Private Equity

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2007 was a very big year for private equity. Some of the biggest ever deals were consummated. There were almost $4.8 trillion of global M and A deals, of which around 16% were buy outs-up from only 12% in 2005. In spite of a slow down in the last quarter 2007 was the best ever for merger activity.

Private equity also made news in other less appealing ways. Political pressure on the funds grew, stimulated by a rather effective trade union campaign. There was criticisms on 3 main counts:

- Asset stripping: don’t funds buy corporate assets, strip out the attractive bits and close the rest down?
- Disclosure: why do private equity owned firms disclose less than publicly owned companies?
- Tax: why do private equity partners pay only 5% on carried interest and, indeed, if they are non-domestic, they pay even less?

During the year this campaign moved from the trade unions and the newspapers to parliament, and the Treasury Select Committee took a live interest in it. That resulted, first, in the self destruction of the then Chief-Executive of the BVCA, then a new Chief-Executive was appointed and David Walker was asked to produce a voluntary code on disclosure which came out near the end of November.

As we start 2008, how do things look? On both the business and the public policy front. I will set out a few thought on both these areas, which may be helpful background to the discussions over the rest of the day.
State of the Business

There is no doubt that things do not look as buoyant today as they did 12 months ago. How gloomy you are may depend on your view of the state of a global economy. I am quite pessimistic and think that a recession born in the United States may well transmit itself, albeit perhaps less fiercely, to Europe.

But industry spokesmen themselves think that there is trouble ahead. David Rubenstein of Carlyle said the other day “after a great ride for five years, private equity is entering a more challenging period. It’s a bump in the road, but not an unhealthy one” he says. But he thinks that private equity firms are much better prepared for a slow down than they were and that the industry may well come back stronger. Jonathan Russell also talked in the PT last week about a ‘bumpy ride’, but said his work in progress pipeline is as full as I can remember it with deal opportunities.

However, not everyone is quite so optimistic. And the first big news of the year was the collapse of the PHH sale to a consorting lend by the Blackstone Group. And there are reasons to think that the over hang of commitments in the investment banks will constrain the supply of finance to private equity firms for a little while. The investment banks are sitting on losses from commitments made earlier last year on deals which have not yet been consummated, but which they are obligated to fulfill. They expect to sell off the debt at a loss, which of course reduces their interest in providing new facilities until this is worked through.

Russell says that private equity firms can no longer rely on banks to underwrite and syndicate debt. Instead PE must now underwrite its own debt packages by building a club of banks.

Jon Moulton of Alchemy thinks the industry deserves the bad times on the way. He thinks that quality control deteriorated last year and that there was what he describes as a CLO (collateralised loan obligations) feeding frenzy. In his words “debt going into deals went from four times historic EBITDA to eight times. Debt went from two or three layers as many as eleven in ever more complex structures - governance became light then silly, and then
vanished”. So his prediction for the next year is that “chickens will come home. And no longer can firms borrow more debt to solve the problem. Failure rates will rise. Mega funds will lack the debt ammunition to do deals. Funds will be deployed slowly” but he argues that the effect will be selective. “the worst of the bubble excess was in the larger deals. Buy out in venture capital businesses dealing in smaller figures will carry on”. On the plus side he thinks that “there will be substantial opportunities to invest in restructuring and rescue and some great deals from forced sellers in the large LBO world”. But he is clear that there will be a significant slow down.

Another observer with a good record in forecasting the MNA business is Marty Lipton, who runs a legendary law firm in New York. He says that his best guess is a decline in global deals of more than 25% in 2008, though the wild card will be the Sovereign Wealth Funds, who are loaded with cash and who may not be constrained by the difficulty of raising debt finance. So if the major acquisition wave continues, it is likely to be financed to a much greater extent by the Sovereign funds. I presume you are all sending your CVs to CIC and ADIA, in Chinese and Arabic of course.

Public Policy Issues

Let us turn to the public policy issuers.

a. private equity

For the three public policy issues the first, about the economic and employment benefit of private equity, has gone quiet recently. One oddity is that the BVCA here (and the UK represents all the 60% of European venture capital) has published an annual economic impact study for the last few years, but the last one was published in 2006 and there seem to be no plans for the next one. So they continue to quote rather out of date figures which suggest that private equity firms create jobs faster than the average – plus 9% over 3 years versus 1 to 2% for public companies. That their sales grow faster than the average -9% versus 7% average and that they are therefore positive for the economy.
It would be interesting to know why no follow up report has been published for a little while.

**b. Disclosure**

The disclosure issue has of course moved on a lot. David Walker, a former Chairman of the old Securities and Investment Board, published some draft proposals at the end of November which, if private equity firms sign up to them, would involve disclosure of a range of information comparable to that published by public companies. There would also be a monitoring group chaired by Sir Michael Rake, the former senior partner of KPMG and now Chairman of British Telecom. They would ensure that private equity firms who signed up to the code did in fact follow it.

How is this code being received? The answer is mixed. Many of those who have actually read it find it a rather good document with some very balanced proposals. But even the chief executive of the BVCA acknowledged the other day in an article in the Daily Mail that “the vitriol and baseless allegations continue”.

Essentially there are two criticisms: that it is unfair and that it is inadequate.

On the unfair side it would appear that some private equity firms themselves have complained that they would then be required to disclose more public information than other private companies, especially those owned by wealthy individuals like Philip Green or Richard Branson. Also, the disclosure would not apply to Sovereign Wealth Funds. So while it may be a good idea, it is going to create some unevenness and unfairness in the market. David Walker’s answer to this is that he hopes the Sovereign Wealth Funds and the individual entrepreneurs will follow his code, but there can be no solid expectation that they will.

On the other side, John McFall of the Treasury Select Committee thinks it is inadequate. “If the aim is to keep the barbarians from the gates, they have failed”. That bodes ill for the parliamentary reaction.
The Unions have been even more critical. Jack Dromey of the TGWU (the Labour party Treasurer who knows nothing about campaign donations) said “it didn't take mystic meg to predict David Walker would offer a merest sprat on transparency and absolutely failed to address the real concerns of workers faced by private equity takeovers”. The GMB said it was “madness even to contemplate allowing them to volunteer what they tell the public”.

Independent commentators have also been lukewarm. The Lombard column in the Financial Times said that “David Walker has had to wrap his hardly radical recommendations in cotton wool, soothing the highly strung buy out specialists who helped with the report”.

As I said, my own view is that these are quite positive and brave recommendations, but they do not seem to have calmed the political waters as was hoped.

c. Taxation

On the tax front the position is now as clear as mud. The Treasury must be wishing they have never heard of the private equity industry. Because it was concern about the low tax rates paid by private equity partners, which were attacked by some in the industry itself, notably Nick Fergusson and Ronny Cohen, which led the Government to propose a reform of capital gains tax generally. They removed all the complex reliefs put in place by Gordon Brown and lowered the rate from 40 to 18%. That would cause a few, perhaps only 30 or 40, private equity partners to pay somewhat more tax, but would also reduce tax on speculative activity and on owners of second homes, while increasing tax on entrepreneurs and holders of small business assets. That has generated, as you will have seen, a storm of controversy and it is hard to find many friends of the Chancellor’s proposals. He is committed to producing something new this month, but goodness knows what it will be.

From the narrow private equity perspective, however, it means that the focus has moved away from wealthy private equity partners in Mayfair and on to Alistair Darling.
Conclusions

That I think is the background in which the industry faces in 2008.

A slowing economy.

Greater difficulty in raising debt to finance leveraged transactions.

More competition from Sovereign Wealth Funds, or alternatively a new set of players with whom to collaborate. The Chinese, of course, are still nursing a significant loss from their investment in Blackstone, so the prospect of buy ins to private funds by the SWF’s may not be very promising.

Continue political controversy about the economic impact of private equity, where the industry has a lot of work to do to convince people.

And an uphill struggle to persuade parliament and others that the disclosure proposals will be helpful and are the best that can be achieved.

The risk of further controversy on tax, if the Treasury’s proposals come unstitched.

But of course many of the underlying reasons for the recent growth of private equity, the stimulus to corporate efficiency and the flexibility of decision making remain in place. And a down turn, as the Economist said the other day “may even have a silver lining for the industry if it curbs the recent political attacks on private equity”.