



UniSuper

**UniSuper Submission to the
Senate Standing Committee on Economics:
Inquiry into Private Equity Investment**

26 April, 2007



Purpose

This submission is made to the Senate Standing Committee on Economics regarding its Inquiry into Private Equity Investment.

Background

We have been advised that the terms of reference for the Inquiry are as follows:

- (a) An assessment of domestic and international trends concerning private equity and its effects on capital markets;
- (b) An assessment of whether private equity could become a matter of concern to the Australian economy if ownership, debt/equity and risk profiles of Australian business are significantly altered;
- (c) An assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects;
- (d) An assessment of whether appropriate regulation or laws already apply to private equity acquisitions when the national economic or strategic interest is at stake and, if not, what those should be; and
- (e) An assessment of the appropriate regulatory or legislative response required to this market phenomenon, if any.

As a long term investor in this asset class, UniSuper is able to provide commentary on the investment merits of private equity, which should help inform discussion on the above points, and in particular (a), (b) and (e).

Much of our discussion relates to public to private transactions, as these have been a significant source of focus on private equity in recent times. However, the principles discussed in this context can be applied more broadly to private equity.

Discussion

The key characteristics that define the private equity sector are:

- **The J-curve effect** – In most funds' early years, investors can expect low or negative returns, due to the small amount of capital actually invested at the outset combined with the customary establishment costs, management fees and running expenses. As portfolio companies mature and exits occur, the fund will begin to distribute proceeds.
- **'Blind pool' investing** – While private equity managers must follow general investment guidelines and restrictions set out in the fund documentation, they still have very wide discretion in selecting particular companies to invest in.
- **Closed end fund structure** – Private equity funds are mostly closed end structures, typically between a seven and ten year term.
- **Wide divergence of returns** – The dispersion of returns between upper quartile and lower quartile managers is significantly wider for private equity managers than for listed equity managers.

The advantages of investing in private equity are as follows:

- **Higher expected returns** – The key benefit of investing in private equity is the potential to earn higher returns than in the traditional asset classes. This is because super-normal profits are expected to arise from information arbitrage opportunities that result from the market's immaturity, and hence relative inefficiency. Also, private companies are not obliged to make public their financial reports in the same way as public companies. Moreover, the governance arrangements of private equity firms are recognized by some researchers and regulators as the best and most effective form of governance: private equity backed companies have concentrated and stable ownership which allows for a closer alignment of interests between all shareholders; private equity owners hold at least one board seat (and often control the board) allowing for more effective engagement with management teams and the board if problems arise; and the level of management ownership in private companies is significantly higher than in public companies which serves to incentivise management. Through these governance structures, private equity managers are able to exploit their access to protected information. The higher expected returns also reflect a premium that may be expected due to the sector's illiquidity.
- **Diversification** – Private equity investments provide diversification benefits due to their low correlation to traditional asset classes such as listed equity, property and fixed income.

The disadvantages of investing in private equity are as follows:

- **Erosion of information advantage** – The strong growth in the size of the private equity market and the dramatic increase in the number of managers and investors in these markets may have led to the information asymmetry arbitrage being eroded.
- **Higher risk** – Private equity investing involves higher risk than investing in traditional asset classes for the following reasons:
 - A listed company is typically analysed and monitored on a continual basis by multiple analysts, while a private equity manager is typically 'on its own' in reviewing investee or potential investee companies. Thus, the volume of analysis that is readily available and the ability to source multiple views as a check on one's own views in respect of listed companies is absent when investing in private companies;
 - There is often a significant probability that the company may not meet its target objectives and the business may fail, particularly in a turnaround situation;
 - Given that the investee company is unlisted, it is unlikely to have the same levels of transparency, reporting or corporate governance practices that are required of a listed company; and
 - Listed markets provide a relatively easy exit strategy with the price provided by the wider market. On the other hand, exiting private companies is more complex, takes longer and involves a subjective price determined by the buyer and seller.
- **Illiquidity** – The closed end structure means that there is effectively little, if any, opportunity to exit the investment early
- **High investment costs** – Private equity managers typically charge an annual management fee of between 1.5% and 2.0% per annum on capital committed (as opposed to capital drawn down) plus a performance based fee typically of the order of 20% of performance in excess of 8% per annum. Moreover, there may also be due diligence and legal costs in assessing and then implementing new investments.

Institutional Investment in the Private Equity Asset Class

Any institutional investment in private equity must be viewed in the context of a Fund's overall asset allocation. A typical strategic asset allocation for the asset class would range between 2.5% and 7.5% of total assets. For a \$5 billion fund, this represents an aggregate exposure to private equity of \$125M to \$375M. By way of comparison, if that fund had a 50% exposure to listed equities, with 8 managers in the structure, each listed equity mandate would be approximately \$312.5M in size. Thus for a typical institutional investor, the aggregate exposure to private equity is small in a relative sense.



Institutional private equity portfolios are also constructed with regard to a number of portfolio risk controls to ensure appropriate diversification:

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

Public to Private Transactions

Public to private transactions involve the purchase and delisting of public companies by private equity funds in order to improve performance in a private environment outside the scrutiny of the public eye.

With the substantial growth of the Australian private equity industry over the past 5 years, there has been an emergence of a number of large public to private transactions (e.g. Coles and Qantas). In 2006, there was an unprecedented level of public to private transactions in the Australian market. These deals are listed below and ordered by size of enterprise value.

Company	Sector	Enterprise Size (\$M)	Fund managers	Board Approval	Transaction Status
Coles Myer	Retail	17,000	KKR ¹ , TPG ² , Bain Capital, CVC ³ , Blackstone, <i>Wesfarmers</i>	Pending	-
Qantas	Airlines	11,100	<i>Macquarie</i> , <i>Allco</i> , TPG	Accepted	Pending
Alinta ⁴	Utilities	7,000	<i>Macquarie</i>	Pending	-
PBL Media	Media	5,500	CVC	Accepted	Completed
Seven Network	Media	3,200	KKR	Accepted	Completed
DCA Group	Healthcare	2,700	CVC	Accepted	Completed
Flight Centre	Retail	1,600	<i>Pacific Equity Partners</i>	Pending	-
RepcO	Retail	570	CCMP (ex-JP Morgan)	Accepted	Pending
Colorado Group	Retail	450	Affinity Equity Partners	Accepted	Pending
Rebel Sport	Retail	370	<i>Archer Capital</i>	Accepted	Pending
Global Television	Media	50	<i>Catalyst Investment Managers</i>	Accepted	Pending

¹ KKR: *Kohlberg, Kravis and Roberts*

² TPG: *Texas Pacific Group*

³ CVC: *Citigroup Venture Capital*

⁴ Alinta was announced in early 2007

Note: *Italics indicates Australian-based fund manager/entity*

The growth of the private equity industry and public to private transactions is a result of the following factors:

- The growth of the superannuation industry and the 'search for alpha' has led to a significant influx of capital to alternative assets classes such as private equity. To accommodate this demand, domestic private equity managers have collectively increased capital raised each year from AUD1.0B in 2000 to AUD4.0B in 2005. Globally, private equity managers have also increased capital raised each year from USD245B in 2000 to USD313B in 2005;
- The easy availability of credit, driven by banks seeking to establish market positions in the leveraged loan market and securitising such loans to fulfil the appetite of investors for lower grade debt, has also provided private equity managers with the 'fire power' to acquire public companies; and

- The Australian economy is very attractive for private equity managers. Almost every sector has companies that have dominant market shares in profitable industries with predictable earnings, long term track records and high yields. These companies typically have high barriers to entry, proven themselves as long term creators of shareholder value. Buyout private equity managers favour companies with predictable earnings because they can more readily service debt repayments.

There has been extensive coverage in the media of the public to private transactions, given the large size, public profile and often iconic status of the target companies. It is fair to say that, in general, the coverage has been cautionary, even sceptical, rather than supportive. This has been driven by a characterisation of the typical public to private process as restructuring the company's balance sheet by increasing debt, cutting costs, selling off non-core assets, and then refloating the company, all within a very short time and for a very handsome fee paid to the private equity manager(s). The critical concern is whether the private equity managers are merely financial engineers who 'churn' companies for a disproportionately large fee or whether they genuinely add value to the underlying businesses.

Concerns have also been raised from a governance perspective. Often, senior management of the company are offered equity in the privatised company and are thus conflicted. Directors may also be offered positions on the board of the privatised company, placing them too in conflicted positions. These were exemplified in the recent Qantas bid where the CEO and certain Board members did not participate in the Board decision, and in the Alinta case where the Chairman and the CEO themselves instigated a management buyout. In the latter case, the Chair and CEO were ultimately forced to resign.

We believe that the concerns raised in the press are not unfounded. In particular:

- Debt is a very effective way of increasing returns. In essence, equity holders earn the difference between the return on equity and the interest rate on the debt for very little capital outlay. However, it is important to strike a balance between higher debt and ensuring the ability to meet debt payments robust, even in adverse circumstances. If debt is too high, the company risks going bankrupt; and
- If the private equity manager is undertaking financial engineering rather than building the underlying business as the primary source of value-add, any uplift in value may be less robust and therefore more vulnerable to the business cycle. This is particularly the case at present, where the economic environment is strong, credit is cheap, and equity valuations are generally expanding across the board.

On the other hand, public to private transactions play an important role in listed markets by reinvigorating listed companies that have become encumbered by the constraints imposed by the listing rules or whose management and/or Board may have become complacent in respect to driving return to shareholders. This reinvigoration can occur for the following reasons:

- **Private ownership may improve corporate governance** – When a private equity investor acquires a business, it spends a lot of time on due diligence so that when it joins the board, it already has a detailed understanding of the company. That enables the private equity investor to immediately and effectively participate in board discussion and decision making. In addition, privately owned companies can make decisions quicker than their listed counterparts as they don't have to wait for the next planned board meeting, they don't need to communicate anything to a wide range of investors and other interested parties, and they don't have to spend a lot of time meeting all the requirements that listed companies face today; and
- **There is a stronger alignment of interest between the ultimate owners (i.e. the investors in the private equity funds) and the board** – Typically, the private equity firm appoints its executives and selected parties to the board. This means that the directors' remuneration (via the private equity manager's performance based fee) is tied directly to how the business performs over the full duration of the holding period. Consequently, the directors are very informed on the business, follow the business very closely, and actively interact with the management on a regular basis. In contrast, the directors of listed companies, in general, are more removed from the company and have less personal motivation in respect to their contribution to the company and board decision-making. This difference leads to better decisions and stronger ownership of those decisions in private companies.

This strategy has been employed by large and mega buyout managers for many years and the associated risks are not new. Indeed, it could be argued that the only significant difference with the latest round of public to private transactions is the extent of media coverage, and the size of the fees being paid to intermediaries.

In conclusion, the concerns raised in the extensive media coverage of the recent frenzy of public to private transactions in Australia (and on the US, UK and European stock exchanges) are not new to private equity or to the buyout managers that undertake such transactions. UniSuper recognises these risks and, rather than shun buyout managers, public to private deals, or private equity more generally, seeks to manage these risks through sound portfolio construction and manager selection.

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