

Private equity: the emperor's new clothes?

The failed Qantas bid and the battle for Coles Myer highlight the emergence of private equity as a serious player in the Australian corporate scene. **WAYNE LONERGAN SF FIN** examines the private equity phenomenon.



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Until 2006, private equity in Australia was largely confined to purchase of unlisted companies, subsidiaries of public companies, smaller listed entities and leveraged management buyouts.

Private equity funded takeovers were generally of well-established but smaller companies and businesses with stable or at least relatively predictable cash flows.

More recently, the ability of private equity to attract large equity and high levels of debt finance is now so substantial that, either on a standalone

basis or in a consortium (referred to as "club deals"), private equity could acquire all but the largest listed companies in Australia.

Despite some very high-profile recent takeover attempts, the total value of successful public company bids is still relatively small. For example, private equity bids in the ASX 300 represented less than 4% of ASX market capitalisation. Of those, Coles is still in progress and the Qantas bid, the second largest, has failed.

Whilst small relative to ASX total market capitalisation, private equity nevertheless attracted \$14 billion of

TABLE 1

Recent large PE public company takeover offers to March 2007	\$bn	Status ¹	Likely outcome
APN	1.9	Presently withdrawn	PW
Coles	20.0	First approach rebuffed. Tender sale in progress	LTS
Myer	1.4	Completed	S
Orica	10.0	Rejected	LTF
Qantas	11.0	Offer failed	PW
Rebel	0.4		S
Symbion	2.8		U
Veda Advantage	0.7	In progress via scheme	LTS
Other PE acquisitions			
Colorado	0.5	Lew acquired 10%. Second mop-up bid successful	S
Flight Centre	1.4	\$1.4 bn initial offer opposed. Subsequently proposed \$1 bn capital injection into "partnership".	U
PBL	5.3	50% initial investment made in downstream company subsequent 25% sale. No public offer	S
Seven Network	3.3	50% investment made in downstream company. No public offer	S

To March 2007 PE represented one-fifth of listed takeover bids, more than three times the comparable period in 2006.²

NOTE: 1 At time of writing **2** Source: Dealogic **LTS** likely to succeed **U** uncertain **S** successful **PW** presently withdrawn **LTF** likely to fail

equity between 1999 and 2006, with the average fund growing in size by 27% per annum during this period.¹

The compound overall growth rate increased to 63% in the period 2003 to 2006¹. In early 2007 one private equity fund alone was seeking a further \$4 billion.

The bottom-line conclusion is that private equity in Australia is serious money, but the equity base of private equity is much smaller, at less than 2% of ASX market capitalisation (See Table 1).

By way of international comparison:

(a) in 2006, US private equity bought 654 companies for US\$375 billion, 18 times the level of 2003;²

(b) Private equity in the UK raised £11.2 billion (some A\$27 billion) in the first half of 2006. This is more equity than was raised on the London Stock Exchange during that period. Furthermore, PE accounted for almost half the UK takeover bids in the first half of 2006, up from some 22% in the previous half year.³

To put in perspective the potential bidding power of private equity, 13 UK banks had a combined loan exposure to private equity in 2006 of £67.9 billion (about A\$163 billion). This exposure significantly understates the scale, as UK banks typically distribute 81% of private equity debt within four months.⁴

Based on overseas experience, private equity could become a lot larger in Australia.

One concern about private equity is that it is not clear exactly who is providing all the PE equity, to whom private equity debt is being distributed, or who, when the bubble bursts, will end up holding the large amount of debt involved.

WHY THE SCALE OF PE IS SO LARGE

A number of factors have contributed to the quantum jump in the supply of debt and equity capital available to private equity:

- the weight of global money
- relatively low interest rates (around 30% to 40% of those prevailing in the 1980s)
- the globalisation of world capital markets
- the carry trade from Japan (i.e. borrowing at very low rates in Japan and investing at a multiple of those rates in other countries)
- compression of investment yields
- high and rising equity values
- pursuit of higher investment returns
- greater appetite for risk.

WHAT'S SO CLEVER ABOUT PE?

Private equity managers, and proponents of PE, claim that PE has advantages over traditional equity. Most of these purported advantages do not stand up to close examination. The purported advantages include:

- ability to make long-term investment decisions without the pressure to maintain stock market share values. (In some cases, at least, this purported ability is offset by

the short-term focus of many PE funds, many with a three to five year exit horizon, and their lenders' short-term debt repayment requirements);

- a willingness to accept significantly higher debt to equity ratios. (This is true, but is not enthusiastically touted as an advantage of PE because of the obviously greater risks involved);
- reduced compliance, reporting and shareholder communication costs (this is valid, although its materiality is questionable in larger acquisitions);
- a greater alignment of interests between senior management, who are also leveraged equity investors, and shareholders (Exactly why large seven figure traditional salary and option packages no longer sufficiently incentivises senior management and achieves alignment is not clear);
- the ability to better identify under-performing and under-recognised businesses and to improve that performance and benefit from the realisation of that potential. (It is at best intuitively unlikely that the analytical skills of PE managers are really superior to those of other investment professionals);
- ability to increase the speed at which balance sheets are restructured.

TABLE 2 WHAT'S SO CLEVER ABOUT PE?

• Invest for the long term
• Increase debt/equity ratio
• Cut excessive costs
• Manage cash better
• Restructure quicker

Which of the above could capable management not do?

Why leverage is so important to PE

Obviously, there is a lot more that a successful PE manager does than simply increase leverage. However, it is important to understand just how significant the impact of leverage is.

This is best illustrated by way of a simple example of two hypothetical companies. One is called Kanga Air which retains its traditional ownership and financial structure. The other is taken over by PE and restructured financially. Both companies' EBIT grows at 10% per annum.

The balance sheets of the two companies are set out in Table 3 (overleaf).

Assuming that both companies grow EBIT by 10% per annum, the respective profit and loss accounts and resulting equity values are set out in Table 4 (overleaf).

It is readily apparent from Table 4 that as a result of higher leverage the private-equity-owned equity holders increase the value of their equity some 166% in three years, whereas the conventionally geared Kanga Air shareholders only increase their equity value by 50%.

The PE managers of Kanga Air would also be entitled to annual management fee totalling \$180 million⁶ plus a whopping \$815 million⁷ success fee (being 20% of profit over 8% per annum), notwithstanding that the underlying earnings of the business barely achieved the CAPM rate of return.

TABLE 3 INCREASING LEVERAGE

	Kanga Air \$bn	PE Air \$bn
Enterprise value	15	15
Debt	5	12
Equity value	10	3
EBIT	1.35	1.35
Interest	(0.35)	(0.85)
NPBT	1.0	0.5
Tax	(0.30)	(0.15)
NPAT	0.70	0.35
Value:		
– at a PER of 14.3 times ⁽¹⁾	10.0 ⁽²⁾	n.a. ^{(1), (3)}
– at a PER of 8.6 times ⁽²⁾	n.a.	3.0

NOTE: 1 The lower PER of PE Air reflects the impact of much greater leverage on the cost of equity capital and hence the applicable PER. **2** At the same enterprise value the PER of PE Air is 8.6 times (ignoring, for the sake of simplicity, the potential value of the tax shield created by the interest cost of extra debt and the applicable PER). **3** n.a. – not applicable.

Even higher success fees would apply if the transaction was structured to generate pre-tax returns rather than the post-tax returns shown in this simplified example.

Obviously, the example is a simplified one and ignores a number of complicating factors such as higher debt costs, transaction costs, and, tax and stamp duty leakage.

However, the basic principles remain valid:

(a) greater leverage alone can have a significant impact on equity returns; and

(b) PE managers can become entitled to massive fees even if they make no net contribution to underlying profits:

TABLE 5 WHO GETS THE UPSIDE¹

	Manager of PE ^{(2), (3)} \$bn	Equity investors in PE \$bn	Transaction and Merchant Banking fees \$bn ^{4,5}
Potential reward	1.0	4.1	0.5 (+)
Capital at risk	-	100%	-

NOTE: 1 If any. **2** Annual fee \$180 million, success fee \$815 million (see note 1). **3** No clawback on losers. **4** May also be equity investors. **5** If all transaction and merchant banking were paid by PE, this would reduce PE management fees (by \$0.1 million) and equity investors' profits (by \$0.4 million).

Is PE that clever?

Clearly some Australian PE managers have done well in the past. However, past success in some cases is a result of, or has at least substantially benefited from, a combination of the effect of high leverage, bargain purchases, falling interest rates and a very significant increase in equity market values generally.

Given the higher purchase prices now being paid by private equity, management complexities associated with larger

TABLE 4 THREE YEARS LATER (AT 10% PER ANNUM PROFIT GROWTH)

	Kanga Air \$bn	PE Air \$bn
EBIT (end of year 3)	1.80	1.80
Interest	(0.35)	(0.85)
NPBT	1.45	0.95
Tax	(0.45)	(0.28)
NPAT	1.00	0.67
Enterprise value	20.00	20.00
Debt	(5.00)	(12.00)
Equity value	15.00	8.00
Gain in equity value (%)	50%	166%

acquisitions, much higher prevailing earnings multiples, examples of very high leverage (leaving almost no margin for market volatility or management error) and the prospects of further interest rate increases, it is inevitable that large losses will occur in the Australian PE market.

In some cases these losses will also be the result of the business strategy of some PE managers being excessively focused on maximising funds under management (FUM). At annual fees of 1.5% to 2% of FUM, payable regardless of performance, and success fees based on hurdle rates of only 8%, barely above the cost of debt, this is an understandable strategy. It also creates a significant incentive on the PE manager to be fully invested and attract even more FUM.

More responsible PE managers have complained privately to the writer that their reluctance to pay high prevailing earnings multiples have put them at a significant comparative disadvantage relative to their less cautious competitors⁸ who were increasing their FUM.

Given the very high fees being charged by private equity, it is surprising that PE continues to attract even a fraction of the capital that it does.

The flood of money to PE is even more surprising given the very high returns even passive stock market investors have enjoyed in Australia in the last three years.

Warren Buffet recently described PE as “Wall Street’s pied pipers” and said it was “folly” for investors to pay ever greater commissions and fees in an attempt to increase returns.

ARE INVESTMENT MANAGERS TO BLAME?

Some commentators have blamed investment managers for the recent rapid growth in PE takeovers of listed companies.

Investment managers are often criticised for:

- (a)** their excessive focus on relative performance and short-term investment performance;
- (b)** their focus on pre-tax rather than post-tax returns;
- (c)** in many cases, their business model being an asset accumulation model rather than an investment performance model;

- (d) that many fund managers are “index huggers” or “closet index funds”;
- (e) being too willing to pass over control of public companies without securing an adequate premium for control;
- (f) crystallising tax liabilities for their underlying clients;
- (g) reinvesting takeover proceeds at rising multiples;
- (h) repurchasing at much higher prices in the same company a few years later (partly, at least, for index weighting reasons).

Whilst such criticisms are valid in many cases, and there is clearly generally excessive focus on pre-tax rather than post-tax investment returns, such criticisms are not valid at the better end of the investment management spectrum. Indeed, there have been a number of more recent high-profile cases where large fund managers have rejected PE bids despite the (initial) control premium offered.

Furthermore, excessive focus on short-term performance and index-based comparisons are often driven by the investment mandates of superannuation fund trustees and investors.

There are many examples of outstanding investment performance by Australian fund managers and some fund managers have rejected PE takeover bids in favour of backing incumbent management to produce higher long term gains.

Risks in PE

The key risks of an excessive growth in private equity include:

- excessive leverage;
- conflicts of interest; and
- unclear ownership of economic risk.

Other risks that have been identified,⁹ but which presently appear much less significant, at least in Australia, are market abuses and reduced market efficiency.

CONSEQUENCES OF HIGH LEVERAGE

Risks of high leverage

Older readers, brought up in an era where debt-to-equity ratios were even prescribed in trust deeds not to exceed the “60/40 rule” (i.e. 60% total debt to 40% equity)¹⁰ are aware that debt to equity ratios in most listed public companies today are low by historical standards.

This reflects a combination of generally high prevailing profit levels which have enabled expansion to be internally funded and debt repaid, and some lingering conservatism resulting from the high debt and interest rate levels of the 1980s and the resulting collapses.

The generally low public company debt levels are surprising given the relatively low prevailing interest rates and the huge increase in the availability of, and sophistication of, interest rate and credit derivatives. Under-optimisation of the weighted average cost of capital is also surprising given the much greater focus on capital management in recent years.

Indeed, in the view of the writer, it is the reluctance of

most boards to accept higher, but still prudent, debt-to-equity ratios (with appropriate derivative protection) which is a significant contributor to the recent proliferation of private equity takeover bids for public companies.

Conversely, however, excessive debt-to-equity ratios in PE-funded acquisitions obviously increases the risk of collapse if business conditions or industry conditions deteriorate or if serious management errors occur. Depending on where the equity and debt risk is dispersed, this may pose wider risks to orderly market conditions, increase volatility, cause sharp debt and equity market corrections, cause a loss of investor confidence, and, at least short-term, cause an upwards repricing of risks.

At a practical level these risks have been reduced (or at least deferred) in private equity by the increase in the use of non-amortising debt, bullet debt and payment in kind interest. These debt arrangements reduce short-term debt servicing commitments. However, they may encourage even higher levels of leverage.

Rising purchase price multiples

Historically, in Australia, earnings multiples paid by PE in the private company sector were generally six times EBIT or less. However, in response to increased competition for deals, the general increase in equity values, and a significant increase in public company takeovers by private equity, EBIT multiples in unlisted acquisitions are now 7 to 8 times EBIT or higher. On public company acquisitions double digit EBIT multiples are now being paid in Australia (e.g. Coles Myer 17 times, Veda Advantage 17 times, etc.).

In the UK, the FSA has reported that the average EBITDA multiple (note not EBIT multiples) paid by private equity in 2006 was a staggering 14 times. This was a 27% increase on 2005 multiples of 11 times. Even with the slightly lower interest rates prevailing in the UK (LIBOR around 5% compared to Australia bank bill rate of around 6%), it is clear that interest cover ratios in the UK for private equity are perilously low even assuming (somewhat unrealistically) that all replacement capital expenditure can be deferred.

Leverage is high and increasing

It is difficult to obtain industry-wide leverage data for PE in Australia. However, public comments by Australian PE managers indicate debt-to-equity ratios are generally around 3 to 4 times. This is more than triple conventional debt-to-equity ratios for listed companies outside the finance sector.

In the UK, leverage on the five largest PE transactions in FY 2006 was 4 times. In the UK it is clear with debt to equity ratios of 4 times and EBITDA multiples of 14 times (the latter indicating annual cash flow only barely covers total interest costs) that PE, at least in the UK, is an accident waiting to happen.

Chief executives of many Australian financial institutions (including the RBA, NAB, Westpac, etc.), other capital market participants and the financial press have all expressed similar sentiment, that is, that the PE boom in Australia will end in tears. The writer shares this concern.

OTHER RISKS OF PE

Conflicts of interest

There is massive potential for conflicts of interest in PE-funded takeovers. The most obvious conflicts arise when management owns part of the PE equity. It is difficult to see how management can simultaneously extract the maximum takeover value for shareholders whilst simultaneously having a significant financial interest in minimising the acquisition cost base of the PE vehicle in which they are an equity participant.

Further, but narrower, conflicts arise where the opposition to (or concern about potential opposition to) a PE offer by some large shareholders is overcome by management cooperating in some downstream structure involving an in substance (at least partial) sale to the PE group.

Furthermore, executives in a company taken over by a PE consortium are not only employed by the consortium but also hold equity and run the company post takeover. They often also realise other significant financial benefits as a result of the takeover including receipt of golden parachutes and exercise of non-vested options (i.e. bypassing all performance hurdles, etc.).

This highlights a further serious potential conflict of interest when it comes to deciding whether, or not, and, if so, at what price to recommend a PE based offer.

Further and obvious management conflicts of interest arise in forecasting future profits, providing full and balanced information to all potential purchasers, disclosing all “hollow logs” and other significant profit improvement opportunities.

Theoretically, proper processes can be put in place to reduce management conflicts. However, such processes can hardly be considered conflict proof.¹¹ Furthermore, there have been a number of cases where processes have been less than proper. In other cases the reluctance to disclose profit forecasts, or to attach disclaimers to them, inevitably creates an unsavoury impression.

Conflicts of interest also apply to other participants in PE takeover bids. These include fund managers, who may also have equity in PE, between the proprietary and advisory activities of merchant banks and other professionals whose firms have a wide range of clients. Indeed most investors, advisers, and senior management involved in PE are likely to have conflicts of interest with respect to different client groups who are clients of their firm.

A further and obvious conflict issue that has received little public comment to date is the conflict of interest that a PE manager has with its own investors. It is self-evident that a PE manager’s financial success will be maximised by:

- (a) attracting lots of FUM;
- (b) selling winners relatively early (to maximise their “success” fees); and
- (c) not selling under-performers/losers (to avoid losing some of (b) and to avoid reputation damage).

Whilst the potential PE success fee on a successful investment might dwarf the annual fees, this is much less likely to occur across a whole PE portfolio, let alone across all PE firms and over the longer term. The dangers of an asymmetric risk/reward distribution are obvious.

Unclear ownership of economic risk

Informal comments from Australian regulators indicate a surprisingly widely held view that the riskier end of PE debt and equity is sourced from overseas and that the level of exposure of Australian institutions, superannuation funds and investors to PE is very low.

These views sit inconsistently with the unlikelihood of a scenario where an overseas “good fairy” is the only one materially exposed to the riskier end of PE.

These views also sit inconsistently with anecdotal evidence that superannuation asset consultants are recommending that superannuation funds have a 5% to 10% exposure to private equity.

The reality of the riskier end of PE is that no one knows where the risk exposure ultimately lies. Australia, at least indirectly, is exposed to overseas PE risks.

Furthermore, there are significant contagion risks: firstly, in the form of a potential domino style collapse. Secondly, the business models of some participants, or a wide dispersion of risks via assignment and sub-participation transactions, may make it more difficult for distressed firms to survive, thus compounding losses as going concern values are reduced to distressed sales values.

The problems created by having a large number of underlying participants should not be under-estimated. Many investors (eg superannuation funds) will be unprepared for, or not have established procedures in place in advance of, credit defaults. Furthermore, the consequential rush for liquidity in the event of a significant collapse, or market downturn, will adversely impact the values of even the soundest companies.

Differing contractual and legal interpretations will abound and some participants will try to extract ransom values for their securities from other investors seeking to avoid the collapse of the underlying entity. At the very least there will be a legal and litigation bonanza.

Market abuses

As more parties become involved and as the size of transactions grows, the flow of private information creates the potential for market abuse. So far, there is no evidence that this is a material issue in Australia.

Reduced market efficiency

It has been suggested that the quality, size and depth of PE expansion risks damaging the public market for securities.

Such concerns include PE takeovers of the better listed companies and those with higher growth prospects, the subsequent floatation of those companies which have gone ex growth or which have been “stripped to the bone”, and lack of public access to the benefits that PE can bring.

So far, these concerns appear misplaced on materiality grounds, as PE takeovers (as opposed to offers), at least in Australia, are still a relatively small proportion of ASX market capitalisation. Furthermore, the relative exclusion of public access to PE may also prove to be a blessing in disguise at least for some investors.

Summary of relative risk weighting

It is interesting to compare the relative risk weighting of PE identified by the FSA in the UK with that in Australia.

Risk	FSA UK Risk assessment	Australia Risk assessment
Conflicts of interest	High	High
Market abuse	High	No evidence (so far)
Excessive leverage	Medium/high ¹	Medium/high
Unclear ownership of economic risk	Medium/high	Medium/high
Market access	Medium/low	Low
Reduction in market efficiency	Low	Low

NOTE: 1 Given the much higher PE-leverage reported in the UK, in the view of the writer this risk should be weighted extremely high in the UK.

SOME VALUATION ISSUES

Accounting and reporting issues

Private equity, by its very nature, invests in unquoted investments substantially financed by multiple tranches of debt, including mezzanine debt, pay-in-kind debt, bullet repayment loans, etc.

Whilst valuation issues at the inception of the deal are relatively straightforward, they become less so when refinancing or a default occurs or where a recapitalisation leads to the payment of management fees.

From a financial reporting perspective some PE firms may be required to follow IFRS reporting requirements and consolidate investee controlled entities.

IFRS contains some interesting (indeed peculiar) valuation rules,¹² including the prohibition on the recognition of internally generated goodwill, the asymmetric treatment of goodwill write-downs and write-ups, the prohibition on the revaluation of identifiable intangible assets, and (inconsistently) the allowance as an impairment testing criteria of value in use which excludes the effect of refinancing, capital upgrades and the recognition of the time value of deferred tax assets and liabilities.

At a practical level it is presently unlikely that future financial reporting will be a major issue for PE funds. If it were ever to become so, they would contract out of it.

PE fees

As stated earlier, PE generally charges a 2% annual fee and a 20% profit share for pre-tax returns above 8% per annum on realised gains.

By way of comparison the capital asset pricing model indicates a 12% per annum after tax return¹³ for a diversified equity portfolio, which is equivalent to some 17% per annum pre-tax assuming, for simplicity, grossing up at the standard rate of tax.

It can be readily observed from this simple comparison that:

- (a) annual PE management fees are very high;¹⁴
- (b) the success fee cuts in at less than half the long-term pre-tax rate of return of a diversified listed equity portfolio;
- (c) for PE to return the same return to its investors after all PE fees as a listed equity portfolio it has to out-perform CAPM by some 23% per annum (see Table 6);
- (d) in many cases a success fee can be charged on “winners” without offsetting the lack of profit or, indeed unrealised losses on under-performing investments.

The required level of out-performance required to justify PE fees¹⁵ and still generate the same rate of return PE as CAPM

indicates a diversified listed portfolio will generate, is calculated as follows:

TABLE 6 PE HURDLE RATE REQUIRED TO COVER PE FEES

	%
CAPM 12% after tax equals 17% pre-tax ¹ or at 23% over CAPM equals	21
Less annual management fee (2% per annum times FUM)	(2)
Performance fee (20% over 8%) rounded	(2)
CAPM pre-tax	17
Less tax at 30%	(5)
CAPM after tax ³	12

NOTE: 1 All numbers rounded for simplicity. **2** Grossed up at the standard rate of tax for reasons of simplicity. **3** R_f plus R_m (6% plus 6%). **4** Ignores, again for the simplicity, any additional return required because of much higher leverage and the lack of liquidity of PE equity compared to listed equity.

Where does the extra profit come from?

PE can only generate the required additional returns by:

- (a) buying cheap; (b) leverage; (c) better management;
- (d) selling dear; (e) multiple expansion.

The benefits and dangers of leverage are set out earlier in this article, (d) is intuitively unlikely (other than due to equity values continuing to rise)¹⁶ and (c) is yet to be proven.

That PE can acquire listed companies cheaply is prima facie unlikely (e.g. because of competition from industry buyers and other PE firms, shareholders’ expectations as to bid premium etc), unless they are in possession of non-public information. Indeed, takeover premiums in PE bids for listed companies in Australia have, to date, been consistent with average takeover premiums. However, this does not mean that pre-bid prices necessarily reflected the real upside potential of the PE-targeted companies.

Prima facie consistency with general takeover premiums is also somewhat surprising given the lack of synergy benefits available to PE acquirers compared to those available to industry offerors.

Reliance on multiple expansion as a source of future value is a particularly high-risk strategy, as purchase multiples are already high, leverage is being pushed to the limit and interest rates are at historical lows.

Some valuation technicalities

Conventional valuation theory has it that if a company has materially higher leverage than the company, or peer group, from which its beta is derived, then the company/peer group beta should be degeared and then regeared to calculate the cost of equity for the company being valued. This also applies to PE-owned companies.

The end result is the higher the leverage, the higher the equity beta for the PE leveraged company, the higher the cost of equity and therefore the lower PER. For example, in the simplified example in Table 3, the PER falls from 14.3 times under public ownership to 8.6 times under PE ownership.

Put simply, the much higher leverage of PE reduces the PER applied to private equity profits. This is a matter not just of mathematics. It also reflects market experience, and common

sense, that highly leveraged companies command lower PERs than their comparable peer group with normal industry levels of leverage.

Interestingly, PE capital raising documents appear to be silent on this important valuation issue.

Operating leverage

In assessing the market value of PE (or any other company), degearing and regearing formulas should not just be mechanistically applied.

This is because the more commonly used degearing and regearing formulas only consider the impact of financial leverage. They do not separately assess the effect of operating leverage.

Nor do the more commonly used formulas differentiate between very high cash flow generating businesses such as Qantas (with its huge cash flow from aircraft depreciation), from less fixed capital intensive businesses (e.g. Coles).

Value leakage issues

Assessing the future performance and hence value of PE also needs to consider the significant value leakages that occur in public company takeovers, particularly if exit is intended to occur via a subsequent public relisting.

These costs and order of magnitude percentages are summarised in Table 7:

TABLE 7 POTENTIAL VALUE LEAKAGES	
	Percentage of total value %
Payment of premium for control	25
Merchant Bank, legal and professional fees	5
Stamp duty ¹	1–5
Capital gains tax	Significant
Underwriting fees and float discount on relisting ²	5(+)

NOTE: 1 Depending on the nature of assets acquired and the state in which they are located. **2** 5%(+) of post-acquisition value.

SUMMARY AND CONCLUSIONS

The following conclusions can be drawn:

- (a)** the importance of PE in Australia and overseas equity markets has grown significantly;
- (b)** PE performance substantially depends on high debt-to-equity ratios;
- (c)** PE involves significant leverage risks;
- (d)** Who is ultimately bearing the higher-risk end of PE equity risk and the toxic-waste end of PE debt is not transparent;
- (e)** It is widely and correctly believed that the PE boom will end in tears;
- (f)** PE fee levels are very high and may be payable even for lacklustre performance due to the benefits of high leverage;
- (g)** Covering high PE fees requires significant ongoing investment out-performance;
- (h)** Significant ongoing out-performance is, at best, intuitively unlikely for all but a few PE managers;

(i) To generate/justify high fees some PE managers will make higher-risk investments;

(j) Paying high PE fees, which are largely generated because of the impact of high leverage, does not appear to be an attractive or sound investment proposition.

Some PE firms have a solid track record of performance and some will continue to perform well in the future. However, the risks of high leverage, particularly on riskier investments and high prevailing equity values, inevitably means serious losses will be incurred by some investors and lenders to PE when (not if) equity values subside.

A major boom in litigation will inevitably follow.

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Notes

- ¹ Source: PwC/AVCAL Survey.
- ² Source: Thomson Financial as quoted by Robert Samuelson, *Washington Post*, March 15, 2007.
- ³ Source: London Stock Exchange data.
- ⁴ Source: Financial Services Authority (UK) “Private Equity: a discussion of risk and regulatory engagement”, November 2006.
- ⁵ To achieve greater alignment of interests, employee options could be modified so that the exercise price increases annually at the cost of capital.
- ⁶ 2% times \$3 billion times 3 years.
- ⁷ \$8 billion less (\$3.8 billion (\$3 billion times 8% for 3 years) less \$180 million management fees net of 30% tax times 20%.)
- ⁸ The actual expression used was less polite.
- ⁹ For example by the UK FSA.
- ¹⁰ Financial institutions had significantly higher permissible debt-to-equity ratios.
- ¹¹ In one recent bid management performance bonuses and other payouts reportedly totalled \$91 million (Source: Creedy, S., ‘Takeover doubts deflate Qantas’, in *The Australian*, 22 February 2007, p23.
- ¹² Refer article “Accounting for Impairment” in *JASSA*, Spring 2005 by W. Lonergan.
- ¹³ Risk free rate of 6% plus market risk premium of 6%. There are different views about the size of the current market risk premium: 6% is the long-term rate, is used by regulators and used in most IER valuation reports.
- ¹⁴ For all but the best PE managers, unsustainably so, in the view of the writer.
- ¹⁵ Before allowing any return for the substantial extra leverage risk.
- ¹⁶ The game of musical chairs comes to mind. **1**