AIST SUBMISSION TO SENATE STANDING COMMITTEE ON ECONOMICS

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

May 2007

A. AIST and its Members

On 2 January 2007, the Australian Institute of Superannuation Trustees, Conference of Major Superannuation Funds and the Industry Fund Services Training Group merged into one new company. The new national company operates under the name of Australian Institute of Superannuation Trustees.

The bringing together of these three groups under one umbrella has created an organisation that provides a range of services to the representative superannuation industry, including professional development and training, and major events and conferences, in particular the annual Conference of Major Superannuation Funds ('CMSF'). The new company also engages in public policy relating to superannuation, and liaises with Government, regulators, and other groups involved in the superannuation industry, as well as providing compliance and licensing services.

The Australian Institute of Superannuation Trustees is a membership based professional body. Its members are representative superannuation funds, their Trustee Directors, Executive Management and Fund Staff.

B. AIST's Submissions

1. With the introduction of compulsory superannuation in Australia in 1992, the superannuation sector has grown into an industry that now has $1 trillion dollars invested for Australian workers' retirement. With this growth has come the continued need to find new investment vehicles.

2. Private Equity has been one of these investment vehicles, and provides superannuation fund Trustees with diversification from traditional asset classes such as Australian and Overseas equities, property and fixed interest, and the potential for enhancement of returns.

3. 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.

4. AIST will address the Committee's Terms of Reference in order.

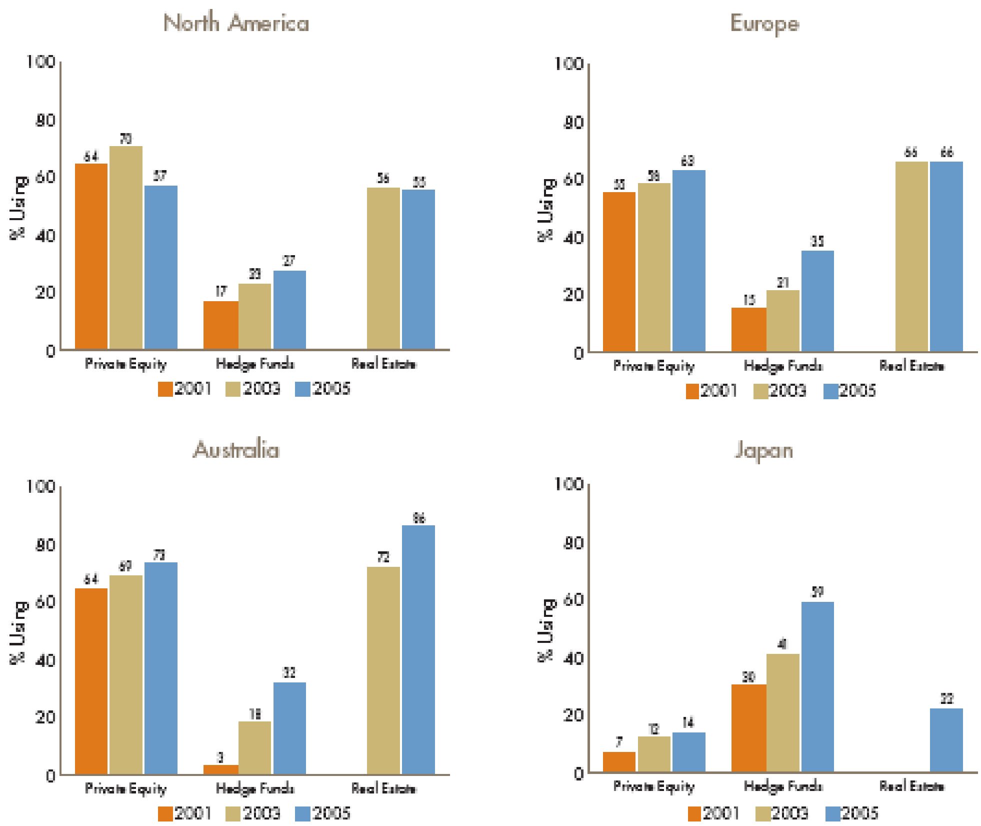
(a) AN ASSESSMENT OF DOMESTIC AND INTERNATIONAL TRENDS CONCERNING PRIVATE EQUITY AND ITS EFFECTS ON CAPITAL MARKETS

5. A survey by Russell Investment Group[1] of 327 large institutional investors globally, showed that private equity is a small but growing part of most institutional investors' portfolios.

6. The percentage of respondents that are investing in private equity has increased over the past 5 years in most geographies. In Australia, 73% of respondents were investing in private equity in 2005, compared to 64% in 2001 (refer to Chart 1, over page).

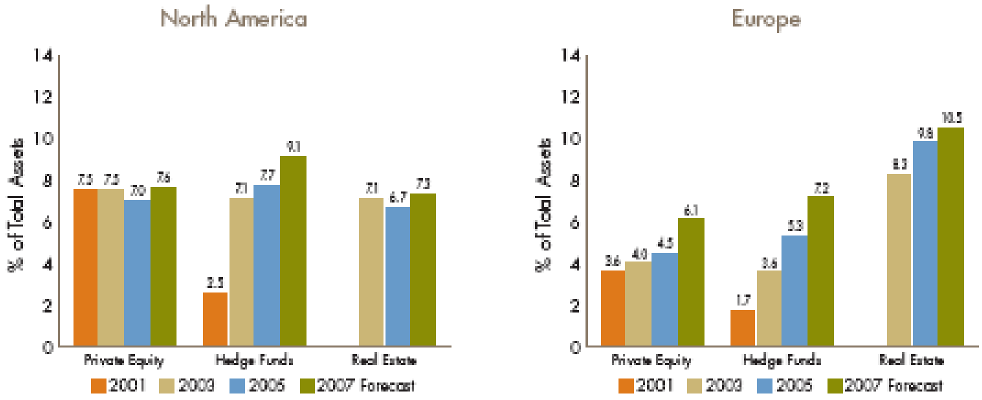
[1] The 2005-2006 Russell Survey on Alternative Investing, Russell Investment Group (http://russell.com/DE/AlternativeInvestingSurvey.pdf)

Chart 1: Percent of Respondents Utilizing Alternatives

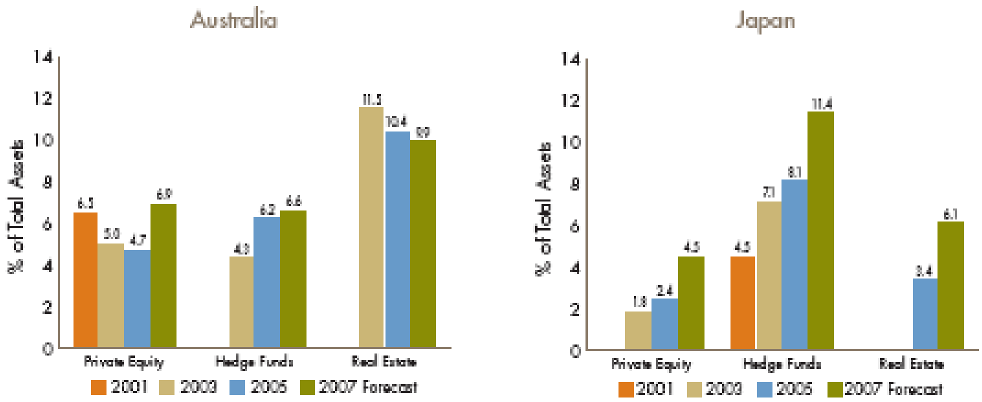


7. Moreover, the strategic asset allocations to private equity are forecasted to reach record levels across all geographies in 2007. In Australia, the mean strategic asset allocation is forecasted to increase from 4.7% in 2005 to 6.9% in 2007 (refer to Chart 2, over page).

Chart 2: Current and Forecast Mean Strategic Allocations to Alternative Investments



Note: 2001 North American hedge fund allocation is represented by the median.



2003 (2005 in Japan) is the first year that information on strategic allocation to real estate was collected. Hedge fund allocations in Australia and private equity allocations from Japan in 2003 were drawn from a small number of respondents.

8. The growing appetite from institutional investors for private equity investments has contributed to private equity managers raising record levels of funds in 2005-2006, both in Australia and internationally.

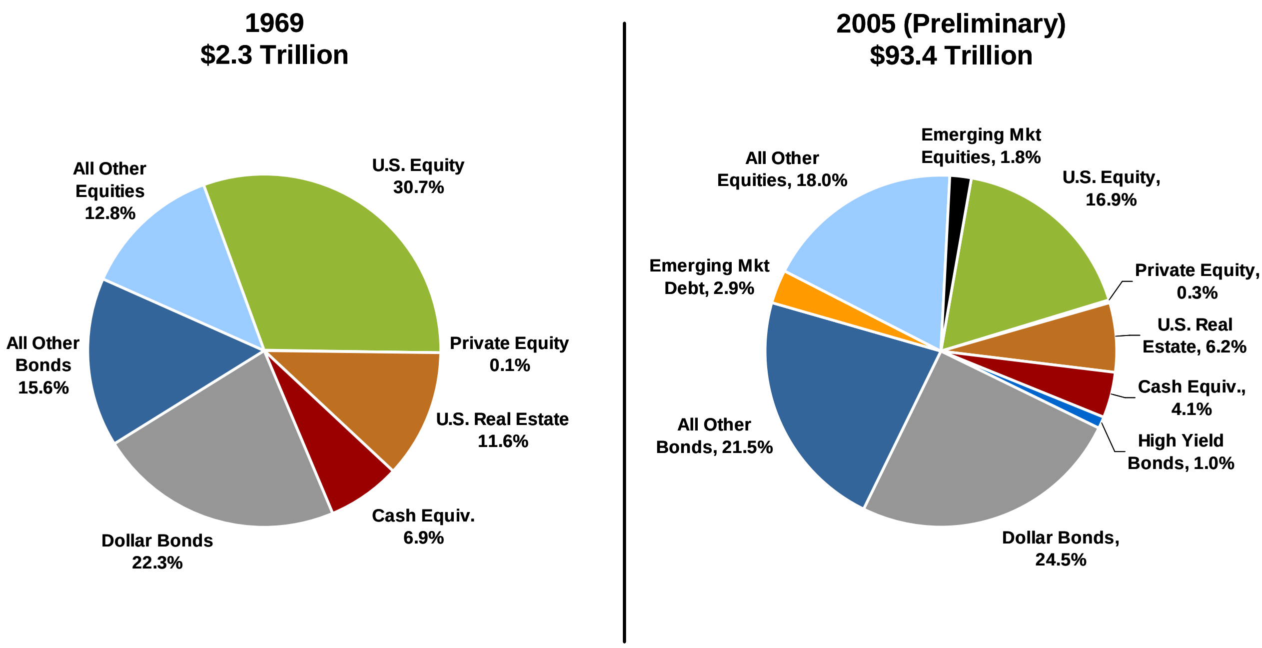
9. Nevertheless, private equity still represents a relatively small asset class, particularly when you compare total private equity funds under management with the market capitalisation of global listed equities.

10. Chart 3 which compares the size of the investable capital markets in 1969 and 2005, shows that private equity remains a very small part (0.3%) of the capital markets.[2]

---

[2] Presentation to Australian Private Equity and Venture Capital Association Ltd (AVCAL), November 2006, Hanneke Smits (http://www.avcal.com.au/events/NSW1106_Hanneke.ppt).

Chart 3: Total Investable 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

11. Any assessment of the risks posed by the Australian economy needs to first recognise that private equity is made up of a number of distinctly different segments, which can be categorised according to the nature of the business issuing the equity:

11.1 **Early-stage ventures –** Early stage companies vary somewhat in size, age and reasons for seeking external capital. The smallest type of venture is the entrepreneur who needs financing to conduct research and development to determine whether a business concept deserves further financing. A more mature type of venture within the early stage category is one that already has some evidence that production on a commercial scale is feasible and that there is a market for the product.

11.2 **Later-stage ventures –** Companies that need later-stage venture capital have a more proven technology behind their product and a more proven market for it than for early stage ventures.

Such companies need private equity financing to add capacity or to update their equipment to sustain their fast growth. Alternatively, such companies may seek capital to support a buy-out of the original investors.

11.3 **Middle market private companies –** Middle market companies are generally well established and are typically much larger than early-stage venture and are in most cases larger than later-stage ventures. They typically have more stable cash flows and lower growth rates than ventures. Many are family-owned enterprises that don't have the size or desire to go public.

11.4 **Public companies –** Companies that undergo public-to-private transactions typically have stable cash flows. The new investors transform the company from a publicly listed into a privately owned company (i.e. de-list it from the respective stock exchange).

12. Across all four categories, private equity managers try to increase the company's value through the following strategies: (a) buy assets cheaply; (b) improve the profitability of the company. In the case of middle market private companies and public companies, private equity managers can also: (c) use leverage by borrowing to multiply the profit of the business.

13. The use of leverage by private equity investors in middle market and public companies is at record levels, which may pose a risk if the economic landscape deteriorates. However, the increased sources of cheap debt currently available will continue to benefit good managers that prudently apply leverage to middle market and public companies.

14. Ultimately, private equity managers investing in middle market and public companies must increasingly focus on finding companies where they can achieve significant operational improvements in order to achieve their targeted returns. This is because the opportunity to buy assets cheaply within these two segments is becoming increasingly rare.

15. A recent survey[3] by PricewaterhouseCoopers in conjunction with AVCAL of 50 Australian private equity investee companies showed that private equity managers generally have a positive impact on a company's financial performance (i.e. sales, costs management, operational efficient and cash flow) as well as a company's non-financial performance (i.e. exports, marketing, executive recruitment, other recruitment and strategy). Moreover, the survey showed that private equity is an important job-creation driver and also contributes to technological innovation and R&D commercialisation in this country.

---

[3] Economic Impact of Private Equity and Venture Capital in Australia, 2006, PricewaterhouseCoopers and AVCAL (http://www.avcal.com.au/ftp/AVCAL_PWC_Reports_07.pdf).

16. A survey of venture capital investing in the United States yielded similar results.[4] It showed that venture capital backed companies make an enormous contribution to jobs, sales, economic growth, and technological progress in the United States.

(c) AN ASSESSMENT OF LONG-TERM GOVERNMENT REVENUE EFFECTS, ARISING FROM CONSEQUENCES TO INCOME TAX AND CAPITAL GAINS TAX, OR FROM ANY OTHER EFFECTS

17. AIST believes that the Department of Treasury is best equipped to look at an assessment of long-term government revenue effects. This question is too far reaching and includes too many variables that are best left to Treasury to apply the appropriate modelling to assess the impact on revenue.

(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.

18. As the questions (d) and (e) are inter-related, both points are covered below:

    18.1 Superannuation funds, both in Australian and Overseas, invest across a range of investment vehicles. Private Equity is merely one part of superannuation Trustees' asset allocations.

    18.2 In Australia the amount allocated to Private Equity is generally less than 5% of a fund's total asset allocation.

    18.3 Furthermore, when compared to other types of investments, Private Equity merely has a different ownership structure, than for example, Public Companies. We therefore do not believe that there is any need to treat Private Equity any differently than other asset classes.

    18.4 Rules regarding Foreign Ownership and Strategic Interest already apply to Private Equity, and provide a framework within which such investments are made.

[4] Venture Impact — The Economic Importance of Venture Capital Backed Companies to the U.S. Economy; Third Edition — Data Updated Through 2005; National Venture Capital Association (http://www.nvca.org/pdf/NVCA_VentureCapital07.pdf).

18.5 Private Equity is in the main, an investment vehicle for large Global Pension Funds, who have been investing in this asset for many years.

18.6 Within Australia, Superannuation Funds have invested in Private Equity for over a decade.

18.7 Australian Superannuation Funds have a strong track record in Private Equity, and seek external professional advice on their overall asset allocation and any private equity investments.

18.8 Investments are monitored on a continuous basis, and adjusted where needed.

18.9 Private Equity is part of the investment landscape, and is needed as more money flows into the system.

18.10 The amount invested by Australian Superannuation Trustees, is by no means large, and is less than is invested by European Pension Funds.

18.11 Private Equity is a growing sector for Australian Superannuation funds as they look to optimise returns versus risk.

18.12 Private Equity can also play a useful role in terms of listed companies, particularly those that are under performing, by making them take notice, and can be a catalyst to reform.

19. AIST believes that Private Equity plays a small, but important, role in a superannuation Trustee's overall investment portfolio as they look to maximise returns, whilst managing risk, with the primary intent of providing superior investment returns to their members.

20. 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.

21. According to SuperRatings the median return over 5 years for superannuation funds is 9.77% per annum. Listed below is a small sample of 5-year returns for some of our members, who invest in Private Equity.

22. 5 Year average returns in the balance portfolio – from SuperRatings:

Superannuation Fund	**5 Year Return**
Australian Super	11.43%
CARE	10.94%
Host Plus	11.70
LUCRF	10.57%
MTAA	13.49%
AGEST	10.54%
Cbus	10.70%

Concluding Comments

23. In recent times there has been a great deal written in the media on the role Private Equity plays in the investment market, in particular where it has related to large Australian Companies, such as Qantas and Coles Myer.

24. Many of AIST members are still trying to determine the longer-term impact of Private Equity on the listed markets.

25. Superannuation funds in the main see a distinction between the private equity deals in which they invest and those of the high profile private equity deals that could be better classified as "corporate raiders".

    25.1 Superannuation Funds generally consider their private equity investments to be loosely referred to as "venture capital", in that those investments provide the funds for "start-ups" and development projects as distinct from the "corporate raider" type investors.

    25.2 "Corporate Raiders" in this context refer to those who take large profitable companies, break them up and/or load them with debt to provide returns to investors.

    25.3 Most Superannuation Fund Trustees in Australia have stringent corporate governance arrangements and procedures, and these procedures, combined with the advice from their asset consultants and investment managers, provide the Superannuation Fund Trustees with detailed information and advice in choosing its investments. These governance guidelines and procedures assist the Trustees in determining the nature of all its investments, including private equity, to assess whether an investment in private equity is of the "venture capital" type, or a "corporate raider" type.

    25.4 The distinction being that the first activity creates opportunity and business and the second does nothing more than extract value from companies leaving them laden with debt.

C. AIST Contact Information

Should the Committee require further information, AIST would be happy to assist the Committee. The Committee can contact the following persons from AIST:

Ms Angela Emslie, AIST Acting Chair
angela@limegroup.net.au
(03) 9645 1499
0419 754 760

Ms Fiona Reynolds, Chief Executive Officer
freynolds@aist.asn.au
(03) 9657 4302
0408 336 116

Ms Peta-Gai McLaughlin, Legal & Compliance Manager
pgmlaughlin@aist.asn.au
(03) 9923 7153
0416 048 487