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Private equity: higher risk, higher return, higher danger

By Andrew Murray

Private Equity is attracting attention because of the nature and scale of its offers. To mimic the beer ad - "it's all good!" But is it?

Many see private equity activity positively:

Nicholls said that while listed companies are burdened by heavy corporate governance, and shareholder, media and regulatory scrutiny, private equity companies are free from these constraints, providing them with a safe haven and a much calmer environment in which to do business. (Financial Planning, December-January 2007.)

Explicit in that statement is the view that corporate governance and regulatory requirements are bad for investors.

Let's pause there. Modern Australian corporations law sits comfortably with the most dynamic and successful business market Australia has ever seen, with record levels of mergers, acquisitions, profits and tax revenues. It is also the safest market Australian investors have ever experienced. There are a number of reasons for that, but beefing up the law and the regulators after the horrors of the 80s, and after the lessons of Enron, HIH and others, has produced good dividends. Literally.

It is the "heavy corporate governance requirements, and the shareholder, media and regulatory scrutiny" that secures such good returns in a relatively low risk environment.

Private equity wants to be free of those constraints. That is so that they can take more risk free of scrutiny and regulation, so avoiding all the lessons we have learnt since the 80s; that scrutiny and regulation are better for the market than their absence. They want to be able to take higher risks for higher returns. With that comes higher danger.

Good corporate governance rests on five foundations - mandated constitutional provisions, behavioural restraints and processes under law, a strong active regulator, public reporting and accounting requirements, and the discipline of the market.

In big corporate deals private equity funds have targeted listed corporations that have lucrative government licenses - such as air routes and television channels.

If private equity funds broaden their market activity substantially they can affect our whole economy. If as a consequence the market as a whole is exposed to much higher risk, then so is Australia exposed to much higher risk.

By private equity funds replacing equity with debt in their targets, we go back to over-gearred vulnerable business balance sheets. By requiring the servicing of higher levels of debt, tax revenues fall. By going private, investors are exposed to greater risk because of less regulation and limited scrutiny.

Unlike the public share register of a listed company it is not possible to identify the real investors or beneficial or substantial owners in private equity funds. Without public scrutiny it is not possible to determine their intentions or interests. Where capital is foreign it is not interested in Australia other than as an investment vehicle. In the case of sensitive or strategic industries such attitudes may not always be in Australia's national interest.

The solution is not to inhibit private equity fund deals. In the main, private equity funds are legitimate market participants that add variety and choice to investment vehicles. But the higher risk they bring has to be managed.

Certainly foreign private equity fund deals must continue to be subject to review under the *Foreign Acquisitions and Takeovers Act*. But the solution for all private equity deals is to return to the prudential measures that are tried and true - scrutiny and regulation.

The solution is to require corporations in sensitive or strategic sectors, or businesses of economic significance - (the latter probably determined by high market capitalisation) - to have the same governance, accountability, and reporting obligations of listed companies, and be subject to the same intensity of regulation by ASIC. Otherwise, in the absence of that, Australia will pay.

There needs to be a shift in perception. Private equity is often far from private, as it includes public money from legions of small investors in investment and superannuation funds. That involvement of public money demands prudential market supervision.

Otherwise, Australia will pay in a variety of ways. It is not just a matter of people who choose to invest in private equity companies - they are at least free to make their own investment decisions and to take the consequences, whether that is a substantial gain in the short term, or a disastrous and substantial loss.

Some of the biggest investors in private equity are the world's largest pension funds, or those funds holding the superannuation of Australia's millions of workers.

Private equity is accused of being interested in short term gains, not in long term advantage, whereas most investors in superannuation funds are looking to invest long-term and prudentially for their future retirement. They do not have short term profit in their sights, at high risk, but a steady and material gain over time.

Superannuation investors, both individuals and the large funds, could also be negatively impacted if leveraged private equity firms are unable to meet their debt obligations.

This would have a long term impact on those people relying on their superannuation fund for retirement, and would then impact on the taxpayer. If there was such a financial disaster, then people left without superannuation savings would be reliant on the taxpayer funded pension for their ongoing support. It is already clear that with the baby boomer generation coming up for retirement that such a situation would have a very negative impact on the Australian economy.

Companies which have embraced private equity firms see themselves as freed up to make money without pesky interference from regulators or from diligent shareholders. However, the checks and balances in place for public companies create an environment which protects investors and consumers without undue interference in the operation of the market.

The enthusiasm for private equity investment runs in the face of the corporate failures of the 1990's like Enron and HIH. For all that private equity firms argue that public companies are hampered by over-regulation and shareholder scrutiny, the Parliamentary Joint Committee on Corporations and Financial Services found, in a recent report, that for public corporations the regulations strike the right balance between protecting the interests of investors without interfering too much in the operation of the market.

In the US an area of concern to regulators is the possibility that the close ties between private equity firms and investment banks could reduce the price paid to shareholders. This has also been identified by the Financial Services Authority in Britain as an area which it will be looking at, but it is not just a concern in the US and the UK. ASIC has flagged it as an area in which it is taking an interest in Australia, especially given the rapid increase in private equity investment in Australia in 2006.

Private equity investment companies suggest that Australia is not in a boom of private equity investment, but rather it is just catching up to the rest of the world. If that is the case, then the lessons learned in other markets need to be assessed and, if relevant, applied in the local market.

Many of the private equity deals which have been put together in Australia in recent months have involved close relationships between investment banks and private equity firms, including the recent proposed management buy-out of Alinta, the purchase of Coles Myer, Cleanaway and 3M, the Asia Pacific pharmaceuticals business, so it is clear that it is an area which needs to be closely monitored.

In evidence to the Joint Parliamentary Committee on Corporations and Financial Services, Mr Cooper, the deputy chairman of ASIC advised the Committee that the regulator is considering matters of conflict of interest, the transparency of information flow to investors, the size of management fees and whether the appropriate disclosure mechanisms are in place. As Mr Cooper pointed out, "It is a delicate balancing act about

not dampening something that might be beneficial while being alive to the potential downside.”

I accept that there is nothing inherently bad in private equity investment and that in some circumstances it is an appropriate investment vehicle. However with the increase in activity in Australia, the move into sensitive markets and into markets which are for all intents and purposes oligopolies, there needs to be the appropriate checks and balances. This ensures that private investors and fund investors are kept apprised of matters which could put their investments at risk, and which could, in the long run, and in particular circumstances, put the economic interests of all Australians in jeopardy.

The best and easiest solution is simply to require most of the reporting and disclosure requirements placed on companies on the Australian stock exchange to apply to large private equity companies too. That would secure the public interest.

Senator Andrew Murray is Taxation and Workplace Relations Spokesperson for the Australian Democrats and a Senator for Western Australia.