Chapter 3

Effects of private equity on capital markets

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

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

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

Equity markets

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

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

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

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

Stockmarket capitalisation

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

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

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

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

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

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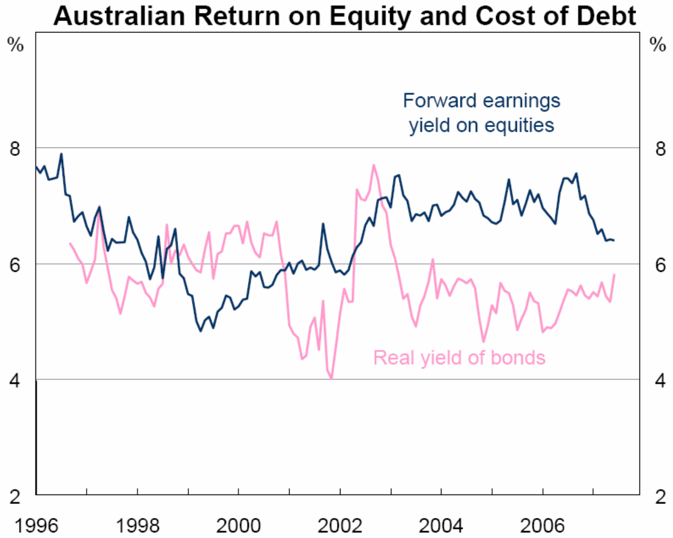
2 Reserve Bank of Australia, Financial Stability Review, March 2007, p. 67.

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Defensive behaviour of listed companies

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

Debt markets

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

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

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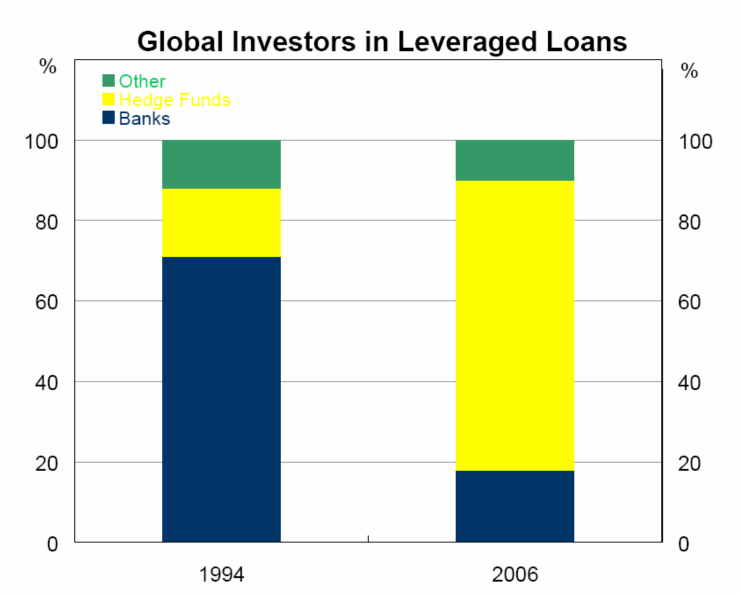
15 Australian Private Equity and Venture Capital Association Ltd (AVCAL), *Submission 17*, p. 20.

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

Other effects

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

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

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

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

Conclusion

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

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

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

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