billion in 128 businesses. The track record of successfully investing capital into retail businesses has helped to create some of the market's best known household brand names, who are now industry leaders in a number of key segments within retail. In this submission we have included some of the case studies of private equity backed businesses such as JB Hi-Fi, Aēsop and Kathmandu, to illustrate the breadth and depth of private equity's investments across the retail and consumer products sector.

Independent data compiled by ASIC confirms that the survivability rates for businesses in the retail sector is lower (57%), on average, than the equivalent metrics for non-retail sector businesses (62%[1]).

There is no question, therefore, that retail is a tough sector to compete in. Most segments within the retail sector must constantly manage a number of significant and challenging issues, ranging from the impact of digitization of consumer purchasing preferences, through to marketing and brand positioning, as well as management of leasing commitments and supply chain and inventory decisions.

AVCAL's analysis of the rate of failure of retail businesses supported by private equity investment is considerably lower than the industry average for retail. That data tells us private equity backed businesses operating in this sector have a much better chance of survival than others, which is entirely consistent with the greater focus on strategy and cashflow that comes with private equity investment.

The collapse of any business is always deeply saddening for all of those closely involved; shareholders, management, employees, suppliers and customers. While it is simply not possible – in any open market economy – to completely eliminate business risks and therefore avoid the possibility of business failures altogether, it is entirely appropriate to seek to identify the reasons underlying the collapse of any business. The lessons that can be learned from such analysis can be helpful to all entrepreneurs and businesses. Also, over time, an understanding of the key issues involved helps to determine whether there is any systemic pattern to business failures that should give rise to a policy or regulatory response from government.

Private equity industry in Australia

Beyond the retail sector, the private equity industry in Australia is an important and significant part of our broader economy.

We are exceptionally proud of the contribution that our industry makes towards investing capital into high growth potential Australian businesses, which has been comprehensively documented and analysed

[1] ABS, *Counts of Australian Businesses*, Cat. no. 8165.0

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through a variety of different channels over many years. One of the more recent economic studies into the contribution of private equity to the Australian economy was completed by Deloitte Access Economics. That analysis concluded that our industry contributes more than four percent per annum to the nation's economic output, and is responsible for supporting more than half a million jobs.

Private equity in Australia has more than $28 billion in capital under management for a wide array of investors such as superannuation and public pension funds, sovereign wealth funds, endowments and high net wealth families. That capital is allocated across more than 600 Australian businesses operating in almost every industry sector of our economy.

There is also considerable independently prepared data to support the important financial contribution that our industry makes to building the retirement savings of all Australians through the realisation of higher investment returns which flow back to large institutional investors such as domestic superannuation funds. As an indication, the private equity asset class delivers a five year cumulative net return of more than 13% per annum to investors such as large industry superannuation funds, which far exceeds the returns generated from listed equities.

In 2007, the Senate Standing Committee on Economics examined the structure and role of the private equity industry in Australia, to determine whether the activity of investing capital – mostly sourced from domestic superannuation and offshore public pension funds – represents a risk to the economy. The Standing Committee concluded that our industry:

- Is appropriately regulated by the machinery of existing corporations and taxation laws, foreign investment policy, competition and consumer laws, as well as international accounting standards.
- Makes a significant and important contribution towards reinvigorating underperforming businesses, which is to the ultimate benefit of all Australian consumers and the economy.
- Plays an important role in attracting investment capital from offshore institutions, to support the continued growth and expansion of the domestic economy.

In our view, the conclusions reached by the Standing Committee in 2007 continue to be relevant in the context of the contemporary Australian marketplace within which private equity operates.

Indeed, the overarching policy and regulatory landscape relevant to the private equity industry has continued to improve since the time of the Standing Committee's work in 2007. There is now – even more so than was the case back at that point in time – much deeper day-to-day engagement between our industry and key regulatory bodies such as ASIC, ATO and APRA. Our industry, and individual industry participants, proactively engage with these bodies on all issues relevant to specific market transactions as they arise.

Additionally, through AVCAL's work on behalf of the industry, we make an important contribution to broader policy and regulatory reforms in a variety of areas relevant to improving the Australian economy's competitiveness, tax system, corporations law, and innovation, science and industry policy agenda. In 2015, AVCAL made more than 30 policy submissions as part of various government consultation processes, which includes a significant contribution to the development of the *National Innovation and Science Agenda* announced by the government in December 2015.

And while private equity has made a significant and positive contribution to the Australian economy over more than two decades, there is a tremendous opportunity for us to do more.

AVCAL estimates that there are more than 30,000 Australian businesses who are in need of investment capital to help them grow and expand the competitive market position of their business, manage succession planning challenges, and employ more people. Private equity will be an important part of the solution to meeting that demand.

Key outcomes from the 2007 Senate Inquiry into Private Equity in Australia

- In 2007 the Senate Standing Committee on Economics conducted an inquiry into PE investment in Australia.
- The Terms of Reference, while seeking to understand the implications of PE investment on capital markets and the Australian economy, recognised that PE often includes investment by funds holding the superannuation savings or investment monies of millions of Australians.
- The Inquiry received 31 submissions and witnesses at the public hearings included senior representatives from the Treasury, RBA, ASIC, APRA, Takeovers Panel, ATO, AICD, IFSA, AIST and Unisuper. Excerpts are provided below.

"Private equity plays an important role in improving the efficiency of companies and the capital market. There is no evidence that private equity is having adverse effects at the moment or is likely to do so in the foreseeable future. Increased regulation of private equity could affect all privately held companies, which would be a severe overreaction. If anything, the growth in private equity is usefully highlighting the adverse effects of excessive regulation of public companies. Instead, governments around Australia would be better advised to examine the current level of regulation of public companies and limit this regulation to ensure that private equity is not being driven by excessive regulation other forms of investment." ***(Australian Chamber of Commerce and Industry submission)***

"Superannuation funds are long-term investors, looking to maximum returns for their members. Private Equity is an appropriate vehicle to meet the objectives of long-term investors…Private Equity is part of the investment landscape, and is needed as more money flows into the system…AIST further believes that the proof of the success of the role that Private Equity plays in this overall asset allocation, is in the returns provided to members." **(Australian Institute of Superannuation Trustees submission)**

"IFSA is supportive of private equity investment and believes that like any other form of investment, it presents its own unique risks and opportunities which investors need to appreciate before investing. IFSA also believes that the current regulatory arrangements imposed by the Corporations Act 2001 are adequate to appropriately regulate private equity investment activity." ***(IFSA submission)***

"In summary, the Committees consider that Private Equity investments do not require any special treatment under Australia's income tax laws or under Australia's financial market regulation." **(Law Council of Australia submission)**

"Based on our experience, we have not identified any regulatory changes that need to be made in the private equity asset class… Our private equity managers are intimately involved with the investee companies within which they invest. We are able to get any information that we require from our private equity managers about their own operations and about the companies in which they invest." ***Unisuper, from the Hansard, Thursday 26 Jul 2007***

"There has been evidence put to us by almost everyone from the financial council … that there is probably a greater level of financial reporting to owners with companies under private equity management than there is to shareholders under listed companies because of that very close relationship between the owners and the managers." **Chair of the Senate Committee, from the Hansard, Thursday 26 Jul 2007**

Key outcomes from the 2007 Senate Inquiry into Private Equity in Australia

"…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. Mr Battellino [RBA] 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. The same observation was made by Mr Cooper [ASIC] who described the disclosure obligations of the Corporations Act as 'quite comprehensive'." **(Section 5.9 of the final report)**

"Mr Morris [Takeovers Panel] 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'." **(Section 5.13 of the final report)**

"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." **(Sections 4.41-4.44 of the final report)**

"Both regulators also expressed confidence that the current regulatory framework for private equity activity was adequate to safeguard institutional investors. Mr Cooper [ASIC] 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'. He added that private equity is already 'quite comprehensively regulated' with disclosure obligations for private companies not listed on the ASX. Further, he argued that the current size and nature of private equity activity in Australia does not warrant further powers of new regulation. 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." **(Section 5.5 of the final report)**

"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.

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." **(Sections 5.33-5.34 of the final report)**

Submission to the Senate Economics References Committee

1. THE AUSTRALIAN RETAIL SECTOR AND PRIVATE EQUITY

Private equity (PE) firms have been successfully investing into the retail sector in Australia for many years. This section of the submission sets out an overview of how PE firms go about adding value to the businesses that they invest into, as well as referencing important data about the structure of the retail sector in Australia.

Also included is an outline of the key issues which typically affect the financial success and longevity of businesses operating in the retail sector, along with evidence supporting the significant and positive contribution that PE firms have made to a large number of retail and consumer-related businesses across the economy. One of the little known facts about our industry is that some of Australia's most successful retail businesses have been backed by more than $5 billion in PE investment over the past decade.

1.1. The Australian retail sector

The Australian retail sector generates an estimated $293 billion in annual turnover, and employs over 1.2 million people across the nation. It is generally accepted that the health and performance of the sector is seen as a barometer for the overall wellbeing and confidence of the entire economy.

The number of retail businesses operating in Australia was estimated at over 132,000 as of 30 June 2015. Over the preceding four years (from June 2011 to June 2015), the number of businesses involved in retail trade fell by 8%.

Data confirms that survivability rates for retail businesses are lower compared to business survivability across other industries. For example, only 57% of retail businesses trading in Australia in June 2011 were still trading in June 2015, whilst the comparative figure across all industries was 62%.[2] These figures confirm the anecdotal experience; operating and maintaining a successful and sustainable business in the retail sector in Australia can be significantly more difficult compared to other industry sectors.

1.2. PE investment in retail and consumer products sector

The table identifies that PE has invested more than $5 billion in 128 businesses operating in the retail and consumer products sector of the economy over the past decade.

Key facts	
Retail and consumer-related companies backed by PE in Australia	128
PE investment in retail and consumer-related companies, FY2006-2015 (A$)	$5.8b
No. of PE investments in retail and consumer-related companies, FY2006-2015	172

Source: AVCAL

[2] ABS, *Counts of Australian Businesses*, Cat. no. 8165.0

Contrary to the perception of some commentators, PE has delivered a consistently strong value proposition to all of the businesses they have invested in over that time.

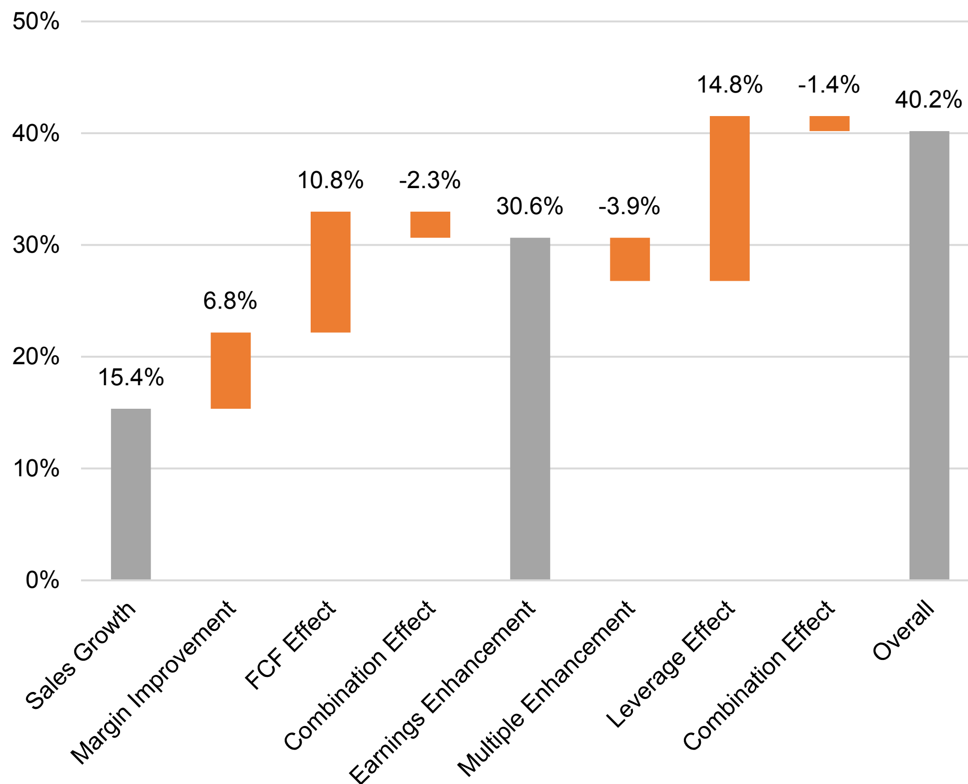
The approach adopted by PE firms to adding value to the businesses that they invest into – whether in the retail sector or in other industries – is typically centred on defining and developing strategic business growth plans, and putting in place operational improvements that generate productivity gains.

One assertion often levelled at our industry is that PE firms are focussed only on the use of debt and leverage to generate value; that view is fundamentally wrong and unsupported by the facts.

A study of mid-market buyout deals by PE firms from 1990 to 2011 found that, on average, about two thirds of the total return on those deals was attributable to strategic and operational initiatives increasing the investee companies' earnings, rather than multiple expansion or leverage (see Figure 1 below).

While that analysis was based on investments across the European marketplace, the results would be directly comparable to an equivalent analysis of Australian PE investments. The size of the domestic market in Australia, coupled with the analogous economic and regulatory environments within both jurisdictions supports this view.

Figure 1: Returns analysis by value creation drivers, European mid-market buyout deals



Source: Center for Entrepreneurial and Financial Studies

Note: Based on 332 European fully exited mid-market buyout deals undertaken by 15 different firms over the period 1990 to 2011. Average (median) deals size of €125 million (€68 million). *FCF Effect* refers to value drivers not attributable to *Sales Growth* or *Margin Improvement*, and may include efficiency gains from working capital management, earnings volatility and pay-out policy; *Combination Effect* refers to a difference buffer not captured in any of the other effect measures.

The ability to identify and then deliver on strategic and operational improvements relies on the deep industry and functional expertise of the PE firms which invest into businesses. All of this work is done

alongside the management teams of each business, which is why it is often said that PE firms are 'in the trenches' with the management teams of the portfolio businesses that they back.

Set out below is an outline of six key features of the approach that PE firms will commonly adopt with all portfolio businesses into which they invest equity capital:

- **Adopt a constant focus on value creation**, which means investing in core operations and leveraging competitive advantages in the marketplace. Achieving outcomes in this context will often necessitate the elimination of low-value discretionary activities.

- **Become familiar with the businesses' cashflow movements and manage it closely**, which in almost all cases centres around managing demands on working capital through receivables and payables as well as inventory and stock levels, improving supply chain processes such as procurement, and negotiating appropriate commercial terms for major financial commitments such as project investments. Effectively managing and monitoring cashflow is an important ingredient in improving capital efficiency for businesses.

- **Put a price on staff time**, which allows management to be clear on how discussions and ideas can be efficiently taken from concept to action. Management teams are empowered to devote the majority of their focus towards the development, implementation and monitoring of business plans, without the distraction of other external stakeholders commanding their time.

- **Invest in core value-enhancing activities for long-term sustainable growth**, which is fundamentally about ensuring that the businesses strike an appropriate balance between improving short and medium-term performance, in parallel with investing in core value-enhancing strategies that will underpin an ongoing improvement in business capability over a sustained period of time. This approach supports the ongoing growth and expansion of the business beyond the period during which the PE firm is invested.

- **Assemble the right team for the job**, which is a critically important part of having strong and effective leadership in place to drive the success of the business. In some cases, the decision by PE firms to invest into a particular business will be made – at least in part – on the strengths and capabilities of the existing management team. In other cases, it will be necessary to appoint new management teams to the business, who can bring the required skills and experience to add significant value and allow for unrealised potential to be achieved.

- **Align the interests of senior management with shareholders**, which ensures that the CEO, and the broader management team, are deeply invested in the performance of their business. It is common that the structure of remuneration packages for senior management personnel within businesses backed by PE firms often involves a modest base salary, with a significant portion of the overall package being 'at-risk' through variable performance payments. Equity-based rewards are also used as an incentive mechanism to align the interests of management with the achievement of returns for the institutional investors into PE funds. Where business objectives are not achieved, incentive payments and equity rewards are foregone.

Here in Australia, PE firms have invested over $5 billion in more than 100 retail and consumer-related companies over the last ten years, from small one-store businesses to large multinationals and department stores featuring internationally recognised brand names.

1.3. Retail restructures and insolvencies

As set out above, the challenges of operating and maintaining a sustainable retail business in Australia are well recognised, and supported by a number of relevant data points.

Data compiled by ASIC recorded a total of 739 insolvencies for Australian retail businesses over the FY2015 period, based on initial external administrators' reports.[3]

Importantly, based on available information and our analysis of the insolvencies during the course of FY2015, none of the 739 retail businesses were PE-backed investments.

Notwithstanding that, the common causes for failure identified through the ASIC figures were:

- inadequate cashflow and mounting trading losses
- poor strategic management of the business and financial controls, and
- poor economic conditions.

Not all retail businesses that face financial stress fall into insolvency. In recent years there have been many successful retail sector turnarounds, or controlled down-sizings which, in turn, preserve value and employment.

Based on the experience of PE firms, as well as independent retail restructuring experts, some of the key steps which typically need to be addressed as part of a successful turnaround process are described below.

Customer and brand first – If the business in distress is to be sold to another party (and not wound down), then existing customers are critically important. Maintaining brand presence and equity through loyalty clubs, gift cards, social media and other avenues remain critical to the success of the turnaround.

Landlords are major financial stakeholders – In Australia, landlords are major financial stakeholders in any restructure, and as such they need to be engaged as early as possible to explain to them the plan to first restructure the business, and then grow it. Without a growth plan, it would be difficult for the restructure plan to be supported by landlords, which in turn, will make the turnaround strategy less likely to succeed.

Selling the growth plan to front-line employees – The growth plan is not just critical for the landlords but for all other stakeholders, especially employees. Store employees are the 'front line' conduit between the business and its customers, and they impact the brand every day. Morale and belief in the future can have a major positive impact on business survivability. Conversely, a drop in morale and a lack of belief can have the opposite impact.

A 'battle-hardened' board – Incumbent and large boards are often not used to taking the risks or decisive actions that are required during a restructure. In many cases, insolvency practitioners are typically not in the best position to advise boards on how to avoid insolvency, which is why it is critically important that the right turnaround experts are engaged in the process and work closely with the board.

Cash and working capital – Cashflow, and the ability to generate more of it, can be crucial in providing the time needed for a turnaround plan to be put in place. Where possible, cash-saving initiatives should not have a deleterious effect on the businesses' customer experience.

Resourcing the restructure and growth plans – Without the right team in place, the restructure will be less likely to succeed, or take a lot longer (and therefore be more expensive) than planned. Installing a new management team to implement and operationalise the restructure and growth plans may be

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[3] ASIC, *Australian insolvency statistics – Series 3: External administrators' reports*, released October 2015

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necessary in some cases, depending on the skills, expertise and experience of the incumbent management team.

1.4. PE-backed retail businesses

PE firms have invested in many prominent retail and consumer-related businesses. Presented on the next few pages are case studies of these companies, providing some general background on each business and how PE has helped those businesses to grow and expand over time.

Appendix 1 features other examples of PE-backed businesses, both from within the retail sector as well as other industries.

Aesop

Aēsop®

Aesop is a manufacturer and retailer of high-quality cosmetics and skin-care products. It was established in 1987, is headquartered in Melbourne, and operates dozens of stores throughout Australia, the US, Europe and Asia. Harbert Management Corporation Australia invested in the business in 2009, acquiring a 40% minority stake.

The company used that capital and the expertise and networks available through Harbert to boost its nascent international operation and improve the overall performance of the company. Harbert's stake in Aesop was eventually acquired by Natura Cosmetics three years after the initial investment.

"As the CEO of a private business you can be very isolated – there are only so many things you can talk to direct reports about. The private equity team provided me with a great sounding board for ideas and problems."

Michael O'Keefe
CEO, Aesop

"As an investor Harbert took the time and effort to listen and consider as the Aesop working culture was introduced. As a result what had steered our brands success was never comprised and the resulting expansion then occurred."

Suzanne Santos
Country Manager Australia/NZ, Aesop

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JB Hi-Fi

JB Hi-Fi is Australia's largest home entertainment retailer of electronics, audio/music, DVD and video games. The business started with a single store in Victoria, and has expanded to nearly 200 stores located across Australia and New Zealand.

The company was purchased by senior management and PE investors in 2000. The PE firm that invested in the company, Macquarie Direct Investment, put a plan in place to expand the business nationally, and the company was eventually floated on the ASX in 2003. As a listed company, its market capitalisation is more than $2 billion and it employs over 7,000 people.

> *"I was able, as CEO, many times to bounce off what we were thinking of doing with [the PE representative on the board], knowing that we would get great input to the strategies."*
>
> Richard Uechtritz
> Former CEO, JB Hi-Fi

Kathmandu

The adventure clothing and equipment company Kathmandu was founded in 1973 by medical student and mountaineer Jan Cameron. From humble beginnings of sewing together her first sleeping bags in the back room of her Melbourne student flat, Jan successfully grew the business, with overseas expansion beginning in the early 2000's.

In 2006, Jan left the company to pursue other interests and sold her entire stake to PE firms Quadrant Private Equity and Goldman Sachs JBWere, in a buyout transaction valuing the company at $230 million.

The new owners saw a clear strategy to further expand the company's existing footprint in Australia, New Zealand and the UK. The capital injected through the buyout would enable Kathmandu to double its number of stores over the ensuing three to five years, and increase the size of existing stores.

November 2009 saw Kathmandu's shares debuting on the Australian and New Zealand stock exchanges with a market capitalisation of $340 million. The company now has 160 stores, and employs over 2,000 people.

"The company has been in private equity ownership.
They've invested a lot of money.
They've improved just about every aspect of the company."

James Strong
Chairman, Kathmandu

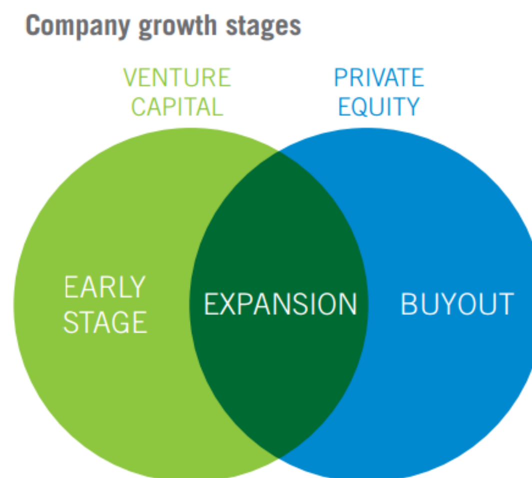
2. AN OVERVIEW OF PRIVATE EQUITY

2.1. What is private equity?

PE is, in the broadest sense, an equity investment in a business not quoted on a public exchange. This would include, for instance, equity investment in a newly formed startup or an established private family company. PE is more often used in a narrower sense to describe investment in unlisted businesses with the aim of building and improving them over a period of years and then selling them in order to generate a return. PE investments of this type are frequently categorised according to the stage of development of the company being invested in. The following categories are often used:

- early-stage investment;
- expansion or growth stage investment; and
- buyout investment.

An even narrower definition of PE arises from these categories. Buyout stage investments are often termed 'private equity' investment, whereas early stage investments are termed 'venture capital'. Expansion stage investments can often fall into both categories (see diagram below).



Some PE funds may focus on making investments in unique market segments, such as providing mezzanine debt funding or investing in companies that are in financial distress or in need of help to turn the business around (often referred to as 'turnaround' strategies).

PE and venture capital (VC) have many common features despite the different development stages of the businesses invested in. Both involve equity investment typically over a three-to-seven year investment period in unquoted companies that are considered to have significant growth potential. Both involve active involvement by the investor in the governance and management of the business and both contemplate, at the time of investment, the subsequent sale of the investment rather than the indefinite retention of it.

PE and VC firms aim to build better, more sustainable businesses that can compete and sustainably grow well into the future. This approach creates value not only for the businesses being invested in, but also for the investors that back the VC and PE funds managed by the PE firms.

The most common sources of funding for PE firms are superannuation and pension funds, sovereign wealth funds, academic endowment funds, foundations and family offices.

PE and VC firms in Australia and overseas typically have the following features:

- The funds are 'closed end' rather than evergreen. The legal documentation governing each fund contemplates that all investments of the fund will have been realised and the funds returned to the investors within a particular time-frame, usually 10 to 12 years.
- All investors are sophisticated (rather than retail or 'mum and dad') investors who, before deciding to invest in a fund, undertake detailed due diligence on the PE fund manager, often over a number of years, during which the manager's prior investment performance is monitored and assessed. The investors also rigorously review the fund documentation and have sufficient bargaining power to negotiate terms with the managers of the fund.

PE and VC investments have several characteristics that set them apart from other forms of business ownership, particularly the public markets:

ALIGNMENT OF INTERESTS

PE fund manager and investor interests are aligned through legal agreements, performance fees and PE firm employees committing capital to their funds to ensure they have 'skin in the game'. The alignment of interests between the management of the business, and its shareholders, is achieved through management equity plans and other ownership models.

DETAILED DUE DILIGENCE

PE fund managers conduct a thorough analysis to gain insights into the strengths and weaknesses of the business, and how to generate growth and value.

LONG-TERM INVESTMENT

PE fund managers develop a long-term plan together with company management to grow the business and increase its value. Investments have an average three-to-seven-year holding period, and place long term growth in value ahead of short term profit considerations.

Importantly, this ownership period is considerably longer than the average holding period of stocks in Australia listed equities, which sits between 12 and 18 months on average.[4]

ACTIVE STEWARDSHIP AND EXPERTISE

PE fund managers do much more than simply invest capital into businesses. They also bring a sharp focus on strategy, operational improvements, access to networks and new markets, and an approach which involves working closely with senior management to ensure they have the right skills and expertise to achieve the business objectives set within the strategy. In some cases, PE fund managers may review and improve the composition and diversity of the board of directors of the business they have invested in, and put in place better information systems and processes to instil a more proactive and engaged form of corporate governance and stewardship.

2.2. Unique PE characteristics

PE investments have a number of characteristics which make them unique as compared with most other forms of investing:

- PE funds invest into established businesses with growth potential.
- PE investments have the greatest impact with businesses needing:
  - expansion capital;

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[4] Della Croce, Stewart and Yermo, *Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies*, OECD Journal: Financial Market Trends – Volume 2011 Issue 1

- greater management focus;
- strategic direction and turnaround capabilities;
- succession planning;
- ability to undertake 'bolt-ons' (acquiring similar businesses and merging with existing investments to achieve efficiencies) and roll-ups (acquiring and consolidating a number of businesses in a fragmented market).

– PE fund managers tend to be actively involved in the strategic processes and management of the businesses.
– PE funds typically finance their acquisitions through a combination of equity, and to a lesser extent, debt.

2.3. The investment model

PE fund structures generally involve a collective investment vehicle (CIV), such as a limited partnership or a trust. PE firms raise their funds by securing commitments from investors, which are pledges of capital to the PE or VC fund. PE funds are closed-end with a life of typically 10 to 12 years, and investors will normally remain committed for the entire life of the fund.

PE fund managers allocate the fund's capital across a number of investments that fit the fund's investment mandate or focus. These investments are typically long-term with average holding periods of three to seven years.

Investment life cycle

Fund managers normally manage PE funds through an investment life cycle, which is comprised of the stages highlighted below.

Capital is gradually drawn down from investors over the life of the fund through a series of 'capital calls' as and when investments are made (typically during the first five years of the life of the fund). Once an acquisition has been made, a representative of the PE fund manager usually joins the company board and actively works with the investee company during, and often after, the investment period.

After an average period of three to seven years, PE funds exit their investments to realise a return for investors. Divestments often take place via trade sales (selling the business to a company in that sector or in a similar industry sector), some are secondary sales (to another PE firm), some are divested via a share market listing, and some are sold to existing or new management. For example, 27% of businesses exited by PE funds in FY2015 were via trade sales, whilst 22% of companies were divested through Initial Public Offerings (IPOs) on listed markets over the same time period. More information on the breakdown of PE exits by exit type is available in section 3.1.3 of this submission.

How does PE add value to investee companies?

PE fund managers aim to add value to the businesses that they invest in through a variety of ways, and will most often look for and make investments with these value-adding opportunities in mind. The most common value-add strategies are listed below:

- Operational improvements
  - Improving business processes
  - Overseeing staff development and lifting work safety standards
  - Increasing economies of scale and scope (e.g. group purchasing)
  - Implementing business efficiencies and cost reductions where possible
- Management improvements
  - Defining and then implementing the strategy of the business
  - Aligning management incentives
  - Filling skills gaps
  - Bridging gaps in succession planning
  - Acting as a sounding board for management
  - Providing access to contacts and networks
- Growth through acquisition
  - Acquiring competing or complementary businesses to build more substantial, valuable and resilient businesses
- Governance improvements
  - Building management oversight
  - Improving reporting standards
- Capital efficiency
  - Funding and increasing capital expenditure
  - Working capital management and putting excess cash to productive use
  - Finding efficient funding for the business

2.4. Industry investment practices

AVCAL members adhere to a set of standards to ensure that the industry remains committed to self-regulated best practice. This is achieved through the use of an industry investment reporting guide, a code of conduct, a code of corporate governance, and the embedding of global industry environmental, social and governance (ESG) practices across the PE industry.

Valuation rules in the form of International Private Equity and Venture Capital Valuation (IPEV) Guidelines, based on the concept of fair market value as opposed to historical cost, are also a core part of the industry's standards framework.

The formalisation of good governance practices for Australian PE fund managers demonstrates that the industry holds itself up to high standards, and fund managers must also adhere to other regulatory requirements, such as applicable corporations' law, tax obligations, and duties that may arise at common law and relevant statutes (see further details on this set out in section 5 of this submission).

2.5. Fees and returns

Once a fund is raised, PE fund managers begin to receive a management fee based on the size of the fund. The management fee is negotiated between the investors and PE fund managers at the time the funds are raised and usually calculated as a percentage of the capital committed to the fund. An indicative figure is 2% per annum for smaller funds and 1% to 2% for larger funds. This figure covers the overheads of managing the fund, including salaries and the costs of conducting due diligence on investments.

Investors only realise gains when distributions are made. Investors may also occasionally receive some interest and dividend income from the PE fund. These amounts are typically only a small proportion of their investment returns, and may also be reinvested back into the fund.

If the investment's returns exceed a predefined hurdle rate, usually around 8%, fund managers receive a share of the realised gains, known as *carried interest*. This is typically calculated net of management fees and only distributed after actual cash returns have been delivered to the investors. Globally, investors favour this key feature of PE funds because it aligns their interests with those of the fund managers.

3. PRIVATE EQUITY IN AUSTRALIA

Key facts	
Funds under management	$25b
No. of active fund managers	76
No. of portfolio companies held	345
Investment in FY2015	$3.3b
Value added to Australian economy	$59b per annum
No. of jobs supported by the industry	Over 500,000

Note: As of 30 June 2015.
Sources: AVCAL, Deloitte Access Economics.

The PE industry in Australia today manages around $25 billion in funds, supporting close to 350 portfolio companies. These companies represent a diverse range of industries and company sizes, as well as being spread across all Australian states and territories.

3.1. PE activity trends

Trends in PE activity are generally measured by three metrics: fundraising, investment and divestment. This section looks at the multi-year trends in activity for each of these.

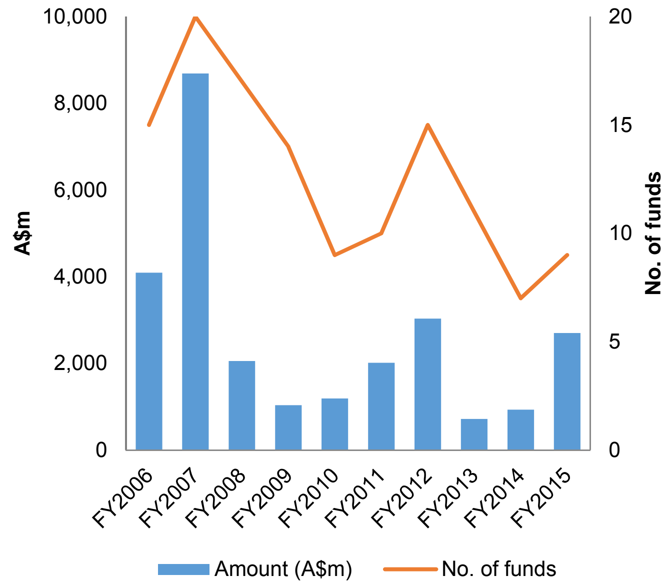
3.1.1. Fundraising

Australian PE fundraising has seen a number of cyclical fluctuations over the last ten years. A peak of $8.7 billion raised by Australian PE funds was reached in FY2007, and annual totals since then have been far smaller.

The latest available data, for FY2015, shows that $2.7 billion was raised across nine funds. These funds represented the spectrum of PE in Australia, including growth and expansion PE, large buyout funds, turnaround funds, and mezzanine debt funds. The total amount raised was the highest seen in the last three years, and the second highest seen in the last eight years.

Figure 2 below sets out the aggregate PE fundraising numbers for the past ten years.

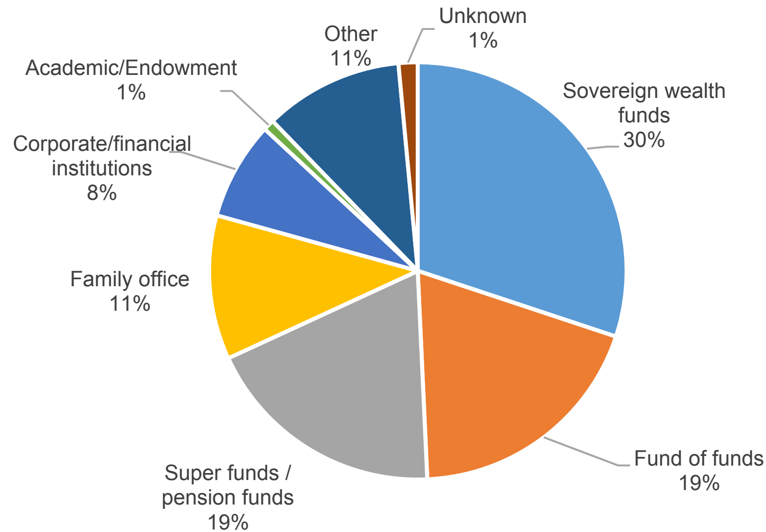
Figure 2: Australian PE funds raised by fiscal year (in AUD millions)



Source: AVCAL

Australian PE funds are raised from a number of investor types, such as industry superannuation funds and public pension funds, sovereign wealth funds, and corporate and financial institutions. Figure 3 below shows the proportion of new commitments to PE funds coming from different investor segments in FY2015. 30% of new commitments came from sovereign wealth funds, whilst funds of funds and superannuation/pension funds each contributed 19% to new commitments.

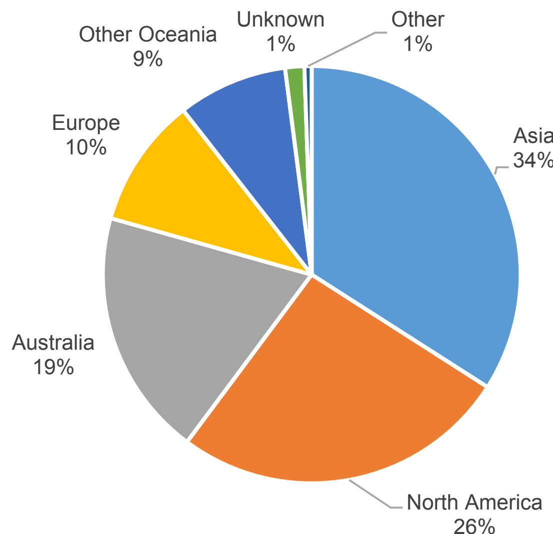
Figure 3: Sources of new PE commitments by investor type, FY2015



Source: AVCAL

The geographical spread of investors contributing to Australian PE funds is just as diverse (see Figure 4). In FY2015, Asian and North American investors contributed a combined 60% of all new commitments to Australian PE funds (34% and 26%, respectively), outweighing even domestic investors, who accounted for 19% of all new PE commitments. Over the FY2010-FY2014 period, however, Australian investors accounted for close to 40% of all domestic PE fundraising. This shift in sources of capital is attributable to a range of factors, including some regulatory issues that have affected the ability of domestic institutional investors, like superannuation funds, to invest in the PE asset class.

Figure 4: Sources of new PE commitments by geography, FY2015

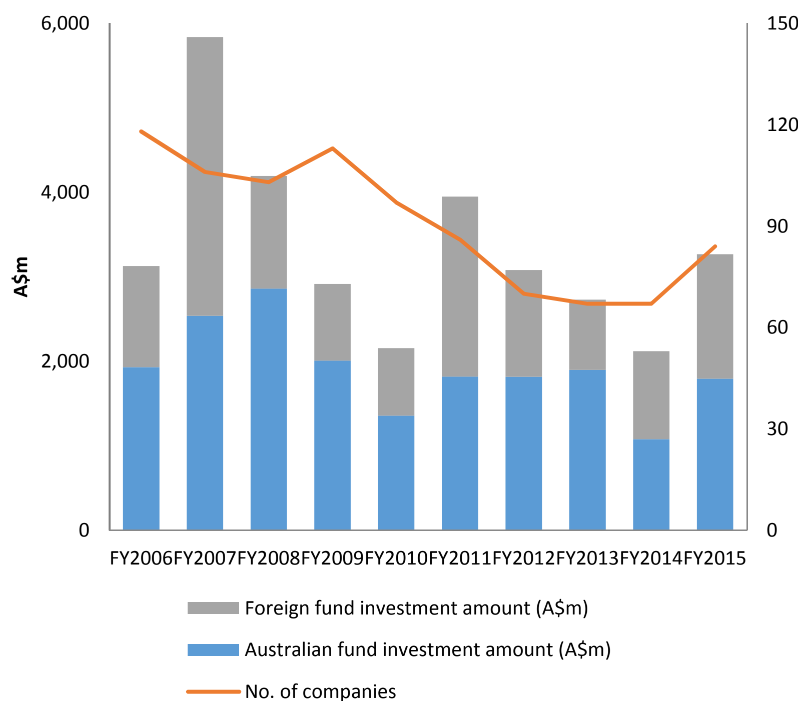


Source: AVCAL

3.1.2. Investment

Similar to the cycles of activity in PE fundraising, PE investment activity in Australia has seen a number of cyclical phases over the last ten years (see Figure 5 below). For example, FY2014 recorded the lowest level of PE investment in Australia seen in the last ten years, both in terms of the dollars invested and the number of companies receiving PE investment. This marked the low point of a four-year decline, as investment activity bounced back in FY2015.

Figure 5: PE Investments by fiscal year (in AUD millions)



Source: AVCAL

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A significant amount of PE investment activity in Australia is attributable to overseas-based funds investing in Australian businesses. In FY2015, these overseas funds invested close to $1.5 billion in Australian companies, which made up 45% of the total dollar amount invested. Whilst overseas PE funds normally account for fewer investments, the transaction sizes of these investments were generally larger than for domestic PE funds, and therefore these investments are mostly related to large listed or privately-owned companies.

PE investment is normally diversified across a wide range of sectors. In FY2015, business and industrial products/services, healthcare, and the consumer sector were the more active sectors in terms of PE investment. Likewise, PE investments are typically spread across different stages of company size and growth. For example, over the FY2011-2015, 60% of companies that received PE investment were at the growth/expansion stage, whilst 23% of companies were invested in at the buyout stage (which is more typical for mature businesses).

Figure 6: PE investments by sector in FY2015 (based on AUD millions)

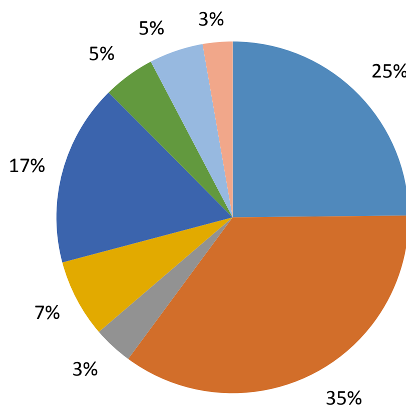
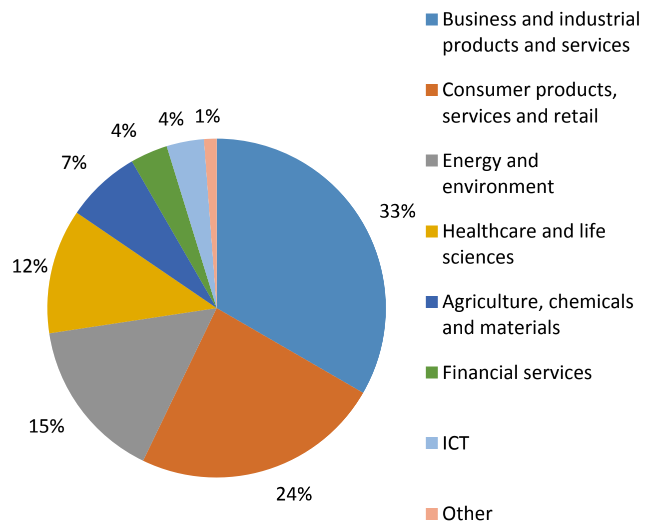


Figure 7: PE investments by sector in FY2015 (based on number of companies)



Source: AVCAL

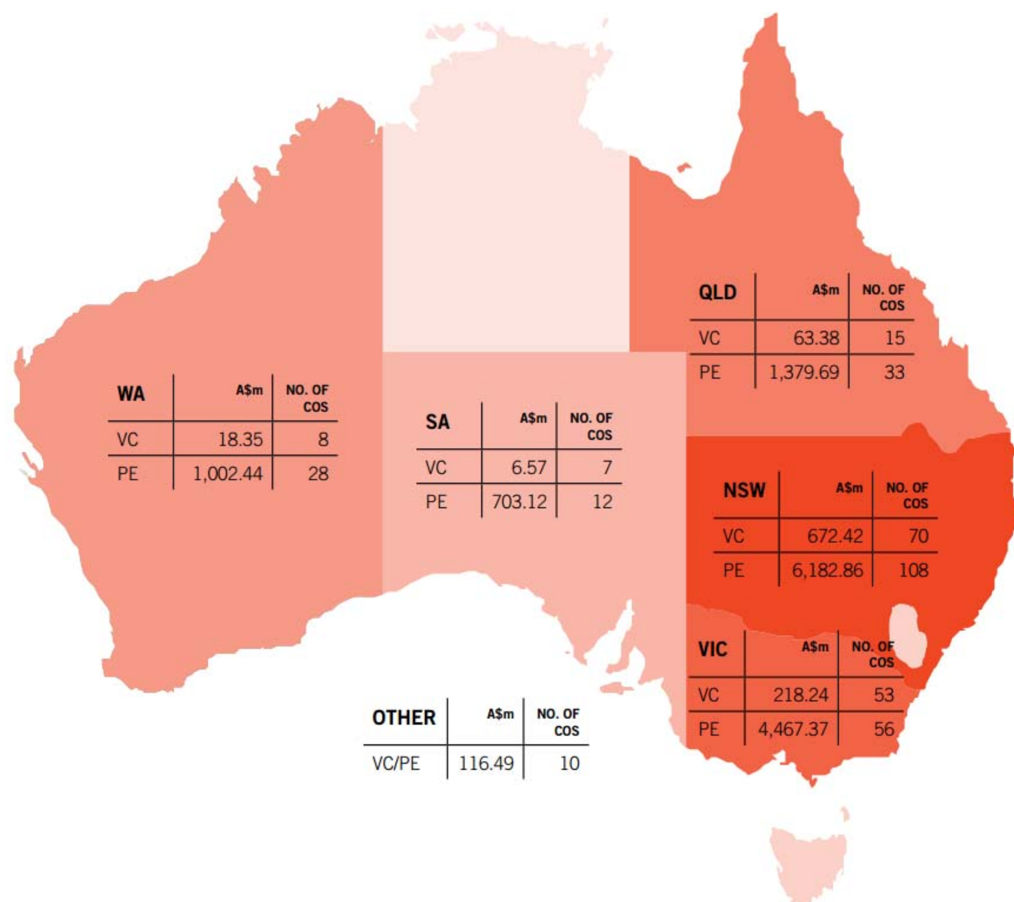
Table 1: PE investments in FY2011-2015 (by stage of investee company)

STAGE	AMOUNT (A$m)	% OF TOTAL PE	NO. OF COMPANIES	% OF TOTAL
Expansion/growth capital	4,233.28	28%	224	60%
Turnaround	275.78	2%	19	5%
Buyout	7,759.45	51%	86	23%
Sale to another PE firm	2,014.52	13%	30	8%
Other PE	865.28	6%	19	5%
Total PE	**15,148.31**	**100%**	**374**	**100%**

Source: AVCAL

Over the FY2011-2015 period, investments made by PE funds have flowed to companies around Australia, with more than $10 billion worth of investments going to New South Wales or Victorian-based companies. The spread of PE investee companies around Australia is discussed further in section 3.2.

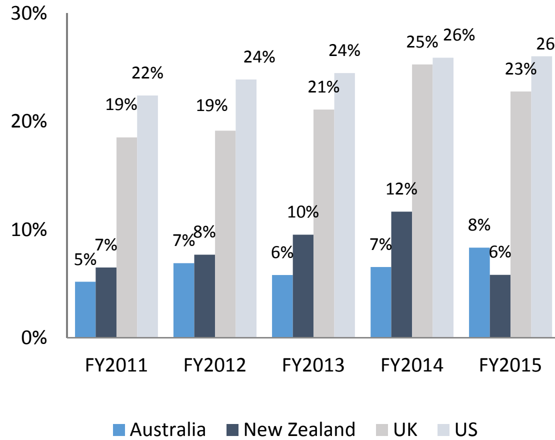
Figure 8: Distribution of Australian PE and VC investments in FY2011-FY2015 (by location of company headquarters)



Source: AVCAL

Merger and acquisition (M&A) transactions by PE firms accounted for approximately 5-8% of all M&A deals in Australia over the last five years. Whilst this is in line with other developed countries such as New Zealand, this proportion is far smaller than that seen in markets with more mature PE industries, such as the UK and the US, where PE transactions can account for more than a quarter of all M&A deals.

Figure 9: Number of PE transactions as a % of total M&A transactions

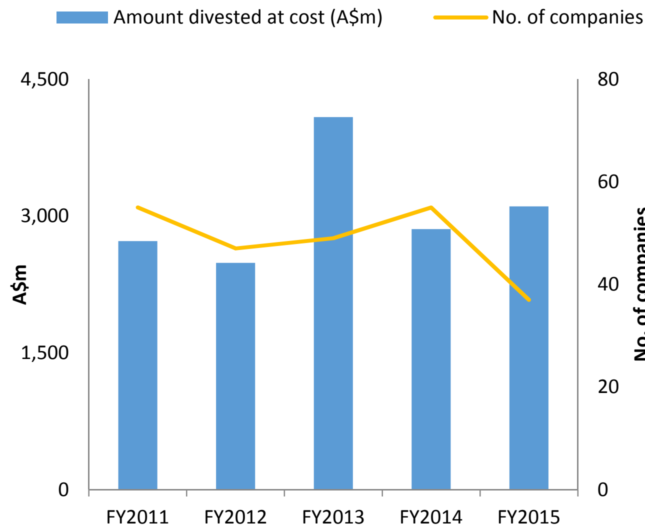


Source: AVCAL

3.1.3. Divestment

Divestments of portfolio companies by PE funds, in terms of the number of companies divested, was lower in FY2015 compared to the previous four years, down from a total of 55 companies divested either fully or partially in FY2014 to 37 in FY2015. In terms of the amount divested at cost (i.e. the total amount of investment that divested companies had received from PE funds), divestments in FY2015 were slightly higher compared to the previous year at $3.1 billion, but lower than the total of $4.1 billion recorded in FY2013.

Figure 10: Divestments by Australian PE funds by fiscal year (in AUD millions)



Source: AVCAL

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In FY2015, close to half of all full or partial exits were through listed markets, either through an IPO, or through the sale of equity stakes after the company has been listed on the public market. Exits via trade sale (i.e. the full or partial sale of a portfolio company to a buyer in that same industry) were also an important avenue for PE exits in FY2015, with 10 companies being divested via trade sales.

Table 2: PE divestments by exit route, FY2015

TYPE OF DIVESTMENT	DIVESTMENT AT COST (A$m)	NO. OF COMPANIES
Divestment by trade sale	825.51	10
Divestment on flotation (IPO)	1,379.38	8
Sale of equity post-flotation	708.61	10
Repayment of preference shares/loans	157.59	7
Other	35.03	3
TOTAL DIVESTMENTS	**3,106.12**	**37**

Source: AVCAL

The various divestment processes shown above allow PE funds to recoup their investments and generate returns for fund investors. For more information on returns, refer to section 4.3 of the submission.

3.2. PE backed businesses in Australia

PE investments are directed to a substantial number of businesses around Australia. The number of businesses (domestic or foreign) backed by Australian and overseas PE funds as of 30 June 2015 was estimated at 345.

These PE-backed businesses are located all around Australia. Importantly, businesses that benefit from PE investment have a presence in not only major metropolitan areas, but also in regional centres and in remote and rural communities. The maps below show the locations of PE-backed businesses around Australia and the major cities.

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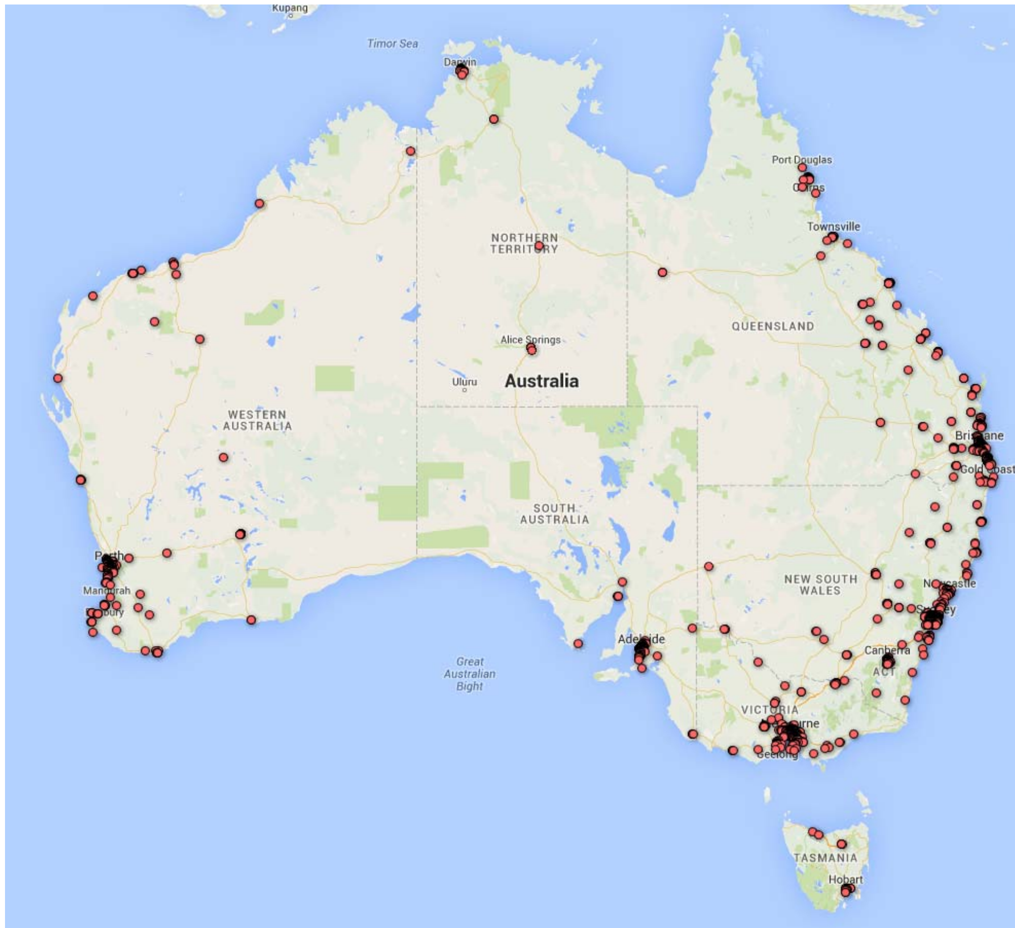
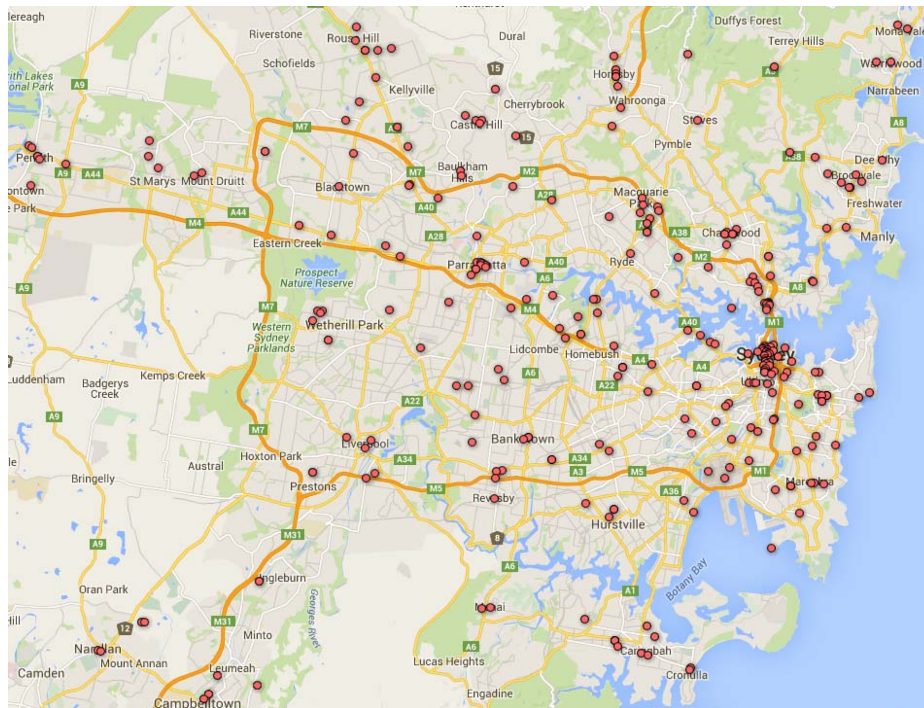
Figure 11: Locations of PE-backed companies in Australia



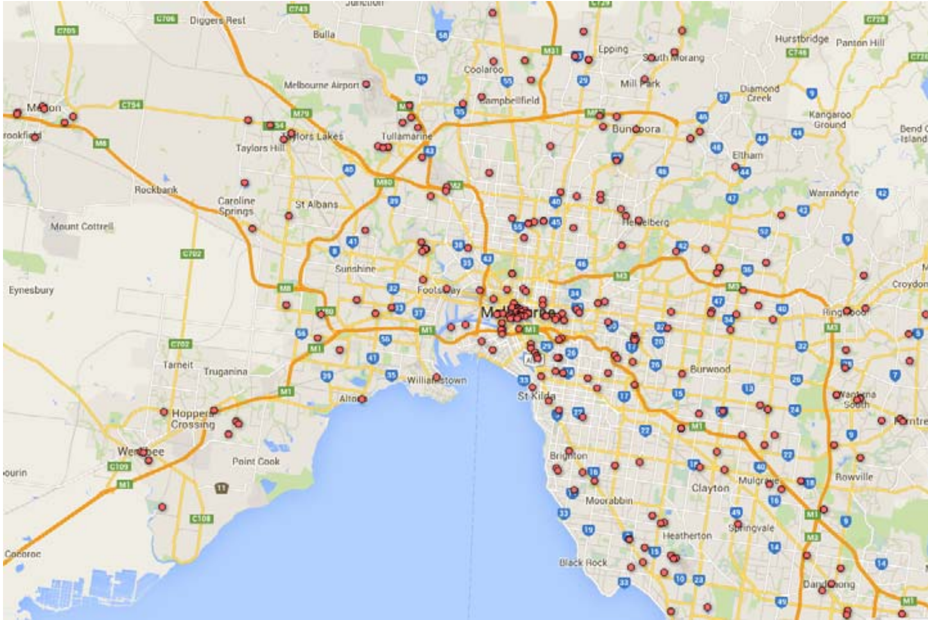
Source: AVCAL

Sydney



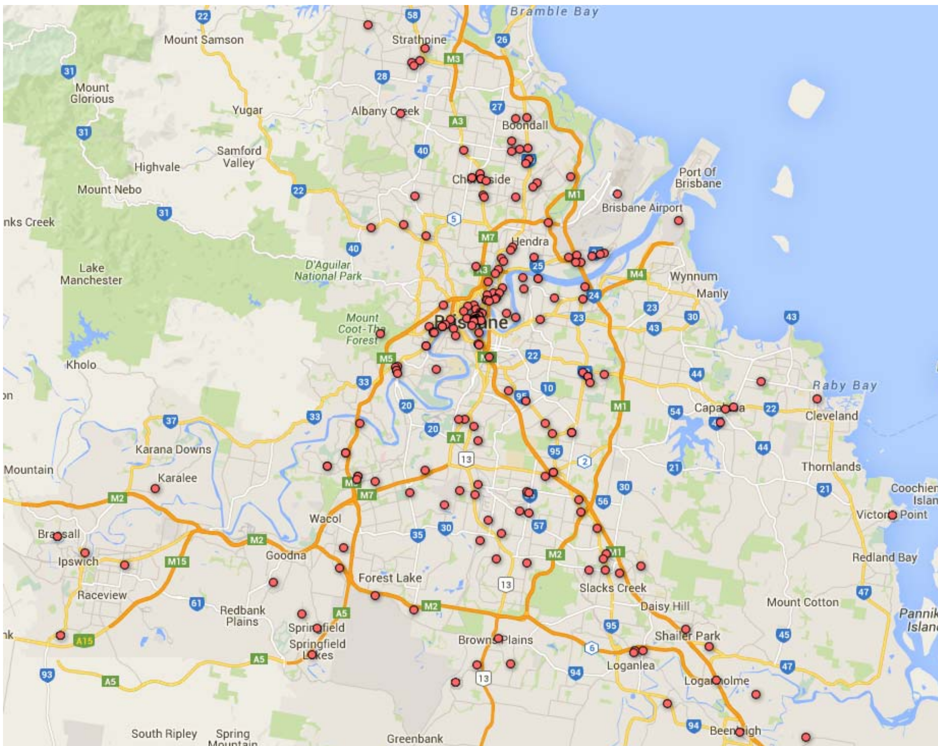
Source: AVCAL

Melbourne



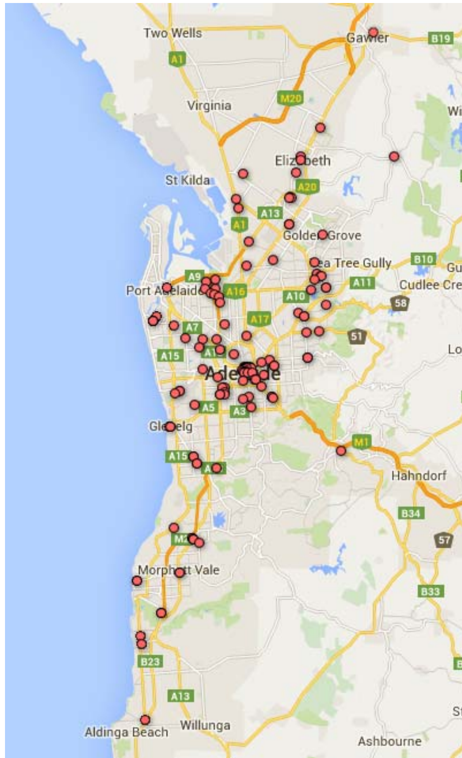
Source: AVCAL

Brisbane

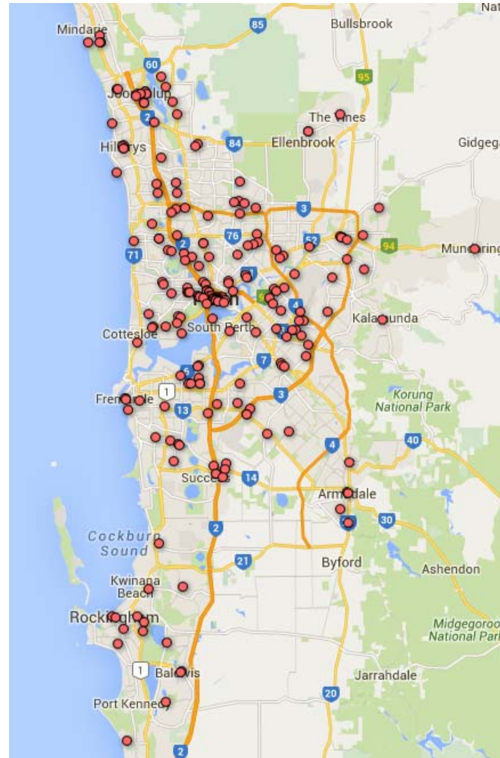


Source: AVCAL

Adelaide



Perth



Source: AVCAL

3.3. Governance

The governance framework that guides the PE and VC industry in Australia is built around several codes developed by AVCAL that members adhere to upon acceptance of membership – the AVCAL Code of Conduct and the AVCAL Code of Private Equity Governance. AVCAL encourages industry participants who aren't members to also adhere to these codes. The Code of Conduct and the Code of Private Equity Governance can be found in Appendix 2 of the submission.

All of the Australian codes have been developed to be consistent with international best practice for the industry.

PE fund managers are also bound by legal duties specified in agreements and contracts with their investors, and fiduciary duties more broadly. The regulatory framework for PE activity is discussed in more detail in section 5 of the submission.

AVCAL Code of Conduct

The Code of Conduct sets out the standards that all AVCAL members must meet or exceed as a requirement of membership, with particular reference to:

- **Integrity**: Members shall promote and maintain ethical standards of conduct and at all times deal fairly and honestly with each other and with companies seeking private equity or venture capital.
- **Compliance, monitoring, and relevant legislation**: Members must take adequate steps to ensure that they conform to all relevant responsibilities imposed by law, and ensure strict observance of all laws and regulations relevant to the conduct of their business.

Fund manager members (i.e. PE and VC firms), must also adhere to more specific rules relating to their conduct, especially regarding:

- **Financial resources**: members must ensure they maintain adequate financial resources to meet any risks to which their business is subject.
- **Investors and investees**: members must understand the requirements of their investors, adopt standards for measuring and reporting investment performance, recognise that their primary business is building the strength of their investee companies, which will result in the funds under management making long-term capital gains.

AVCAL Code of Private Equity Governance

The AVCAL Code of Private Equity Governance establishes a set of basic principles that PE and VC firms who are AVCAL members are obliged to adopt and implement (on an “if not, why not” basis). Each principle acts as a reference point for fund managers to inform their decision-making. The code deals with governance at the fund level, and at the portfolio company level.

AVCAL Code of Private Equity Governance Principles	
Principle 1	Promote and safeguard the interests of the fund’s investors, recognising the diverse nature of those interests
Principle 2	Embed ethical, responsible and rigorous decision-making by General Partners and portfolio company boards and management
Principle 3	Promote effective portfolio company board composition and structures
Principle 4	Respect the interests of stakeholders at both fund and portfolio company levels
Principle 5	Ensure the integrity and utility of reporting by portfolio companies to General Partners, Limited Partners and other stakeholders (private disclosure)
Principle 6	Be transparent in dealings with other key stakeholders in portfolio companies (public disclosure)
Principle 7	Align financial reward with financial performance

Improvement in company governance also forms an important part of the value creation process that PE funds implement within the businesses that they invest into. The adoption of strong governance principles is essential to ensuring that management of the portfolio company operates transparently and effectively, and that interests between management and shareholders are properly aligned.

Recent changes and other aspects of governance

During the course of 2016, AVCAL will continue to work with all of its members to update and refresh the existing Code of Conduct and Code of Private Equity Governance, to ensure consistency with international best practice across other developed markets.

Another relevant aspect of governance within the PE industry relates to the investment professionals who form the nucleus of the industry.

PE firms are generally comprised of investment professionals with various background qualifications in areas such as accounting, finance or law.

By virtue of this, all investment professionals within our industry adhere to exceptionally high standards of conduct, equipping them with the analytical and decision-making skills and knowledge to identify and resolve professional and ethical issues when they arise.

Most investment professionals within the industry maintain their underlying professional standing through membership of relevant associations including Chartered Accountants Australia & New Zealand, FINSIA, and the Law Council (and various Law Societies) of Australia, as well as other professional and standard-setting bodies.

Ultimately, these ethical standards embed themselves within the broader corporate culture of the PE industry and influence all industry participants and stakeholders.

4. BENEFITS OF PRIVATE EQUITY TO THE AUSTRALIAN ECONOMY

The PE industry has a profoundly positive effect on the Australian economy. The economic contribution of the industry is made principally through three channels:

1. Impact of PE on the individual businesses that it invests into;
2. Direct and indirect contribution to economic activity; and
3. Role of PE in enhancing investor returns.

Each of these is discussed in more detail below.

4.1. The positive impact of PE investment on businesses

In 2012, AVCAL commissioned Deloitte Access Economics (DAE) to conduct a study of the economic contribution of private equity in Australia. This section presents the key findings on the role of PE in the Australian economy in terms of revenue and jobs growth, and how the PE model impacts the businesses invested in.

A copy of the report, *The Economic Contribution of Private Equity in Australia*, is appended to the submission (Appendix 4).

The DAE report shows that PE investment makes a significant economic contribution in Australia through total value added and the creation of employment. The modelling finds that, if PE investee companies were an industry in their own right, their revenue would exceed that of either the coal mining or the general insurance industry. They would also directly employ more people than either the automotive or the banking industries.

This analysis is based on survey data for 106 Australian investee companies that had PE investments made since FY2000, for which at least three years of data is available. This data was provided by 18 PE firms that account for around 70% of total PE funds under management in Australia.

Length of ownership. The average length of ownership of the investee firms for those that have been disposed of was 48 months. For the firms which were still held by the PE investors as at 30 June 2012, the average length of ownership was slightly longer at 51 months. The fact that PE owners maintain their exposure to the investee firms for four years on average suggests a substantial commitment to adding value to the firm.

Impact on business operations. The PE business model brings a high degree of agility to running firms and an alignment of owner/manager interest that may not be possible under other ownership structures. While this can provide advantages for investors in PE funds, more flexible businesses can also be good for the broader economy, building resilience and enabling innovation in the face of change. This report finds that PE investment has a significant impact on the operational and management structures of investee companies, and adds capital and expertise to help the firm grow. It also brings a new focus and a greater sense of urgency to the task by changing operational practices and management. The extent of this influence can be found in the range of management improvements introduced by private equity, as shown below:

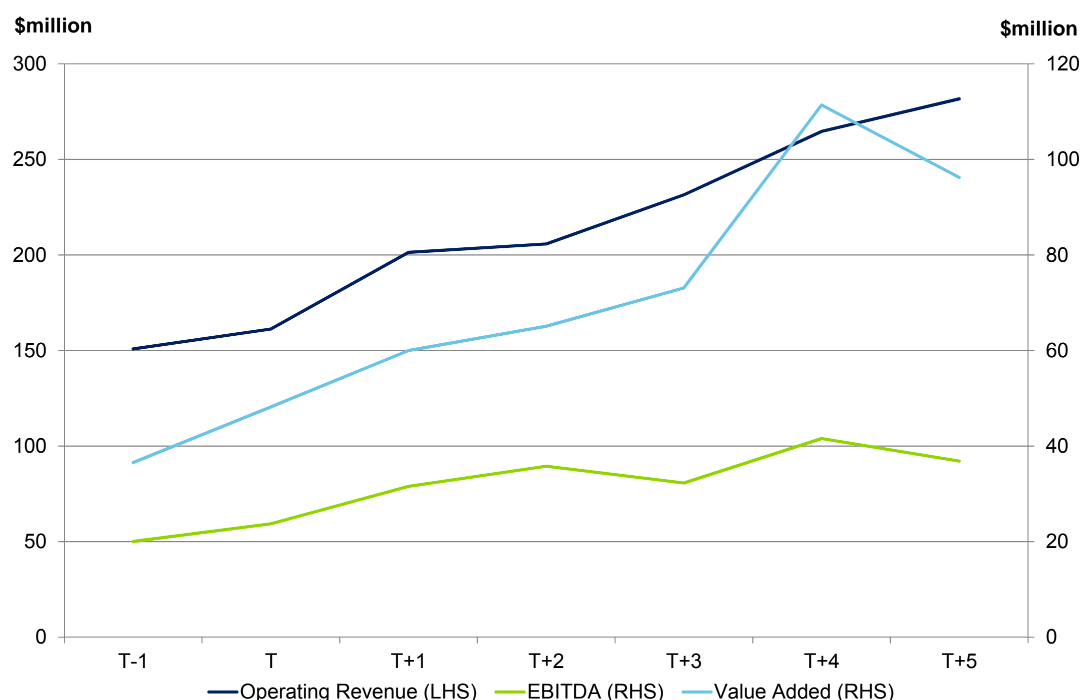
- 90% of PE fund managers introduced new operational practices in their investee companies;
- 85% introduced new managers to help drive and support the growth strategy; and
- 70% injected additional capital into the company.

Additional case studies support the findings that PE-owned companies have strong people management and operational management practices. This legacy is likely to remain even after PE funds exit from the investee companies.

Impact on financial performance: The proof of the benefits of the PE model lies in the performance of the firms acquired and transformed by PE backed management. In the majority of cases, the report finds improved performance across a range of industries. During a typical five-year period of PE investment:

- Revenue grew at a compound annual growth rate (CAGR) of 11.0%;
- The average EBITDA grew from $20 million to $37 million after five years, at a CAGR of 10.7%; and
- The average value added (the sum of EBITDA and wages) was $37 million per company prior to acquisition, rising to $96 million after five years at a CAGR of 17.5%.

Figure 12: Impact of PE investment on selected financial measures

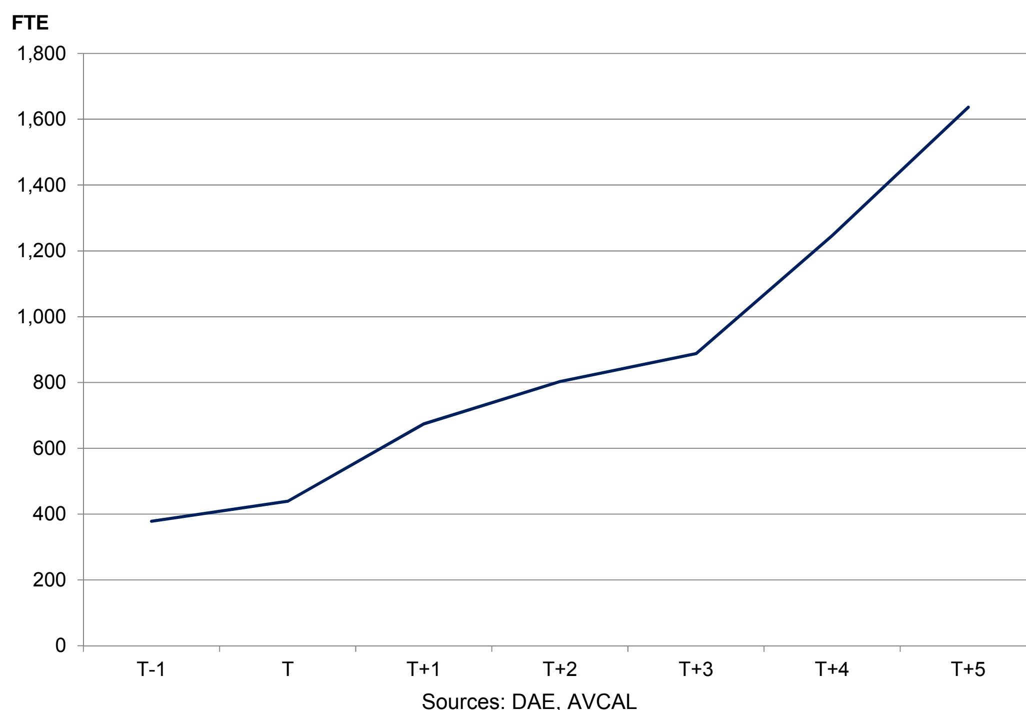


Sources: DAE, AVCAL

Impact on employment: PE investment is a significant creator of new employment opportunities. Over a five-year period from the year of initial investment:

- Investee companies expanded their workforces at a CAGR of 27.6%; and
- The average workforce per company grew from 378 to 1,636 full-time equivalent (FTE) jobs.

Figure 13: Impact of PE investment on employment



Sources: DAE, AVCAL

The PE investment model is also becoming a more viable option for many family-owned companies, especially those that are looking for financing the next stage of growth and facing succession planning issues.

4.2. The contribution of PE to the Australian economy

The economic contribution analysis in the DAE report was based on a representative sample of 49 investee companies for which financial and employment data was available throughout the sub-period of FY2007 to FY2011.

The economic contribution of private equity is measured in terms of:

- **value added,** which is the contribution to GDP; it includes wages paid to employees and the gross operating surplus generated including taxes less subsidies; and
- **employment** generated, measured in full-time equivalent jobs.

Contributes total value added of $58.8 billion per annum to GDP

The annual direct contribution of the PE industry to the Australian economy is estimated to be $25 billion. This is a substantial figure by itself. But PE investee companies also contribute indirectly to the economy by acquiring goods and services from other firms. This is the indirect contribution made by investee companies to the economy, obtained by subtracting EBITDA and wages from revenue. This needs to be taken into account when estimating the flow-on effects. The indirect contribution of PE investee companies is estimated to be $33.8 billion in value added. This brings the total economic contribution of investee companies to an estimated $58.8 billion.

Employs more jobs than the automotive or banking industries

PE investee companies employ an estimated 262,000 full-time equivalent jobs. To put it in context: the average number of jobs employed by PE-owned companies over FY2007-11 exceeds both the banking

and automotive industries in Australia (which employed an average of 196,000 and 260,000 people respectively over the same period).

Investee companies also indirectly support an additional 251,000 full-time equivalent workers. All in all, companies backed by PE provide employment for 513,000 full-time equivalent workers.

Generates more revenue than coal mining or general insurance

The total revenue of PE investee companies is estimated to be around $63.5 billion. This exceeds the coal mining (black and brown coal) and the general insurance industries, which had average turnover of $55 billion and $54 billion during FY2007-11, respectively.

4.3. The role of PE in enhancing investor returns

4.3.1. Returns to PE fund investors

Australian PE and VC funds, as an asset class, have performed well over the last ten years. These funds have, on the whole, outperformed listed markets (both the S&P/ASX 300 Index and the S&P/ASX Small Ordinaries Index) over multiple time horizons. For example, over the one-year period to 30 September 2015, Australian PE and VC funds outperformed the S&P/ASX 300 Index by almost 20%.

Table 4: PE/VC returns

Index	1-Year	3-Year	5-Year	10-Year	15-Year
Australia Private Equity & Venture Capital Index (A$)[1]	**18.97**	**19.33**	**13.07**	**10.58**	**11.91**
S&P/ASX 300 Index	-0.66	9.09	6.29	5.22	7.26
S&P/ASX Small Ordinaries Index	-4.90	-1.22	-2.54	0.41	4.16
UBS Australia Bank Bill Index	2.47	2.74	3.51	4.61	4.84
UBS Australian Composite Bond Index	6.91	4.90	6.64	6.41	6.46

Source: Cambridge Associates

[1] Figures are pooled end-to-end returns, net of fees, expenses, and carried interest, for Australian PE and VC funds.
Note: all figures are as of 30 September 2015.

It is important to note that the beneficiaries of these strong performance results are the superannuation funds, as one of the main sources of capital for PE and VC fund managers, and their members.

4.3.2. Average IPO performance

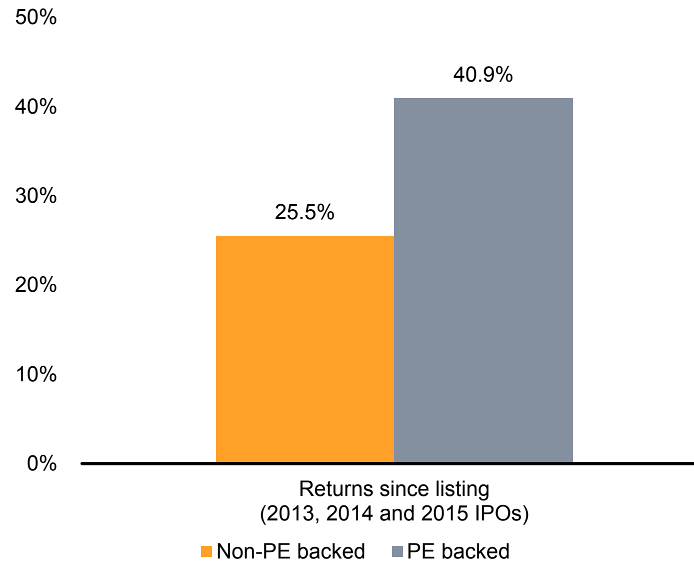
Despite the notion of *private equity* being separate to and removed from *public equity* markets, the PE industry also has a positive effect on the Australian share market.

Companies coming out of PE ownership are well managed, efficiently run, and have the capital necessary for future growth of the business. By listing their businesses through IPOs, PE funds give many investors (including institutional investors such as superannuation funds and wholesale funds, or retail investors) the opportunity to own shares in the companies that have benefited from PE investment and ownership.

In February 2016, AVCAL, in association with advisory firm Rothschild, published a study on the performance of PE and non-PE backed IPOs. The study examined all ASX-listed IPOs with an initial offer size of $100 million or more from 1 January 2013 to 31 December 2015. The data showed that PE-

backed IPOs posted an average return of 40.9% since listing, compared to a return of 25.5% for non PE-backed IPOs, over that time period.

Figure 14: Average IPO returns



Source: AVCAL/Rothschild

4.3.3. Post-IPO selldown analysis

One typical misconception of PE is that once a PE fund has sold its stake in a business (especially a listed company), the company subsequently underperforms. The report addressed this issue by measuring the performance of IPOs between the date when a PE fund sold a large stake in the company (also referred to as a 'selldown') after initial listing and 31 December 2015.

The report found that overall returns have been favourable, averaging 16.5% across the total sample of 21 selldowns from 11 PE backed IPOs. This suggests that after PE funds have exited their investments, strong returns are still available for other investors.

4.3.4. Escrow and lock-up agreements

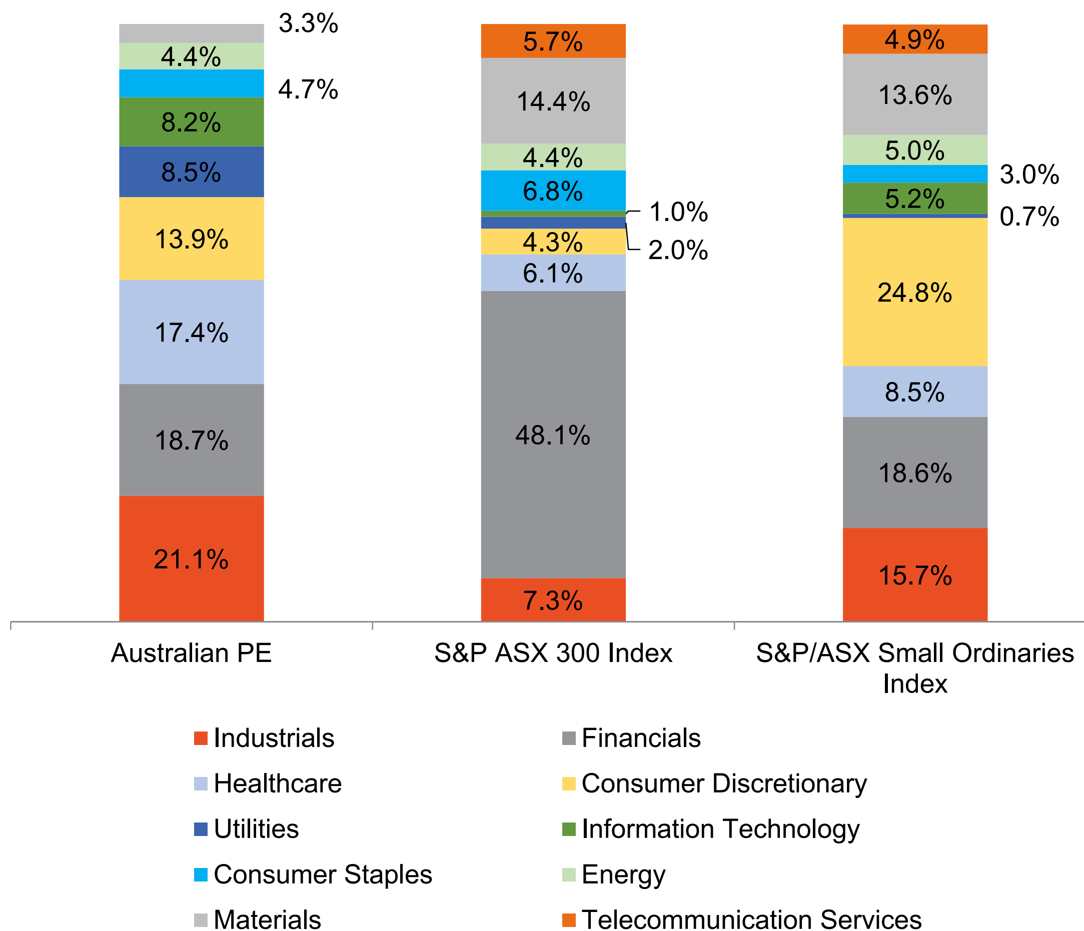
A common feature of recent PE backed IPOs is an agreement by the PE fund(s) involved to keep their stake (or a significant portion) 'locked up' under escrow, with a condition that those stakes can only be divested after a certain period of elapsed time, such as 12 months after the date of listing, or after the first annual report is published and annual results are known. Early release conditions may apply for a small portion of the stake if the stock price is trading significantly higher. The specific escrow agreements for each transaction are largely guided by market expectations rather than legal or regulatory rules.

In Australia, the period that shares owned by PE funds remain under escrow would typically be for 12 months. This is double the lock-up period seen in other jurisdictions such as the UK and the US, where periods of six months and 180 days, respectively, commonly apply.

4.3.5. Diversification

Australian PE funds invest in many industry sectors that are underrepresented by the listed markets. Figure 16 shows that PE funds in Australia provide investors with a balanced exposure to different industry sectors compared to the S&P ASX 300 and S&P ASX Small Ordinaries Indices, which may be heavily skewed towards a particular sector (e.g. companies in the financial sector account for almost half of the total value of the S&P ASX 300 Index).

Figure 15: Industry sector breakdown of Australian PE fund investments vs the S&P ASX 300 Index and S&P ASX Small Ordinaries Index

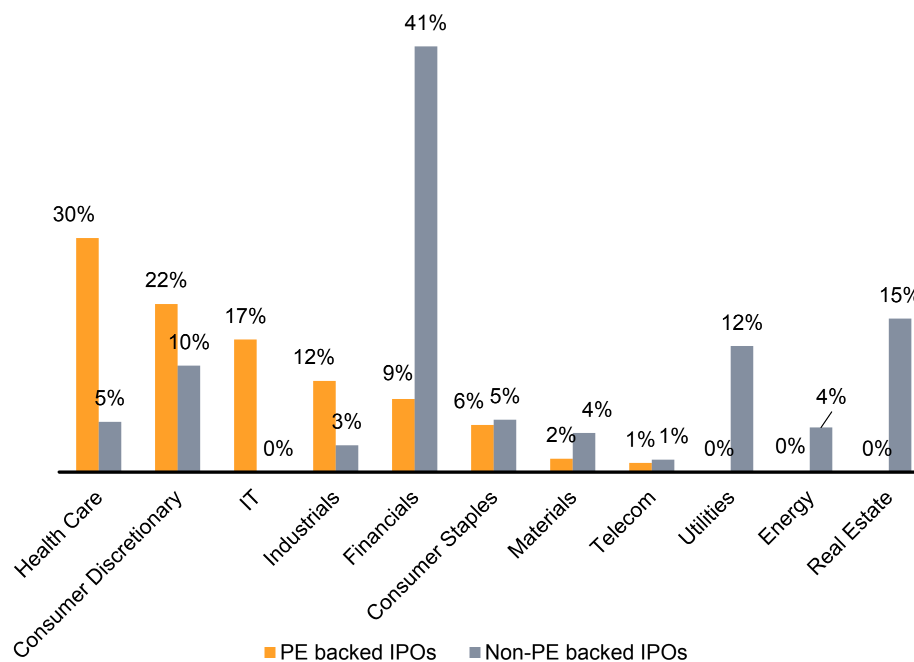


Source: Cambridge Associates

As of 31 March 2015

Once the time comes for PE investee companies to be divested, subsequent PE backed IPOs offer retail and institutional investors a chance to diversify their investments into sectors that are often underrepresented by the ASX and by non-PE backed IPOs. For example, over the 2013 to 2015 period, the healthcare, IT and industrials sectors were better represented by PE backed IPOs, whilst non-PE backed IPOs offered greater exposure to sectors that are already heavily represented by the composition of the ASX, such as the financial sector and real estate.

Figure 16: Industry sector composition of PE backed and non-PE backed IPOs, by offer size (2013-2015)



Source: AVCAL/Rothschild

5. REGULATORY FRAMEWORK

Current regulation and legislation has ensured that the PE industry in Australia is thoroughly regulated and monitored. The regulatory framework around PE firms and their activities relates to the regulation of PE funds, regulations regarding the purchasing, owning and selling (either whole or in part) of companies by PE funds, and rules relevant to the taxation of PE funds.

5.1. Regulation of PE funds

Fund raising activities carried out by PE funds in Australia are subject to the same regulatory regime that applies to other funds or companies when they raise funds in Australia. AVCAL suggests that the regulatory regime is reinforced by due diligence and the negotiation of terms by the sophisticated investors who invest in PE funds (see section 5.2 of the submission).

These investors also require and receive regular monitoring reports typically using the AVCAL Reporting Guidelines which are consistent with global standards.

AFSL regulations

PE funds in Australia are regulated by the financial services regime that applies to other entities which engage in financial services in Australia. If an entity provides financial services in Australia it must hold an Australian Financial Services Licence (AFSL). An entity that wishes to hold a financial services licence must meet certain standards before it is granted a licence, and there are ongoing compliance requirements to hold the AFSL, including annual independent audit requirements and the maintenance of financial conditions.

PE fund managers, be they the General Partners of limited partnerships, or the trustees of the trusts (both of which may form part of a PE fund), and the manager who provide services to these PE funds are required to hold an AFSL or be an authorised representative of an AFSL holder.

AFSL holders, or licencees, have a general obligation to do all things necessary to ensure that they provide their financial services efficiently, honestly and fairly. Specific obligations include:

- conduct and disclosure
- the provision of financial services
- the competence, knowledge and skills of responsible managers, as well as their good fame and character
- the training and competence of representatives and authorised representatives
- ensuring that representatives (including authorised representatives) comply with the financial services laws
- compliance, managing conflicts of interest and risk management
- the adequacy of financial, technological and human resources.

PE funds in Australia, as well as PE fund managers, are also governed by duties (including fiduciary duties) that may arise at common law or under the statutes that apply to PE funds. These duties are consistent with the duties that apply to partners of partnerships and trustees of trusts. For example, the trustee of a trust must act in the best interests of the beneficiaries of a trust (i.e. the investors) or not to benefit from its role as trustee/manager to the detriment of the beneficiaries). These duties are usually documented in policies and procedures which the General Partner/trustee/manager must follow.

5.2. Regulation regarding purchasing, owning or selling of companies by PE funds

Public company takeovers

The long-established regulatory regime in this area, which ensures that the acquisition of shares in a company takes place in an efficient, competitive and informed market and that shareholders know the identity of the bidder, have sufficient time to consider the proposal and have a reasonable and equal opportunity to participate in the benefits of the proposal, applies equally to transactions proposed by PE as to transactions proposed by others.

Listed portfolio companies

In cases where PE funds invest or hold post-IPO stakes, in listed companies, those companies are subject to the listing rules of the relevant exchange on which they are listed and the associated governance principles and other regulatory requirements applicable to other companies listed on that exchange.

For example, the ASX has an extensive list of rules that set out the specific requirements that an entity has to meet in order to list on the ASX (irrespective of whether that entity is a PE investee company or not) and which are underpinned by a set of principles that ensure the quality of the market that the ASX operates. There are also ongoing requirements for entities listed on the ASX, which apply irrespective of whether an entity has PE shareholders, such as continuous disclosure requirements, periodic reporting requirements, and requirements for shareholder approval for certain major transactions or transactions with related parties. These rules are designed to serve the interests of both investors and listed entities and are underpinned by principles based on fairness, transparency and timeliness of disclosures.

The ASX has also issued the ASX Corporate Governance Council Principles and Recommendations (Recommendations) which set out recommended corporate governance practices for entities listed on the ASX that, in the ASX Corporate Governance Council's view, are likely to achieve good governance outcomes and meet the reasonable expectations of most investors in most situations.

While the Recommendations are not mandatory and do not seek to prescribe the corporate governance practices that an entity listed on the ASX must adopt, all entities listed on the ASX (except those listed in the 'foreign exempt listing' category) are required to disclose in each Annual Report the extent to which they have complied with the Recommendations. If an entity has not followed a Recommendation it must provide an explanation as to the reasons why. Requiring this explanation ensures that the market receives an appropriate level of information about the entity's governance arrangements so that:

- shareholders and other stakeholders in the investment community can have a meaningful dialogue with the board and management on governance matters;
- shareholders can factor that information into their decision on how to vote on particular resolutions; and
- investors can factor that information into their decision on whether or not to invest in the entity's securities.

Regulation when a business is sold

When it divests one of its investments, a PE fund will typically do so via a private sale or via an IPO. In both cases, the PE fund is subject to the same laws as any other seller.

A private sale will be commercially negotiated and subject to the operation of the Trade Practices Act and other statutory and common law rules.

An IPO is regulated under the *Corporations Act 2001* (Cth) (Corporations Act) and the listing rules of the relevant exchange in which the entity is seeking a listing (for example, the Listing Rules of the ASX). These rules apply equally to transactions proposed by PE funds as to transactions proposed by Australian entities.

In the context of an Australian IPO, the Corporations Act (together with applicable ASIC regulatory guidance) also sets out detailed disclosure requirements which must be satisfied in a prospectus prepared by the issuer. Such disclosure requirements are not simplified for PE backed businesses and apply equally to PE transactions and to transactions proposed by other entities.

In addition, the customary due diligence process undertaken in the context of an Australian initial public offering (which is designed to ensure that the prospectus meets the requirements of the Corporations Act, including the content requirements and the prohibition on misleading and deceptive conduct, and that the issuer and others involved in the preparation of the prospectus for the IPO are able to avail themselves of the due diligence defences in the Corporations Act) does not differ between PE transactions and non-PE transactions.

Foreign investment

Laws in relation to foreign investment in Australia apply equally to transactions proposed by PE funds as to transactions proposed by others.

Competition law

The Trade Practices Act applies equally to transactions proposed by PE funds as to transactions proposed by others.

Sector-specific legislation

Specific restrictions for companies operating in sectors such as media, finance and insurance, aviation, health and gaming also apply to transactions proposed by PE funds.

Conflicts of interest

Conflicts of interest are regulated by existing rules at common law and under statute which apply equally to transactions proposed by PE funds as to transactions proposed by others.

In addition, AVCAL has expressed its support to the Takeovers Panel for Guidance Note 19 which deals with the management of insider participation in control transactions. This Guidance Note specifically states that it does not distinguish between PE bidders and other types of bidders.

Insider trading

The law in relation to insider trading applies equally to transactions proposed by PE funds as to transactions proposed by others. Instances of insider trading are actively monitored and, where applicable, prosecuted by ASIC.

Ultimately, businesses owned by PE funds are subject to the same laws, regulatory frameworks and due diligence processes as they would be if owned by a privately-held company.

5.3. Compliance with taxation laws

PE backed companies and PE funds are generally subject to the same taxation framework as all other areas of economic activity in Australia. As was noted in the 2007 Senate Standing Committee on Economics report into Private Equity Investment in Australia: "(*t)he 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".[5]

Indeed since this time the ATO has increased its attention on PE funds, particularly PE investment undertaken by offshore funds. The ATO's work is led by a dedicated team with sector specific expertise, who engage on a daily basis with the PE industry.

The following key areas of the taxation system are relevant to any consideration of the investment activities of PE funds in Australia:

- interest on debt;
- company profits;
- capital gains;
- stamp duty;
- carry forward of tax losses; and
- fees paid

Each of these areas is explored further below.

Analysis conducted by AVCAL (and summarised in the 2007 AVCAL submission to the Inquiry into Private Equity by the Senate Standing Committee on Economics) shows that, on balance, PE should not have a material effect on taxation revenue collections in the long term.

5.3.1. Interest on debt

There is a public perception that the use of debt in some PE investments leads to a significant reduction in taxation revenue collections. However, the facts don't support such an assertion.

Interest deductions

PE backed borrowers are subject to all the same rules in relation to deduction of interest costs as other Australian businesses.

Interest expenditure by an Australian business is generally an allowable deduction but there are exceptions to this general principle. These exceptions include rules relating to thin capitalisation, benchmarking and transfer pricing, all of which can operate to limit interest deductions.

For instance, the thin capitalisation rules limit the amount of deductible interest-bearing debt a foreign-owned Australian entity can maintain by denying deductions for interest expenses when certain debt/equity ratios are breached. PE transactions are generally geared at far lower rates than large infrastructure transactions (which can be geared between 80%-90%, with lenders willing to commit more on the basis that 'annuity type' returns are either regulated or more certain in nature) and therefore represent a lower risk to revenue.

Interest income

Interest paid on funds borrowed from Australian resident lenders is included in the assessable income of the lender. Therefore, the net effect of any borrowings by PE funds is effectively nil.

Interest paid on funds borrowed from non-resident lenders results in less taxation revenue than equivalent amounts of interest paid to Australian resident lenders. This difference is reduced to the extent that interest withholding tax is deducted from payments to non-resident lenders.

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[5] Paragraph 4.44 of that report, referred to in this section as the Senate Economics Committee Report

Not all interest paid to non-resident lenders is subject to withholding tax due to the operation of certain exemption rules, such as treaty relief where interest is paid to a US bank.

Australian resident lending versus non-resident lending

AVCAL research indicates that most PE backed businesses borrow from Australian resident lenders; whilst borrowing from non-resident lenders has risen somewhat in recent years, there is no incentive for PE backed businesses to borrow from non-resident lenders unless their requirements exceed the capacity of Australian resident lenders. If a large amount, say $1 billion, is required for a borrowing by a PE backed business, the majority of that debt will still come from Australian resident lenders.

The effect on taxation revenues of PE borrowing is therefore minimal.

To the extent that capital is provided by borrowing from the PE fund, then that interest will be subject to either income tax (where attributed to domestic investors) or interest withholding tax (where attributed to foreign investors), unless an exemption applies.

5.3.2. Company profits

PE investment increases the operating profit of businesses through business improvement measures (see section 4.1 of the submission). Increases in operating profit generally lead to an increase in the taxable income of a business.

The taxable income of a business will be reduced by any deductible interest expense. This issue of deductible interest expense in relation to private equity has been considered above.

In AVCAL's opinion, a proper analysis of the effects of PE on tax revenue must take account of the following important factors.

An increase in the operating income of a PE-backed business should increase tax revenue to the extent that it leads to one or more of the following, in any particular case:

- a distribution to, and therefore increased tax payments by, investors;
- increased borrowing leading to more taxable income in the hands of lenders;
- investment of the increased income (or increased borrowing) in further profit improvement initiatives leading to further increases in operating income;
- repayment of loan principal which will reduce future interest payments leading to further increases in operating income; and
- an increase in the value of the business that will be reflected in increased capital gains tax (CGT) when the business is sold by the PE fund.

5.3.3. Capital gains

PE investment has the potential to increase capital gains tax collections by:

- bringing forward and increasing the number of taxing points; and
- increasing the value of businesses and therefore the size of taxable gains on sale

Taxing points

PE investment results in a transfer of business ownership. The outcome of business transfers is that unrealised capital gains (and potentially losses in some circumstances) are brought forward, thereby triggering a taxing point earlier than would otherwise have occurred. As was acknowledged in the

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Senates Estimates Committee Report that "*a proportion of gains realised by shareholders whose shares have been acquired in a PE takeover continue to generate tax revenue.*"[6]

Generally, a PE fund will have a limited term of approximately 10 years. Accordingly, an investment period by PE of less than 10 years in the life of a business will inevitably lead to a greater number of taxing points for the various investors into that business. With each taxing point triggered, the potential for the realisation of unrealised capital gains arises.

AVCAL notes that in some cases a PE investment will cause a business to be brought into the CGT system for the first time and to that extent PE, again, will increase tax revenue.

Furthermore, the various taxing points lead to a very important distinction that can be drawn between PE backed investment and takeover by a foreign corporate. Where a PE firm (either foreign or domestic) backs an Australian business, the typical structure would result in the PE firm backing the Australian-based management team whilst also providing capital and expertise to help the business expand. Following the PE ownership period, it's probable that the company will once again end up in the hands of Australian owners. However once in the hands of a foreign multinational, it's highly likely that such assets will never again be held for the benefit of Australian owners.

Gains on sale of a business

PE investment generally increases the value of a business over time and so can be expected to deliver a gain on sale for investors.

The tax consequences of a divestment by a PE fund will depend on the location of the fund investor and its tax attributes. An Australian investor in the fund will pay tax.

In respect of a non-resident investor, factors including the investor's specific residency will play a major part in determining the Australian tax paid.

But in most cases, "business profits" (as defined under a relevant tax treaty) of a non-resident fund arising on the sale of Australian investments are not subject to tax in Australia to the extent that investors in the PE fund are resident in countries with which Australia has a double tax treaty. The ATO set out its views in 2010 and 2011 with the publication of 4 tax determinations in relation to the taxation implications of private equity transactions.[7] In particular in TD 2011/25 the ATO accepts the OECD principle of allowing treaty benefits to 'flow through' PE funds structured as fiscally transparent limited partnerships. As noted above, the ATO and PE industry have increased dialogue to ensure that PE fund meets their obligations on exit.

The carried interest entitlement of Australian PE fund managers is generally taxed in Australia as ordinary income when paid or as a capital gain when derived through a Venture Capital Limited Partnership.

Australian management equity in a company owned by a PE fund will, in most cases, also be realised when the business is sold. Any gain that has been made will be taxed at this point.

There are specific exemptions for non-resident investors in Venture Capital Limited Partnerships and all investors in Early Stage Venture Capital Limited Partnerships. The taxation treatment of these entities has recently been the subject of a Board of Tax review and further improvements to these regimes has been announced in the recent National Science and Innovation Agenda.

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[6] Paragraph 4.35 Senate Economics Committee Report
[7] See TDs 2010/20, 2010/21, 2011/24 & 2011/25

5.3.4. Stamp duty

PE investment increases stamp duty payments to the states and territories by causing changes in ownership of businesses to occur earlier and more often than would otherwise be the case.

When a PE fund buys or sells a business stamp duty will generally be paid in relation to the transfer of assets of (or shares in) the business. In many circumstances, landholder duty may be payable as may duty on loans to the business.

5.3.5. Carry forward of tax losses

PE investment may increase tax revenue by preventing businesses they purchase from claiming any carry forward tax losses which were available immediately prior to the purchase.

In almost all cases, a PE purchase causes a break in ‘continuity of ownership’ of the business. As a result carry forward tax losses can only be recouped against future taxable income if the company satisfies the more restrictive same business test.

5.3.6. Fee income

PE activity increases taxation receipts by increasing the fee income of Australian resident taxpayers.

Management fees received by Australian resident PE funds from non-resident investors are taxed in Australia and increase tax revenue.

Further, PE investments and divestments increases the level of transaction activity which increases the fee income of advisers involved. These fees in a transaction are approximately 4% to 5% of transaction value.

The fees are assessable income in full in the year they are earned. However, only a small percentage of these fees are fully tax-deductible on an up-front basis. The remainder must be capitalised and claimed over a period of years or included in the cost base of goodwill and therefore never deductible. This leads to an increase in tax revenue.

Similarly, the fees will often be subject to Australian goods and services tax (GST) but in most cases part of the GST paid cannot be claimed as a credit and is said to be ‘irrecoverable’. PE activity increases taxation revenue to the extent it results in irrecoverable payments of GST.

Appendix 1: Portfolio Company Case Studies

Retail industry case studies

Burson Auto Parts

Burson Auto Parts, founded in 1971, is one of the largest suppliers of automotive parts in Australia. Quadrant Private Equity facilitated a management buyout of the business when the original founder was looking to sell it in 2011.

The PE firm and new CEO put in place a leadership structure, rolled out new stores, invested in an advanced online ordering system in order to help customers, and helped to empower and educate store management teams in driving profitable sales for the business.

The company was listed on the ASX in April 2014 and operates over 130 stores Australia-wide.

Crumpler

Crumpler is a global travel and lifestyle bag brand based in Melbourne. Crescent Capital Partners acquired a stake in the business in 2014.

The company now has 20 stores located throughout Australia, and is stocked in major retailers and department stores such as Myer and David Jones. It is making a push into the Asian market, and is the official luggage sponsor of the Australian Olympic team.

Lorna Jane

Lorna Jane is a Brisbane based designer, wholesaler and retailer of its own proprietary range of women's fitness and leisure apparel. It opened its first store in 1990, and has been expanding its product range and retail footprint ever since.

Growth PE firm CHAMP Ventures took a significant minority stake in the business in 2010, partnering with the founders to help grow the business further.

Since CHAMP Ventures' investment, the company has grown from 74 stores in Australia to now over 200 stores located around Australia, the US, Europe, South Africa and SE Asia. Lorna Jane products are also now sold world-wide through wholesale and licence arrangements and has developed a strong online presence.

Rebel Group

The Rebel Group was created through the integration of three separate businesses in the sports retailing space by Archer Capital from 2004 to 2007: Amart All Sports, Rowe and Jarman, and Rebel Sport (which, as an ASX-listed company, was bought out in a public-to-private transaction).

The combined entity became the clear leader in its industry segment with 150 stores and a 45% market share, over three times larger than the next biggest competitor. Archer led a significant restructuring and reorganisation of the business during the holding period, introduced private label products, and improved the profitability of the business.

In 2011, Rebel was acquired by Super Retail Group for $610 million.

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The Reject Shop

The Reject Shop is one of Australia's largest discount variety retailers serving a broad range of consumers, founded in South Yarra, Victoria in 1981.

The company was partly acquired by the PE arm of Macquarie Bank in 1994, which was able to execute on a turnaround strategy by bringing in new management, fixing internal controls and financial/management reporting, improving stock control and developing a focussed property strategy to sustainably build the business.

It was floated on the ASX in June 2004 and remains a listed company, with over 330 stores and close to 6,000 employees.

2XU

2XU is an Australian multinational corporation engaged in the design, development and selling of sporting apparel including compression garments, triathlon, cycle, running, open water swimming and general fitness wear.

In 2011, Lazard Australia Private Equity acquired a minority stake in the business, whilst L Capital (backed by luxury goods company LVMH) bought a 40% stake in 2013.

The company has opened a number of stores around Australia and the US, and is stocked in many major sports stores. 2XU also has 24 distributors across 50 countries in Asia, Central and South America, Europe, and North America.

Non-retail sector case studies

Rafferty's Garden

A baby food producer founded in 2007, Rafferty's Garden has been able to revolutionise the market thanks to backing from a PE fund.

Anancacia Capital bought a 67% stake in the company in 2010 and brought in a new chief executive and bolstered the company's board. It also supported further research and development in order to expand Rafferty's Garden's product range, significantly increasing vegetable-only baby food and new lines aimed at toddlers.

The product was already being sold on the shelves of Coles and Woolworths prior to PE becoming involved, but PE investment helped to expand the product to other stores such as Big W and Target, as well as developing an online and export presence.

GenesisCare

GenesisCare is Australia's largest provider of radiation oncology, cardiology and sleep treatments. With more than 1,400 employees, GenesisCare provides essential health care services across more than 125 sites and clinics ranging from the major capital cities to regional and rural centres.

In July 2009, Advent Private Capital invested in GenesisCare to help support the growth of the business. The PE firm also expanded the management team, aligned the interests of management with executive incentives, help acquire additional practices, and set the company up for its next phase of growth by selling the business to KKR, another PE firm.

> *"Advent has been a great partner over the last three years as we rapidly expanded. They provided excellent support and guidance as we pursued our strategy to improve and expand access for patients to high quality healthcare."*
>
> Dan Collins
> Managing Director, GenesisCare

Sundrop Farms

Sundrop Farms is a pioneering arid climate agribusiness based in Port Augusta, South Australia, growing its crops in state-of-the-art glasshouses using a unique proprietary technology developed to address the water and food security issues typical to arid regions.

In December 2014, KKR provided $100 million of growth capital to the company to significantly expand Sundrop Farms' glasshouse facility in South Australia and underpin its international development, by financing a 20-hectare greenhouse facility capable of producing more than 15,000 tons of vegetables annually for markets across Australia.

Sundrop and KKR also intend to develop a hub of agricultural innovation for arid climates in Port Augusta which would allow for further development in countries with similar environmental conditions. KKR's investment in Sundrop Farms would also support its plans to expand into the Middle East, North America and other supply-constrained markets around the world.

Appendix 2:

AVCAL Code of Conduct and Code of Private Equity Governance

CODE OF CONDUCT

Australian Private Equity & Venture Capital

Association Limited

Adopted 14 May 2009

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Definitions

Association means the Australian Private Equity & Venture Capital Association Limited.

Chair means the chair of the Association for the time being, elected or appointed (as the case may be) in accordance with the Constitution and includes for the avoidance of doubt the Independent Chair.

CEO means the chief executive officer of the Association from time to time appointed by the Council in accordance with the Constitution.

Code of Conduct means this code of conduct.

Constitution means the constitution of the Association.

Council means the governing council of the Association from time to time.

Individual Member means person being an individual who has been admitted as a Member.

Independent Chair has the meaning given in clause 36.1(b) of the Constitution.

Industry means the investment of private equity and venture capital funds primarily in unlisted companies.

Investor means a corporation, person or other entity which invests in funds managed by an Investor Member.

Investor Member means a corporation or other entity which is not an individual which has been admitted as an Investor Member in accordance with clause 12.1 of the Constitution.

Member means a person who has been admitted as an any Investor Member or a Non-Investorbut does not include Member Representatives.

Membership means membership of the Association.

Member Representative means a person appointed by a Member in accordance with clause 13 of the Constitution.

SIS means Superannuation Industry Supervision Act, 1994 as amended from time to time.

Valuation Guidelines means the valuation guidelines adopted by the Association from time to time.

Introduction

The Association was formed in 1992 to represent the views of participants in the venture capital industry.

The following Code of Conduct sets out the standards of conduct that Members must meet or exceed as a requirement of Membership.

Objects

The objects of the Association are:

(a) to represent the interests of Members to state and federal governments, commissions, enquiries, regulatory authorities, industry associations and professional associations;

(b) to promote the recognition of the Industry as a professionally managed and ethical sector of the Australian investment community, which is worthy of support by current investors and new participants;

(c) to provide for the examination and discussion of the Industry in Australia;

(d) to promote fellowship and provide a forum for the exchange of ideas and views amongst the Members and business community at large;

(e) to assist Members develop and improve their skills in relation to Industry activities, and become knowledgeable about issues which affect the Industry; and

(f) to collect and distribute information with respect to the Industry.

Code of Conduct

1. Financial Resources

Investor Members must ensure they maintain adequate financial resources to meet any risks to which their business is subject. These resources may comprise:

(a) subscribed capital and reserves, held in cash or readily negotiable securities; and

(b) where relevant, parental commitments by way of subscribed but uncalled capital, irrevocable guarantees or letters of comfort (where parents are of demonstrable financial substance),

which in aggregate must be adequate to meet both prudent financial resources criteria, and the relevant guidelines set from time to time by regulatory authorities that govern various financial service activities within Australia.

Investor Members should hold adequate insurance against theft, fraud (including computer fraud), etc and have sufficient financial resources or professional indemnity insurance to meet any potential negligence claims.

Investor Members must comply with all regulations and industry standards approved by the Association for custody of assets.

2. Integrity

Members shall promote and maintain ethical standards of conduct and at all times deal fairly and honestly with each other and with companies seeking private equity or venture capital. Members shall conduct business in a professional way, and will not engage in practices that may be damaging to the image of the Industry.

Members shall not malign, defame or unfairly criticize any other Member in any dealings with proposed client companies or otherwise.

Members shall neither take improper advantage of their position in the Association nor abuse any confidential information addressed to the Association.

Members who sponsor investment syndications with other parties, whether members of the Association or not, must operate on the basis of full disclosure to such other parties.

Members shall respect confidential information supplied to them by companies seeking private equity or venture capital or by companies in which they have invested.

Investor Members will not accept into their funds subscribed capital from unspecified sources.

Investor Members shall not use their funds to promote their own interests or the interests of their directors, managers, employees, representatives and nominees, except to the extent they benefit from the success of such fund through established compensation and/or profit-sharing contracts.

Members shall abide by this Code of Conduct and any other standards issued by the Council or a committee appointed by the board of the Association. Unethical conduct will include, but not be limited to, any evasive action intended to conceal non-compliance with this Code of Conduct. Members shall require their directors, employees, representatives and nominees to abide by this Code of Conduct.

3. Conduct of Members

The Council has the power at any time to investigate the alleged conduct of any Member. If a complaint is made to the Association about the conduct of a Member, or the Council believes that the conduct of a Member should be investigated, then the Council will appoint a committee to investigate the matter (**"Committee"**). This Committee will have the same powers as the Council with respect to clause 19 of the Constitution.

A Committee will be made up of five Members, of whom one will be the Chair. For a person to be eligible for appointment to the Committee, the Council must first be satisfied that the prospective appointee has no unfair bias toward the Member whose conduct is the subject matter of investigation.

The Committee shall be entitled to require any Member to give an explanation of, or provide any information, or access to information (including access to witnesses as provided in clause 19.1 of the Constitution), required by the Committee in relation to any conduct or alleged conduct of such Member which the Committee considers is or may be:

(a) prejudicial to the objects of the Association;

(b) prejudicial to the good name of the Association and its reputation for promoting and retaining high standards of business conduct and professional competence; or

(c) is in breach of this Code of Conduct.

If the Committee finds, in its absolute discretion, that any Member is guilty of conduct which is in breach of this Code of Conduct, is otherwise unbecoming a Member or is prejudicial to the objects of the Association, the Committee will have the power to censure, suspend or expel the Member in accordance with the Constitution.

The Committee may decide, in its absolute discretion, whether to publish the findings of any investigation.

4. Investor Relationships

Investor Members must understand the requirements of their Investors. A management agreement should be prepared with each Investor detailing the basis on which the Investor Member is appointed. Agreed standards should be met for:

(a) Record keeping, to ensure that proper records are kept to describe accurately, completely and fairly the services provided.

(b) Reporting, to ensure that each Investor receives a full, fair, timely and clearly stated account of the management of their assets. The reporting of investment performance should be comparable with that relating to other similar investment services or products and enable Investors to meet their regulatory requirements including those specified by the SIS legislation.

(c) Custodial arrangements, where applicable, to ensure proper protection of the Investor assets, including:

- Segregation and identification of the assets held for each client in the records of the manager; and
- Proper registration of assets bought or held for the Investor.

Investment mandates, where applicable, should detail agreed investment objectives, investment powers and appropriate benchmark(s) against which Investor Members are to be measured.

5. Requirement for Disclaimer

Offer documents that acknowledge Membership, must contain the following disclaimer:

> *Australian Private Equity & Venture Capital Association Limited ("AVCAL") does not endorse this document. Investors should make independent enquiries prior to investing. AVCAL does not take any responsibility for the contents of this document*

To be placed prominently on the inside front cover in upper and lower case, Times New Roman font not less than 12 point and 1.5 line spacing.

Members who wish to mention the Association in offer documents are required to submit a draft of the relevant section(s) of those documents for Association approval.

6. Compliance Issues and Monitoring

Members must take adequate steps to ensure that they conform with all relevant responsibilities imposed by law. A few example steps include:

(a) maintenance and retention of full and complete business records;

(b) internal procedures to monitor adherence to regulations and other "Relevant Legislation"; (see below); and

(c) disclosure of interests by directors of investment management companies who are also directors of investee companies.

7. Relevant Legislation

Members should ensure strict observance of all laws and regulations relevant to the conduct of their business, including but not restricted to:

- Financial Services Reform Act 2001;
- Corporations Act 2001;
- Venture Capital Act 2002;
- Australian Stock Exchange Business Rules;
- SIS;
- Income Tax Assessment Act 1936 (ITAA 1936);
- Income Tax Assessment Act 1997 (ITAA 1997);
- Fringe Benefits Tax Assessment Act 1986;

- Pooled Development Funds Act 1992;
- Trade Practices Act 1974; and
- Relevant anti-money laundering legislation.

In addition, they should be aware of other laws, regulations and precedents which may have a general relevance in investment activities, including those relating to the issues of "Chinese Walls" and "Insider Trading". Members should ensure that appropriate policies and procedures are in place to address these issues.

Members should deal with regulators in an open and co-operative manner and keep them informed of relevant matters concerning their activities.

8. Investee Relationships

Investor Members recognise that their primary business is building the strength of their investee companies, which will result in the funds under management making long-term capital gains.

Membership implies an active involvement by Investor Members in the companies in which they invest. Any conflicts of interest, or potential conflicts of interest, that are likely to arise as a result of the Investor Member's nominee director attempting to ethically discharge his fiduciary duties as a director must be declared to the relevant parties.

9. Performance Measurement and Reporting

Investor Members must adopt standards for measuring and reporting investment performance that conform with the Valuation Guidelines adopted by the Association or FAS 157. The Valuation Guidelines include, but are not limited to, providing clear and fair statements regarding:

- exactly what is being measured;
- the method or process which is used to provide the measurement;
- the relevant time period for the measurement; and
- reasonable assumptions in projecting future performance.

10. Industry Surveys

Objective measurement of the industry is the only credible way to justify the performance of private equity and venture capital as an asset class. The perception of private equity and venture capital as an asset class is of vital importance to the industry, at both a wholesale and retail level.

In order to obtain objective measurement of the performance of the industry, the Association (or another entity on behalf of the Association) will distribute performance surveys to Members. Members, as a condition of Membership, are required to complete these performance surveys.

The Council may grant an exemption from the survey completion requirement in extenuating circumstances. For clarity, inconvenience or the costs associated with survey completion will not constitute grounds for exemption.

11. Advertising

Members must ensure that in placing advertisements for their services or products that they:

(a) comply with regulatory requirements and meet professional and ethical standards;

(b) can demonstrate that claims made within advertisements are fair and reasonable;

(c) clearly identify any historical performance information with appropriate disclaimers; and

(d) clearly define any assumptions in predicting future performance.

12. Media Comment

(a) Members should exercise care when talking to members of the media, and should make every effort to convey an accurate representation of the facts. In situations where journalists misconstrue information supplied by a Member, the Member has a duty to ask the journalist to publish a correction.

(b) Members shall be careful in making general comments about the industry not to cause harm to another Member.

(c) Members shall refer journalists to the Association's CEO for comment on public policy matters.

13. Staff

It is expected that Investor Members will:

(a) remunerate staff in accordance with the requirements of the position;

(b) provide an environment, facilities and equipment conducive to performance of the tasks to be undertaken; and

(c) encourage staff to undertake appropriate training and otherwise facilitate career development of staff.

SEPTEMBER 2011

The AUSTRALIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION Limited

Code of Private Equity Governance

In association with

Blake Dawson

FOREWORD

The Australian private equity (**PE**) industry is a major provider and manager of patient risk capital for Australian businesses. It currently manages capital in the order of $25 billion. Although still a young industry in Australia, PE attracts a relatively large amount of interest from regulators, the government and the financial press. The industry, by its nature, is often involved in high profile public transactions involving well known Australian businesses. However, what is less well known is that the majority of PE investments are made in small and medium-sized Australian businesses, many of which will go on to form part of the bedrock of the future Australian corporate landscape.

AVCAL is publishing this Code of Private Equity Governance (**the Governance Code**) with the twin objectives of making the activities of Australia's PE industry better understood and helping PE fund managers (**General Partners**) discharge their duties to their stakeholders (including investors, regulators and employees of the PE fund's Portfolio Companies).

The Governance Code sets out principles and guidance to inform decisions about how PE funds and Portfolio Companies might be better governed. It also recognises that good corporate governance is a key element in value creation. Ultimately, whether or not the PE industry is seen as responsible in its governance and successful in the discharge of its duties to various stakeholders will depend on the commitment and efforts of individuals working in the industry. Nonetheless AVCAL expects that this Governance Code will be a useful tool in the hands of those individuals.

The Governance Code has been developed in consultation with a wide range of stakeholders, and with reference to a number of other existing corporate governance guidelines such as the *ASX Corporate Governance Principles and Recommendations* and the *EVCA Corporate Governance Guidelines*. This has been done in order to provide a robust governance framework for the Australian PE industry that incorporates widely accepted governance standards relevant to the Australian PE industry, but which also takes into account important distinctions between private and public markets.

General Partners' primary responsibilities are owed to the investors in their funds (**Limited Partners**); they are first and foremost custodians of their investors' capital. Nevertheless, General Partners make investments in Portfolio Companies and so they owe a responsibility to a range of stakeholders for ensuring that those Portfolio Companies are well governed and comply with statutory and common law duties.

The Governance Code acknowledges and reflects some key aspects of PE investing:

- There are two levels of governance involved in PE investing: the governance of the PE fund itself which focuses on the relationship between the General Partner and the Limited Partners, and the governance of the fund's Portfolio Companies.
- In contrast to their investors and the funds through which they invest, General Partners are active managers. Through the boards of their Portfolio Companies and working closely with their management teams, General Partners strive to assist their Portfolio Companies to become more productive and more profitable.
- The PE industry invests with a view to value creation over the long term. While General Partners work to realise investment gains within the lifespan of the funds, they must have a long-term perspective of value creation and put in place structures which endure beyond their exit from a Portfolio Company.
- The development of appropriate governance structures occurs within the period of PE ownership. Often this begins from a very low starting point, for example, where PE invests in Portfolio Companies that need to build up their governance structures in preparation for their next stage of expansion. Where the exit from a PE investment may take the form of a public listing, those governance structures must be appropriate to support the initial listing and the sustained operation of the Portfolio Company as a stand-alone listed entity.

- The ownership of Portfolio Companies is concentrated. PE funds typically have large stakes in a relatively few number of Portfolio Companies compared to managers of listed equity funds.

The most effective mechanism by which the activities of a General Partner are prescribed and monitored is the investment agreement between the General Partner and the Limited Partners (as manifested, for example, by a limited partnership deed or trust deed). The Governance Code seeks to supplement such documents and to provide external PE industry stakeholders such as regulators, government and the financial press with an appropriate level of assurance that General Partners are responsible stewards of their investors' capital and of their Portfolio Companies' businesses.

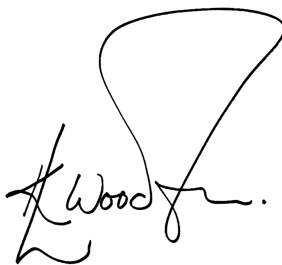
The Governance Code recognises and builds on the various international initiatives aimed at promoting corporate governance best practices in recent years. In particular, the global push towards well-defined environmental, social and governance (**ESG**) policies and practices calls for an active response by the PE industry itself. The introduction of AVCAL's Governance Code is, accordingly, consistent with other initiatives by the international PE community to foster widely accepted governance practices within the PE industry, in a transparent and consultative manner.

The Governance Code is to be read and implemented by AVCAL members in conjunction with the AVCAL Code of Conduct. Implementation of the Governance Code is to take effect from 1 July 2012.

Similar to the *ASX Corporate Governance Principles and Recommendations*, the Governance Code is intended to provide a series of guidelines, rather than prescriptive rules. The application of the guidelines will have to be tailored to the individual circumstances and needs of General Partners, their funds and their Portfolio Companies. If a General Partner considers that any aspect of the Governance Code is inappropriate to its particular circumstances, it has the flexibility not to adopt it. However, AVCAL members who elect not to adopt any aspect of the Governance Code must be in a position to explain why – the "if not, why not" approach.

Corporate governance is a dynamic concept that must necessarily evolve with changing circumstances. AVCAL's challenge is to ensure that the Governance Code remains relevant to the PE industry and AVCAL's members. If you have any suggestions on how the Governance Code may be improved or queries about how the Governance Code operates, please address your comments and questions to the Chief Executive Officer of AVCAL (members@avcal.com.au).

Finally, we would like to thank Blake Dawson, the AVCAL Council and the other parties that have generously contributed their time and insights towards the production of the Governance Code.



Katherine Woodthorpe
Chief Executive, AVCAL
7 September 2011

INTRODUCTION

RELEVANCE OF CORPORATE GOVERNANCE TO THE PRIVATE EQUITY INDUSTRY

The importance of effective corporate governance in the efficient operation of companies is well understood.

"Effective corporate governance structures encourage companies to create value through entrepreneurialism, innovation, development and exploration, and provide accountability and control systems commensurate with the risks involved."[1]

Effective corporate governance structures are as essential to value creation in the PE industry as they are in any other type of industry. Building strong businesses with robust and embedded governance structures and processes creates value for Limited Partners which is realised when Portfolio Companies are divested from the PE fund. Building strong, well governed businesses also helps to develop the reputation of the PE industry as a source of high quality businesses with long-term sustainability.

APPLYING CORPORATE GOVERNANCE PRINCIPLES TO THE PRIVATE EQUITY INDUSTRY

Corporate governance is relevant to the PE industry at both the fund investor level and the Portfolio Company investment level. There are some key characteristics of the PE industry which influence the content of the Governance Code:

- In the context of the fund, a General Partner is often a fiduciary and its primary responsibility is to act in the best interests of the Limited Partners. However, when acting in the capacity of director of a Portfolio Company, an executive of a General Partner must put the interests of that company uppermost.
- The relationship between General Partners and Limited Partners is heavily regulated and monitored via a complex contractual framework.
- Portfolio Companies are generally closely held by the PE fund, usually in conjunction with members of the senior management team of the Portfolio Company.
- In contrast to the investors in a PE fund and the PE fund itself, the General Partners and Portfolio Company management co-owners are not passive investors; the nature of the PE model means they are necessarily active stewards of the Portfolio Companies they own.
- By investment industry standards, PE investments are usually held for a long period of time.

To be effective, corporate governance structures applied to PE funds must recognise and reflect these fundamental characteristics of PE investing.

BACKGROUND TO THE AVCAL GOVERNANCE CODE

The Governance Code has been prepared having regard to the substantial body of law, regulation and literature in the field of corporate governance, as it applies to both the PE industry and more broadly.[2] The appended bibliography sets out the wide range of guidelines and regulations that have been taken into account in developing the Governance Code.

The Governance Code draws and elaborates on the underlying values which shape the way in which General Partners carry on their business:

- ***Responsibility*** for taking into consideration the interests of key stakeholders.
- ***Accountability*** of General Partners and the board and management of Portfolio Companies.
- ***Transparency*** of the PE fund's activities and those of their Portfolio Companies.
- ***Integrity*** in General Partners' dealings with Limited Partners and Portfolio Companies.
- ***Stewardship*** of the funds they manage and of the Portfolio Companies in which they invest.

In issuing the Governance Code, AVCAL aims to promote greater understanding of the PE industry, promote industry transparency, inculcate appropriate industry best practice and provide guidance to our members on these matters.

[1] The ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations with 2010 Amendments*, 2nd Edition, 2011, 3.

[2] Blake Dawson has advised AVCAL in respect of the relevant legal and regulatory background to corporate governance in Australia.

HOW TO APPROACH THE GOVERNANCE CODE

The Governance Code recognises and builds on the various international initiatives designed to promote corporate governance best practices in recent years. These include initiatives by other national industry associations, Limited Partner associations, responsible investment advocacy groups, and public markets stakeholder groups.

The Governance Code does not prescribe how it is to be implemented. Rather, the Governance Code recognises the diverse nature of PE investment activities and the need for General Partners to respond quickly to changing economic and regulatory environments.

Nevertheless, it does establish a set of basic principles that General Partners who are AVCAL members are obliged to adopt and implement (on an "if not, why not" basis). Each principle acts as a touchstone for General Partners to inform their decision-making.

Given the principles-based approach of the Governance Code, it falls to the General Partners to apply the principles in a consistent and effective manner.

The Governance Code deals with governance at the fund level and at the Portfolio Company level. Each of the principles potentially impacts upon the role of the General Partner at both of those levels, and so the Governance Code does not seek to limit the operation of the principles to one or other level.

AVCAL encourages Limited Partners to require that General Partners adopt the Governance Code by incorporating such a requirement into constituent documents of future funds (for example partnership or trust deeds). We encourage General Partners to publicise (for example on their websites) the approach they have adopted in implementing the Governance Code.

It is also recognised that good governance is not restricted to applying the Governance Code alone. These principles should be considered in conjunction with other relevant legal and regulatory requirements governing the fund and its Portfolio Companies.

PRINCIPLES OF THE GOVERNANCE CODE

Principle 1:

Promote and safeguard the interests of the fund's investors, recognising the diverse nature of those interests

Principle 2:

Embed ethical, responsible and rigorous decision-making by General Partners and Portfolio Company boards and management

Principle 3:

Promote effective Portfolio Company board composition and structures

Principle 4:

Respect the interests of stakeholders at both fund and Portfolio Company levels

Principle 5:

Ensure the integrity and utility of reporting by Portfolio Companies to General Partners, Limited Partners and other stakeholders (*Private Disclosure*)

Principle 6:

Be transparent in dealings with other key stakeholders in Portfolio Companies (*Public Disclosure*)

Principle 7:

Align financial reward with financial performance

THE GOVERNANCE CODE:
PRINCIPLES AND GUIDANCE

Principle 1: Promote and safeguard the interests of the fund's investors, recognising the diverse nature of those interests

BACKGROUND AND GUIDANCE

- This principle recognises that a General Partner is often a fiduciary and its primary responsibility is to act in the best interests of its Limited Partners. Effective stewardship of Limited Partners' capital is the mainstay of this responsibility.
- Limited Partners are drawn from a broad range of investor classes, including wholesale investors such as superannuation (or pension) funds, endowment funds and insurance companies. Limited Partners' interests may, during the life of a PE fund, diverge and potentially conflict with those of other Limited Partners and/or those of the General Partner.
- Fund structures and contractual terms should align the interests of General Partners with those of the Limited Partners. In preparing fund documents and throughout the life of a PE fund, General Partners should frame their contractual obligations and put in place structures and processes which:
  - are consistent with their primary responsibility to act in the best interests of their Limited Partners; and
  - deal transparently and fairly with conflicts of interest.
- General Partners should give particular attention to governance mechanisms (such as Limited Partner advisory committees), annual general meetings and to the scope and timeliness of disclosures to their Limited Partners.

Principle 2: Embed ethical, responsible and rigorous decision-making by General Partners and Portfolio Company boards and management

BACKGROUND AND GUIDANCE

- This principle draws on AVCAL's activities in encouraging greater implementation of environmental, social and governance (**ESG**) policies and practices in PE investment activities. It also reflects global trends, driven largely by institutional investors, in support of integration of ESG policies and practices in PE investing. AVCAL has taken on a leadership role among its peers globally, working with the United Nations-backed Principles for Responsible Investment and a working group of global PE associations to achieve consistent approaches to ESG around the world.
- This principle must be understood in the following context:
  - General Partners work towards achieving an optimal capital structure for each Portfolio Company and its shareholders and developing appropriate growth strategies, in each case for building value in Portfolio Companies.
  - PE investing requires General Partners to assume and manage financial and business risks, not to avoid them. In discharging their responsibilities, General Partners often adopt a risk-return profile which might differ significantly from that of most public companies.
- AVCAL encourages General Partners to develop responsible investment policies and practices that define their approach to managing and reporting on ESG factors within their Portfolio Companies.
- General Partners are encouraged to disclose publicly (for example by publishing on their website) the ESG policies and practices which they have developed or adopted in the operation of their Portfolio Companies.
- AVCAL's Council encourages General Partners to consider becoming signatories to the United Nations-backed Principles for Responsible Investing (PRI).

Principle 3: Promote effective Portfolio Company board composition and structures

BACKGROUND AND GUIDANCE

- The directors and officers of Australian-incorporated Portfolio Companies are subject to the same statutory and common law duties that apply to directors and officers of all incorporated Australian companies.
- Portfolio Company boards should be:
  - composed of appropriately qualified, competent directors who have the resources to perform their roles. In some circumstances, this may require appointing one or more external directors with specialist industry expertise;
  - sufficiently familiar with the current and emerging issues of the Portfolio Company's business to provide strategic guidance to the company and effectively supervise and review the performance of management, including oversight of risk management; and
  - flexible enough to enable timely decision-making and quick responses to changing circumstances.
- While the interests of the Portfolio Company will generally be aligned with the interests of the fund and the Limited Partners, this may not always be the case. An individual appointed to a Portfolio Company board by a General Partner will, like any director, have an obligation to act in the best interests of the Portfolio Company.

Principle 4: Respect the interests of stakeholders at both fund and Portfolio Company levels

BACKGROUND AND GUIDANCE

- The primary business of General Partners is to invest in appropriate Portfolio Companies, support and, where appropriate, develop and grow the businesses of those companies, and ultimately realise the value in those companies in a manner that provides the best returns to Limited Partners. This cannot be done consistently without respecting the interests of key stakeholders in the Portfolio Companies.
- General Partners should therefore actively seek to identify:
  - key stakeholders at both the fund and the Portfolio Company levels whose relationships with the Portfolio Company are material to its long-term success (such as employees, suppliers, and customers);
  - those stakeholders' legitimate interests; and
  - the manner in which those interests may be affected by the business operations of the Portfolio Company and the investment decisions of the General Partner and its representatives.

THE GOVERNANCE CODE: PRINCIPLES AND GUIDANCE

Principle 5: Ensure the integrity and utility of reporting by Portfolio Companies to General Partners, Limited Partners and other stakeholders (Private Disclosure)

BACKGROUND AND GUIDANCE

- Australian-incorporated Portfolio Companies are subject to the financial and administrative public reporting obligations imposed by the Corporations Act. General Partners who are AVCAL members are also required to comply with the International Private Equity and Venture Capital Valuation Guidelines (relating to the valuation of investments) and AVCAL's reporting guidelines.
- In addition, in order to fulfil their own duties to stakeholders, Limited Partners require extensive reporting from General Partners, including reporting on risks faced by individual Portfolio Companies and aggregated risks across the fund. Typically these reporting obligations are included in the PE fund's constituent documents.
- General Partners should embed effective reporting structures within Portfolio Companies to ensure management and boards receive the information which they require to report to General Partners, so that General Partners can in turn effectively discharge their reporting obligations to Limited Partners.

Principle 6: Be transparent in dealings with other key stakeholders in Portfolio Companies (Public Disclosure)

BACKGROUND AND GUIDANCE

- The approach to this principle is aligned with similar initiatives across the world and reflects some of their language, including for example, the Walker Guidelines in the UK.[3]
- A General Partner should ensure that the management of a Portfolio Company communicates in a timely and effective manner with its employees, in particular at the time of a strategic initiative or a transaction involving the Portfolio Company, as soon as confidentiality constraints permit.
- General Partners should publish and regularly update their websites to communicate the following information:
  - a description of the General Partner's history and investment approach, including investment holding periods, where possible illustrated with case studies;
  - information and biographies of the senior partners of the General Partner; and
  - a description of Portfolio Companies in the General Partner's portfolio.
- In the event that a Portfolio Company encounters difficulties that leave its equity investment with little or no value, the General Partner should be attentive not only to the full discharge of its fiduciary obligations to the Limited Partners but also to its responsibilities to other key stakeholders.

[3] Walker Working Group, *Guidelines for Disclosure and Transparency in Private Equity*, 2007 at www.walker-gmg.co.uk

Principle 7: Align financial reward with financial performance

BACKGROUND AND GUIDANCE

- General Partners are charged with the stewardship of Limited Partners' capital and are obliged to act in the best interests of Limited Partners. PE funds should be established and governed in a way which is consistent with this responsibility (see Principle 1). In particular:
  - fund structures and constituent documents should align the interests of General Partners with those of their Limited Partners; and
  - contractual arrangements with management co-owners at Portfolio Company level should, to the maximum extent possible, align their interests with those of Limited Partners.
- Contractual terms dealing with General Partner remuneration should be clearly drafted, readily understandable by Limited Partners and certain as to their application.
- General Partners may wish to refer to the Institutional Limited Partners Association's Private Equity Principles for a detailed discussion on the alignment of General Partner and Limited Partner interests.

GLOSSARY

Corporations Act
The Corporations Act 2001 (*Cth*).

ESG or Environmental, Social and Governance
ESG or environmental, social and governance factors are typically non-financial risks and opportunities that can affect the performance of PE investments.

General Partner
The managers of the PE fund are typically described as "general partners" in the fund because they manage the fund and are often liable for its debts and obligations. The term should be read to include all managers of PE funds, whatever the legal structure of the fund or manager.

Limited Partner
The investors of the PE fund are typically described as "limited partners" in the fund as their liability for debts and obligations of the fund is limited to the amount of their investment in the fund. The term should be read to include all investors into PE funds, whatever the legal structure of the fund or limited partner.

Portfolio Company
An investee company of the PE fund. The terms should be read to include all investment vehicles of PE funds, whatever the legal structure of the investment vehicle.

Private Equity (PE)
PE refers to investment by fixed term funds in unlisted businesses, with the aim of building and improving these businesses over a period of years and then selling them at an increased value. PE is frequently categorised according to the stage of development of the company being invested in, for example: seed investment, early stage investment, expansion stage investment, and buyout investment.

PRI
The United Nations-backed Principles for Responsible Investment is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact to identify and act on the common ground between the goals of institutional investors and the sustainable development objectives of the United Nations.
They reflect the view that ESG factors can affect the performance of investment portfolios and therefore must be given appropriate consideration by investors if they are to fulfil their fiduciary (or equivalent) duty.
They provide a voluntary framework by which investors can incorporate ESG factors into their decision-making and ownership practices and so better align their objectives with those of society at large.

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| avcal.com.au |

Level 41, Gateway Building
1 Macquarie Place
Sydney NSW 2000
Tel + 61 2 8243 7000

Appendix 3:
AVCAL member list

Accretion Investment Management
Addisons
ADVANCY
Advent Private Capital
AIG
Allegro Funds
Allen & Overy
Allens
Allier Capital
Anacacia Capital
Anchorage Capital Partners
ANU Connect Ventures
ANZ Structured and Acquisition Finance
Aon Risk Solutions
Apollan Investments
Archer Capital
Arnold Bloch Leibler
Arowana International
ASB Bank NZ
ASF Capital
Ashurst
Atlas Advisers
ATP Innovations
Australian Executor Trustees
AustralianSuper
Bain & Company
Bain Capital Asia
Baker & McKenzie
Bartier Perry
BDO Corporate Finance
Bioscience Managers
Blackbird Ventures
Blue Sky Private Equity
Blue Sky Venture Capital
Brandon Capital Partners
Cambridge Associates
Campbell Lutyens
Capbridge
Cbus
CFO Strategic
Challenger Financial Services Group
CHAMP Private Equity
CHAMP Ventures
Citco Fund Services
CitiGroup
Clayton Utz
Clifford Chance
Coller Capital
Commonwealth Bank of Australia
Commonwealth Superannuation Corporation
Continuity Capital Partners
Cornwall Stodart
Corporate Venture Capital
Corrs Chambers Westgarth
Credit Agricole CIB
Credit Suisse
Crescent Capital Partners
Crowe Horwath Corporate Finance
CSIRO
Deakin Commercial
Deloitte Corporate Finance
Deutsche Bank
DibbsBarker
DLA Piper
East West Perpetual Group
Emil Ford & Co
Equity Partners
EY
Future Asset Management International
GBS Venture Partners
GE Capital
Gerson Lehrman Group
Gilbert + Tobin
Goldman Sachs
Grant Thornton
Greenstone Partners Private Capital
Greenwoods & Herbert Smith Freehills
Hall & Wilcox Lawyers
Harbert Management Corporation
HarbourVest Partners
Hawkesbridge Capital
Helmsman Capital
HESTA
HLB Mann Judd Corporate
Holding Redlich Lawyers
HOSTPLUS
HRL Morrison & Co
IFM Investors
Intermediate Capital Managers
InterRISK Investec
IQX
Ironbridge Capital
Ironshore
J.P. Morgan
Johnson Winter & Slattery
Kain Corporate + Commercial Lawyers
Kestrel Capital
King & Wood Mallesons
Kirribilli Funds Management
KKR
KPMG
L.E.K. Consulting
Livingbridge
LGT Capital Partners
Lucsan Capital
Macquarie Group Services
Marsh
Mayne Wetherell
McGrathNicol
Mercury Capital
Merrill Lynch Markets
Miles Advisory Partners
Minter Ellison Lawyers
Mizuho Corporate Bank
MLC Investment Management
Moelis & Co
Morgan Stanley
MPR Group
MVision Private Equity Advisers
National Australia Bank
Navis Capital Partners
New South Capital

Next Capital
Ngai Tahu Holdings Corporation
Nomura
Norton Rose Fulbright
One Investment Group
OneVentures
Onward Business Consultants
OPTrust
Pacific Equity Partners
Pacific Road Capital Management
Partners for Growth
Partners Group
People One
Perpetual
Pitcher Partners
PKF Corporate Finance
Pomona
Principle Advisory Services
PwC
Quadrant Private Equity
Rabobank
Record Point
Resource Capital Funds Management
Reunion Capital Partners
Risk Capital Advisors
rks consultants
RMB Capital Partners
ROC Partners
Rothschild
Russell McVeagh
S&P Capital IQ
Scale Investors
Southern Cross Venture Partners
SparesBox.com.au
Sparke Helmore
Squire Patton Boggs
Stafford Private Equity & Infrastructure
Sumitomo Mitsui Banking Corporation
SunSuper
Talbot Sayer Lawyers
Talu Ventures
Tanarra Capital
TATA Capital
Terra Rossa Capital
The Riverside Company
Thomson Geer
Top Tier Capital
Torrens Capital
Trident Debt Capital Advisors
UBS Investment Bank
Vantage Asset Management
Westpac Banking Corporation
Wilshire
Wolseley Private Equity
Yuuwa Capital
Z5 Venture Capital

As of 19 October 2015

Appendix 4:

The Economic Contribution of Private Equity in Australia

Deloitte Access Economics

The economic contribution of private equity in Australia

The Australian Private Equity and Venture Capital Association Limited (AVCAL)

March 2013

Deloitte.

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Glossary

ABS	Australian Bureau of Statistics
ADS	Australian Drilling Services
ANZSIC	Australian and New Zealand Standard Industrial Classification
ASX	Australian Stock Exchange
AVCAL	The Australian Private Equity and Venture Capital Association Limited
CAGR	Compound Annual Growth Rate
CAPEX	Capital Expenditure
CEO	Chief Executive Officer
CFO	Chief Financial Officer
COO	Chief Operating Officer
CSG	Coal Seam Gas
DAE	Deloitte Access Economics
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation
EIU	Economist Intelligence Unit
EY	Ernst & Young
FTE	Full-time equivalent
FY	Financial Year
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GICS	Global Industry Classification Standard
GOS	Gross Operating Surplus
ICT	Information and Communications Technology
IPO	Initial Public Offering
LBO	Leveraged Buyout
MBI	Management Buy-In
MBO	Management Buyout
PE	Private Equity
PTP	Public to Private
PWC	PricewaterhouseCoopers
R&D	Research and Development
RBA	Reserve Bank of Australia
ROA	Return on Assets
VC	Venture Capital

Executive Summary

The private equity (PE) business model is well established in Australia, as it is overseas. Above all, PE brings a high degree of flexibility and urgency to running firms that may not be possible under other ownership structures. While this can provide advantages for investors in PE firms, more flexible businesses can also be good for the broader economy, enabling innovation and building resilience in the face of change.

The proof of the benefits of the PE model lies in performance of the firms acquired and transformed by PE management. The Australian Bureau of Statistics (ABS) does not collect the data required to analyse the economic contribution of PE to Australia. The analysis in this report is based on survey data provided by members of The Australian Private Equity and Venture Capital Association Limited (AVCAL). The survey focuses on PE investee firms and the survey responses are representative of the population of PE investee firms.

PE investee firms in Australia turn over an estimated $63.5 billion per year, contributing around $58 billion in total value added and 512,000 full-time equivalent jobs to the economy.[1]

If private equity investee firms were an industry in their own right, their revenue would exceed coal mining or the general insurance industry; and they would directly employ more people than the automotive industry or the banking industry.

The definition of PE investee firms used in this report adopts the ABS demarcation between VC and PE for convenience, including 'early expansion' investee firms in the former group. The ABS estimated there were 346 PE investee firms in Australia in FY2011 (compared with 529 VC investee firms), down from a peak of 420 in FY2008. PE managers provided information for 106 investee firms over the period FY2007 to FY2011 which is used in the private equity impact analysis in Section 4. We further narrow this down to a sample of 49 investee firms providing the 130 annual data points over the period FY2007 to FY2011 used in the economic contribution calculations in Section 5.

Estimates based on the survey indicated that the average PE investee firm in Australia:

- had annual turnover of $195 million;
- paid $42 million in wages, to 827 full-time equivalent (FTE) employees;
- generated $34 million in EBITDA for investors; and
- contributed $77 million in direct value added to the economy.

Under PE ownership, surveyed investee firms experienced revenue growth of 11% CAGR during the first 5 years. These firms also greatly expanded the size of their workforces, at an average rate of 28% a year over 5 years.

Combining these estimates with the ABS data for the number of investee firms indicates PE investee firms in Australia account for a substantial part of the economy, including:

- annual turnover of $63.5 billion;
- direct value added by the firms of $25 billion, plus flow-on effects to other firms in the economy contributing indirect value added of $34 billion; and

[1] Annual average for FY2007 to FY2011

- providing 262,000 direct full-time equivalent (FTE) jobs and another 251,000 jobs indirectly in related firms.

Survey and ABS data show PE investors are involved in a wide range of industries, notably manufacturing & utilities, trade & accommodation and health and other services. PE is under-represented in primary industries and construction, where there can be long lead times before earnings start to flow.

> *PE investee firms play a particularly important role in facilitating change to enable industries and businesses to grow, especially in medium-sized firms.*

Around two-thirds of PE investee firms could be classified as medium-sized based on their annual revenue of $10 to $200 million. Of the remaining firms, the majority were large, with annual revenue exceeding $200 million. This weighting differs from listed firms, where large firms are the majority, and the broader economy, where small firms dominate.

Survey returns highlighted the extent to which PE management affected change. PE investment in firms lasts for around 4 years on average. PE majority ownership (>50% of equity) occurred in 70% of investee firms in the surveys. Also:

- new management was introduced in 90% of firms
- operating practices were changed in 85% of firms; and
- additional capital was injected in 70% of firms.

These findings highlight the role of private equity in transforming firms, including e.g.:

- the Easternwell Group, where private equity helped the amalgamation of six specialised mining services firm seeking to reach a critical mass;
- for Bis Industries, a provider of logistics to the resources sector, PE investors helped improve operational and capital efficiency;
- an MBO of 3m's Asia-Pacific pharmaceuticals resulted in private equity revitalising the business under the name of iNova Pharmaceuticals; and
- private equity helped turn around the fortunes of Lomb Scientific.

Respondents provided information on debt and assets for a small subset of firms in the sample that showed:

- the average return on assets (EBITDA divided by total assets) for the private equity investee firms was, on average, higher than for publicly-listed firms in the IBISWorld database; and
- the average debt to asset ratio for private equity investee firms fell from around 35% in FY2007 to 20% in FY2011, converging to the level of listed firms.

Conclusions

Survey data collected from AVCAL members indicate that, based on the average investee firm, private equity makes a substantial contribution to the Australian economy. Private equity investee firms tend to cluster in specific industry sectors and be of medium size. Under private equity management, the firms are transformed, experiencing increasing revenue and expanding their workforces.

Deloitte Access Economics

1 Background

1.1 Aim of the report

The Australian Private Equity and Venture Capital Association (AVCAL) seeks to promote a greater understanding of the importance of private equity (PE) to the Australian economy and to augment the body of evidence on the economic role of private equity, in particular the contribution of private equity investee firms to the economy.

There is a body of international evidence that illustrates the value of private equity to an economy. However, the evidence base for Australia is patchy and mostly predates the Global Financial Crisis (GFC), a period that raised questions about the resilience of the private equity model. Consequently, AVCAL commissioned Deloitte Access Economics (DAE) to develop a methodology for collecting relevant data and analysing it to improve the understanding of the role of private equity in the Australian economy. This report presents the key findings of these endeavours.

Presenting previously unavailable information on the activities of private equity investee firms – including estimates of their economic contribution in Australia and the role played by private equity management in transforming these firms – serves to shed new light on some of the tangible benefits of private equity.

1.2 Defining the scope of private equity

Private equity investment can take various forms. The private equity industry is defined here as the private funds that acquire and manage the investee firms only, although other models exist, e.g. involving superannuation funds and individual investors. Private equity and venture capital (VC) funds generally invest in companies that are considered to have high growth potential. Other investors, such as superannuation funds and individuals, also invest in these companies.

It can be argued that firms or industries that benefit from private equity capital investments, such as healthcare, manufacturing and communications, should also be included. Indeed, it is this broader definition that has more appeal in the context and process of defining the economic contribution of the sector and this report focuses on investee firms in Australia owned by private equity funds.

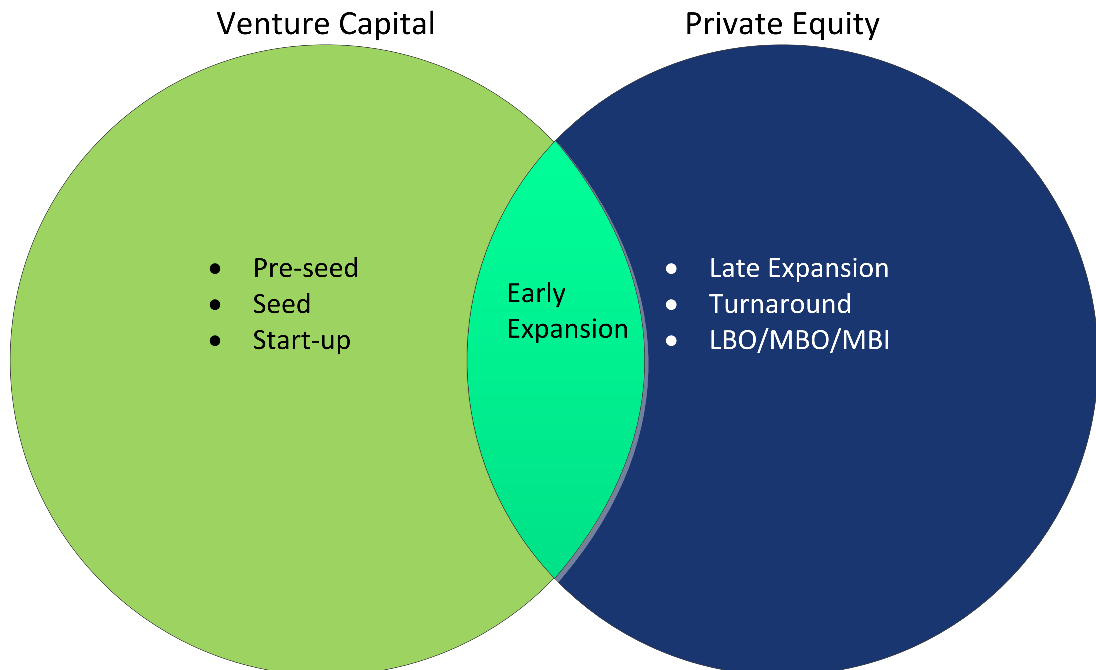
The Australian Bureau of Statistics (ABS) collects data about the activities of the private equity funds, including some incidental information about the firms the funds invest in (see ABS 5678.0 - *Venture Capital and Later Stage Private Equity, Australia*). The ABS categorises investee firms according to the stage of the private equity investment.

> *While VC usually invests in early stage firms and PE generally invests in growth/expansion and buyout stages, there are areas of overlap. (AVCAL 2011)*

In the early stages of a venture capital fund's investment, the product is not yet in the market and the investee firm is not fully operational. The boundary between venture capital and the later stage investments that are the subject of this report on private equity is illustrated in Figure 1.1. The VC stages of investment are shaded green and the private equity stages are shaded blue. In this report, the ABS practice of counting investments in

the early stage of expansion as venture capital has been followed, although it may be difficult to distinguish where 'early expansion' ends and 'late expansion' begins in practice.

Figure 1.1: ABS investee firm stages



Source: ABS 5678.0

Consequently, this report deals only with later stage investments, comprising:

- late expansion;
  - typically, the firm's product is in the market and revenue is growing
- turnaround; and
  - a firm is a mature business requiring a turnaround
- LBO/MBO/MBI
  - mature business requiring new ownership, direction, consolidation or sale

The FY2011 ABS survey shows at the end of the 2010-11 financial year there were 875 firms which received private equity/venture capital funding, of which 534 firms were classed as venture capital investments and 341 were considered later-stage private equity investments.

1.3 Approach to quantifying the role of private equity

A wide range of companies in Australia have come under private equity ownership. Private equity ownership has proved to be especially valuable where firms face the need to expand or refocus their operations in what may be fluid economic and commercial conditions. These firms may have an opportunity to develop (e.g. based on a new technology) or need to restructure in a fundamental manner (and would find it more difficult to do so as, say, a listed entity.) Moreover, private equity funds are able to swiftly mobilise management expertise and capital and provide focus and urgency, which is especially useful if the window of opportunity to transform a firm is narrow.

Thus, private equity contributes by adding value to investee firms and providing additional flexibility to the way in which firms are managed. This results in improved productivity for investee firms, with flow-on impacts throughout the economy.

To capture the various dimensions of the contribution of private equity to the Australian economy, it was necessary to:

1. design a data collection tool in consultation with AVCAL to obtain data for the investee firms;
2. collect, validate and analyse the data returned by the survey, including making comparisons at industry level;
3. estimate the value added and employment generated by private equity investee firms, based on the data provided by the private equity managers, to calculate the economic contribution to Australia; and
4. use case studies to illustrate some of the benefits of private equity that are not easy to quantify.

1.4 Contents of the report

This report builds on a scoping report prepared for AVCAL by DAE, some of which is reproduced in the following chapters. For example, Chapter 2 summarises the methodology employed in this report that was developed during the scoping study, with additional material contained in Appendix A.

The data collection task is explained in Chapter 3. Much of the data required for the subsequent analysis were collected from a new survey of AVCAL members and are, therefore, unique. More detail is provided in Appendix C.

Key insights into the way the private equity management transforms investee firms are presented in Chapter 4. Additional information is in Appendix D.

The economic contribution of private equity firms to the Australian economy is the subject of Chapter 5. Estimates of the total contribution and relative contribution to selected industries are provided. Explanation of the calculations can be found in Appendix E.

The report concludes with a review of the key findings of the research project and recommendations for areas of further study that are likely to yield valuable insights into the impact of private equity on the Australian economy.

Figure 1.2: Easternwell Case Study

The initial Easternwell investment by the private equity firm, Ironbridge, involved bringing together three private, independent, specialist, and well-regarded drilling businesses to form a national drilling business called Australian Drilling Solutions (ADS). Each of these three original businesses had complimentary skill sets and resource exposures and, by putting them together, the private equity firm was able to create a national, diversified business.

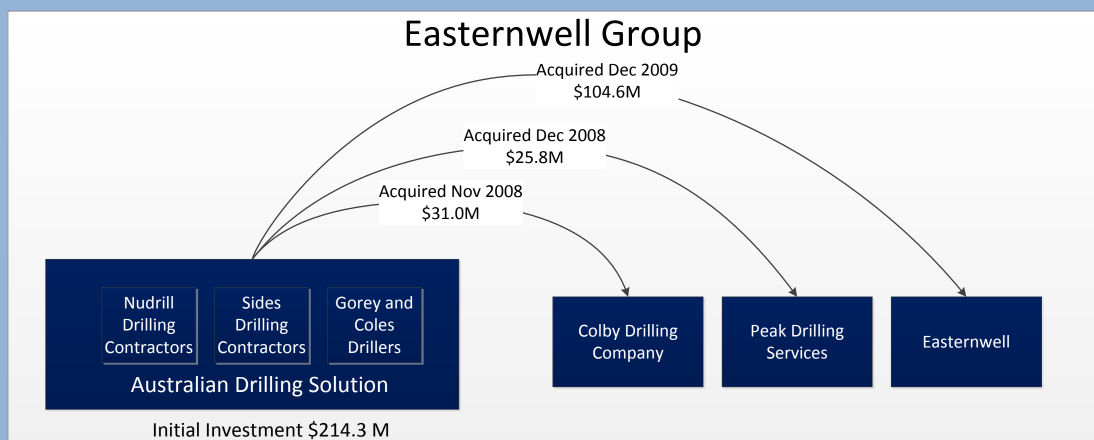
In late 2008, ADS acquired two more businesses in the iron ore drilling market, further enhancing the company's presence in that sector. In December 2009, Easternwell itself was acquired, further diversifying the group into coal seam gas (CSG) and well-servicing operations.

Through the course of 2010 the private equity firm set about integrating the Easternwell and ADS businesses to form the Easternwell Group, through the re-alignment of the business to focus on its two key end markets: Energy & Utilities and Minerals.

Ironbridge led additional investment in health and safety, aiming to create an industry-leading safety culture and practice. Significant investments were also made in new equipment, with over $30 million of new capital expenditure to generate incremental earnings.

The wide geographic spread of the businesses brought together meant the private equity firm was also heavily involved in business planning. It worked together with management to put together five-year plans for each of the businesses, establish a national head office and a finance function with appropriate systems and reporting. Initially providing the interim CFO, Ironbridge then hired the initial group CEO and CFO, and executed and resourced the Group's roll-up acquisition strategy, looking at over 20 opportunities in the course of this investment, and settling six acquisitions (see Figure 1.3)

Figure 1.3: Easternwell Group



Source: Ironbridge

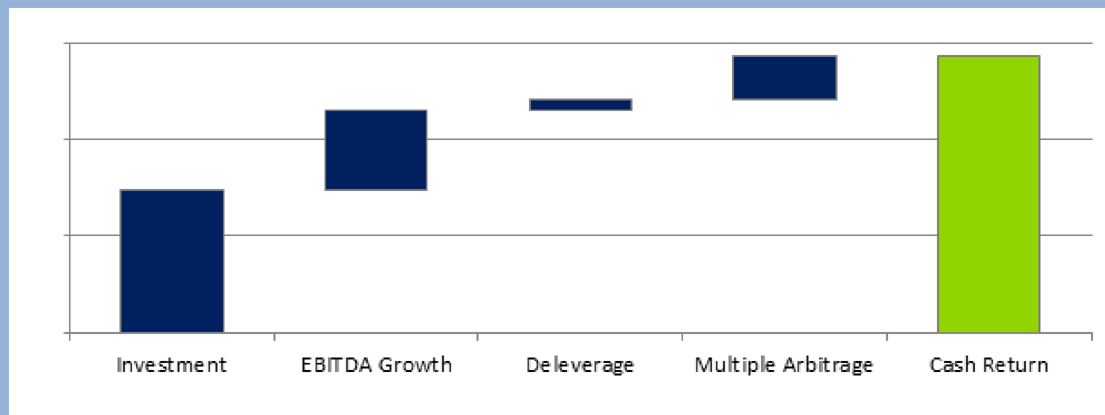
Each of the vendor Managing Directors remained within the Easternwell Group, continuing to run their businesses day-to-day. In order to align interests it was a condition that each vendor rolled a significant portion of their proceeds following acquisition into the Group. For the older vendors the involvement of private equity helped them establish a succession plan while, at the same time, also providing the necessary capital for further growth.

Throughout 2010, a number of unsolicited inbound inquiries to acquire either some or part of the Group were received from local and offshore parties. The private equity firm set out to run a dual-track trade sale/IPO in early 2011.

One of the parties that made an initial approach, Transfield Services, was keen to build a strong presence in the oil and gas market but wanted to avoid a competitive process. Shortly afterwards it entered into exclusive negotiations, eventually acquiring Easternwell in December 2010.

The private equity owners provided a disciplined acquisition strategy, ensuring that the newly created Easternwell Group was focused on production-related drilling, rather than exploration; and worked closely with management to find the right entry point into the CSG market. In addition, the private equity firm helped the company secure both expansion projects and complementary acquisitions. The drivers of the equity returns from the investment are in Chart 1.1.

Chart 1.1: Drivers of equity return for Easternwell Group



Source: Ironbridge

2 How private equity adds value

International evidence goes some way to supporting the argument that private equity's main contributions to the Australian economy are:

- the direct economic contribution, in value added and employment; and
- a critical role fostering innovation and flexibility for the whole economy

A review of literature relating to private equity reveals that international studies show that Private equity improves the performance of the economy and flexibility of management. However, there is a lack of comparable studies showing how private equity contributes to the broader economy in Australia. The challenge then is to find an approach that has been used abroad that lends itself to being replicated with Australian data.

2.1 International evidence

There have been many papers published on private equity, and numerous papers summarising the state of play of understanding the role of private equity and the impact it has on the economy. Generally, studies of performance and management of private equity firms are favourable towards private equity. For example:

- Bernstein et al. (2010) show industries where private equity funds have invested have significantly higher growth rates of production (+0.9% p.a.) and value added (+1.1% p.a.) than non-private equity industries;
- Bloom et al. (2009) find that private equity-owned firms have strong people management practices and even stronger operational management practices, compared to other firms.
- Wilson et al. (2011) examine private equity performance through the GFC in the UK, finding that private equity-backed buyouts show stronger performance than a matched sample of other private companies and listed firms.

However, studies of the impact of private equity on total employment, wages and transfers of wealth resulting from buyouts are more mixed. An informative discussion of the impact of private equity can be found in *Private Equity and Corporate Governance: Retrospect and Prospect* (Wright et al 2009), summarised in Table 2.1.

Table 2.1: Summary of evidence regarding private equity buyouts

Themes	Evidence
What are the short-term and medium-term performance gains from PE buyouts?	Short- to medium-term gains in accounting performance, efficiency (productivity and cost reductions), and entrepreneurial actions (e.g., new product and market development; patent citations and better use of R&D).
What is the role of active investors and other governance mechanisms?	Active, experienced, and specialised PE investors and management equity ownership especially important in generating performance gains.
Are there transfers of wealth to/from employees after PE buyouts?	Initial reduction in employment followed by subsequent increases in employment, especially in Management Buyouts (MBOs); wage effects less positive especially for Management Buy-ins (MBIs).
Are there transfers of wealth to/from shareholders after PE buyouts?	Debate about the role of insider information, but managers' perceived undervaluation important in recent public to private (PTP) buyouts.
Do gains persist from PE buyouts over time?	Accounting and market performance gains most notable over 3-5 years for most firms. IPOs are a special exit case, but performance differences with non-PE firms persist although at a declining rate. In the short term, the benefits appear clear to outgoing owners and to the new owners and management while in the longer term the benefits are less clear. While non-financial stakeholders argue that other stakeholders suffer in the short and long term, the evidence to support this view is at best mixed.
Does the national institutional context influence PE buyouts?	Most previous research conducted in the US and UK. Compared with these two governance environments elsewhere there are concerns over the sources of deals, less positive entrepreneurial attitudes to doing PE buyouts, less favourable infrastructure to do deals and availability of exit markets. More positive attitudes are emerging elsewhere, but at a variable rate.

Source: Wright et. al. (2009)

2.2 Australian evidence

Australian analysis of the impacts of private equity on businesses and economy-wide outcomes is limited and primarily qualitative and survey based. Despite gaps in the Australian evidence base, it is possible to ascertain a number of key themes which characterise the Australian studies. These themes are similar to those highlighted in international studies (see Appendix A).[2]

2.2.1 Australian examples of estimating private equity effects

Anecdotal analysis of the beneficial characteristics of private equity as a form of financing for business is discussed widely. For example, Parkinson (2007) noted that private equity investment assisted three firms, particularly through providing a higher level of financial

[2] Analysis of the impacts of venture capital, particularly on corporate governance of VC-backed companies in Australia, and the impacts of the Australian Governments Innovation Investment Fund are outside the scope of this study.

expertise and improved management styles. Jones (2007) discusses the benefits of private equity financing in assisting turnarounds, workouts and insolvencies, by increasing available capital and improving corporate structures.

Methodology

Surveys and case studies are a common means for distinguishing the effects of private equity in Australia. Utilised by Ernst & Young (EY), the Economist Intelligence Unit (EIU) and PricewaterhouseCoopers (PwC) Australia this type of analysis has been used to determine strengths of the private equity-style business model (EY, 2008), the impact of private equity on Australian business from the perspective of key executives (EIU, 2008) and the economic impact of private equity and venture capital in Australia (PwC, 2006).

A number of studies have outlined how private equity leads to better financial or other economic outcomes, including that private equity ownership and innovation are positively related. It is important to note that many of these studies were undertaken prior to the GFC. For example Ernst & Young (2008) notes that analysis of private equity firm exits was undertaken when the market in both Australia and globally was very strong which may have contributed to higher valuations. Similarly, the selection of investee companies by private equity managers may have contributed to the stronger innovation and R&D results of private equity firms relative to other firms. These factors need to be controlled for in any analysis of the effects of private equity.

Evidence

Ernst & Young (2008) found that the impact of management and governance practices in private equity investee firms led to stronger financial performance. The study analysed 13 exits in the Australian market during 2007, and found that private equity increased EBITDA at 36% CAGR, which was nearly five times the CAGR for publicly listed companies. Jones (2007) noted that active assistance and governance, in the form of active partnership with existing management led to positive outcomes for firms facing insolvency. Results from the EIU (2007) survey also support the view that good governance leads to better outcomes, as many Australian executives felt that streamlined decision making was a key benefit of private equity ownership, with almost as many citing clarity of focus and objectives as positives of private equity ownership.

Almost three quarters of executives surveyed by the EIU (2007) believed that private equity was positive for Australian businesses as it compelled firms to become more efficient, and increase their productivity. This view applied not only to private equity firms themselves, but across all Australian firms. The PwC (2006) report noted that technological and R&D commercialisation is a primary benefit for private equity funded companies. Around three quarters of the companies surveyed launched a new product within the year preceding the survey in contrast to 27% prior to receiving private equity funding.

The key findings from the Australian studies are outlined in Table 2.2.

Table 2.2: Summary of findings and implications of Australian evidence

Themes	Findings and implications for future study
Management	Australian case study evidence of the role of management style and governance provides useful insights but warrants further analysis of samples representing the broader private equity industry. This will assist with understanding how the operational management practise effect firms outcomes and in particular the impacts of this for firm profitability.

Productivity	Australian evidence suggests productivity is important in improving private equity firm performance. Creating a proxy for productivity would assist with estimating the full effects of productivity on firm outcomes, and the flow on economic impact of this for the Australian economy.
Innovation and R&D	Australia evidence has outlined that private equity firms have a higher level of innovation and R&D outcomes. Quantitative analysis could determine the full extent of these impacts for individual firms and the economic impacts of this on the Australian economy.

Source: Various, including Parkinson (2007), Jones (2007), EY (2008), PwC (2006) and EIU (2007)

Figure 2.1: Bis Industries Case Study

Bis Industries is a provider of specialist logistics to the resources sector in Australia. It was purchased along with Cleanaway in 2006 by funds advised by a global investment firm, Kohlberg Kravis Roberts. With Australia being a resilient and growing economy, and with attractive opportunities in the resources sector, the private equity investors saw substantial potential and growth in Bis Cleanaway Ltd. The Cleanaway business was later sold and Bis Industries was consolidated into its current form.

From the beginning, Bis Industries' management team and the private equity investors worked to focus on organic growth through contracts with new customers and mine sites. They also sought to improve the performance of existing contracts and grow through the acquisition of other firms.

Bis Industries' management team invited the private equity investors to identify and implement operational improvements and capital efficiency. This work included developing a strategic sourcing capability and standardising equipment maintenance procedures across sites.

Taking truck maintenance as an example, the Bis Industries management team worked with the private equity team to develop, implement and track a standardised maintenance program. The focus of the program centred on effective planned and preventive truck maintenance to reduce down-time through equipment breakdowns. Through their joint efforts, truck reliability improved by almost 60%.

The private equity investors supported the building of the business by investing over A$600 million to drive organic contract growth and make a number of acquisitions including Allied Plant Services in 2007 and the Gulf Group in 2010.

Throughout this growth, Bis Industries continued to build upon its safety program and with it 'Zero Harm', i.e. zero injuries, zero environmental and zero equipment damage. From FY2005 through FY2011, Bis has improved upon all the key safety metrics. These include measurements such as Total Recordable Injury Frequency Rate and the Lost Time Injury Frequency Rate.

In terms of environmental credentials, Bis Industries is focusing on fuel efficiency by decreasing idling time, improving driver efficiency, enhancing equipment usage and increasing load utilisation. This is designed to improve the company's environmental performance while also benefitting the bottom line.

Bis Industries now has more than 100 long-term contracts Australia-wide, and around 2,000 employees across six states and territories, up from 1,200 at the time of investment. Six years after the initial investment, Bis Industries and its management team continue to build new businesses while ensuring that existing operational initiatives generate sustainable results.

Source: Kohlberg Kravis Roberts

3 The survey of private equity investee firms

Private equity fund managers regularly provide a range of financial information about the firms they acquire to their investors. AVCAL collects these data and other information from its members. However, the range of data required to assess the economic performance of private equity investee firms has not been systematically recorded in Australia. Consequently, AVCAL's members were invited to participate in a new survey.

NB The relatively small sample size in the earlier half of the sample period should be taken into account when interpreting the results in this chapter.

3.1 The nature of the survey

AVCAL asked private equity managers to complete an electronic survey requesting information for each investee firm in their portfolios. The questions related to investments made since FY2000 for which at least three years of data are available.[3] The private equity managers were encouraged to report the data for *all* eligible firms to guard against selection bias.

The information requested about the investee firms fell into three broad categories:

1. basic information about the investee company;
    - the length of the private equity fund involvement in the firm, i.e., when the stake in the firm was acquired and the duration of the private equity investment in the firm;
    - the ownership share acquired;
    - the industry in which the investee firm primarily operates;
2. changes made after acquisition by the private equity funds; and
    - changes to management, practices or capital structure;
3. financial information;
    - key operational data which includes revenue, wages and other costs, earnings and profit, employment, and total assets and net debt;
    - additional data on activities undertaken outside Australia, depreciation and amortisation, interest and financial costs, tax, research and development expenditure, capital expenditure and government subsidies (where applicable).

3.2 Survey responses

Responses were received from private equity managers responsible for around 70% of funds under management in Australia.

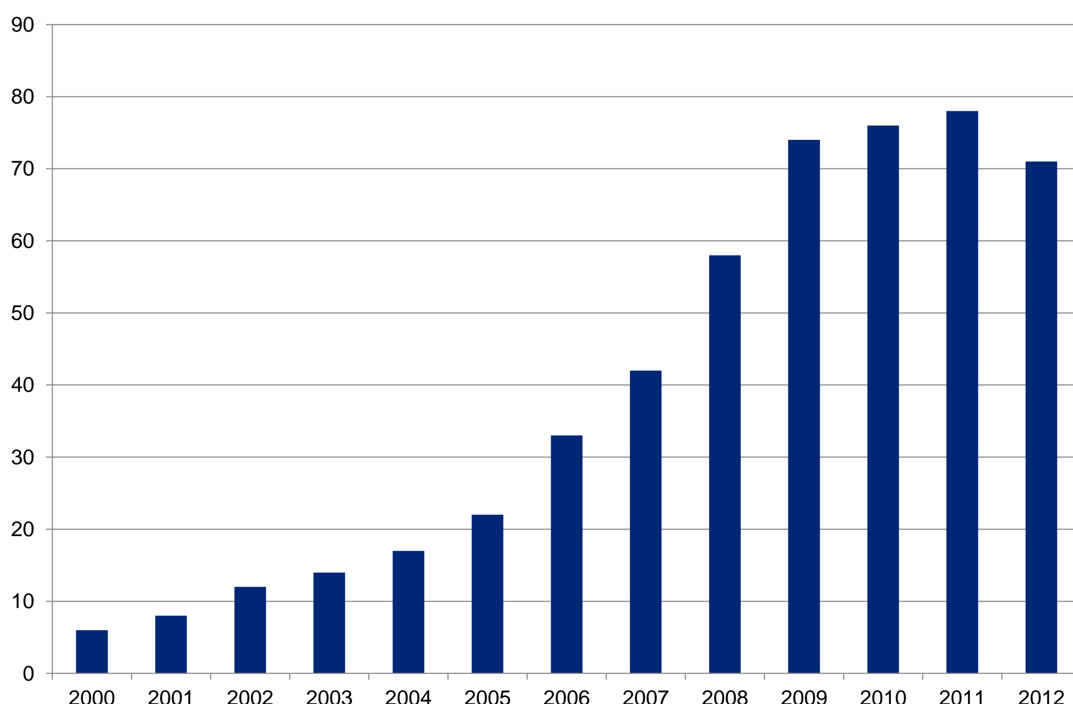
[3] The investee firms were de-identified in the returns provided to DAE to ensure confidentiality.

3.2.1 Number of responses

Responses were received for 116 firms, reduced to 106 after adjusting for duplication and foreign-based investee firms.[4] There was also a lot of variation in the number of individual firm responses across financial years and metrics. (Not all firms were active throughout the period FY2000 to FY2012, so a smaller sample of 49 firms that were all active in the same year was used to estimate private equity's economic contribution in Australia in Chapter 5.[5])

The breakdown of the number of responses for each financial year is presented below in Chart 3.1. The richest data were for the years from FY2007 to FY2011, consequently much of the following analysis focuses on this five-year period. Reporting for FY2012 had not been completed when the survey was out in the field.

Chart 3.1: Number of firm responses, by year



Source: AVCAL, DAE

Additional information on the data requested and data-gathering tool used for reporting the data can be found in Appendix C and Appendix D.

[4] Of the 116 firms, 2 firms were duplicated and 8 firms were based overseas. These were excluded, leaving 106 domestic investee firms in the initial sample.

[5] The reference year chosen was FY2009, to maximise the sample size and to align the data with the most up to date ABS benchmarks.

3.2.2 Financial characteristics of private equity investee firms

Table 3.1 presents selected data from the sample of private equity investee firms.

Table 3.1: Financial Characteristics of private equity investee firms

Financial Year	Average Revenue ($M)	Average EBITDA ($M)	Average Employment ($M)
2001	132	16	750
2002	239	23	1555
2003	224	27	1680
2004	331	41	357
2005	230	35	355
2006	201	20	557
2007	259	41	780
2008	225	37	970
2009	224	35	881
2010	184	31	874
2011	168	32	684

Source: DAE, AVCAL

Revenue

Broadly speaking, the revenue of the average private equity investee firm was larger before the GFC. The revenue of private equity investee firms averaged between $130 million and $330 million between FY2001 and FY2011 (Table 3.1). The apparent decline observed towards the end of the period reflects that private equity funds were investing in smaller firms, on average, during this period, while tougher economic conditions may also have crimped the revenue of funds' existing investments.

Firm size

Size is a factor that potentially can influence firm performance; e.g. large firms can take advantage of economies of scale that are not available to smaller firms. Private equity investee firms range in size from small firms to large enterprises; for example, in FY2009 the smallest firm in the sample had annual revenue of $5 million and the largest turned over $1.2 billion. Investee firms can be categorised into different sizes, based on annual revenue.[6,7]

This report defines a small firm as one with annual revenue below $10m, and a large firm as one with over $200m in revenue; the remainder by default are classed as medium sized. Chart 3.2 shows the distribution of private equity investee firms by size, compared with firms listed on the ASX (from the IBISWorld database) and the totality of firms throughout the economy. More detailed information can be found in Appendix D.

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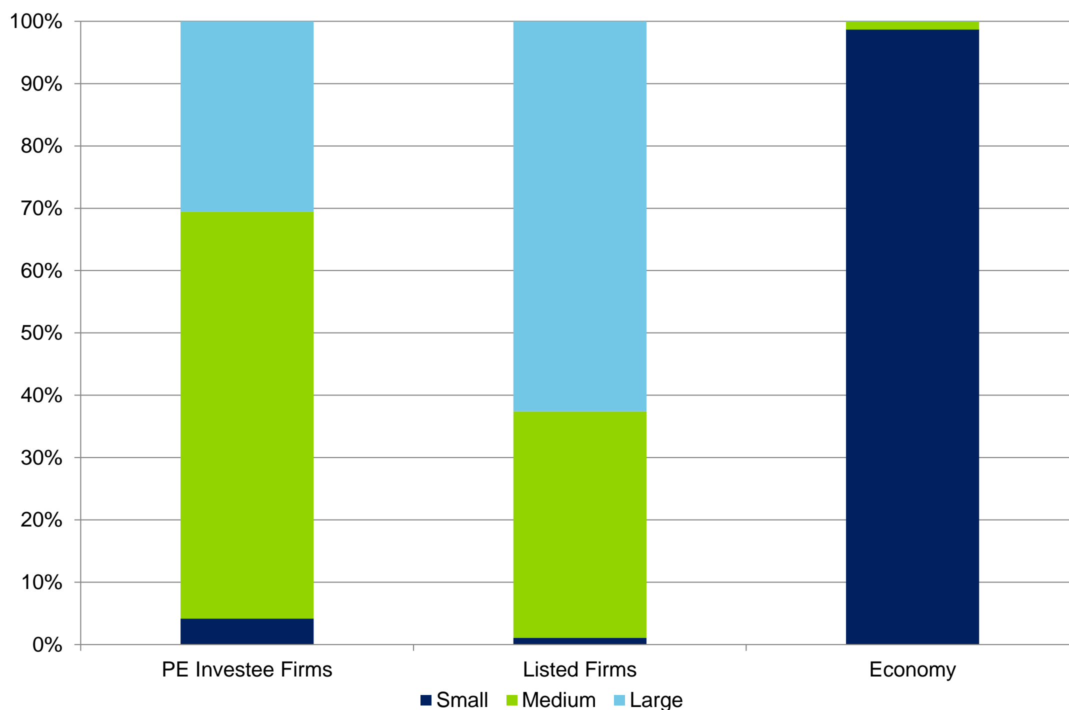
[6] There are a range of measures used by central agencies to categorise firms by size, of which revenue is one. The RBA presents an informative discussion on the topic at http://www.abs.gov.au/websitedbs/d3310114.nsf/4a256353001af3ed4b2562bb00121564/d291d673c4c5aab4ca257a330014dda2/$FILE/RBA%20Small%20Business%20An%20economic%20Overview%202012.pdf

[7] FY2009 used as the bench mark, due to the high number responses and the availability of detailed ABS firm level data for that year. Where data for FY2009 are not available, the revenue in the year closest to FY2009 is used as the benchmark.

This size distribution of firms is presented visually in Chart 3.2, clearly showing private equity investee firms and publicly-listed firms clustered in the medium and large categories, in stark contrast to the distribution across the broader economy.

Chart 3.2: Distribution of firms by revenue (FY2009)



Source: AVCAL, ABS 8165.0, IBISWorld

EBITDA

Private equity investee firms' reported EBITDA per firm fell through the latter half of the sample period. Table 3.1 summarises average EBITDA of the private equity investee firms. The data indicate that private equity managers were investing in smaller firms, and they may also have been affected by the slowdown in the broader economy.

Employment

Table 3.1 also summarises average employment of the private equity investee firms in the sample. The average firm employed between 400 and 1,000 full-time equivalent staff in the latter half of the sample. This lends weight to the impression given by the revenue data: mid-sized companies are the favoured investments of the private equity funds.

Leverage and return on assets

Private equity firms are perceived to be highly leveraged. The *average* leverage in the sample was higher than for an industry-weighted average of listed firms in the middle of the last decade, but subsequently converged to the same level.[8] For example, in FY2009 the average leverage was 30.2%, down from an average of 36.5% in FY2007 (see Chart 3.3).

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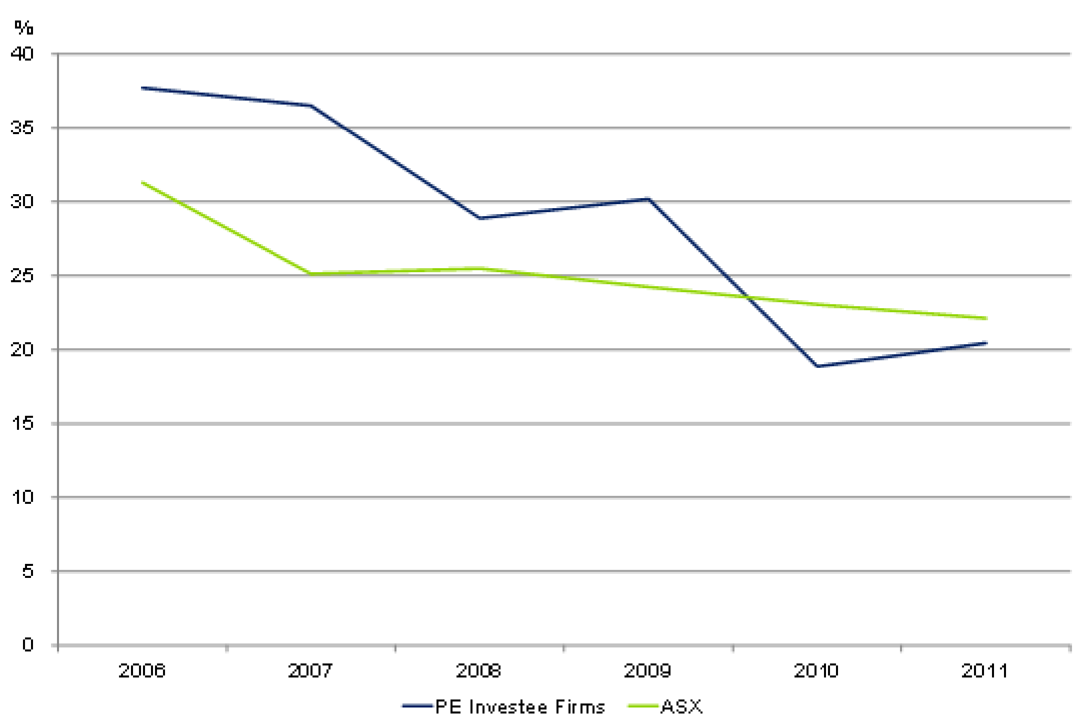
[8] The data presented goes to FY2011 since there were too few reports forFY2012 causing sharp deviation from the trend.

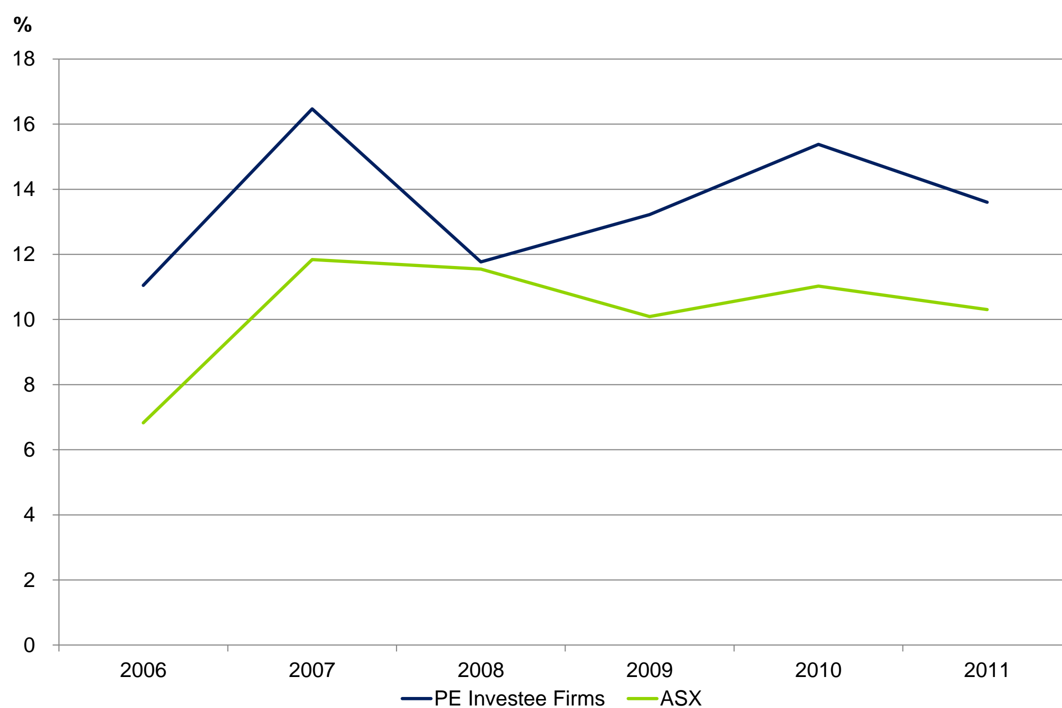
Chart 3.3: Average debt to asset ratio



Source: AVCAL, IBISWorld

The return on assets (ROA), measured by the ratio of EBITDA over total assets, generally was higher for the sample of private equity investee firms than for an average of listed firms (Chart 3.4).

Chart 3.4: Average return on assets



Source: AVCAL, IBISWorld

3.2.3 Industry representation

Private equity investee firms are more prevalent in some industries than others. In part, this reflects restrictions on many funds that prevent them from investing in, for example, mining (but not services to mining) or property development.

The ABS consolidates the 19 ANZSIC industry sectors into seven larger groups for private equity, to facilitate analysis (see Appendix C and ABS 5678.0 - *Venture Capital and Later Stage Private Equity, Australia*). In the AVCAL survey, the largest industry representations came from the Manufacturing & Utilities group and the Trade & Accommodation group. Over time, these two groups were well represented in the survey, although the Transport & Communications group and the Health & Other Services group have become more prominent in recent years. A breakdown of the investee firms into industry categories can be found in the Table 3.2.

Table 3.2: AVCAL and ABS later-stage private equity investees, by industry (five-year average)

Industry	AVCAL sample	ABS population
Agriculture and Mining	4.6%	5.9%
Manufacturing and Utilities	27.9%	29.1%
Construction	2.8%	2.8%
Trade and Accommodation	24.2%	19.4%
Transport and Communications	16.3%	10.1%
Finance and Property	7.7%	18.1%
Health and Other Services	16.6%	14.6%

Source: AVCAL and ABS

The private equity firms captured in the survey sample have an industry distribution that closely resembles the distribution of firms in the total private equity investee population as measured by the ABS – on this basis, it is considered a representative sample.

Figure 3.1: iNova Case Study

iNova Pharmaceuticals (iNova) is a business that was formed following the sale of the operations of 3M Pharmaceuticals in Australasia, Asia and Sub-Saharan Africa by 3M in late 2006. The business owned and marketed a range of prescription and over the counter medicines in therapeutic areas such as weight loss, cardiology, pain, respiratory, throat, and cough.

At the time two Australian private equity firms, Ironbridge and Archer Capital, identified the Asian business opportunity as an attractive one. Being familiar with the business and its management team, they knew that the business was now non-core to its current owner. They saw the opportunity to reinvigorate and invest in 3M Pharmaceuticals to turn it into a well-resourced, standalone regional pharmaceutical company.

Given the size of the potential transaction, the two local private equity firms joined forces in their efforts to secure this asset. Following a competitive sale process, they emerged as the new owners of the re-branded iNova in December 2006. Management invested alongside the two private equity firms and more than 20 senior managers became shareholders.

The strategy for growth and value creation for iNova was formed during due diligence and refined during the first year of ownership. The business had not had a growth mandate prior to private equity ownership.

One of the first steps by Archer Capital and Ironbridge was to change reporting lines, so as to create a co-ordinated regional pharmaceutical-focussed company with its head office located in Sydney.

They hired a very experienced COO to start a business development function and to create a product pipeline. A new CFO was also hired to set the business and its systems up as a standalone, scalable operation.

The size of the prescription sales force was doubled in the first 6 months of ownership - for a business previously operating under a headcount freeze, this was a game-changer for existing product sale growth. Further expansion of iNova's investment in its field sales force continued in subsequent years, and over time additional senior experienced management from the pharmaceutical sector was added.

Under private equity ownership, significant in-house operational expertise was also applied to projects, particularly around the company’s supply chain. This delivered major efficiency gains. This project ultimately saw the production element of iNova's supply chain transitioned to third party contract manufacturers both in Australia and overseas.

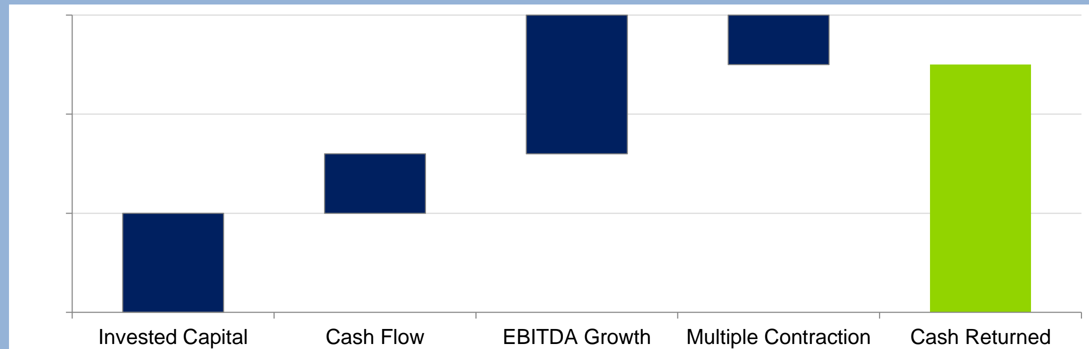
By 2011 iNova’s earnings momentum was strong and the outlook into 2012 and beyond was very positive. Free cash flow had enabled the business to pay down the initial acquisition debt to less than 2x EBITDA. Management had driven the performance of the business very well and had continued both to launch new products with significant new investment and build further on the expanded sales force coverage. The business was on plan with its original earnings forecasts, notwithstanding the strong Australian dollar holding back earnings growth on iNova's export business.

Given all these factors, a decision to consider exit options was taken. While an IPO had always been perceived as an attractive option given the lack of genuine specialty pharmaceutical opportunities for investors on the ASX, the listed equity market was not reliable enough for an IPO exit strategy in 2011.

It was therefore decided that any exit strategy should focus on qualified trade buyers and other private equity buyers. Following the initiation of a sale process, Valeant Pharmaceuticals emerged as the leading bidder and acquired the business in December 2011.

During its five year period of ownership by private equity, iNova achieved strong earnings growth primarily driven by significant investment in new products and in sales and marketing (Chart 3.5). By the time of exit, the business had achieved a 60% increase in annual earnings since the initial private equity investment in 2006.

Chart 3.5: Drivers of equity return for iNova



Source: Ironbridge

4 The impact of private equity ownership

4.1 Ownership stake

Survey responses included information on the private equity share of ownership in investee firms by the fund. The initial private equity stake ranged from 15% to 100%, with an average of 66% and a median of 63%. Private equity interests held a stake of 50% or greater in over 70% of investee firms, but the portion of investee firms effectively controlled by private equity interests is higher than this, as indicated by responses to the management questions (see Table 4.1).[9]

The average length of ownership of the investee firms for those that have been disposed of is 48 months. For the firms which are still held by the private equity investors (as at 30 June 2012), the average holding period is slightly longer at 51 months.

The fact that private equity maintains their interest and exposure to the investee firms for four years on average indicates a substantial commitment to add value to the firm.

4.2 The ingredients of transformation

Respondents were asked about the way in which private equity investment had changed the way the investee firm operated. A summary of the responses is presented in Table 4.1.

Table 4.1: Summary of management questions

	Yes	No	No response
Did you introduce new managers?	79	13	14
Did you change operational practices?	83	9	14
Did you inject additional capital?	64	28	14

Source: AVCAL

In general, the private equity managers implemented a number of critical changes during their tenure. In particular, operational changes were made in 90% of the cases and in over 85% of the cases the private equity managers introduced new managers. In almost 70% of the cases the private equity firms injected new capital into the investee firm.

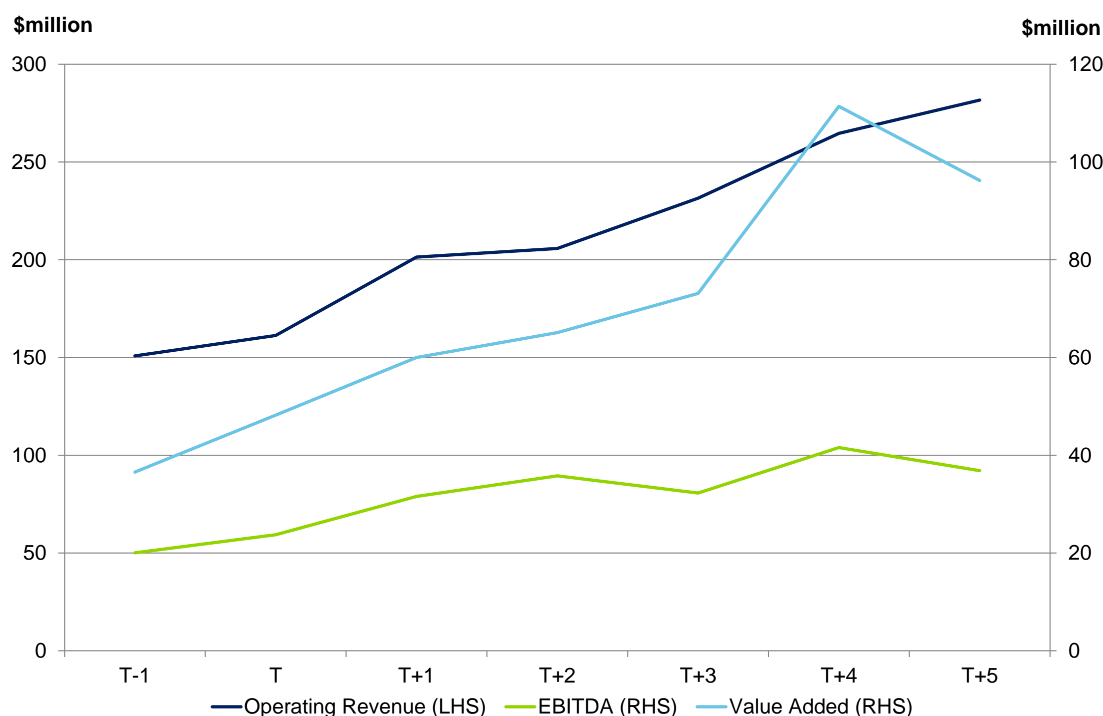
These results suggest that private equity interests had a significant influence on firm performance in the majority of cases. Moreover, the responses indicate that private equity investors add capital and expertise to help the firm grow, and bring a new focus and a sense of urgency to the task, by changing operational practices and management.

[9] The total private equity stake also could be higher if more than one private equity fund invested in the firm. However, if there were any duplicate returns (e.g. same firm, different fund) only one would have been retained in the sample.

4.3 Growing the business

This section compares the performance of the investee firms immediately prior to and during private equity ownership. Chart 4.1 summarises the impact of private equity ownership on operating revenue, EBITDA and value added prior to and during private equity ownership. The chart shows that in the financial year prior to acquisition (period T-1), average operating revenue was $151 million. Revenue rose slightly during the financial year in which private equity interests bought into the firm (T), increased sharply in the first full year of private equity investment (T+1) and continued to grow thereafter, reaching about $282 million by the fifth year of ownership (T+5). The compound annual growth rate (CAGR) of revenue during a typical five-year period of private equity investment was 11.0%.

Chart 4.1: Impact of private equity on selected financial measures



Source: DAE, AVCAL

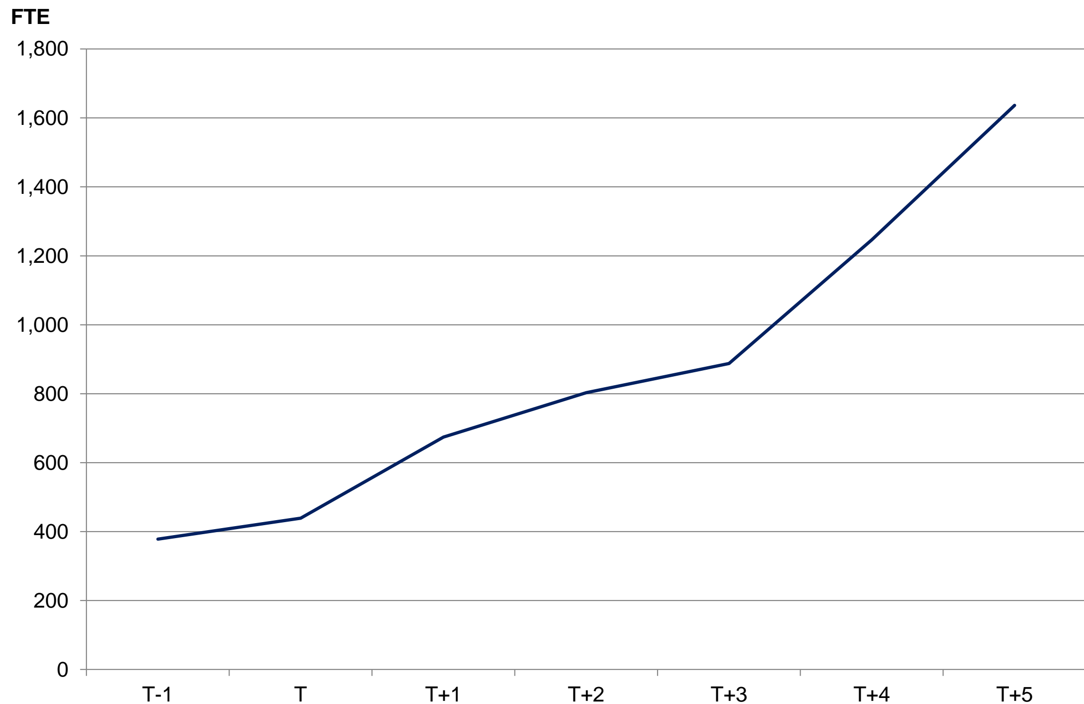
Private equity investment was also associated with solid growth in profits, as measured by EBITDA. The average EBITDA prior to acquisition was $20 million, growing to $37 million after five years, at a CAGR of 10.7%.

The overall value added of the investee firms increased rapidly under private equity stewardship. For the average firm, value added (the sum of EBITDA and wages) was $37 million prior to acquisition, rising to $96 million after five years, at a CAGR of 17.5%. This indicates that the wages paid to employees of the investee firms generally experienced strong growth under private equity ownership.

Employment

The data indicates that private equity investment is a positive catalyst for job creation. Over a five-year ownership period, investee firms expanded their workforces at a CAGR of 27.6%. The average workforce per investee firm grew from 378 FTEs to 1,636 FTEs. This helps to explain the substantial increase observed in value added relative to EBITDA; as more people are employed, total wages also increase, thus boosting value added.

Chart 4.2: Impact of private equity on employment



Source: DAE, AVCAL

4.4 Industry performance

Of the sampled private equity investee firms, those in the Transport & Communications group and the Finance & Property group displayed particularly robust performance.

In the Transport & Communications group, average operating revenue grew at a CAGR of 14.9% and value added grew by 32.8% whilst under private equity management. In this category, Information Media & Telecommunications performed particularly well, with average operating revenue growing at a CAGR of 33.7%, EBITDA growing by 41.0% and value added growing by 32.8%.

In the Finance & Property group, average revenue grew by 24.0% and value added grew by 62.2% over five years of private equity management. In this category, Financial & Insurance Services displayed notably robust performance: average operating revenue grew at a CAGR of 26.5%; EBITDA grew by 26.5% and value added grew by 69.4% over the first five years of private equity management.

In terms of employment, the Finance & Property, the Health & Other Services and Trade & Accommodation categories displayed particularly robust performance. They recorded CAGRs of 38.7%, 32.4% and 28.7%. Particularly noteworthy was the Financial & Insurance Services industry and the Retail industry which grew at 50.5% and 45.9% CAGR respectively.

4.5 Assets and debt

For the sampled firms, their level of assets and of debt tended to rise initially. After which assets tends to grow to about $250 million and net debt stabilises in the $80-$100 million range on average (Chart 4.3). This pattern is consistent with the notion that private equity managers initially borrow to cover the costs of restructuring and investing in, for example, new machinery and other assets with which to expand the firm.

Chart 4.3: Impact of private equity on assets and net debt

Source: DAE, AVCAL

Figure 4.1: Lomb Scientific Case Study

Lomb Scientific (Lomb) was a major Sydney based supplier of laboratory consumables, chemicals and instrumentation to the scientific community. Lomb services scientific markets including healthcare, pathology and government throughout Australia and New Zealand and also into Asia.

Anacacia had been looking for companies in the fragmented scientific supplies market, and first visited Lomb in 2007 although the company was at that point in time not looking for a sale. Subsequent to that initial visit, Anacacia held several relationship-building meetings to establish the alignment of Lomb's need for capital and business expertise for management succession and acquisition integration.

In April 2008 (just prior to the global financial crisis), Anacacia bought into Lomb alongside management and the family of the recently deceased founder. Anacacia took a 40% stake with its $4 million investment into the company.

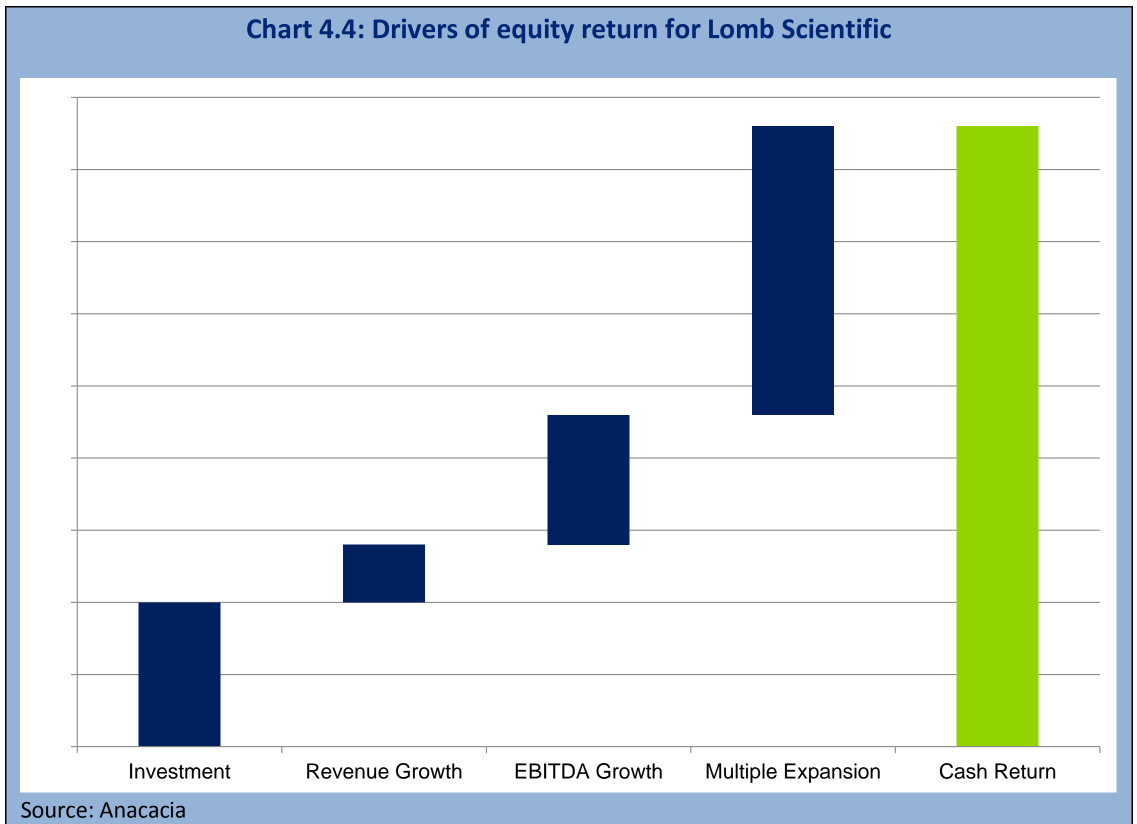
Anacacia focused on execution by the board and management. Its contribution included the integration of three recent acquisitions, increasing the focus on company-owned brands and further investments in pushing exports. The company invested further capital to upgrade the safety and operations of the recently acquired manufacturing facilities.

Anacacia introduced a new CEO with aligned interests to the other shareholders and the board. It also led an improvement programme which included enhancing governance processes, developing systems to manage significant price increases and a better alignment of costs to the revenues, as well as processes to integrate previous acquisitions and focussing the business on a specific brand strategy.

Under the management of the new CEO and with Anacacia's backing, the business saw a steady growth in revenue and earnings. Sales grew from $28 million in 2007 to $40 million in 2011. Earnings (EBITDA) grew by around 35% per annum and net debt (used for acquisitions) reduced considerably during the time of Anacacia's investment.

The quality and sustainability of the earnings and balance sheet were strong when the business was sold in December 2010 to Thermo Fisher Scientific. Anacacia made 4.3x its money for an internal rate of return of 80% per annum for its investors. A breakdown of the drivers of equity return is provided below in Chart 4.4.

Chart 4.4: Drivers of equity return for Lomb Scientific



Source: Anacacia

5 The economic contribution of private equity in Australia

Private equity makes a substantial contribution to the Australian economy, through investee firms spread across a wide range of industries. This chapter calculates the size of this contribution based on value-added and employment data obtained from the survey of the private equity investee firms. The methodology to calculate the economic contribution is explained in Appendix E.

5.1 Estimating the economic contribution

The economic contribution of private equity is measured in terms of:

- **value added** which is the contribution to GDP, and includes wages paid to employees and the gross operating surplus generated including taxes less subsidies; and
- **employment** generated measured in full-time equivalent (FTE) jobs.

5.1.1 The sample firms

The economic contribution calculations were based on a representative sample of 49 investee firms, comprising all firms for which a complete set of data was provided in the period FY2007 to FY2011. The ABS records show the population of private equity investee firms between FY2007 and FY2011 varied between 346 and 420, with an average of 387.

Firms in the growth stage tend to be smaller than firms in the turnaround or buyout stages, so it is important to use a representative mix of firms by stage when estimating the size of the economic footprint of private equity. Table 5.1 shows the distribution of sample firms by stage of investment closely matches the distribution of the full population captured in the ABS survey, and hence looks to be a representative sample.

Table 5.1: Number of firms by investment stages (FY2007-11)

	Growth	Turnaround	Buyout
AVCAL survey (49 firms)	26	3	20
- Proportion of sample	53%	6%	41%
ABS survey (387 firms)	206	47	134
- Proportion of sample	53%	12%	35%

Source: ABS 5678.0 and AVCAL

The key assumptions in these calculations are: that the sample is broadly representative of the industry structure of all private equity investee firms; and private equity investors have a controlling interest in the firm. The analyses in Section 3.2.3 and Section 4.1 indicate that there is a reasonable basis to believe that the sample meets these assumptions.

Based on survey responses, in the five-year period ending in FY2011, post-acquisition the average private equity investee company had:

- annual turnover of around $195 million;
- paid $42 million in wages annually, to 832 full-time equivalent employees;
- generated $34 million in EBITDA annually for investors; and
- contributed $77 million annually in direct value added to the economy.

5.1.2 Direct value added and employment

Based on the average number of private equity investee firms in Australia (387), and the average firm's characteristics, the annual direct contribution of private equity to the Australian economy is estimated to be $25.0 billion (Table 5.2). Private equity investee firms also provided an estimated 261,817 FTE jobs to the economy.

Table 5.2: Direct economic contribution

Wages ($ million)	13,912
EBITDA ($ million)	10,875
Direct value added ($ million)	**25,015**
Direct employment (FTE jobs)	**261,817**

Source: AVCAL, Deloitte Access Economics.

Direct value added of $25 billion is substantial. If private equity was an industry in its own right, average direct employment for the period under review (FY2007-2011) exceeds the automotive industry in Australia which employs 260,000 people and is more than all the banks in Australia which employ 196,000 people.[10]

The total revenue of private equity investee firms is estimated to be around $63.5 billion, exceeding coal mining (Black and Brown Coal) which had an average turnover of $55 billion and the general insurance industry which had an average turnover of $54 billion during FY2007-11.

5.1.3 Indirect contribution

Private equity investee firms purchase goods and services from other firms. These 'other costs' reflect the expenses the firm incurs in running its business and assumes that these services provide business to other firms and thus generates economic activity. Consequently, other firms benefit from the economic activity of private equity investee firms; the value of this is the *indirect* contribution to the economy, (obtained by subtracting EBITDA and wages from revenue).

Different industries require different mixes of inputs; a manufacturer uses a combination of raw materials, labour and equipment to make goods, while the retailer across the street buys finished goods and will employ a markedly different mix of workforce skills and equipment. These difference need to be taken into account when estimating the flow-on effects.

Table 5.3 shows the average 'other costs' for firms in the AVCAL sample in each industry, the total number of firms in the ABS survey of private equity investee firms, and the total costs for the industry calculated as the product of these numbers. For example, the

[10] Based on average annual employment for the period FY2007-011, sourced from the IBISWorld database. Note that the PE firms' employment refers to FTE, while the IBISWorld data refer to total employment.

average annual 'other costs' incurred by manufacturing and utilities firms in the AVCAL sample is $59.3 million and there are 112 such firms, on average, in the ABS survey. Multiplying these together suggests private equity investee firms in manufacturing and utilities have total 'other costs' of around $6.6 billion.

Table 5.3: Average 'other costs' and number of firms by industry (FY2007-11)

Industry	No of private equity investee firms	Other costs ($million)	
		Average	Total
Agriculture and Mining	23	30.0	682.4
Manufacturing and Utilities	112	59.3	6,619.9
Construction	11	157.4	1,692.0
Trade and Accommodation	74	168.3	12,522.4
Transport and Communications	39	232.4	9,017.5
Finance and Property	70	40.4	2,810.3
Health and Other Services	56	105.2	5,912.0

Source: ABS 5678.0 and DAE Calculations

The indirect contribution for each industry is estimated by applying the industry multipliers from the ABS input-output tables to the costs for each industry and adding these up. The indirect contribution of private equity investee firms is estimated to be $33.7 billion, supporting an additional 250,900 FTE workers (Table 5.4).

Table 5.4: Indirect economic contribution

Indirect Wages paid to employees ($ million)	18,154
Indirect EBITDA ($ million)	15,612
Indirect value added ($ million)	**33,767**
Indirect employment (FTE jobs)	**250,900**

Source: AVCAL, Deloitte Access Economics.

5.1.4 Total economic contribution

The combination of the activity and employment generated directly by the investee firms and the flow-on effects to other businesses in the economy is summarised in Table 5.5.

Table 5.5: Total contribution of private equity investee firms

Wages paid to employees ($ million)	32,066
EBITDA ($ million)	26,487
Total value added ($ million)	**58,814**
Total employment (FTE jobs)	**512,717**

Source: AVCAL, Deloitte Access Economics.

5.2 Additional contributions of private equity to the economy

The economic contribution presented in Section 5.1 provides an idea of the size of the footprint of private equity in Australia. There are elements of private equity management that are not captured in basic financial measures, that are difficult to measure, but clearly contribute to the firm and thus economy, captured under two broad headings

1) Company development; and

- In the case studies in this report, company development is a key theme. For example, in the case of Bis Industries, the private equity managers optimised the operations of their firms and ensured that they were also a ‘green’ firm.
- In the cases of Easternwell and iNova, the private equity managers introduced new systems to ensure that the firms became more efficient; systems that should continue to deliver efficiencies after the private equity investors had exited from the firms.

2) Staff development.

- The expertise of the private equity managers also extends beyond company development. In some of the case studies, the private equity managers emphasized safety. For example,, Bis Industries continued to build upon its safety program and with it “Zero Harm”, i.e. zero injuries, zero environmental and zero equipment damage. Lomb Scientific and Easternwell are other examples where safety systems were upgraded.
- In many of these investee firms, private equity managers also played a critical role attracting new senior management into the firm, e.g. iNova and Easternwell. In some cases, the senior management recruits remained with the firms after the private equity owners sold their interests.

The anecdotal evidence presented lends some support to the international findings presented in Chapter 2; that private equity-owned firms bring strong people management practices and operational management practices. The legacy of these practices is likely to remain after private equity investors exit from the firms.

Conclusion

This study breaks new ground in Australia by using, for the first time, comprehensive data that can be used to estimate the economic contribution of private equity investee firms. Moreover, the survey provides a platform that can be built on to allow more detailed analysis of private equity investee firms and more robust conclusions about the impact of private equity in Australia in the future.

Based on the sample, private equity investee firms make a noteworthy contribution to the economy. Private equity investee firms are present in many sectors of the economy, although they tend to cluster in a few sectors, such as manufacturing, retail trade, ICT and health care. Private equity ownership results in growth in both revenue and employment.

The economic contribution of the private equity investee firms is substantial; these firms directly employ as many as 262,000 FTE workers and generate an estimated $63.5 billion of revenue each year. In terms of employment, private equity investee firms compare favourably with the automobile industry; and their total revenue exceeds that of the coal industry.

The key challenge for showing the extent of private equity's impact on productivity lies in making comparisons with the alternative; i.e. what would have happened if the private equity owners had not altered the company's trajectory. However, the survey did demonstrate that private equity ownership had profound effects on investee firms, in most cases resulting in changes to the management team and operating practices and injections of capital. Indeed, shedding more light on these aspects of private equity's input is likely to reveal a lot more about its contribution to the economy.

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Appendix A: Literature review – additional material

International examples of estimating private equity effects

Private equity ownership of firms is heterogeneous in nature, affecting firms via multiple channels. In *Do private equity owned firms have better management practices?* Bloom et al (2009) distilled the range of views of how private equity improves firms' performance to:

1. more effective financing improving profitability, without affecting real performance such as productivity of business units;
2. by raising productivity, through more efficient allocation of labour and capital, including shedding; and
3. introducing new managers and practices to improve management.

Raising productivity

Conceptually, it is not easy to disentangle the effects of 2) and 3), although particular studies do come at the problem from different angles. An example of perspective 2) can be found in *Private equity, industry performance and cyclicality,* where Bernstein et al (2010) show industries where private equity funds have invested have significantly higher growth rates of production (+0.9% p.a.) and value added (+1.1% p.a.) than non-private equity industries – i.e., they are more productive. They use information on production (gross output), value added, labour costs, number of employees, gross capital formation (net asset purchases) and consumption of fixed capital (depreciation) – to estimate private equity performance across 20 countries and 26 industries.

Flexibility of management

Bloom et al (2009) concern themselves with the latter view, using a survey tool developed to look at management practices in detail. They find that private equity-owned firms have strong people management practices and even stronger operational management practices, compared with other firms. Moreover, they find that private equity investors actively target firms where management practices can be improved.

The information gathered by Bloom et al (2009) provides a lot of detail on private equity firms' management practices. However, due to the detailed nature of the survey questions, their approach is one that could not be swiftly replicated in Australia and is better suited to a longer-term plan.

More effective financing

In *Private equity portfolio company performance through the recession* Wilson et al (2011) examine private equity performance through the GFC and recession in the UK, finding that private equity-backed buyouts show stronger performance than a matched sample of other private companies and listed firms. The study used information obtained from company accounts on sales, employment, value added, profits, leverage, working capital and profitability. Additional data on operational risk and regulatory compliance were also used to control for non-financial characteristics of firms.

This provides an insight into 1); given that private equity firms' use of leverage would have put them under additional pressure during the study period, these results suggest that private equity firms' performance is due to more than just the use of leverage.

Appendix B: Methodology – additional material

Private equity involvement can occur at any stage of the lifecycle of the firm. Typically, these stages can be categorised as:

- venture capital, where the investee firm has a concept/product but may not be profitable or even have reliable revenues;
- expansion, which could be early expansion or late, in this category the firm is established and is seeking capital to expand the activities of the firm;
- late, which occurs when the firm is well established and the market in which they have a presence is mature.

The scope of this studies focus on the expansion and late stages.

In this study, a survey was used to estimate the economic contribution of the private equity firms. A total of 116 responses were received, 2 of which were duplicates and 8 were foreign firms, leaving a sample size of 106.

Of the 106 firms in the survey, 74 firms reported EBITDA, wages and/or FTE, and 49 firms reported EBITDA, wages and FTE. To ensure the economic contribution calculation is accurate all the calculations presented in the main text is based upon the sub-sample of 49 firms. That is all the firms which supplied all the required data to calculate a direct economic contribution number.

Of the 49 investee firms, they were then categorised into industries according to the 19 ANZSIC industry division codes. The survey initially also specified GICS as possible categorisation method, thus some concordances were matched according to their economic activities.

Given the sample size, in many of these industries the number of observation was either negligible or nil. Thus the industries were combined using the same categories that the ABS used for their survey of the private equity firms. This resulted in 7 industry groups as mentioned in the main text.

Industry concordance

The industry codes that we use are ANZSIC 2006. Table B.1 provides the concordance of the industry (division) letters to title of the industry.

Table B.1: ANZSIC 2006

Industry (Division) Code	Title
A	Agriculture, Forestry and Fishing
B	Mining
C	Manufacturing
D	Electricity, Gas, Water and Waste Services
E	Construction
F	Wholesale Trade
G	Retail Trade
H	Accommodation and Food Services
I	Transport, Postal and Warehousing
J	Information Media and Telecommunications
K	Financial and Insurance Services
L	Rental, Hiring and Real Estate Services
M	Professional, Scientific and Technical Services
N	Administrative and Support Services
O	Public Administration and Safety
P	Education and Training
Q	Health Care and Social Assistance
R	Arts and Recreation Services
S	Other Services

Source: ABS 1292.0

The survey also had an option to specify a GICS code instead of ANZSIC. The concordance of those codes is provided below:

Table B.2: Concordance of GICS to ANZSIC Codes

ANZSIC Code	GICS Code
Manufacturing	Beverages
Retail trade	Consumer Discretionary
Manufacturing	Consumer Durables & Apparels
Manufacturing	Consumer staples
Other Services	Diversified Consumer Services
Financial and Insurance Services	Diversified Financial Services
Manufacturing	Electrical Equipment
Electricity, gas, water and waste services	Energy
Financial and Insurance Services	Financials excluding (A-REITs)
Manufacturing	Food, Beverages, Tobacco
Health Care and Social Assistance	Health Care
Information Media and Telecommunications	Information Technology
Manufacturing	Industrials
Information Media and Telecommunications	IT Services
Mining	Metals and Mining
Retail trade	Retailing
Information Media and Telecommunications	Telecommunications Services
Other Services	-

Source: ABS 5678.0

Data from IBISWorld uses ANZSIC 1993 to classify their firms. Accordingly to standardise the industry categories to ANZSIC 2006, the following concordance was used (see Table B.3)

Table B.3: Concordance of ANZSIC 1993 to ANZSIC 2006

ANZSIC 1993 Industry Code	Title (ANZSIC 1993)	Concordance to ANZSIC 2006
A	Agriculture, Forestry and Fishing	A
B	Mining	B
C	Manufacturing	C
D	Electricity, Gas and Water Supply	D
E	Construction	E
F	Wholesale Trade	F
G	Retail Trade	G
H	Accommodation, Cafes and Restaurants	H
I	Transport and Storage	I
J	Communication Services	J
K	Finance and Insurance	K
L	Property and Business Services	L
M	Government Administration and Defence	O
N	Education	P
O	Health and Community Services	Q
P	Cultural and Recreational Services	R
Q	Personal and other services	S

Source: ABS 1292.0

Due to the relatively small sample in each of these industries this report also merges the 19 industries in 7 industries as suggested by ABS 5678.0. The concordance is shown Table B.3

Table B.4: Concordance to ANZSIC Codes

ABS Category	Assumed ANZSIC Concordance
Agriculture and Mining	A,B
Manufacturing and Utilities	C,D
Construction	E
Trade and Accommodation	F, G, H
Transport and Communications	I, J
Finance and Property	K, L
Health and Other Services	Q, S

Source: ABS 5678.0

This report also decomposes the sample by revenue to proxy the size of the firm. The purpose of this decomposition is to provide an impression of how representative the sample is compared with the economy and the publicly listed firms. This decomposition was done for FY2009 since this was the final year where the ABS provided a comprehensive revenue decomposition for the firms in the economy. Revenue is the proxy since it was widely reported by the private equity investee firms.

ASX data and calculation

The data for the listed companies were derived from the IBISWorld database. The database contained complete financial data for over 650 companies; the companies were classified according to ANZSIC 1993. The concordance reported in Table B.3 was used to ensure that the data of the listed firm was comparable with the private equity sample (which used ANZSIC 2006). The reporting period was for a financial year.

In calculating the debt to assets ratio of a listed firm "interest bearing debt" was used as the relevant measure of debt and total assets as the measure of asset. This ratio was calculated for each firm for each financial year. An average ratio is then obtained by averaging the ratio for all the companies.

In calculating the debt to assets ratio of a listed firm "interest bearing debt" was used as the relevant measure of debt and total assets as the measure of asset. This ratio was calculated for each firm for each financial year. An average ratio is then obtained by averaging the ratio for all the companies for each financial year.

In calculating the returns on assets of a listed firm EBITDA was used as the relevant measure of returns to asset, this was to ensure that the data is comparable to that of the private equity sample. This ratio was calculated for each firm for each financial year. An average ratio is then obtained by averaging the ratio over for all the companies for each financial year.

Appendix C: Data collection

Table C.1: Data collection tool definitions

DATA REQUESTED	DEFINITIONS
General information	
Name of investee company	Full company name of investee company
Financial year end date	End of investee company financial year
Acquisition date	Date of acquisition of interest in investee company
Final exit date	Date of final exit from investee company
Ownership share acquired	The share of equity held by the investor, or investors (measured as a percentage of total equity) at acquisition date
Industry	GICS or ANZSIC classification
	Primary activity of investee company, e.g. retail trade
Mandatory data for reporting periods	
Number of months of data	If data are for a period of less than 12 months of financial year, indicate the number of months included
Total employment	Number of employees, in Australia and overseas, excluding self-employed and unpaid family members working in the business (measured as full-time equivalent)
Operating revenue	Value of sales for the reporting period
Operating costs	
Wages	*Labour costs, which comprise wages and salaries of employees of the investee firm, paid by employers, as well as other remuneration benefits.*
Other costs	*Non-labour costs*
Net debt	Level of debt *less* cash and cash equivalents at the end of the reporting period
Total assets	Level of assets at the end of the reporting period
EBITDA	Earnings before interest, tax and depreciation allowance for reporting period
EBT	Earnings before tax
Profit	Total revenue *less* operating costs, depreciation, interest and tax
Optional data for reporting periods	
Employment outside Australia	Number of employees, excluding self-employed and unpaid family members working in the business (measured as full-time equivalent), employed outside of Australia
Wages outside of Australia	Labour costs, which comprise wages and salaries of employees of the investee firm, paid by employers, as well as other remuneration benefits to employees outside of Australia.
Depreciation & amortisation	The loss in value of assets (physical and non-physical) over time
Net interest	The cost of servicing (interest-burdened) liabilities *less* revenues generated by interest-bearing assets
Other financial	Value of other non-operational expenses for the reporting period,

costs	such as fees and charges on loans
Tax	Government financial charges and levies on taxpayers
R&D expenditure	Expenditure on research and development
Capital expenditure	Investment in plant, equipment etc
Government subsidies	Total Government subsidies over the reporting period

Table C.2: Screenshot of data tool

PRIVATE EQUITY SURVEY

Mandatory inputs	Optional inputs	Calculations

Name of investee company		
FY end date	20/09	*eg 30/06*
Acquisition date	30/06/2008	*dd/mm/yyyy*
Strategy fully implemented	30/06/2009	*dd/mm/yyyy*
Final exit date	30/08/2015	*dd/mm/yyyy*
Industry	<Please select> <Please select>	
Ownership share acquired	100%	
Management strategy	<Please select>	Did you introduce new managers to the firm?
	<Please select>	Did you change operational practices at the firm?
	<Please select>	Did you inject additional capital into the firm to help it expand operations (e.g. in addition to buying out previous owners)?

	Data requirements	Optional	Optional	Mandatory	Mandatory	Optional	Optional	Optional	Optional	Optional	Optional	Mandatory	Optional	Optional	Optional
		Year	**Year**	**Pre-acquisition Year**	**Year of acquisition**	**Under PE management**	**Under PE management**	**Under PE management**	**Under PE management**	**Under PE management**	**Under PE management**	**Under PE management**	**Under PE management**	**Under PE management**	**Under PE management**
	Financial year	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Number of months of data															
Employment															
Total	*FTE*														
Employment outside of Australia	*FTE*														
Revenue and costs	*$ million*														
Operating revenue	*$ million*														
Operating costs															
Total wages	*$ million*														
Wages outside of Australia	*$ million*														
Other	*$ million*														
Non-operating revenue															
Government subsidies	*$ million*														
Other	*$ million*														
EBITDA															
Depreciation and amortisation	*$ million*														
Other financial costs	*$ million*														
Net interest	*$ million*														
Earnings before tax	*$ million*														
Tax	*$ million*														
Profit	*$ million*														
Net debt	*$ million*														
Total assets	*$ million*														
R&D expenditure	*$ million*														
Capital expenditure	*$ million*														
Summary information															
Debt / Asset ratio		-	-	-	-	-	-	-	-	-	-	-	-	-	-
Turnover / FTE ratio		$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Average wage		$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -

Appendix D: Survey data summary – additional material

There was a wide variance in the number of responses to key variables, such as earnings and wages (both integral components of value added), for example:

- in FY2009, EBITDA was reported for 67 of 74 firms. Information on employees proved to be more elusive; data on the number of employees and wages paid were provided for 50 firms and 42 firms, respectively; and
- hence, value added (wages + EBITDA) could be calculated for 42 firms from the data provided for FY2009; compared to just 13 firms in FY2006 and 19 firms in FY2012.

Table D.1: Distribution of firms by size of revenue (FY2009)

	Small (<$10m)	Medium ($10-$200m)	Large (>$200m)	Sample size
PE investee firms	3.9%	61.6%	34.6%	78
Economy wide	98.7%	1.2%	0.1%	2,007,276
Publicly listed	1.1%	36.3%	62.6%	644

Source: AVCAL, IBISWorld, ABS 8165.0

Table D.2: Revenue, Wages data for investee firms

		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Revenue	**Total**	0.7	2.4	2.9	4.7	5.7	8.4	7.8	10.4	13.8	14.6	11.5	9.8	4.5
	Sample Size	6.0	11.0	12.0	16.0	20.0	34.0	37.0	55.0	73.0	71.0	67.0	60.0	26.0
	Average	0.1	0.2	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
	High	301.9	680.3	720.3	1,151.6	1,229.7	1,268.5	1,037.6	1,117.2	1,172.3	1,155.9	1,134.2	1,229.2	801.7
	Low	5.0	10.7	13.6	13.9	10.8	13.0	5.9	5.3	5.2	4.6	3.7	7.9	8.6
	Coefficient of Variation	1,092.5	912.4	797.9	977.5	1,106.3	1,197.1	1,074.5	1,206.2	1,197.5	1,165.5	1,154.2	1,277.4	945.5
	Median	69.3	189.4	199.1	255.1	159.4	151.0	168.8	94.6	78.2	104.6	106.8	90.9	144.3
Wages	**Total**	40.2	208.5	233.4	62.9	176.1	238.8	505.1	719.8	1,369.3	1,683.6	1,409.3	1,431.8	598.3
	Sample Size	2.0	4.0	5.0	4.0	3.0	5.0	13.0	26.0	43.0	42.0	37.0	39.0	19.0
	Average	20.1	52.1	46.7	15.7	58.7	47.8	38.9	27.7	31.8	40.1	38.1	36.7	31.5
	High	39.6	136.5	157.1	46.0	166.5	168.5	169.2	176.7	183.5	192.3	203.3	210.6	96.0
	Low	0.6	4.8	3.5	3.7	4.7	5.2	1.5	0.8	0.8	2.5	1.2	1.6	1.9
	Coefficient of Variation	1.4	1.1	1.4	1.3	1.6	1.4	1.2	1.5	1.2	1.1	1.1	1.1	0.7
	Median	20.1	33.6	26.0	6.6	4.8	21.5	18.1	9.9	16.2	23.3	23.2	24.2	25.3

Source: AVCAL (Note that the figure are in millions of dollars and percentage terms). Coefficient of variation is the standard deviation divided by the average.

Table D.3: EBITDA and Value Added for Investee Firms

		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Value Added	**Total**	78.3	309.0	340.6	92.3	12.3	43.8	999.9	1326.4	2296.9	2712.9	2464.3	2602.1	1082.8
	Sample Size	2.0	4.0	4.0	2.0	1.0	3.0	13.0	25.0	40.0	40.0	37.0	39.0	19.0
	Average	39.1	77.2	85.2	46.1	12.3	14.6	76.9	53.1	57.4	67.8	66.6	66.7	57.0
	High	77.3	187.1	216.2	86.2	12.3	21.0	416.1	515.0	519.3	426.3	505.2	584.6	143.8
	Low	1.0	6.0	6.4	6.1	12.3	8.3	9.8	3.0	3.0	1.6	3.1	2.4	4.3
	Coefficient of Variation	1.4	1.0	1.1	1.2		0.4	1.5	2.0	1.6	1.2	1.4	1.5	0.8
	Median	39.1	58.0	59.0	46.1	12.3	14.5	24.2	17.9	29.1	39.8	39.9	42.6	45.4
EBITDA	**Total**	60.5	202.3	273.4	516.4	640.3	854.8	1,057.9	1,609.4	1,899.6	2,048.1	1,949.7	2,033.8	602.3
	Sample Size	5.0	10.0	12.0	16.0	18.0	30.0	37.0	51.0	69.0	67.0	65.0	63.0	23.0
	Average	12.1	20.2	22.8	32.3	35.6	28.5	28.6	31.6	27.5	30.6	30.0	32.3	26.2
	High	37.7	50.6	59.1	134.0	147.9	165.9	246.9	338.3	335.8	234.0	301.9	374.0	88.4
	Low	-0.1	1.2	2.2	2.4	3.7	-0.5	-12.9	-1.9	-21.0	-3.1	-7.1	-7.4	-4.0
	Coefficient of Variation	1.3	0.7	0.7	1.0	1.1	1.4	1.6	1.8	1.7	1.2	1.5	1.7	1.0
	Median	4.5	19.6	22.7	23.4	20.2	18.4	13.0	12.2	14.1	19.1	16.2	11.4	17.5

Source: AVCAL (Note that the figure are in millions of dollars and percentage terms). Coefficient of variation is the standard deviation divided by the average.

Table D.4: Debt/Asset Ratio and EBITDA/Asset data for Private Equity Investee Firms

		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Debt/Asset Ratio	**Average**	24.1	45.1	50.7	45.8	51.3	30.9	37.7	36.5	28.9	30.2	18.9	20.5	42.9
	Sample Size	3.0	5.0	6.0	7.0	7.0	12.0	15.0	23.0	36.0	37.0	36.0	35.0	19.0
	High	50.2	71.2	82.2	88.4	108.8	111.5	95.1	87.3	180.2	259.0	80.2	57.0	233.3
	Low	-4.9	20.3	29.6	16.2	28.1	-85.1	-78.9	-68.6	-55.5	-57.9	-61.0	-46.5	-50.8
	Coefficient of Variation	1.1	0.4	0.4	0.5	0.6	1.6	1.0	1.0	1.5	1.8	1.5	1.1	1.2
	Median	27.0	45.6	44.6	41.0	34.2	33.6	44.4	44.6	33.5	30.2	21.1	22.9	40.0
EBITDA/Assets	**Average**	8.6	11.9	16.4	17.7	22.9	17.3	11.0	16.5	11.8	18.3	15.4	13.6	21.9
	Sample Size	3.0	5.0	6.0	7.0	8.0	12.0	17.0	24.0	36.0	38.0	39.0	37.0	18.0
	High	19.1	17.2	20.8	26.0	46.5	44.2	22.1	58.7	45.3	215.7	47.3	72.2	200.0
	Low	-1.6	3.8	8.3	9.5	7.1	-8.3	-28.7	-12.3	-32.5	-17.4	-4.6	-12.4	-3.2
	Coefficient of Variation	1.2	0.4	0.3	0.4	0.6	0.9	1.1	0.9	1.2	2.0	0.7	1.0	2.1
	Median	8.3	13.3	17.5	18.5	21.1	16.7	14.6	12.1	10.3	11.4	13.1	11.6	14.0

Source: AVCAL (Note that the figure are in millions of dollars and percentage terms). Coefficient of variation is the standard deviation divided by the average.

Table D.5: Number of Private Equity Investee Firms by Industry

	Agriculture and Mining	Manufacturing and Utilities	Construction	Trade and Accommodation	Transport and Communications	Finance and Property	Health and Other Services
2006	27	80	4	82	32	61	40
2007	21	107	8	80	42	74	49
2008	21	131	9	84	43	73	59
2009		114		82	38	69	64
2010	26	105	11	66	42	65	63
2011	23	101	15	60	29	67	46

Source: ABS 5678.0

Table D.6: Distribution of Investee Firms by Revenue

	0-$25k	$25k-$50k	$50k-$75K	$75k-$100k	$100k-$150k	$150k-$200k	$200k-$500k	$500k-$1m	$1m-$2m	$2m-$5m	$5m-$10m	$10m-$20m	$20m-$50m	$50m-$200m	$200m+
Private Equity Firms	0	0	0	0	0	0	0	0	0	1	2	6	12	30	27
Proportion of total	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.3%	2.6%	7.7%	15.4%	38.5%	34.6%
Total Economy	353,260	243,193	186,857	167,014	201,480	138,468	365,986	170,250	101,934	70,090	25,424	13,092	7,781	4,648	1,934
Proportion of total	17.2%	11.9%	9.1%	8.1%	9.8%	6.7%	17.8%	8.3%	5.0%	3.4%	1.2%	0.6%	0.4%	0.2%	0.1%
ASX Firms	5	0	0	0	0	0	0	0	1	0	1	3	15	216	403
Proportion of total	0.8%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	0.0%	0.2%	0.5%	2.3%	33.5%	62.6%

Source: AVCAL, IBISWorld, ABS 8165.0

Appendix E: Economic contribution methodology

Economic contribution of private equity

Economic contribution studies are intended to quantify measures such as value added and employment associated with a particular industry or firm, in a historical reference year. The value added and employment generated are measures of the economic contribution by a firm or industry. The estimate of the economic contribution of the industry or firm in a given year generally is not used for direct comparison with other firms or industries; time-series or multiple year data are needed for comparisons, to reduce the risk of unrepresentative data distorting the analysis.

Value added is the value of output (goods and services) generated by the entity's primary factors of production (labour and capital) as measured by the income to those factors of production. Value added is calculated as the sum of labour income, capital income (also known as gross operating surplus) and net taxes on production.

In practice, it is possible to calculate value added by adding:

- **Labour income**: number of FTEs x average wage rate; and
  - Industry-average wage rates from the ABS can be applied; however, it is always preferable to use firm-specific data, since the structure of the typical firm may differ from the actual structure of the firm under study.
- **Capital income**: measured as the earnings before interest, tax, depreciation and amortisation (EBITDA).
- **Tax on production** less subsidies provided for production**:** taxes are counted in EBITDA, so tax data is not necessary to calculate the economic contribution if EBITDA and wages (or FTEs) is supplied. If tax data is available, it may be useful to show how much tax private equity firms contribute.
- **Employment** is measured by the number of full-time equivalent workers, including management, at a company. Employment may fluctuate over the course of a year; typically, the headcount is done on the last day of the financial year.

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Contact us

Deloitte Access Economics
ACN: 149 633 116

Level 1
9 Sydney Avenue
Barton ACT 2600
PO Box 6334
Kingston ACT 2604 Australia

Tel: +61 2 6175 2000
Fax: +61 2 6175 2001

www.deloitte.com/au/economics

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