

Private Equity – Deconstructing the boom

The role played by private equity funds in bidding up prices for both listed and unlisted assets built to a crescendo over the course of 2006. Private equity funds have facilitated leveraged buyouts (LBO's) of a vast array of assets by executive management teams often sourced from the target companies themselves.

According to Thompson Financial, private equity buyers announced over 1,000 US takeovers in 2006 valued at over US\$220 billion as compared to US\$141 billion for 2005 in total. The level of leveraged buy-out activity in Australia has ballooned to over A\$13 billion in 2006 after averaging A\$1.5 billion over each of the past five years.¹ What has caused this phenomenon and what risks does it pose for the financial system and markets?

Exhibit 1

Private Investors Respond to Attractive Environment



Source: FactSet Mergerstat, Morgan Stanley Research

Developments in the global economy over the past decade have boosted return on equity and profits

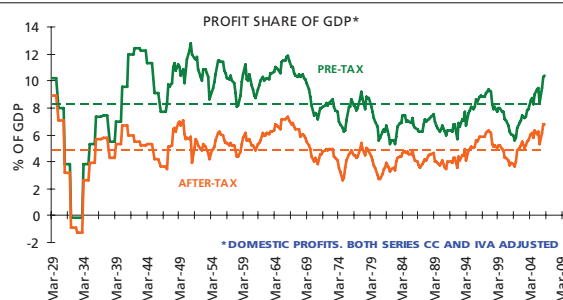
Outsourcing of elements of the production process to low cost locations has improved productivity and enabled companies to manage their businesses more efficiently. This has boosted profit margins. It has also removed capital intensive processes from corporate balance sheets.

Today US after tax profits are close to their peak set in the 1950's and 1960's. See Exhibit 2.

So not only are many companies in the developed world less capital intensive, high profitability has left companies less reliant on debt to fund growth. Corporate balance sheets have been substantially de-leveraged as a result.

Exhibit 2

Back to Normal?



Source: DataStream, Morgan Stanley Research

To the extent that profit margins are sustainable, higher valuations will be placed on earnings streams generated by companies. With corporate balance sheets largely ungeared, and a large supply of credit untapped, strategies are being implemented to take advantage of the situation. Private equity driven LBO's seek to derive returns in part from re-leveraging those balance sheets.

Mean reverting arguments would suggest profit margins and profit share are unlikely to remain at these levels. As a consequence whilst corporate balance sheets are strong now, any move to significantly re-lever those balance sheets could leave those companies exposed in any downturn. Furthermore, debt burdens carried by individual consumers are the mirror of corporations. On the other hand these phenomena may not be explainable by short cycle terms. The structural forces associated with globalisation may sustain high profit shares as we saw over the course of the 50's.

High levels of scrutiny by the share market have had a systemic impact on management strategic decision making

After the disasters of some of the late 90's Internet driven capital investment decisions, combined with the spectacular malfeasance at the likes of Enron and Worldcom, investors increasingly demanded corporate investment decisions meet strict benchmarks with respect to return and transparency. Company management has been increasingly focused on capital discipline and corporate best practise.

Estimates are that the amount of time absorbed by executives dealing with shareholders, analysts and the media is around 40% leaving them a substantially reduced amount of time to deal with the key task of running the business. Additionally the need to justify every investment decision to a wide range of interested parties and then have its subsequent performance continually monitored at quarterly intervals will affect even the toughest psyches within corporate management.

This has tended to lead to the operational management of companies being judged significantly on short term deliverables. It has led to a skewing of risk premia biasing corporate strategies to short term objectives.

For example, internally determined 'high' hurdle rates are leading to companies avoiding many investment decisions that could create significant shareholder value. Morgan Stanley in their research piece titled 'US Portfolio Strategy – The Great Wealth Transfer' indicate that their latest surveys show corporate America is using a cost of capital hurdle of 13.3% which indicates a current equity risk premium of 8.5% as against the 3.7% they feel is more appropriate. As they state, 'a 13.3% hurdle rate might make sense if interest rates were at 8.0% and John Travolta was still strutting his stuff in Saturday Night Fever!'²

Furthermore the maintenance of share price can lead to 'under-investment' in the long term to support shorter term profitability... the harvest strategy. A management culture may operate resisting those forces. It may do so explicitly or implicitly. It is highly likely however that such a culture would need to manage the tension between the internal expectations of the firm, and investor expectations. It is ironic in an era of low rates, some firms seem so discouraged from risk taking.

The current regulatory environment was constructed in part to protect the interests of shareholders against management that might seek to extract amounts of value from the company that were not in the interests of the shareholders, or the company's longer term development. An atomised shareholding base has a limited capacity to directly administer the underlying business.

Following the Enron scandal and other US based corporate issues at the beginning of this decade, regulation was tightened in an attempt to protect against such issues arising again. The Sarbanes Oxley Act of 2002 has proven time consuming and costly and has had global ramifications for any company listed in the US. Has the pendulum swung too far?

Some management and boards will resent the operation of that scrutiny. Those objections could be characterised both as a consequence of management not wishing to be accountable, versus feeling negatively impacted by investor short-termism.

Management may see LBO's by private equity groups as lessening certain elements of that scrutiny. They may permit longer term decision making. To this end many private equity groups attract operational management staff from the businesses or business sectors to be LBO'd.

A desire to avoid some of this scrutiny may have assisted in contributing to the 'perfect storm' of circumstances that has led to today's private equity frenzy. This 'increased capacity' to focus on the long term, combined with the discipline imposed by higher debt levels, will be often referred to now as a positive element of the LBO phenomenon. Whilst there may be truth in this in some of the deals, it is not to say that some of these deals are equally focussed on the short term gains to be made by re-leveraging a balance sheet.

Limited requirements for capital funding further enhance the attractiveness of going private

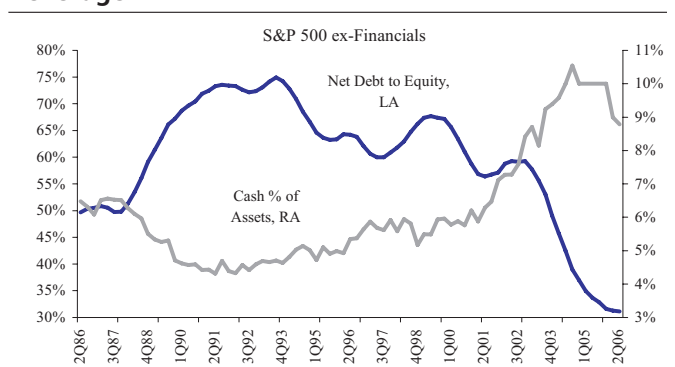
Is the private equity phenomenon we are currently witnessing a move back to a more traditional form of capitalism, whereby ownership and management become reconnected?

There are certain benefits that will be accrued by participants in this process that may not be accrued by traditional shareholder bases. Firstly an under-utilised balance sheet may be an asset to which the equity market has difficulty in attributing value.

Exhibit 3 shows Net Debt to Equity and Relative Cash Levels for US companies at their respectively lowest and highest levels since the mid 1980's.

Exhibit 3

Corporate America: Too Much Cash, Too Little Leverage



Source: Compustat, Morgan Stanley Research

Whilst in theory the price of a share should reflect the actual or potential capital structure of the company, the real value of this is hard to determine. In gaining full control of a company the

owner gains direct access to cashflows and balance sheet structure. Debt can be increased, and surplus equity can be extracted to generate a degree of immediately realisable return.

Are the private equity executives more talented than their public company cousins? Or is their ability to deliver 'enhanced more a function of balance sheet 'wizardry' rather than anything special that will be done to enhance the Profit and Loss statement through growing revenues or operating a business more efficiently.

This is now being termed in the markets the 're-leverage' trade.

This is not new. Certain previous takeover 'booms' have been characterised by this phenomenon. Not all takeover booms however have this characteristic. Mergers and Acquisitions (M&A) funded by the issuance of new equity do not increase the leverage basis of the firm, however in the current world, where liquidity and cash are in abundance, it is doubtful this cycle will witness much in the way of aggressive share issuance.

Potential fees will drive Investment banks to exploit a perceived opportunity

Given the conservatism of current 'listed company' executives with regard to capital management, as compared to the aggressiveness of the private equity groups, the Investment Banking community is now fully mobilised to scout out re-leverage deals (under leveraged listed company balance sheets) that may appeal to their deep pocketed private equity clients.

Indications are that private equity giant Kolberg, Kravis and Roberts (KKR) took less than one month to consummate their deal with Australian based Channel 7. No doubt the investment banking community will continue to circle their 'listed company' prey until the deals become increasingly marginal or conditions change in such a way that this boom, like all previous booms, falters and stops.

Surplus Savings?

The world is awash in surplus liquidity that has been generated by a combination of factors. As already discussed, one factor is high corporate Return on Equity (ROE's) relative to corporate capital expenditure requirements, which are leading to de-leveraging of both corporate and bank balance sheets. Another is the high price of resources and oil generating massive excess funds amongst producers.

The Chinese industrialisation process is producing a massive trade surplus which may or may not be sufficient to internally fund Chinese investment levels? Chinese domestic monetary policy and interest rate settings underwrite high levels of investment. Additionally, as is the case in Australia, savings pools are being built in certain countries to fund the retirement of ageing populations. Finally, in countries such as the US monetary and exchange rate policy has been managed to facilitate ongoing consumption through the expansion of credit.

These surplus savings are now being accessed by private equity funds to finance the 're-leveraging' trade.

The growing income differentials see a re-weighting of capital towards high net worth individuals away from the collective savings pools of the pension funds. Those individuals have different risk return profiles and have demonstrated a higher inclination to longer term investment strategies, as opposed to the short term strategies that traditionally have seemed to dominate pension funds. Those pension fund strategies are the natural consequence of a confluence of factors, ranging from regulatory structures, their lack of capacity or incentive to directly administer assets, and the operation of consultants in driving clients return expectations.

The pension funds are now finding themselves limited in their capacity to participate directly in this re-leveraging trend. This is creating business pressures and as the saying goes 'if you can't beat them join them', leading to pension funds increasing their supply of capital to private equity firms thereby assisting in part to remove companies from public equity markets. Those investments may not be marked to market over the same time frames as listed equity investments which change the return profile of the pension funds. California Public Employees Retirement System, CALPERS, now has over US\$6 billion invested in buyout funds.

The interest here is that given the time profile of the pension fund they can afford to make longer term less liquid investments and additionally, the recent returns for private equity funds have exceeded that of the US equity market since the bursting of the dot-com bubble. But whether these excess returns will continue is the million dollar question.

Risks

In a boom, discussion will always shift to the consequences of this herd like behaviour. We know introducing leverage increases risk and this cycle is no different.

So what are the risks to the private equity re-leverage strategy? One is that the economic cycle rolls over and turns down, whether it is due to cyclical factors, or some exogenous shock. Under these scenarios the downturn reduces the potential profit pool minimising returns to private equity investors and potentially putting lenders at risk.

Qantas is a good case in point as it is currently under a buy-out offer from a syndicate led by Macquarie Bank. As we know the airline industry is notoriously volatile and subject to all manner of external impacts including; global economic wellbeing, oil shocks and terrorism. Imagine a scenario that combines high fuel costs with a weakening economy, throw in a couple of terrorist incidents for good measure and you could see how quickly a leveraged airline business could quickly unravel.

Around the traps the story goes 'an investment banker says we are making money on implementing these deals, whether it be introducing leverage via LBO's or through breaking up companies... then we will make money bringing them back to the stockmarket, or if it goes bad, as some of these leveraged deals must, we will make money on the fix up job.' As such there is a degree of morale hazard in the phenomenon.

But is there an alternative? Would a regulatory framework that seeks to prevent the potential excesses in these transactions limit the healthy functioning of the market to optimise capital allocation.

From a regulatory viewpoint should Central Banks be concerned?

It raises the question what is the appropriate regulatory stance?

Central bankers are watching developments with interest. The private equity phenomenon echoes, and avails itself of the expansion of liquidity in financial asset markets in new structures which pose challenges to the monitoring capacity of those central banks. Private equity driven LBO's are not the same as leveraged hedge fund trading of asset classes. But both activities are connected through the global financial system, sourcing liquidity from 'surplus savings' and 'cheap credit'. And of course these two drivers are deeply interwoven.

At a regular annual gathering of the world's central bankers at Jackson Hole, Wyoming, in the US, a couple of years ago, the Bank of England's governor Mervyn King came up with a colourful simile. He likened central bankers trying to keep up with developments in financial markets to a mother with children playing in the back yard where she can't see them. She yells out of the kitchen window, 'I don't know what you're doing, but stop it.'³

Obviously controlling inflation is one major plank of Central Bank policy. The question becomes what is the relationship between money supply or liquidity, according to various definitions, and the operation of the physical economy, through various transmission mechanisms. One of those avenues is through impact on pricing. If excess liquidity bids up the prices of financial assets, (as we may be witnessing with share prices during this private equity boom), without spilling over to the prices of goods and services i.e. inflation, should the central bank be concerned?

The other traditional central banks function has been the protection of the banking system from risks of illiquidity and insolvency. Currently there are general concerns over the rise in off balance sheet debt balances that could ultimately detrimentally impact those institutions organising the financing or the supervised banking system as a whole. Increasingly parallels are being drawn between the debt fuelled excess of the late 80's that created so much grief for the global banking system and what is happening in private equity and hedge funds today. To the extent that an excessive level of bank sourced debt is funding this LBO activity central banks will be concerned. But not all leverage is visible, and some of it will be borne not by the banking system, but rather by pension funds and private individuals which are significantly beyond central banker's purview.

Should we be concerned? Well horror stories have long circulated about the possible consequences of bursting a debt bubble. Both concern and complacency in the light of these phenomena go in and out of fashion. There is no doubt, however, that monitoring has increased.

What are the longer term consequences of the current LBO/M&A 'boom'?

Is private equity bidding up the valuation of assets to unreasonable levels and increasing debt levels in a manner that is risky to the economy? Valuations have certainly risen. That increase reflects both the effect of longer term structural forces, and the availability of liquidity.

The common view is that the increase in valuations is justifiable to the extent that profit margins are broadly maintainable. As such the LBO process is the natural and ultimate step post the restructuring of industry due to the impact of new technologies and globalisation, whereby balance sheets now take full account of this reality, as opposed to the very defensive stance that was taken at the beginning of the process. This is what we term 'the long cycle stance'.

Unsurprisingly then risks posed by these LBO's are effectively the same as the broader cycle risks associated with the globalised economy. Higher levels of debt will either focus management on extracting greater returns from assets, or on colluding to reduce the risk of competition eroding profit margins. It is not clear what the final consequences of this will be. What is becoming increasingly clear is that just as in other periods of high corporate activity circling the wagons and hoarding cash will no longer be seen as acceptable strategies on the part of corporate management.

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