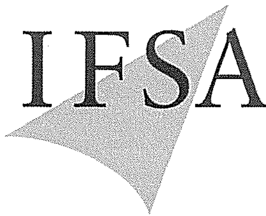

Investment & Financial Services Association Ltd

2 May 2007

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Email: economics.sen@aph.gov.au

Dear Secretary

Thank you for the invitation to comment on this important inquiry into private equity investment.

The Investment and Financial Services Association (IFSA) represents the retail and wholesale superannuation, funds management and life insurance industries and has over 140 members who are responsible for investing over $950 billion, on behalf of more than ten million Australians.

Given the extent of media coverage and general speculation about private equity, IFSA believes that this inquiry is both important and timely. The inquiry will also undoubtedly facilitate a more informed and evidence-based policy debate about private equity investment going forward.

In its submission, IFSA has focussed on matters where it believes it can offer informed comment relevant to the terms of reference for this inquiry.

IFSA is supportive of private equity investment and believes that like any other form of investment, it presents its own set of 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* (the Act) are adequate to appropriately regulate private equity investment activity.

We further recognise the complementary additions to the Act provided by the Takeovers Panel in releasing its 'Issues Paper on Insider Participation in Control Transactions' and also by the Council of Financial Regulators in their paper 'Private Equity in Australia', as released by the Reserve Bank in its Financial Stability Review in March.

It is our view that these publications represent informed additions to the debate about the features, risks and benefits of private equity activity.

As this form of investment continues to grow and attract greater attention, appropriate guidance is useful in providing greater certainty to market participants about regulatory expectations surrounding how the relevant laws are expected to be applied.

Should you have any questions regarding the content of our submission, please feel free to contact either myself or Martin Codina, Senior Policy Manager Investment, on (02) 9299 3022.

Yours sincerely

Richard Gilbert
Chief Executive Officer

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PRIVATE EQUITY INVESTMENT

Approaches to private equity investment

Private equity investment takes place at a number of different levels.

At one level, there is *direct* investment. This is the investment made by private equity firms in other firms that are seeking expansion capital or have been identified as a buy-out target. The controllers of the private equity firm decide which investments to make and how the investment will be financed.

At another level, there is *indirect* investment. This type of private equity investment often represents the equity component in the *direct* investment. This investment represents the capital contributed by those that invest in the funds controlled by the private equity firm/s. These investors do not generally control the underlying investment. Instead, they are typically seeking passive exposure to private equity as an asset class.

Finally, there is at least a further layer of private equity investment which is even more passive than *indirect* investment. This involves investors, institutional or retail, investing in a diversified fund of private equity funds. Such investors are seeking to minimise the risk of investing indirectly by relying on the skill and vetting of the manager of the fund of private equity funds in selecting the best possible private equity funds in which to invest. Investors at this level can include retail investors but most often include institutional investors that lack the experience or investment expertise to properly invest directly in a private equity fund.

Another interesting and somewhat ironic development is the establishment of a number of listed entities that allow investors to gain exposure to private equity investments.[1] These listed entities attempt to provide a more liquid exposure to private equity – noting that a common condition of investing in a private equity fund is the 5-10 year 'lock-up' period that can apply to committed funds.

Private equity as an asset class

IFSA members typically think of private equity as a type of investment within a broader asset class known as 'Alternatives'. This term describes non-traditional investments such as private equity, venture capital, hedge funds, infrastructure, commodities and renewable energy among others.

Interestingly there is some dispute as to the extent of correlation, or relationship, between private equity and that of other traditional asset classes. Studies have reached differing conclusions on this point – with some showing that there is a low correlation and others showing a high correlation.

This is relevant as traditional asset allocation theory is based on maximisation of the risk-adjusted portfolio return. This broadly involves estimating the future return and

[1] See for example ING Private Equity Access Limited.

risk and the correlation between the asset classes using historical data, and then calculating the appropriate weighting for each asset class such that the overall risk-adjusted portfolio return is maximised.

Private equity is somewhat difficult to assess in this way as:

- the lock-in periods can vary considerably;
- returns are often 'lumpy';
- the concentration of private equity funds can vary considerably;[2] and
- historical data is not always available.

Consequently, superannuation funds seem to have remained relatively cautious in their approach to private equity and have sought to minimise direct exposures to the asset class. This is covered in further detail below.

Superannuation funds and private equity

It is not possible to obtain comprehensive data on the precise amounts invested by superannuation funds in private equity or how those funds have been invested. However, as a proxy, APRA does publish information relating to the asset allocation of superannuation fund default investment options.

That data reveals that as at June 2006, the average superannuation fund default investment option had an 11% allocation to alternative investments ($35 billion out of a total $318 billion invested), which also includes investments in hedge funds and other alternative assets.[3]

Complementing this data is the RBA's finding that more than half of the largest superannuation funds have a portfolio allocation to private equity, with the average allocation around 5%.[4]

The chart below highlights the extent of superannuation fund investment in private equity – with around 50% of private equity funds raised up to June 2006 having been provided by superannuation funds.

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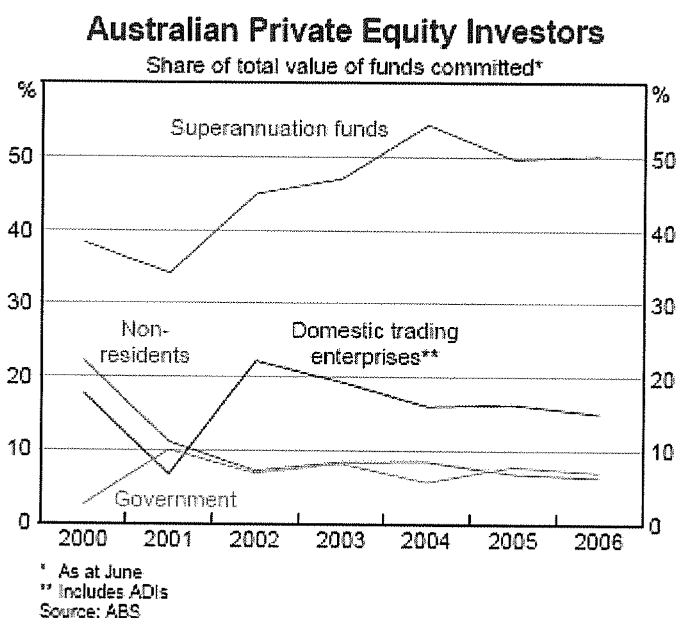
[2] Refers to the number of investments made per fund. Many private equity funds have a cap of around 10-15% exposure to any single transaction.

[3] APRA, Annual Superannuation Bulletin, June 2006, issued 22 March 2007.

[4] Reserve Bank of Australia, Financial Stability Review (March): 'Private Equity in Australia', page 62.



Critically, while the level of funds contributed by superannuation funds is high relative to the size of total private equity investment, it is not nearly as significant when compared to the $1 trillion invested/managed by superannuation funds.

It is also important to consider the types of underlying superannuation fund exposures to private equity. IFSA understands that a large proportion of the funds contributed, especially for off-shore private equity investment, are to funds of private equity funds – rather than more directly to individual private equity funds.[5]

This form of private equity investment is more diversified and also comes with the additional benefit of a manager assessing the merits of underlying funds – significantly reducing the risk of such exposures.

Size of the private equity industry in Australia

Total private equity funds under management in Australia stood at $22.4 billion at the end of June 2006.[6] This represented around 0.2% of total funds under management in the Australia at the time.

By way of further comparison, the market capitalisation of the Australian Securities Exchange (ASX) at the same time was $1,203 billion. By this measure, total private equity funds under management equated to around 0.19% of the market capitalisation of the ASX. The chart below compares this ratio with the global average.[7]

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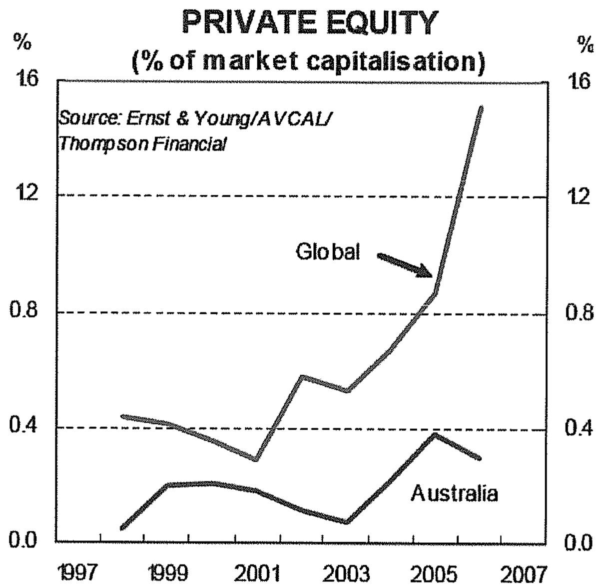
[5] RBA notes that 35 per cent of investor inflows in Australia into private equity have been through 'fund of funds'. See above reference.
[6] Thomson Financial & Australian Venture Capital Association Limited Survey Fiscal Year Ended June 30, 2006.
[7] Commonwealth Bank of Australia: 'Private Equity & the Economy', March 2007.



There is a disparity between the amount of funds raised by private equity firms and the value of private equity transactions conducted or announced. Thus, the value of private equity transactions announced and endorsed by target company Boards reached $26 billion by the end of 2006 – from a previous average of $2 billion over the last 5 years.[8]

Interestingly, while absolute levels of private equity activity are increasing, so too is the average size of new private equity funds. New funds formed during 2006 averaged $414.6 million in size, up 46% from the average fund size at the same time in 2005.[9]

At the same time, the rate of growth in new private equity firms being formed is slowing.

This would appear to highlight that the industry is maturing – with funds becoming more entrenched in the market and subsequently being able to raise more capital.

Global context

To better understand the current levels of private equity activity in Australia it is instructive to also consider the level of activity in Asia, the UK and Europe.

The UK experienced a record year for private equity transactions in 2006 – up from £24 billion in 2005 to £26 billion in 2006. Similarly, in Europe, the total deal value reached €104 billion in 2006, from €92.7 billion in 2005.[10]

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[8] Reserve Bank of Australia, Financial Stability Review (March): 'Private Equity in Australia', page 59.
[9] See 'Thomson Financial & Australian Venture Capital Association Limited Survey Fiscal Year Ended June 30, 2006'.
[10] Deloitte: 'The Big Picture, Private Equity trends', February 2007.

Trends in private equity investments in Asia Pacific (ex-Japan, incl-Australia) were no different where record volumes totalling US$7.6 billion were reached in 2006.[11] This figure represented the highest investment made to the region since 2000, where a total of US$10.3 billion worth of disbursements were recorded.

Australia's share of private equity investments in the Asia-Pacific (ex-Japan) was around 12% of total funds invested – with the main recipients being India, China and Singapore as shown in the table below.

Full Year 2006 Asia-Pacific (ex-Japan) Private Equity Investments

Company Nation	No. of Deals	No. of Comp	No. of Firm	Invested (US$ Mil)
India	143	126	88	2,211.85
China	145	129	110	1,718.41
Singapore	17	17	30	1,529.10
Australia	91	86	57	915.55
Taiwan	14	12	15	477.23
South Korea	12	11	12	306.35
New Zealand	13	12	15	271.53
Vietnam	5	5	5	85.38
Thailand	4	4	4	71.95
Hong Kong	2	2	2	28.00
Indonesia	2	2	2	-
Pakistan	1	1	1	-
Sri Lanka	1	1	1	-
Total	**450**	**408**	**342**	**7,615.35**

These figures highlight that Australia's experience to date has been entirely consistent with that around the world.

Drivers of private equity growth

The increase in global private equity activity has been attributed to a number of factors, including:

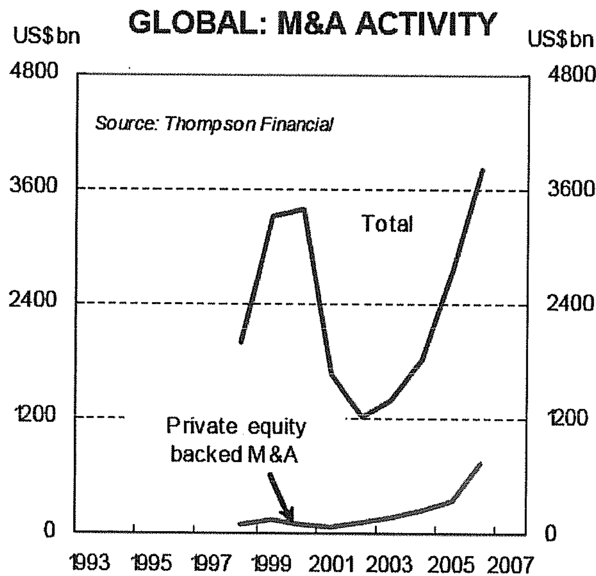
- continuing benign global economic conditions including low inflation and low interest rates;
- a savings glut in major oil exporting countries;
- a savings glut in certain Asian economies looking to invest their current account surpluses off-shore;
- increasing sophistication of pension/superannuation funds; and
- conservative levels of gearing in listed public companies and consequently strong corporate balance sheets.[12]

In essence, positive global macro-economic conditions have provided positive conditions for private equity transactions to flourish. Relevantly, these conditions have also been driving international equity markets to record levels, including the ASX in Australia, and are also likely to be fuelling the current record levels of mergers and acquisitions activity.

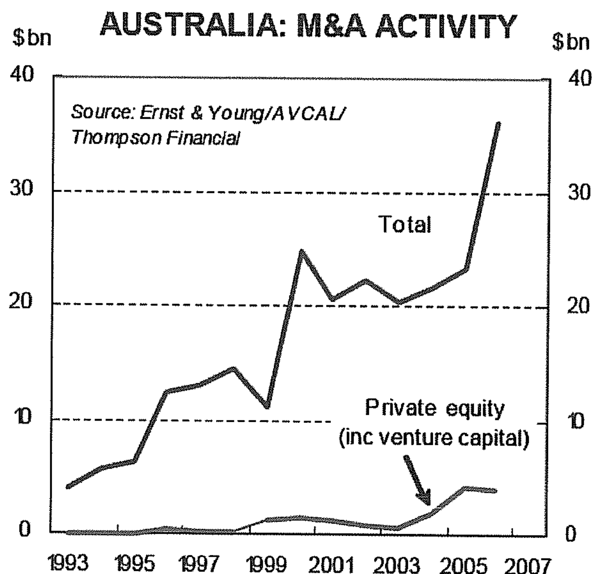
[11] Thomson Financial Asia Pacific Private Equity Markets, 2006 Year-End Report: Asian Private Equity Reach Record High.
[12] See IMF: 'Global Financial Stability Report, Market Developments and Issues', April 2007.

Private equity as a sub-set of mergers and acquisitions (M&A) activity

Private equity activity can also be considered as a subset of broader M&A activity that takes place in the economy. The chart below illustrates that at a global level, private equity funded M&A activity represents less than one third of total global M&A activity.[13]



Domestically, private equity funded M&A activity represented a similar level of overall M&A activity in the economy as shown below.[14]



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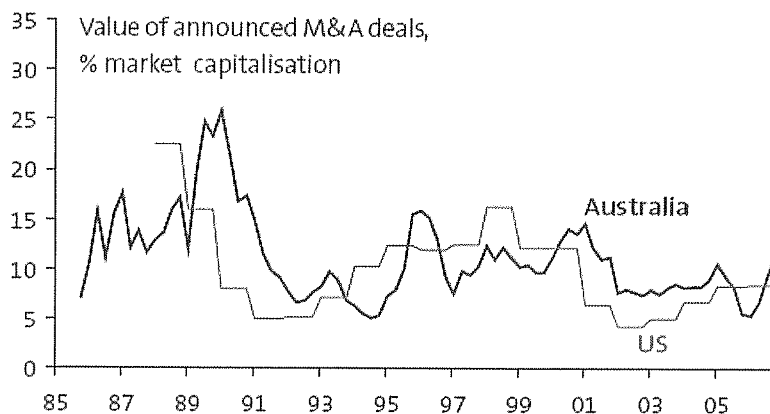
[13] Commonwealth Bank of Australia: 'Private Equity & the Economy', March 2007.
[14] As above.

Finally, looking at M&A activity as a percentage of market capitalisation, it is clear to see that the current levels are not unusually high – though given the amount of media speculation, one would not have expected this to be the case.[15]



In summary, these charts have highlighted that private equity is not a dominant component of M&A activity either in Australia or overseas, and that the private equity share of M&A activity in Australia is less than or consistent with that in other countries.

BROADER IMPACTS OF PRIVATE EQUITY

Private equity plays a broader role in the economy than has been covered off to this point.

Effect of private equity on capital markets

While private equity is a possible substitute for public equity, it is not a perfect substitute, just as taking on debt will also not be a perfect substitute for either private or public equity.

Nevertheless, the existence of private equity clearly imposes a competitive pressure on public market operators (such as the ASX) to ensure that their listing fees (initial, annual and other) are competitive.

It could be argued that in the absence of another public equity market in Australia, the emergence of private equity as a viable alternative, able to provide necessary funds for all sizes of capital expansions, is a positive development.

Some commentators have expressed concern at how effective private equity has become in this area and that it therefore signals a serious threat to public capital markets.

[15] AMP Capital Investors: 'The merger and acquisition boom has further to go', November 2006.

It is interesting to note, however, that many private equity transactions eventually involve the listing of the enterprise on an Exchange. Indeed, a recent survey conducted by PricewaterhouseCoopers found that of nearly 300 companies it surveyed that had received private equity funding, 53% indicated that they had either already listed or were planning to list.[16]

As a result, 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.

Indeed, there does not appear to be any evidence to suggest that the ASX is being adversely affected by the growth in private equity. Over the last 4 years, the market capitalisation of the ASX has increased 130.0%, from $646,163 million to $1,486,366 million. Over the same period, the number of entities listed on the Exchange has increased by 34.3%, from 1,511 to 2,029.

Market discipline

Similarly, IFSA believes that private equity investment activity provides a competitive discipline on the listed company sector. It is arguably no coincidence that some of the most outspoken critics of private equity have been listed company boards.

The existence of a vibrant private equity industry ensures that the market for corporate control is well contested – providing an additional incentive for company boards and senior executives to perform.

Effect on economic efficiency

Private equity is able to fill capital raising gaps in the economy by providing funds where other sources of capital may not be available. A vibrant Australian private equity industry therefore provides current and future Australian companies with a greater opportunity to expand and develop.

REGULATORY ISSUES

Investment fund related issues

IFSA agrees with the Council of Financial Regulators that "private equity transactions do not of themselves raise wholly new regulatory issues".[17]

Where private equity funds are offered to retail investors, they need to be registered as a managed investment scheme under Chapter 5C of the *Corporations Act 2001* (the Act) and also comply with Chapter 7 of the Act – which also imposes conduct, licensing, dispute resolution and disclosure obligations.

[16] PricewaterhouseCoopers and AVCAL: 'Economic Impact of Private Equity and Venture Capital in Australia', page 10.

[17] Reserve Bank of Australia, Financial Stability Review (March): 'Private Equity in Australia', page 68.

Like any other type of investment, private equity presents its own set of risks and benefits which need to be well understood by investors and creditors. The disclosure regime under Chapter 7 of the Act allows for investors to be informed of these and other matters including information about:

- any significant benefits to which a holder of the product will or may become entitled, the circumstances in which, and times at which those benefits will or may be provided, and the way in which those benefits will or may be provided;
- any significant risks associated with holding the product;
- the cost of the product; and
- any other significant characteristics or features of the product or of the rights, terms, conditions and obligations attaching to the product.

Private equity funds typically have unique features relative to other types of investment funds and these would be expected to be drawn out in such disclosures.

For example, whether the investment is subject to a minimum time period before being able to be redeemed and whether any 'break-fees' apply where an investor seeks to withdraw funds before the expiry of that minimum time period is a matter which would be required to be disclosed to a retail investor.

Interestingly, IFSA members that provide retail offerings of private equity funds (typically structured as a fund which itself invests in a number of private equity funds) have attempted to mitigate or remove these more undesirable aspects of private equity investment that are typically faced by direct investors in most private equity funds.[18]

Additionally, as registered managed investment schemes, private equity funds are subject to a comprehensive set of regulatory requirements that cover the scheme's governance structure and the duties of the 'Responsible Entity' that manages the scheme.

Among other things, these duties include to:

(a) act honestly; and
(b) exercise the degree of care and diligence that a reasonable person would exercise if they were in the responsible entity's position; and
(c) act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests; and

[18] See for example: 'Macquarie Global Private Equity Securities Fund' provides a highly liquid exposure to private equity and is open to retail clients who invest a minimum of $50,000 (http://www.macquarie.com.au/au/business/managed_funds/products/private_equity/global_private_equity_securities_fund.htm).

(d) treat the members who hold interests of the same class equally and members who hold interests of different classes fairly; and

(e) not make use of information acquired through being the responsible entity in order to:

   i. gain an improper advantage for itself or another person; or

   ii. cause detriment to the members of the scheme; and

(f) ensure that scheme property is:

   i. clearly identified as scheme property; and

   ii. held separately from property of the responsible entity and property of any other scheme; and

(g) ensure that the scheme property is valued at regular intervals appropriate to the nature of the property; and

(h) ensure that all payments out of the scheme property are made in accordance with the scheme's constitution and this Act; and finally

(i) report to ASIC any breach of the Corporations Act that relates to the scheme and has had, or is likely to have, a materially adverse effect on the interests of members.

Given the extensive regulatory safeguards that are in place, it is difficult to imagine what further regulatory requirements could justifiably be imposed.

Takeover and corporate governance related issues

Similarly, IFSA does not believe that the Corporations Act needs to be amended to deal with private equity related takeover transactions. However, IFSA does believe that private equity type transactions can present a number of governance issues for the corporate sector which need to be carefully considered on a case-by-case basis.

Governance issues

Continuous disclosure

All listed companies have an obligation to comply with Listing Rule 3.1 which generally requires:

> Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of that entity's securities, the entity must immediately tell ASX that information.

However, this general rule does not apply where:

1. A reasonable person would not expect the information to be disclosed; **and**
2. The information is confidential; **and**
3. One or more of the following applies:

(a) It would be a breach of a law to disclose the information.

(b) The information concerns an incomplete proposal or negotiation.

(c) The information comprises matters of supposition or is insufficiently definite to warrant disclosure.

(d) The information is generated for the internal management purposes of the entity.

(e) The information is a trade secret.

In a strict legal sense, this is not an easy test to apply. Investors appreciate that in a private equity context, it is possible that only an initial approach may have been made, which certainly not constitute a complete proposal or negotiation requiring disclosure under the Listing Rules.

However, investors have expressed concerns with companies that decide not to disclose the existence of a bid or reasonably advanced negotiations, although arguably still within their legal rights not to disclose, and subsequently speculation mounts about the existence of a bid which is then some time later confirmed or denied by the company.

At best, this approach results in a false market for the securities until the company makes an announcement. In the meantime, investors may have incurred economic losses from trading in the absence of information which, if known, could have affected their decision to trade.

At worst, given that discussions about a change of control transaction are likely to involve many parties – there is risk that insiders have been able to trade during this period to the possible detriment of others.

Consequently, IFSA members are generally of the view that if companies are in doubt of whether they are required to disclose, they should err on the side of disclosing the facts at that point in time and let the market decide how to react to those facts – that is, whether that information actually has a material effect on the price or value of that company's securities.

Director's duties

Private equity bidders often seek the support of target company Boards when making a takeover bid for a company. Management buy-outs, a sub-set of private equity transactions, typically involve a group of managers and/or executives of a company, in conjunction with a private equity firm, acquiring the company from existing shareholders.

This type of transaction places directors and senior officers involved in the buy-out in a conflicted situation where they are required to act in the best interests of the shareholders of the company and at the same time are attempting to acquire the company at the lowest possible cost from existing shareholders.

The recent draft Guidance Note 19 issued by the Takeovers Panel provides useful guidance on how such transactions ought to be conducted.

While each transaction needs to be considered on a case by case basis, IFSA members will generally expect that in MBO type transactions, independent directors will be primarily responsible for assessing any MBO type offer and deciding on whether to endorse any such offer.

All directors are required to observe their duties of care and diligence, good faith and not using their position to cause detriment to the company. Consequently, it is difficult to imagine a situation where a director that is involved in making a bid should be allowed to continue in their position as a director – at least during the bid period.

Even where they do remain in their position, the Act requires that such directors disclose any material personal interest to the Board and remove themselves from board discussions where such an interest exists. Such directors are also required to abstain from any vote on such matters.

Additionally, investors expect that once the company is aware that a director is involved in making a bid, they will be immediately prohibited from accessing any information that may be relevant to the MBO transaction or any subsequent competing bid.

This highlights the care that the Board needs to take when dealing with an MBO offer. It is important that the offer be managed in such a way as to address the concerns above but also minimise the distraction to the operation of the company posed by the existence of the MBO offer.

It is important to note the heightened concern among shareholders where the remuneration outcome of senior management may be linked to the approval or support for the bid. In such circumstances, it is not unreasonable for shareholders to approve any granting of options and 'success linked' remuneration to management which might flow from a private equity deal *before* it is accepted by the Board.

Finally, in assessing the offer, independent directors should access any external resources that they require in assessing the merits of the bid. This may involve appointing external advisers to seek out competing bids as well as seeking independent valuations of the company.

The sole focus of the independent directors should be on extracting maximum value for shareholders. They should therefore put in place any measures they believe are necessary to achieve this end.

Information asymmetry

Private equity bids typically involve a confidential due diligence process being undertaken by the bidders. This process is crucial to the success of any private equity transaction. However, it also gives rise to issues of information asymmetry between the private equity bidders on the one hand and the market, shareholders and other potential bidders on the other.

As a general rule, shareholders should be placed in the same position as those making a bid for the company. As owners, they should not be placed in any information disadvantage relative to the bidders – especially when the time comes to decide whether to accept or reject the bid.

IFSA again supports the statements made by the Takeovers Panel on this point:

> The Panel considers that, as a general principle, the target should seek to ensure that a bidder who is involved with participating insiders does not have an information advantage over shareholders.[19]

Regulation of public versus private companies

It is often cited that private equity is flourishing because of the comparatively high regulatory burden imposed on public listed companies. The argument is that as public listed companies are more heavily regulated and are under greater scrutiny, private equity has become much more attractive.

While regulatory neutrality is important, it is necessary to reflect on why public listed companies are regulated differently to private companies. Public listed companies have a large and diverse shareholder base. They are usually widely held meaning that no single shareholder is able to control the company.

This type of structure means that it is far more difficult for shareholders to hold boards or executives directly accountable (as their agents) for how the company has performed or behaved.

It is in fact far easier for shareholders in public companies to show their disapproval by simply selling out of the company.

Many, if not most, of the regulatory conditions placed on public listed companies are designed to protect shareholders from the principal and agent problems that could otherwise arise in the absence of these regulatory impositions. They attempt to ensure that shareholders have all the necessary information to make informed assessments about their company's performance, financial position and the conduct of their appointed representatives – the board of directors.

In contrast, a company that is acquired through private equity has a small and concentrated shareholder base – typically with direct shareholder representation on the board.

[19] Draft Guidance Note 19: Insider Participation in Control Transactions, page 6.

This structure enables shareholders to have a much higher degree of control over the company and the Board. There is consequently a much clearer line of sight into the company and the performance of executives/managers.

This approach results in a very direct alignment between executives and shareholder interests. In contrast to the public company model, as the company is privately held, it also means that it is often far easier for shareholders to show their disapproval by removing an under-performing director/executive/manager rather than selling out of the company.

Consequently, it is clear to see why there are necessarily different regulatory obligations imposed on different types of companies.

IFSA acknowledges, however, that if the attractiveness of the public markets relative to private markets was to decline, this would affect the "investible universe" of listed securities in which institutional investors can invest.

Such an outcome would not be desirable and it is therefore worth considering in the context of the matters raised above the regulatory burden imposed on publicly listed companies vis-à-vis other competing companies or businesses – domestic or international.

Finally, it is worth repeating a statistic highlighted earlier in the paper. In Australia, the ASX has experienced consistent growth in the number of companies listed on the exchange over the last 4 years. The market capitalisation of the exchange has also nominally increased over the same period by $840,203 million (or 130.0%). Over the same period, the number of entities listed on the exchange has increased by 34.3%, from 1,511 to 2,029.

Accordingly, at this stage, it does not appear as though the regulatory burden imposed on listed companies has been sufficient to provide a disincentive to companies seeking to list on the Exchange. This is further supported by the lack of evidence coming from exit-surveys conducted on companies that have de-listed – none of which indicated that the regulatory burden imposed on them was the contributing factor leading to their decision to de-list.