Dr David Morrison
TC Beirne School of Law
The University of Queensland
St Lucia QLD 4072
Australia

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Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100 Parliament House
Canberra ACT 2600
Australia

Dear Sir/Madam

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

Following is my submission in respect of the above matter.

Yours faithfully

David Morrison
d.morrison@uq.edu.au

Australian Senate inquiry into private equity investment

Submission by Dr David Morrison
The University of Queensland

April 2007

1. The Australian Stock Exchange site states that private equity is an asset class of investment that allows companies with "less mature businesses (undeveloped or developing products) to access funding for future growth".[1] The site also favours the view that access to this market is best achieved via a managed fund, no doubt true for small investors. It is suggested that whilst there is a degree of market fragmentation in terms of how the market is described for the purposes of gaining investment interest, the dichotomisation of the market as between say, debt and equity or property and securities, is not useful in the context of what constitutes an efficient marketplace and is merely useful for understanding source types of activity.
2. Private equity is generally described as being an opportunity to invest in research and development type ideas that do not attract traditional financing means, the ASX site refers to the bionic ear and the black box flight recording instrument as examples of ideas that were unable to get finance from traditional sources, relying instead on private investors and therefore being a riskier investment (more volatility around the higher expected return) from the point of view of the capital provider.
3. The Reserve Bank of Australia has not released recent data specifically in respect of private equity and as at 2002 defined it as falling into four categories, start-up financing, expansion financing, turnaround financing and management buy-out financing.[2]
4. "Equity" is itself a generic term that, in the case of investment, indicates ownership of an asset as distinct from "Debt" that indicates a financial obligation in order to finance the acquisition of an asset. The reality is that both debt and equity are means of financing the acquisition of assets, including capital market assets, such as Qantas for example. One of the major considerations for managers is to determine the optimal capital mix of holding such an investment. For

[1] http://www.asx.com.au/resources/newsletters/investor_update/20041109_PrivateEquity.htm <accessed 25 April 2007>
[2] http://www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_jun02/bu_0602_1.pdf <accessed 25 April 2007>

investors, classical finance theory suggests that they make their own decisions around debt and equity based on their own holdings.

5. Holders of both debt and equity capital expect a return on their investment and therefore for the firm utilising the capital there is a cost of debt and a cost of equity capital. The cost of debt capital is in its most basic form an interest expense (that is tax deductible). The cost of equity capital is dividends paid – no tax deductible - and to an extent ensuring that the stock price performs as expected in the form of smooth earnings and capital growth for the equity holder.
6. The difficulty in the case of private equity is not an efficient market difficulty per se but rather a concern around political goals (Qantas being an example) or unrealistic assumptions about market behaviour, such as treating superannuation fund investments differently from the usual portfolio approach, that might include a debt element.
7. *An assessment of domestic and international trends concerning private equity and its effects on capital markets* – The most up to date information appears in a McKinsey consulting paper[3], *Mapping the Global Capital Market*, this is not able to be quoted without prior permission however Robert Elstone, Managing Director and CEP of ASX Ltd cites the most relevant data in his presentation of 26 April 2007[4] stating that "between 1995 and 2005 the total size of global equity markets rose by 115% to $US140tr" and that "McKinsey Global Institute forecasts markets will grow to around $US214tr by 2010". ASX data shows that "capital markets reached $A3tr in 2005, up 173% on a decade earlier" and this therefore shows a greater growth in the Australian marketplace since the global average is cited as 115%.[5]
8. The presentation by Mr Elstone also shows that from December 1996 to December 2006 that household financial assets have grown in Australia on average at a rate of 10% per annum and that as at December 2006 this class of

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[3] McKinsey Global Institute (Farrell D, Lund S and Maasry A), *Mapping the Global Capital Market*, Third Annual Report, January 2007, McKinsey & Company San Francisco

[4] Elstone RG, *Australia and the Capital Market Evolution*, presentation, Distinguished Speaker Seminar Series, Faculty of Economics and Business, University of Sydney, 26 April 2007: http://www.asx.com.au/about/pdf/capital_markets_trends_drivers_sydneyuni.pdf <accessed 24 April 2007>

[5] http://www.asx.com.au/about/pdf/capital_markets_trends_drivers_sydneyuni.pdf ,accessed 24 April 2007>

assets comprised; superannuation 55%, shares 20%, Deposits 20% and other at 5%. Therefore superannuation investment comprises a significant proportion of the financial assets held by Australian households.[6] Australian propensity for risk (if one takes it to be measured by increased household debt and increased expenditure on consumer goods) appears to have also increased with lower interest rates allowing for increased household debt.

9. There is no doubt that private equity as a source of funding is having an impact upon domestic and international capital markets, it is part of the expansion generally and it is apparently growing as a proportion of financing method. Whether this is any more significant than any other normal development in the capital marketplace is open to debate. The most useful means of comparison is comparison of historic data, however like weather patterns, our data is only relatively recent and therefore the likely impact of current observations is not able to be asserted with any degree of confidence at this stage. From a markets point of view, there does not appear to be any need whatsoever to regulate the private investment of funds.

10. *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* – it seems likely that Australian business ownership, debt/equity and risk profiles are changing and will continue to change and that private equity has a role to play but is not necessarily the cause of the change.

11. Where a business finds the pace of global change significant then it may need to take strategies that are not able to be implemented effectively if the enterprise is listed publicly and needs to comply with the complex regulatory regime imposed by the *Corporations Act* and the ASX Listing rules. In such circumstances the option to take the business private will be assessed on a cost-benefit basis.

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[6] According to the paper superannuation contributions were $75bn in 2005-2006, growing at the same rate as benefits paid out ($50bn for the same period) at 11% per annum. http://www.asx.com.au/about/pdf/capital_markets_trends_drivers_sydneyuni.pdf <accessed 24 April 2007>

12. Where a business finds that its shareholders or other governances are becoming costly then the option to take up private equity with similarly minded strategic partners will be assessed as a possibility.
13. The increased interest in this form of financing must be associated with reasons other than cost of capital reasons and it is useful for us to know what those reasons are. When we know this, it seems that the appropriateness of a regulatory response can be gauged – but it is not useful to assume that regulation will deal with the problem if we are unable to specify it in adequate detail.
14. *An assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects* – the commonwealth government is concerned about possible tax revenue leakage, as it is with the use of the internet for example. Such leakage appears to occur around the collect of capital gains tax rather than income tax on certain transactions. The dissection between income and capital is reasonably clear in most cases and particular product notwithstanding, the government appears to be collecting tax fairly consistently when measured against GDP as a macro view. It seems that there are two items relating to taxation that need watching most, namely the use of non-registered funds operating internationally as well as the determination between capital and income distributions from trusts to investors.
15. There are other effects that this market is having on the government – the most apparent at present being the public pressure over the Qantas arrangements. The public is pressuring the government not to approve the sale – the reference to the FIRB seems inappropriate and from the corporate regulatory side of things, there are some pretty interesting questions being posed by members of the public in the financial press ethical/directors' duties obligations owed by public company directors to their shareholders when it comes to remuneration and stakes held in ex post restructured entities. I will not comment upon these here except to say that, political and possible other impacts aside, there is no apparent reason why Qantas cannot be taken over or transformed or refinanced from a capital market perspective, including the use of private equity capital.

16. *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* – It is difficult to identify with any degree of certainty national or strategic interest generally. It gets raised as a matter of public perception and comment and is then dealt with in a political way – it seems that a better effort might be made in terms of consistently identifying the investments that are to be held within Australia.
17. Because Australia tolerates a large amount of regulatory complexity that interferes with the purely efficient capital market ideal, it is always difficult to comment on the need for greater regulatory burden. As indicated in paragraphs 12 and 13 above, there are a variety of possible reasons why private equity has grown, including for example the risk/return argument that supports the view that if investors are happy to take some additional risk with their funds, then it is logical for them to invest where the returns are higher – no matter the reason for this – lower compliance costs certainly assist the generation of returns and that may be one reason.[7]
18. If one takes the simplest case of government owned utilities or businesses – it seems that there needs to be open and accountable information in respect of them. For example in the case of Telstra – if that business was returning to the government an internal rate of return greater than the cost of borrowed funds then arguably the business is best kept by the government – on a simple net present value (economic) basis.
19. Where the government seeks to regulate or mandate a particular part of business activity (such as providing special services to remote clients for example), then that activity should be kept out of a privitisation and the service continued as part of the government's political commitment.

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[7] This is a reason that is in at least partially supported by other jurisdictions, such as the city of New York where Governor Spitzer has warned that New York is in danger of losing its place in the global capital market due to factors that include "stifling by stringent regulations, high litigation risks and loss of business and high-skilled workers to overseas competitors";
http://schumer.senate.gov/SchumerWebsite/pressroom/record.cfm?id=267787&&year=2007&
<downloaded 25 April 2007>

20. Looking forward – where the government owns a business that adds value to the Australian economy – a net contributor to the economy, then that business ought not to be sold, unless it is to take advantage of a better and genuine alternate investment opportunity available to the government.
21. Ideally however, the government ought to return surplus funds to Australian taxpayers, rather than making investments – this allows for the individual to make the optimal placement of their own money, however this seems unlikely in the current environment, witness the Future Fund for example.
22. One aspect that must be concerning the government is the way that superannuation savings are being allocated in the Australian capital marketplace. Given that the funding in this area is growing rapidly and the portfolio investment approach of most funds, it may be necessary to observe carefully how funds are put at risk, especially where there is hidden debt that might endanger the stability of an investment fund and therefore put the monies invested at risk.
23. Other than the protection of its tax base, and this is an arguable proposition, it seems that there is no need for the government intervention. The existing corporate regulatory framework is adequate at this stage.
24. *An assessment of the appropriate regulatory or legislative response required to this market phenomenon, if any* – No response required at this stage, private equity is not a market phenomenon, it is merely a market response to a set of conditions that we have been unable to adequately quantify. Once these conditions are properly ascertained, then the true threats, if any, can be further examined. At this stage though it is difficult to imagine how this investment choice might be regulated.
25. One of the key risks that need to be monitored is the impact of this market expansion upon the funds invested in superannuation. Strictly speaking a fund that holds investments pursuant to a trust deed where there are no borrowings ought to be immune from default in other entities, however a greater understanding of where the capital is coming from and how it is being financed will assist in ensuring compliance with superannuation regulations.

26. There is a report that the committee might find useful to refer to published by the Financial Services Authority in the United Kingdom, *FSA report on private equity* that is due to report back in summer 2007.[8] Submissions were due in March 2007. It will be interesting to evaluate the outcomes and to compare them with the Australian environment.

End

[8] http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf <downloaded 25 April 2007>