AUSTRALIAN CHAMBER OF
COMMERCE AND INDUSTRY

Private Equity Investment

ACCI Submission to the Senate Economics Committee

July 2007

LEADING AUSTRALIAN BUSINESS

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ABOUT ACCI

The Australian Chamber of Commerce and Industry (ACCI) has been the peak council of Australian business associations for 104 years and traces its heritage back to Australia's first Chamber of Commerce in1826.

ACCI is Australia's largest and most representative business association.

Through our membership, ACCI represents over 350,000 businesses nationwide, including:

- Australia's top 100 companies
- Over 55,000 medium sized enterprises employing 20 to 100 people
- Over 280,000 smaller enterprises employing less than 20 people

These businesses collectively employ over 4 million people.

ACCI's 35 member organisations include the State and Territory Chambers of Commerce and Australia's leading national employer and industry associations. Our members represent all major sectors of Australian industry including small employers and sole traders as well as medium and larger businesses.

A list of ACCI members is attached.

SUMMARY

Private equity is generally the ownership of businesses directly rather than through stock markets.

It is clear that private equity is increasing in Australia and around the world. However, private equity remains a small proportion of transactions and total asset values.

There are many reasons for the growth in private equity, including lower costs of debt, ability to improve management, reduced burden of regulations and disclosure, greater alignment of interests between owners and managers, faster decision making, and the increased supply of private equity funds.

Substantial evidence of the benefits of private equity are contained in other submissions to this inquiry. However, governments should not regulate private equity investments depending upon whether they provide good returns to investors.

Highly leveraged private equity naturally increase borrowing in target companies, but usually in companies that previously had low levels of borrowing. Total borrowing for private equity is less than 3 percent of Australian bank loans, and banks are well diversified. Business interest payments and gearing ratios are at historically fairly low levels.

The stock market de-listing of a business due to private equity means the reduction in stock market liquidity and the amount of publicly disclosed information. If either of these are public goods, then the government should promote listing by all companies, irrespective of whether or not they were listed in the past. The government should certainly not prevent companies from "going private". Doing so is likely to discourage companies from going public in the first place. Many firms that go private return to stock market listing after a few years.

Market processes and existing regulations appear able to deal with concerns about regulation of private equity transactions. Regulators are monitoring this issue carefully. However, they should not introduce new regulations unless the benefits of regulation outweigh the costs.

Private equity is often partly financed by borrowings. If these borrowings occur from Australian lenders, then the effect on Australian tax is likely to be small.

The revenue effect of foreign borrowings may be larger, but this effect will be constrained by thin capitalisation rules, interest withholding tax and the Australian imputation system. In addition, private equity transactions may raise additional revenue through capital gains tax and stamp duty on transactions and the higher company tax revenues caused by longer term improvement in company performance.

To the extent that the growth in private equity is caused by regulations on listed companies, this should be addressed by reducing these regulations rather than by increasing regulations on private equity.

BACKGROUND

The Australian Chamber of Commerce and Industry welcomes the opportunity to make a submission to the Senate Economics Committee for its Inquiry into Private Equity Investment and its Effects on Capital Markets and the Australian Economy.

Definitions[1]

Private equity is generally considered to be equity investment in businesses where the equity is not traded through the share market. Instead, the businesses and assets are fully owned by private equity investors who can directly manage the businesses, particularly by appointing boards of directors.

- Note that the private equity vehicles may themselves be traded on the sharemarket.

Some private equity investors buy into a company that is listed on the stock market and de-list the company from the stockmarket. The investor then undertakes significant restructuring of the business and then re-lists the business a few years later, presumably making a significant gain on their original investment in the process.

Private equity investment can have large levels of debt. Where this investment occurs in an existing company, this is called a leveraged buyout (LBO).

Private equity that invests in a new business is generally called venture capital. There is little difference in concept between private equity investment in new businesses compared with investment in existing businesses.

- This means that it may be difficult to regulate private equity for established businesses without adversely affecting venture capital, which is often important in the development of new businesses, particularly in technology fields.

Terms of Reference

The terms of reference for the inquiry are as follows:

That the Senate, noting that private equity may often include investment by funds holding the superannuation savings or investment monies of millions of Australians, and because of the actual and potential scale of private equity market activity, refers the following matters to the Economics Committee for inquiry:

- an assessment of domestic and international trends concerning private equity and its effects on capital markets;
- 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;
- an assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects;
- 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
- an assessment of the appropriate regulatory or legislative response required to this market phenomenon, if any.

Trends in Private Equity

Private equity is a growing phenomenon in Australia. The Reserve Bank of Australia (RBA) has analysed the private equity in a number of publications, including:

- The RBA's Financial Stability Review (FSR) for March 2007 had a special section on private equity (attached).
- Recent Statements of Monetary Policy from the RBA focussed on leveraged buyouts (LBO), which are a particular type of private equity involving high debt levels.

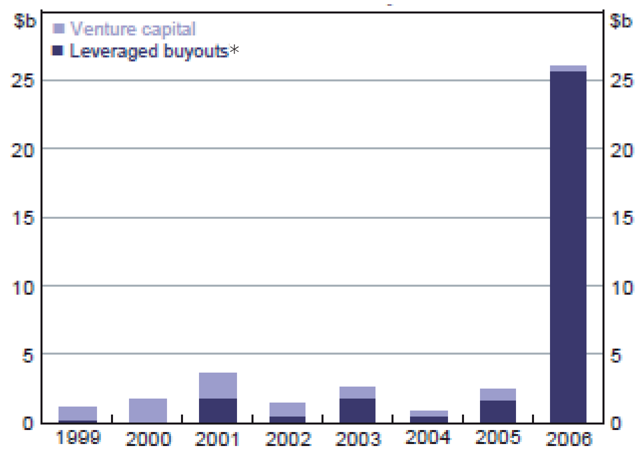
This report showed a very large growth in private equity investment in 2006, as shown in Figure 1 (it is not clear whether the RBA included Qantas in the 2006 data):

Some interesting facts from the RBA's analysis:

- The private equity investment in 2006 amounted to only 2 percent of the total value of the corporate sector. The RBA noted that this is the same as in the United States.
  - The AIST submission to this inquiry argues that private equity was only 0.3 percent of the "investable capital markets" in 2005 (page 4).
- The surge in private equity occurred in 2006 in Australia but occurred earlier in other countries and appears to be occurring in most of the developed world and Asia.
- The increase in LBO activity in Australia was due to an increase in the size of the average deal, rather than an increase in the number of deals. There were 28 deals in 2006 compared to 29 in 2005.

1 This section is drawn from a number of sources, including the ABS and AVCAL submissions to this inquiry.

Figure 1
Private Equity Investments in Australian Companies



* LBOs by domestic and offshore private equity funds. Includes debt and equity funding of deals completed and pending; excludes existing debt of bought-out company.
Sources: *Australian Venture Capital*; *Thomson Financial*.

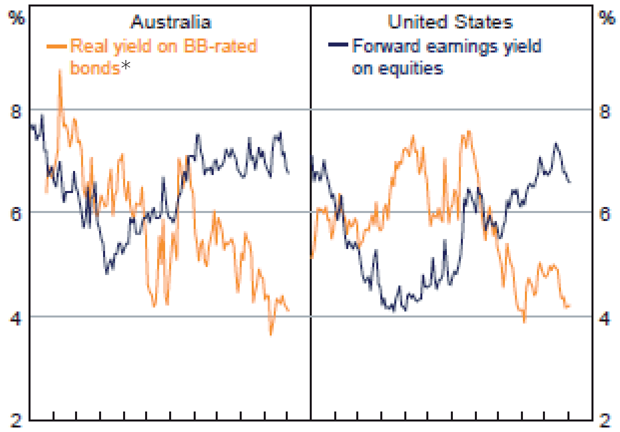
Reasons for Growth in Private Equity

The reasons for an increase in private equity include:[2]

- High rates of world economic growth, along with strong profit growth and low market volatility.
- Leveraged private equity has increased particularly because of the low cost of debt, particularly relative to equity, as shown in Figure 2 from the RBA (the light colour is bond yields, the dark colour is equity yields):
  - The low cost of debt combined with the low borrowing ratios of some Australian companies has made these companies attractive for LBOs which increase borrowing substantially.
- The potential for private equity to improve management, for example:
  - Higher debt levels in leveraged private equity means that free cash flow is reduced, which may limit the ability for management to make poor investments and may increase the incentives for cost cutting.
  - Management may find it easier to take decisions that reduce short term value but improve long term value (these strategies may not be favoured by some market analysts and day traders).
  - Continuous disclosure to the market is not required for companies that are not listed. The announcement of some decisions to the market may benefit competitors.
- The greater regulation of public companies compared to private companies. In the US, complaints have particularly been raised about the prescriptive Sarbanes-Oxley regulations. While a better regulatory system operates in Australia, it still can be quite onerous.
  - An example of an area where regulation has increased significantly (and unnecessarily) in Australia is the Financial Services Reform Act.
  - The AICD submission to this inquiry argues that the increased regulation of public companies has increasingly meant that boards of directors spend more time on compliance rather than strategy.
- Private equity can offer a greater alignment of interests between owners and managers (and a reduction in agency problems). In public companies management can become quite distant from owners.
- Major decisions can be made more swiftly as owners are often in day-to-day contact with management.
- Management spends less time "selling" the company to investors.
- There has been a very large increase in money flowing in to private equity funds, which has enabled these funds

2 This section is significantly based upon the RBA's Financial Stability Review (FSR) for March 2007 and the AVCAL submission with ACCI comments.

Figure 2
Return on Equity and Cost of Debt



* Estimate for Australia.
Sources: *Merrill Lynch*; *RBA*; *Thomson Financial*; *UBS AG*, *Australia Branch*.

to increase investments substantially. In Australia, about half of the money flow into private equity has come from superannuation funds.

The RBA argues that the evidence on whether private equity delivers higher returns is mixed. However, other submissions to this Inquiry provide evidence that private equity does provide significant benefits – for example the Allens Arthur Robinson, AIST and particularly the AVCAL submissions.

However, the role of Government should not be to promote or restrict a particular type of investment based upon whether it provides good return to the owners. The Government should not prevent investors from making poor investment decisions; it should only regulate if by doing so they can improve the performance of the market.

We also note that private equity substantially increases the competitiveness of the "market for control" of companies. This provides additional incentives for productivity and performance of existing companies.

ISSUES WITH PRIVATE EQUITY

Debt Levels and Private Equity

The RBA notes:[3]

- Recent LBOs have substantially increased gearing ratios in target companies, but not as much as the previous LBO boom in the United States.
- In Australia, debt has traditionally provided about 70 percent of the funding for LBOs. The interest rate on LBO debt is 2 percent higher than the swap rate for senior debt and 4-4.5 percent higher for subordinated debt.
- Total lending for private equity represents less than 3 percent of Australian bank loans. The RBA argues that bank exposure is fairly well diversified.
  - With more recent Australian private equity deals, the lending from Australian banks has fallen and lending from foreign banks has increased. This has reduced the debt concerns but may have increase the tax concerns – see below.

The RBA noted that corporate gearing (debt to equity) and interest to profit ratios have increased recently, but are low by historical standards, see Figure 3.

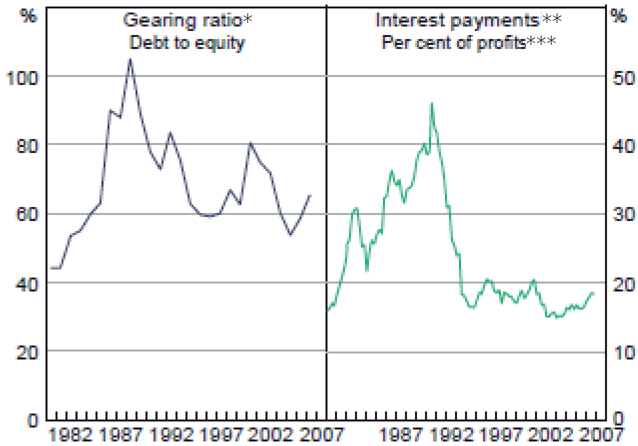
This increase in gearing is largely because of an increase in gearing of companies with low levels of gearing, while companies with high levels of gearing have reduced their gearing, see Figure 4.

The RBA argues that the current situation is "relatively benign" and it is hard to see the current exposures of Australian banks to private equity causing "serious difficulties" for the Australian banking system.

- However, the RBA raises a concern that lenders may not be sufficiently compensated for the risks they are facing.

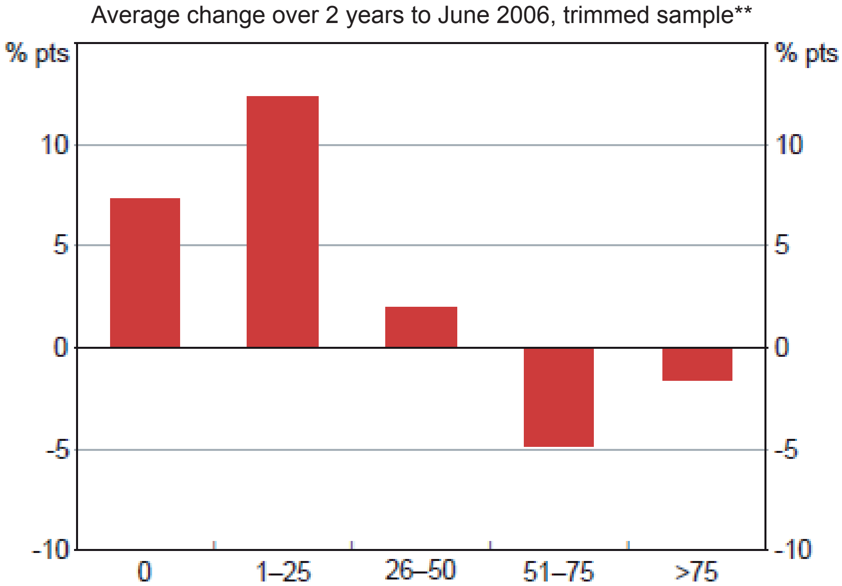
3 RBA (2007) Financial Stability Review for March 2007.

Figure 3
Business Sector Finances



* Listed non-financial corporations.
** Includes the inputed financial intermediation service charge.
*** Profits are measured as the sum of private non-financial corporations' gross operating surplus and gross mixed income of unincorporated enterprises.
Sources: *ABS*; *Aspect Huntley*; *RBA*; *Statex*.

Figure 4
Changes in Gearing Ratios*



* Gross debt/shareholders' equity.
** Companies with June and December balancing dates.
Sources: *Aspect Huntley*; *RBA*.

- The RBA has indicated that it will continue to monitor developments closely in case this situation changes.

It should also be noted that banks have very strong incentives to make sure their loans to investors are repaid. There are no indications that loan defaults are at risky or high levels.

Based on this data, ACCI considers that there is little cause for concern at the moment and the foreseeable future. There is no indication that private equity is substantially altering the riskiness of the Australian economy.

Effect on Stock Markets and Public Information

Concerns have been raised that private equity has an adverse effect on stock markets by reducing liquidity and information disclosure. This may also reduce the quality of public information, because listed companies have to publicly release accounts whereas private firms may not.

If there are concerns that delisting imposes significant costs on the community, then this means stock markets provide a public benefit – and Government regulation appears contrary to this argument. There are many regulations that impose significant costs on stock market listing, for example continuous disclosure requirements and reporting requirements. Regulators actually act as if stock market listing needs to be restricted.

If stock market listing is good, then listing by any company should be promoted, particularly those that have never been listed. There are no reasons to restrict companies from leaving the stock market if there are no incentives for companies to list in the first place.

Therefore, if regulation is diverting investment away from the share market, the appropriate response is to reduce the regulation on the share market, not increase regulation on alternatives.

We also note that private equity investments often re-list their investments after a few years, so any effect on stock markets would only be temporary.

Corporate Conduct

Private equity transactions are largely subject to the same regulation as other transactions.

For example, the AIST submission notes that Australian super funds have been successfully investing in private equity for over a decade, without any major concerns being raised by regulators.

Another issue is conflicts of interest between different parties to private equity deals (particularly between the buyers and the current management and board). These need to be managed carefully and regulators are monitoring this issue.

However, it has not been shown that market mechanisms and current regulations cannot deal with these concerns.

In order to prove more regulation is needed in this area, clear evidence is required to show that the benefits of regulation outweigh the costs. This has not occurred.

We therefore support the conclusion of the AICD submission that "there is sufficient statute and common law to properly oversight director's, officer's and senior manager's involvement in private equity investment transactions" (page 2).

Taxation and Private Equity

The effect of leveraged private equity (or LBOs) on tax revenues is not likely to be large.

The main concern raised is that LBOs have high levels of debt and therefore can claim significant interest deductions, reducing the tax paid by the business that is being bought out.

To the extent a LBO is funded by Australian borrowings, interest payments will be taxable in the hands of the lenders. This is likely to offset the value of interest deductions in the target business. Thus the effect on revenue is likely to be small.

To the extent a LBO is funded by foreign borrowings, the effect on Australian revenue may be larger. However, offshore borrowings can be subject to thin capitalisation rules, restricting the ability for unlimited use of deductions in Australia. In addition, interest payments to foreigners are mostly subject to interest withholding tax and the Australian imputation system actually can create an incentive for companies to increase taxable income in Australia.

It is therefore very unlikely that the hypothetical cases raised in the Speed & Stracey submission will actually occur in practice.

- As noted above, the lending from Australian banks for private equity has recently fallen and lending from foreign banks has increased. While this has increased the tax concerns, it has reduced the concerns about systemic risk to the Australian economy. In other words, a higher tax risk from offshore borrowing reduces the extent of the systemic risk from domestic borrowing.

In addition, ACCI notes:

- private equity transactions themselves can generate substantial revenue through Capital Gains Tax (CGT) because most private equity deals are at a substantial premium to the market price. The transactions may also generate substantial stamp duty revenue.
    - The sale of assets by non-residents is largely exempt from CGT under 2006 changes; however there were many exemptions in double tax agreements before 2006.
- any improvement in performance of companies because of private equity will add to tax revenue.

Concerns have been raised about the tax treatment of success fees from private equity sales (specifically, whether these fees are normal income or capital gains). ACCI does not wish to comment on these concerns.

Note that this analysis is a partial analysis. It does not consider the effect of foreign lending to Australia on the exchange rate or domestic interest rates, which could offset other effects.

CONCLUSION

Private equity plays an important role in improving the efficiency of companies and the capital market. There is no evidence that private equity is having adverse effects at the moment or is likely to do so in the foreseeable future.

Increased regulation of private equity could affect all privately held companies, which would be a severe overreaction.

If anything, the growth in private equity is usefully highlighting the adverse effects of excessive regulation of public companies. Instead, governments around Australia would be better advised to examine the current level of regulation of public companies and limit this regulation to ensure that private equity is not being driven by excessive regulation other forms of investment.

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