Senate Economics Committee

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

Submission
By

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This submission is divided into the following three parts:

- Introduction and overview of key issues involved with private equity investments;

- Problems areas involving private equity investments associated with leveraged buyouts; and

- Published articles dealing with key issues arising from the Qantas private equity bid as well as the lessons from the bid's failure.

The submission includes 14 proposals that could be adopted to deal with key issues arising from private equity investment in Australia.

Introduction and overview of key issues involved with private equity investments

Private equity investment, like any type of investment strategy or financial arrangement, involves risks and rewards that need to be fully understood by all those involved. In the case of private equity investment the rewards can be very large, but so can the risks involved. All too often there is a temptation to focus simply on the very high rates of return that private equity investments can deliver to investors. Talk of risk is down played with the promoters of private equity investments and their advisers reassuring everyone that appropriate safeguards are in place and that we have nothing to worry about.

Certainly where the private equity investment is successful there may be few, if any, complaints. However, the risk associated with private equity investments is generally higher, particularly as these investments are either in risky or unproven start up companies (more commonly known as venture capital investments); or in established companies (typically involving a leveraged buyout).

Of these types of private equity investments, traditional venture capital type investments are much less likely to be of concern. While of course the risk/reward equation needs to be understood by those providing or using this type of financing, this tends to be less of an issue as these venture capital type investments are a well established source of funding for new and emerging companies.

Those using this type of financing should be well of the risks involved with using venture capital. For many of them it may be the only form of financing available to fund their business and for others it is an opportunity to raise capital privately. They may be seen to be too risky by traditional sources such as banks or may not be ready or willing to list on a stock exchange.

In these circumstances, companies may turn to outside venture capital investors who generally provide funds to help develop or expand the company in return for an equity stake in the company. Often the company is at an early or unproven stage of development and this higher risk means that the venture capital investors will require much higher rates of returns.

While a variety of terms such as risk capital, growth capital or business angel may be used to describe these venture capital type investments they all generally share a common theme of outsider investors or a wealthy individual investing in a new or growing business in exchange for a higher rates of return and an equity stake in the company to cover the higher risks involved. These outside investors play an important role in helping start and grow companies that may otherwise struggle to get off the ground or reach critical mass because of a lack of funding from traditional sources.

In this way, traditional venture capital type investments operate to promote innovation and help support companies that would otherwise not be able to access funds to develop new or unproven products or technologies. The associated risks and rewards are generally well known by those involved and, in the event of the company's success the benefits are shared by the company's owners and venture capital investors. Similarly, any losses are also shared by the owners and investors with the overall fallout likely to be localized rather than be economy wide.

In contrast, private equity investment associated with leveraged buyouts of major established companies - the other broad category of private equity investment - is much more likely to have economy wide impacts in the event of the company's failure. These deals tend to be very high profile and usually involve private equity firms pooling very large sums of private funds from a variety of sources such as superannuation funds and combining those with funds from traditional sources such as banks to buy out an established business. Typically, the shareholders of the business are bought out completely and the company goes private with a very high debt structure to later - if all goes well – be re-listed at a much higher share price delivering a large profit to the private equity consortium to complement the significant management fees earned along the way.

A further dimension is added to these leveraged buyouts by the fact that these private equity firms are increasingly inviting the existing management of target companies to participate in the private equity bid for the business. In the past a private equity firm may have been more likely to bring in a new management team with a mandate for reorganizing or breaking up the company. While the removal of management and the reorganization or break-up of a company has typically been the rationale for private equity investment taking over under performing companies, it would appear that private equity firms are now turning their attention to well run companies and seeking management's support for the bid. Under this scenario, the existing management is retained and given a financial interest in the private equity consortium.

It is this leveraged buyout of major Australian companies by private equity firms that is of potential concern. In particular, it is a proper understanding and management of the risks associated with leveraged buyouts of major companies that is critical to ensuring that the failure of such private equity investments do not have a disproportionately large negative impact on the economy.

While it would be unfortunate for any small start company to fail, it may be much more problematic where a major established company fails as the impact may be magnified throughout the economy. Tens of thousands of customers, creditors and employees could be affected by such a failure. Where the failure occurs in a sensitive part of the economy such as the airline or electricity industry the impacts can be quite severe as passengers may be left stranded around the world or homes left without power. Such failures may be the exception, but where they do occur they can have quite a severe impact.

Of course, governments should not pick winners nor intervene unnecessarily in takeover bids. Equally, however, governments and taxpayers should not be left to pick up the pieces or bear any costs where a major company fails under the weight of excessive debt following a leveraged buyout. Given that the failure of major established companies can have a disproportionate large negative impact on the economy private equity investments associated with leveraged buyouts of such companies may require additional scrutiny and safeguards. These are discussed in the next part of the submission.

Potential problem areas involving private equity investments associated with leveraged buyouts

The potential problem areas involving private equity investments associated with leveraged buyouts will be considered under the following headings:

- Financial stability issues;
- Transparency and disclosure issues;
- Taxation issues;
- Trade Practices issues; and
- National interest issues.

Financial stability issues

The very high debt level used in private equity investments associated with leveraged buyouts of major Australian companies should be carefully scrutinised and subject to ongoing review. The debt structure of a private equity bid is of concern because the failure of the company may have economy wide impacts in terms of the stability of the financial system. Given that financial institutions may fund the debt element of a leveraged buyout and that superannuation and other investment funds may provide the private equity funds, it is critical that the financial regulators are well aware of the debt levels involved; and whether there have, at any stage, been any default events (ie a failure to meet an interest repayment or any other terms or conditions imposed by a party involved in the financing of the leveraged buyout). While the involvement of financial institutions and superannuation and other investment funds may be useful in spreading the risk, this spreading of risk may also mean that the impact of a failed leveraged buyout of a major Australian company is more likely to be felt across the financial system and the economy generally.

The Council of Financial Regulators – which draws together the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission, the Australian Treasury and the Reserve Bank of Australia – is well placed to report quarterly on the debt levels of major Australian companies that have been acquired through a leveraged buyout involving private equity investment. The Council has already issued a Report on Private Equity in Australia as part of the Reserve Bank's March 2007 Financial Stability Review. Given the dramatic increase in leveraged buyout activity involving private equity investment in 2006 as noted in the March 2007 Financial Stability Review the quarterly reporting of leveraged buyout activity in Australia may be quite useful.

Proposals - Financial stability issues:

1. That where a major Australian company has been acquired through a leveraged buyout involving private equity investment, the

acquirers be required to (a) report immediately to the Council of Financial Regulators any “default” events in relation to the debt or any other aspect of the buyout’s funding arrangements; and (b) report levels of debt on a quarterly basis to the Council of Financial Regulators.

2. That the Council of Financial Regulators issue quarterly reports regarding debt levels of Australian companies acquired through a leveraged buyout involving private equity investment; and

3. That the Council of Financial Regulators issue quarterly reports regarding the level of leveraged buyouts in Australia involving private equity investment.

Transparency and disclosure issues

Once a major Australian company has been acquired through a leveraged buyout involving private equity investment, it is typically freed from the public reporting obligations under the *Corporations Act*. While of course the company will need to regularly report financial information to the private equity consortium and lenders, this information is less likely to filter down to the wider investing public seeking to track the performance of private equity investments and, in particular, those members of superannuation or investment funds whose money is being invested in private equity deals. It is these members of superannuation and investment funds who are increasingly providing the money for private equity investments such as leveraged buyouts of major Australian companies by private equity firms. As a result, these members should be adequately informed about their superannuation or investment fund's involvement with private equity investments. Such disclosure should occur in a manner that is consistent across different funds thereby increasing the utility of such disclosure.

While varying degrees of disclosure may be made by individual superannuation or investment funds to their members regarding the fund's involvement with private equity investments, this disclosure tends to vary across funds and be of a general nature rather than of a specific nature detailing the performance of particular private equity investments with which the fund is involved. An international example of a fund that does provide comprehensive data regarding particular private equity investments is the California Public Employees' Retirement System (CalPERS). This data can be found at.

http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/equities/aim/private-equity-review/aim-perform-review/home.xml

Increased transparency and disclosure of information regarding private equity investments in Australia is necessary to remove or minimise as far as possible the information asymmetries that may arise in relation to such investments. The removal or minimising of information asymmetries is vital to the proper and efficient functioning of capital markets and, in assisting all those, such as members of super and investment funds, whose money may be invested in private equity deals to be in a position to make more informed decisions about the ways those funds invest the money.

Proposals - Transparency and disclosure issues:

4. That the Council of Financial Regulators be asked to prepare and release for comment a discussion paper outlining alternative mechanisms for (a) promoting greater transparency and levels of disclosure in relation to private equity investment in Australia and, in particular, promoting greater transparency and levels of disclosure regarding major Australian companies that have been acquired through a leveraged buyout involving private equity investment; (b)

ensuring that members of superannuation and investment funds are given adequate, specific information regarding the fund’s involvement with private equity investments and the performance of those private equity investments; and (c) ensuring that disclosure by superannuation and investment funds regarding their involvement with private equity investments occurs in a manner that is consistent across different superannuation and investment funds.

Taxation issues

There can be little doubt that the capital gains exemption provided to foreign residents following the passage of the *Tax Laws Amendment (2006 Measures No. 4) Act 2006* has been a key factor leading to the dramatic rise in leveraged buyouts involving private equity investments. As a result of this legislation, a foreign resident will generally not pay capital gains tax in Australia with respect to capital gains made in relation to private equity investments in Australia. The policy objective behind granting this exemption from Australian capital gains tax appears to have been a desire to promote foreign investment in Australia and to bring Australia's tax law and tax treaty practice into line with OECD tax practice on the issue.

Given the dramatic rise in leveraged buyouts involving private equity investment it is now appropriate to fully model the tax impacts from this surge in private equity investments. In this regard, it may be useful to also review the estimates provided in explanatory memorandum accompanying the *Tax Laws Amendment (2006 Measures No. 4) Bill 2006* regarding the tax revenue losses from the passage of the capital gains exemption. These estimates may have significantly underestimated the potential loss of capital gains tax revenue from a surge of foreign private equity money chasing the tax free status of capital gains by foreign residents.

While there has been considerable discussion regarding the positives from Australia's point of view in granting the capital gain exemption, there appears to have been much less discussion regarding the potentially significant loss of capital gains tax revenue to Australia. There also seems to have been even less discussion about the possibility that capital gains from private equity or other investments by foreign residents may not be taxed anywhere in the world as those foreign residents or private equity firms may be based in tax havens or jurisdictions where those capital gains are not taxable.

Of course, consideration should also be given to the possibility that the capital gains exemption is not relevant where the profits from a private equity investment are of an income rather than capital nature. For example, the regular and repeated buying and selling of companies by a private equity firm could mean that the firm has moved from being a passive capital investor to carrying on a business of buying of selling companies such that they are generating income from that business potentially taxable in Australia.

Proposals – Taxation issues:

5. That an attempt to be made to fully model the tax outcomes associated with private equity investments as soon as possible with the results of this analysis publicly released to facilitate an informed debate about the fiscal impact of private equity investments.

6. That the Australian Taxation Office be asked to publicly issue regular reports setting out its analysis of actual tax issues and outcomes associated with private equity investments.

7. That the Australian Taxation Office be asked to prepare and release a statement or report outlining its position as to tax treatment of private equity investments associated with leveraged buyouts including whether or not the regular and sustained buying and selling of companies by private equity firms amounts to those firms carrying on a business in Australia such that the proceeds from those activities are considered income (rather than capital) for the purposes of Australian taxation law.

Trade Practices issues

Trade Practices issues arise in the following areas:

- "Lock-ups" and other agreements that may substantially lessen competition;
- Common directorships and ownership interests;
- Price discrimination; and
- Creeping acquisitions.

"Lock-ups" and other agreements that may substantially lessen competition

Under s 45 of the *Trade Practices Act* a corporation is prohibited from making a contract or arrangement, or arrive at an understanding, if (i) the proposed contract, arrangement or understanding contains an exclusionary provision; or (ii) a provision of the proposed contract, arrangement or understanding has the purpose, or would have or be likely to have the effect, of substantially lessening competition. Accordingly, any agreement that substantially lessens competition or contains an exclusionary provision may potentially be in breach of the *Trade Practices Act*.

With respect to agreements that have the purpose, or would have or be likely to have the effect, of substantially lessening competition it is necessary to consider the impact of the agreement on the level of competition in the relevant market. Exclusionary provisions, however, are considered "per-se" or outright breaches of the *Trade Practices Act*. In these circumstances, an exclusionary provision is one found in a contract, arrangement or understanding between parties, any 2 or more of whom are competitive with each other; and which has the purpose of preventing, restricting or limiting the supply of goods or services to, or the acquisition of goods or services from, particular parties; or in particular circumstances or on particular conditions by all or any of the parties to the contract, arrangement or understanding.

In relation to private equity bidders serious questions arise as to whether or not various "lock-up" arrangements that are being explored or implemented by private equity bidders as part of a leveraged buyout of major Australian companies involve either an exclusionary provision, or a provision in a contract, arrangement or understanding that has the purpose, or would have the likely effect, of substantially lessening competition in breach of the *Trade Practices Act*.

Such potentially anti-competitive "lock-ups" in breach of the *Trade Practices Act* could include:

- Giving the management of the target company a financial or other interest in the private equity consortium bidding for the company. This may give rise to an agreement between the management of the target company and a particular private equity consortium that may have the purpose or likely effect, of substantially lessening competition in the actual or potential bidding process for the company. In particular, the locking up of the existing management may have the purpose or likely effect of preventing or substantially reducing the likelihood of a competing bid for the target company;

- Arrangements aimed at or having the likely effect of preventing the management of a target company from soliciting or working with a rival bidder for the company;
- Attempts by the private equity consortium to "corner the market" for financial institutions, legal and financial advisers that could potentially be involved in the leveraged buyout. These could involve entering into agreements with these parties that may involve an exclusionary provision, or a provision that has the purpose, or would have the likely effect, of substantially lessening competition in the actual or potential bidding process for the target company. In particular, by locking up financial institutions, legal and financial advisers that could potentially be involved in a leveraged buyout, the consortium could seek to prevent or substantially reduce the likelihood of a competing bid for the target company; and,
- Potential collusion between private equity firms in the bidding process for a target company aimed at, or having the likely effect of preventing or substantially reducing the likelihood of a competing bid for the target company;

Given that these and other possible "lock-ups" devised by private equity bidders to remove or prevent rival bidders may have an anti-competitive purpose or effect, it is critical that the Australian Competition and Consumer Commission (ACCC) be ready to (i) deal immediately with such conduct, and where necessary pursue legal action under the *Trade Practices Act;* (ii) report on current activities in relation to "lock-ups;" and (iii) as soon as possible provide detailed guidance as to the types of conduct by those involved with leveraged buyouts by private equity firms that may constitute a possible breach of the competition law provisions of the *Trade Practices Act*.

Common directorships and ownership interests in companies

With private equity firms increasingly acquiring a series of companies involved in the same or related markets, a concern as to whether common (or "interlocking") directorships or ownership interests between such companies may give rise to potentially anti-competitive conduct. In particular, there is a danger that common directorships or ownership interests may result in or have the effect of the different companies behaving in mutually beneficial manner that is detrimental to competition. While any contract, arrangement or understanding involving common directors or owners behaving in a coordinated fashion may give rise to a breach of s 45 of the *Trade Practices Act*, the problem arises where common directors or owners may individually or unilaterally cause the different companies to behave in a mutually beneficial manner that is detrimental to competition.

While such unilateral behaviour may have the effect of substantially lessening competition it may not generally be caught by the *Trade Practices Act*. Given that any “influence” unilaterally exerted by common directors or owners could potentially have the same anti-competitive effects as a contract, arrangement or understanding to behave in a mutually beneficial manner, consideration should be given to amending the *Trade Practices Act* to expressly prohibit common directorships or ownership interests in companies in the same or related markets that have the purpose or likely effect of substantially lessening competition in those markets.

Price discrimination

Given that private equity firms are increasing buying companies that may be suppliers to other companies owned by the private equity firm, a concern arises at to whether a private equity-controlled supplier of goods or services will discriminate in favour of a private equity-controlled acquirer of those goods or services to the detriment of other independent acquirers of those goods or services. For example, where a private equity firm owns or controls an airport and then buys or acquires an interest in a major airline using the airport, there is a danger that the airport may give the private equity-owned or controlled airline preferential treatment to the competitive detriment of other airlines not controlled by the private equity firm.

At present the *Trade Practices Act* does not expressly prohibit anti-competitive price discrimination. Previously, s 49 of the *Trade Practices Act* did deal with price discrimination, but it was repealed on the understanding that s 46 of the *Trade Practices Act* would adequately deal with price discrimination issues. Unfortunately, in view of the current ineffectiveness of s 46 as shown by the lack of cases taken to court by the ACCC since the High Court’s decision in the Boral case back in February 2003, it is appropriate to consider amending the *Trade Practices Act* to expressly prohibit anti-competitive price discrimination.

While the inadequacy of the *Trade Practices Act* in preventing anti-competitive price discrimination is not an issue confined to private equity investments, the fact that private equity firms are increasingly becoming suppliers of goods or services to not only other companies they own, but also to unrelated companies means that there is a growing risk that private equity firms may engage in anti-competitive price discrimination. Given the very large scale of some private equity investments (eg airports and airlines) such anti-competitive price discrimination may have economy wide competitive detriments and, therefore, needs to be effectively and expressly dealt with under the *Trade Practices Act*.

Creeping acquisitions

The acquisition over a period of time of a series of companies involved in a particular market raises trade practices concerns that are currently not addressed by the *Trade Practices Act*. In particular, this process of creeping acquisitions is currently not considered to be a breach of s 50 of the *Trade Practices Act* as there is currently no express ability under s 50 to be able to group together individual acquisitions over a period of time so as to consider whether collectively they substantially lessen competition. In other words, as s 50 only prohibits an acquisition if it substantially lessens competition, each acquisition is to be considered individually as and when it occurs and assessed on its own for the purposes for determining whether it will substantially lessen competition in breach of s 50 of the *Trade Practices Act*.

Thus, under s 50 of the *Trade Practices Act* individual acquisitions may not on their own represent a substantial lessening of competition in breach of s 50, but if those acquisitions were expressly allowed to be considered collectively under s 50 they could be found to give rise to a substantial lessening of competition in a market. For example, where a company can be seen to be acquiring interests in toll roads, taxi companies, airports and airlines, the question arises as to whether the company is setting out to dominate the transportation market. Thus, while these individual acquisitions may not on their own give rise to a substantial lessening of competition in breach of s 50 of the *Trade Practice Act*, when taken together the acquisitions could be seen as giving rise to a substantial lessening of competition to the detriment of consumers.

While the inadequacy of s 50 of the *Trade Practices Act* in preventing a process of anti-competitive creeping acquisitions in a market is not an issue confined to private equity investments, it would appear that some private equity firms are, over time, acquiring individual companies in the same market or related market with the goal of being the dominant or monopoly player in those markets.

Proposals – Trade Practices issues:

8. That the ACCC be asked to prepare and release a report outlining the types of conduct by parties associated with leveraged buyouts involving private equity investments that may constitute a breach of the competition law provisions of the *Trade Practices Act*.

9. That the ACCC give specific guidance as to whether or not the financial involvement of management in a private equity consortium could potentially constitute a breach of the competition law provisions of the *Trade Practices Act*.

10. That the *Trade Practices Act* be amended to expressly prohibit common (or “interlocking”) directorships or ownership interests in companies that have the purpose or likely effect of substantially lessening competition.

11. That the *Trade Practices Act* be amended to expressly prohibit anti-competitive price discrimination.

12. That s 50 of the *Trade Practices Act* be amended to expressly allow for individual acquisitions in a market over a period of time to be considered collectively for the purposes of determining if there is a substantial lessening of competition. In this way, s 50 could deal effectively with anti-competitive creeping acquisitions.

National interest issues

Private equity investments associated with leveraged buyouts of major Australian companies in sensitive industries such as financial institutions, transport, electricity and gas supply raise national interest issues. These national interest issues arise because the failure of such companies may have an economy wide impact and potentially impose a level of disruption on Australians that would not ordinarily be acceptable in a modern economy.

While the failure of any company is unfortunate, the failure of a bank, airline, electricity or gas supply company is likely to cause a disproportionately high level of disruption to the economy generally and Australian consumers in particular. Thus while any company failure will have a localised impact on its shareholders, creditors, workers and customers, the failure of major Australian companies in sensitive industries can have dramatic economy wide impacts. Indeed, the failure of an electricity supply company could have quite detrimental impacts on the economy, industry and households. Even if the electricity company itself is able to survive, the high debt structure of a leveraged buyout may lead to cuts in capital investment thereby raising the real risk that the company's physical infrastructure will not be renewed and be increasingly prone to breakdown or even total failure. Such concerns led to one United States regulator to block a private equity bid for an electricity company.

The full media release regarding the Oregon Public Utility Commission's decision unanimously deny the application by the Texas Pacific Group (TPG) to buy Portland General Electric (PGE) can be found at:

http://www.oregon.gov/PUC/news/2005/2005_007.shtml

For present purposes the following quotes from that media release highlight Oregon Public Utility Commission's key concerns regarding the private equity bid:

> "The potential harms or risks to PGE customers from the deal outweigh the potential benefits," said Commission Chair Lee Beyer. "Based on the evidence presented to us, we found that PGE customers would not be better off in terms of rates and service than they would with PGE as a separate, stand-alone company.
>
> The Commission cited a large debt burden and short-term ownership as the major sources of risk while discounting the benefits of the deal alleged by TPG.
>
> The large amount of debt to finance the purchase is the "primary source" of potential harm to PGE's customers, the Commission order stated. "It is the single biggest source of risk," said Commissioner John Savage.
>
> "The high debt percentage would likely result in lower credit ratings for PGE than it would in the absence of this transaction," states the order.

> Lower credit ratings for PGE could translate into higher future rates for customers.
>
> The Commission also singled out the lack of an investment grade rating for Oregon Electric debt. "This increases the likelihood that PGE may need to engage in imprudent cost-cutting and reduced capital investment if earnings drop," the Commission wrote in its order.
>
> The Commissioners also found that TPG's intention to resell PGE within 12 years may lead to harm for customers. "While we did not agree with the parties' assertions that TPG would slash costs, we could not dismiss all the risks associated with short-term ownership," said Commissioner John Savage.
>
> The Commission expressed concern that TPG may fail to increase operations and maintenance spending where necessary and might not make discretionary investment that could benefit customers."

The concerns expressed by the Oregon Public Utility Commission are equally relevant to private equity investments associated with leveraged buyouts of major Australian companies in sensitive industries. Equally relevant is the Oregon Public Utility Commission's decision to block the private equity deal because of the particular sensitivities involved in the target being an electricity company.

Within this context, there may be instances in Australia where consideration may need to be given to either restricting the involvement of private equity firms in particularly sensitive industries, or placing restrictions on the level of debt that major Australian companies in sensitive industries can hold where acquired through a leveraged buyout involving private equity investment.

In addition to the sensitivities involved in particular target companies or industries, there is the issue of the fallout from the failure of such a company. Where such companies do fail taxpayers may be called to cover some of the losses flowing from the failure. To assist in defraying some of these losses, consideration should be given to requiring private equity consortiums bidding for such companies to lodge in a trust an amount of money as a "performance" or "security" bond.

A precedent for requiring the lodgement of a performance bond in sensitive industries can be found in the requirement imposed on the private operators involved in the privatisation of Victoria's rail system to lodge a performance bond that would be forfeited in the event that the operators withdrew from their obligations. A discussion regarding the forfeiture of performance bonds where one of the operators did withdraw can be found in *Public Transport Partnerships: An Overview of Passenger Rail Franchising in Victoria*, March 2005. This report can be accessed at:

http://www.doi.vic.gov.au/doi/doielect.nsf/2a6bd98dee287482ca256915001cff0c/a32ae874bdd49651ca256fb9001270b3/$FILE/Rail_Franchsing_Overview.pdf

Importantly, even with the forfeiture of the performance bonds Victorian taxpayers were still required to cover part of the losses arising from the operator's withdrawal. This provides further evidence of the potential cost to the taxpayer in the event that a highly leveraged company in a sensitive industry fails.

Proposals – National interest issues:

13. That consideration be given to either (a) restricting on a case by case basis the involvement of private equity firms in particularly sensitive industries; or (b) placing restrictions on the level of debt that major Australian companies in sensitive industries can hold where acquired through a leveraged buyout involving private equity investment.

14. That in relation to major Australian companies in sensitive industries acquired through a leveraged buyout involving private equity investment, the private equity consortium involved be required to lodge in a trust an amount of money as a "performance" or "security" bond to help cover (a) any costs or losses arising from the disruption to essential services in the event of the company's failure; and (b) any other costs that may otherwise be covered by the Australian taxpayer in the event of the company's failure.

Article regarding key issues arising from the Qantas private equity bid

http://www.news.com.au/story/0,23599,21255824-5007146,00.html

Think about the passengers

By Frank Zumbo

February 20, 2007 12:00am

Article from: Herald Sun

IN deciding whether the Qantas takeover bid is contrary to the national interest, it is critical we buckle up and think from the perspective of paying passengers, writes Frank Zumbo.

To consumers, Qantas is a national icon they expect will always be there to provide safe and affordable travel, and to build on its service standards and faithfully honour its frequent-flyer obligations.

In this regard, the uncertainty surrounding the future of Qantas causes unease among consumers, and rightly so.

Uncertainty brings with it risk and poses a threat to everything that they have come to expect from this national icon.

Of course, the greater uncertainty, the greater the perceived risk.

Central to all the unease is the extremely high level of debt in the Airline Partners Australia's $11.1 billion bid.

APA is putting in $3.6 billion of its own money, but borrowing most of the rest, leaving Qantas geared about 75:25 debt to equity.

That prompted former transport minister John Anderson to voice his concerns and urge the Foreign Investment Review Board to take it into account.

The bid partners have assured us that they intend to grow the business, and this would make the debt manageable.

Such assurances are no doubt well-intentioned but, like all assurances, they are, without more, only as good as a viable Qantas.

Naturally, no bid partner would want to see their investment go bad, but what if there was a global recession?

How about a dramatic rises in interest rates?

Or another major terrorist attack?

Up until now Qantas has been able to weather such shocks, but it has done so on much lower debt levels.

There are numerous examples of where highly geared takeovers have led to the target collapsing under the weight of that debt.

What happens to the value of assurances where a highly geared Qantas struggles to meet its debts?

What happens to the confidence of the travelling public?

What happens to the frequent flyer program?

What happens to safety?

Similar concerns were expressed by the US regulator in seeking to block a private equity bid by the Texas Pacific Group - a prime APA player - for an electricity company in the US state of Oregon.

In particular, the Oregon Public Utility Commission cited a large debt burden and short-term ownership as the major sources of risk associated with the takeover bid.

The commission was also concerned with the danger of imprudent cost-cutting and reduced capital investment if earnings dropped following the takeover.

While minds will differ on exactly how risky the proposed high-debt structure will be for Qantas, there is no escaping that in the minds of consumers it is more risky than the average takeover, and threatens a national icon.

Why does this concern consumers?

For the simple reason that consumers would share in a very big way in the pain arising from a struggling or failed Qantas.

Just ask any Ansett traveller in that airline's dying days (ie, long-delayed or cancelled flights, withdrawn planes due to safety issues and an ageing fleet), or those left high and dry from its failure.

Even if a highly geared Qantas does survive, there is always the question in consumers' minds of how effective or vigorous a competitor it will be under the debt burden.

High debt means the need to maintain or grow profit margins; cut costs and/or delay capital investment.

Will this lead to higher fares or less discounting on routes where Qantas dominates or is protected from competition?

Will it lead to cuts in service standards or culling of routes with lower than expected profit margins?

Will it lead to cuts in safety standards?

Of course, these will be denied, but a mere possibility is enough to unsettle consumers.

The reality is that consumers have come to see Qantas in much the same way as other utilities, expecting it to provide reliable ongoing services at competitive prices, and any threat or perceived threat to that undermines consumer confidence in the bid.

Finally, the real wild card in the bid is the proposed element of common ownership between Qantas and Sydney airport.

While at the moment Qantas may vigorously fight increased airport charges, will this continue where there is common ownership between the two, or will it be easier to just pass those higher charges on to the consumers?

So what would be needed to allay consumer concerns?

Much lower debt and more investment by the bid partners would help.

As would legally enforceable undertakings backed by performance bonds lodged upfront by the bid partners.

These bonds would require funds to be put in trust to be drawn upon in the event that undertakings are breached or Qantas fails.

There is a precedent with the private rail operators in Victoria having been required to put up substantial performance bonds, which would be forfeited in the event that the operator failed or withdrew.

The performance bonds forfeited by National Express on its withdrawal provide an example of the value of these bonds to the Government and consumers left to pick up the pieces after a failure.

Finally, consumers would value an immediate opening up of competition on key routes - particularly across the Pacific - to ensure that a highly leveraged Qantas does not use its existing dominance on those routes to drive up fares or cut service standards.

FRANK ZUMBO is associate professor in business law at the University of New South Wales

Article regarding lessons from the failed Qantas private equity bid

http://www.news.com.au/heraldsun/story/0,21985,21744627-5000117,00.html

Danger if Qantas flies too high

Frank Zumbo

May 17, 2007 12:00am

Article from: Herald Sun

THE failed private equity bid for Qantas has lessons for management, shareholders, regulators and even private equity bidders.

These lessons are likely to take centre stage during a Senate inquiry into private equity investment.

The most important lesson is that where a company does become a private equity target, its shareholders must be compensated for their shares.

It was inevitable that some Qantas shareholders would either want a higher price for their shares or just go along for the ride.

A number of profit upgrades along the way, not to mention greater confidence in airline shares generally, combined to make the Qantas bid look undervalued to some shareholders.

Some shareholders felt they had more to gain by staying in than selling out.

Should the Qantas management have been more attuned to a growing feeling that the original bid may have lost some of its appeal?

Surely a key lesson for management dealing with private equity bids is to seek a much higher opening bid and to be ready to press for upward revisions in a rising market.

For management there is a clearly a fine line between actively participating in a private equity deal and being ready to distance itself from a bid if it ceases to be in the best interests of the company or it fails to fully reflect the company's true value.

If they cannot meet this challenge, they should be ready to stand aside.

Clearly, private equity relies on a very high debt structure to finance the deal and grow the business. It then needs a rising market to sell at a profit.

Private equity deals may return higher rates of return, but they do so at a higher risk.

A solid business in a rising market may generate the high rates of return necessary for private equity.

But what happens in a falling market or where the cash flows fail to cover debt repayments?

What happens to the stability of banks and super or investment funds that help finance a deal if the private equity controlled company struggles or fails?

Companies do fail and private equity controlled companies are at best no exception and at worse more precarious because of their high debt.

Private equity deals are getting bigger and being funded by levels of debt traditionally avoided by management.

Ultimately, all shareholders and members of super and other investment funds need to be mindful of the dangers of private equity deals and not just chase higher returns.

Regulators also have an important role in educating shareholders and fund members about the risks of private equity deals.

Finally, for private equity bidders, the failed Qantas bid shows the dangers of declaring a bid "final" in a rising market.

A bid that looks generous one day can look significantly underpriced six months later.

Ironically, private equity itself is partly responsible for the higher share prices.

Not only is there more private equity money chasing a limited pool of Australian targets, but as that pool shrinks through takeovers the competition for those remaining drives their share price higher.

Increasingly, ordinary shareholders are being drawn in by the temptation of easy gains.

Therein lies a key lesson for private equity bidders.

Beware of creating a feeding frenzy that drives up share prices that make your original bid look undervalued.

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